



**Finance**

**INTERNAL AUDIT REPORT No. 284**

# **Landsbanki Loan Counter Party Failure**

**November 2008**



## **DRAFT REPORT**

**Report Prepared by**

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**Date issued**

**12<sup>th</sup> November 2008**

## **EXECUTIVE SUMMARY**

*The aim of the audit was to examine the events surrounding the Landsbanki failure to repay a loan from Burnley Borough Council.*

### **Principal Issues**

- ❖ The transaction complied with the Council's Treasury Management policy and procedures.
- ❖ The ultimate events were unprecedented at the time of the loan being made.
- ❖ There was an appropriate and immediate reaction to the event to reduce the risk of reoccurrence.
- ❖ Appropriate controls operated to reduce exposure of the Council to failure by Landsbanki.
- ❖ This audit has not been rated with an audit score, as the audit is not suited to provide an opinion for the wider operation of controls in the system.

## **MAIN REPORT**

### **Objectives**

- ❖ The loan transaction to Landsbanki HF Islands.
- ❖ To ensure that controls and procedures were appropriately operated.

### **Scope**

On 8th of October 2008 Burnley Borough Council were expecting a repayment of a loan made to Landsbanki HF Islands (Landsbanki). On 7<sup>th</sup> of October, Landsbanki failed and the day of settlement passed without any payment.

- ❖ Landsbanki loan from 15th September to 8th October.
- ❖ The actions taken.
- ❖ The controls that were in place and how these were implemented
- ❖ This report does not address the compliance with the CIPFA Treasury Management Code of Practice, the action that is still on going to recover the loan or the financial impact on the Council.

The audit was undertaken in November 2008.

### **Audit Opinion**

There are four main controls that all operated to reduce the risk of Counter Party Failure for the Council in this transaction. Staff operated the Treasury Management processes and this effectively reduced the amount of money that the Council invested in Landsbanki.

### **Conclusions**

- ❖ The risk of a failure to repay a loan was identified and suitable controls were in place to manage this risk.
- ❖ The controls operated in the transaction and were updated in December 2007/February 2008, in light of market problems at the time.
- ❖ The Council's review of the approved counter party list in February 2008 acted to reduce the risk of loans to Icelandic banks, and it is likely that this reduced the amount that was invested.
- ❖ It is possible that additional risk information and a different approach to Risk Management may have prevented this transaction, as has been reported from other Local Authorities. However similar approaches, as reported in yet other Local Authorities, also failed to prevent the risk materialising.

## **1. Loan Repayment Failure Risks and Controls**

- 1.1 Treasury Management is how the Council plans its financial resources to meet the various financial demands that are placed upon it. Part of this is management of the flows of money in and out of the authority (cash flow) to ensure that there are enough funds available to meet expenditure and to make best use of available funds.
- 1.2 This process involves the Council in both borrowing from and loaning money to organisations (a counter party to the loan). This activity is controlled through a Treasury Management policy and procedures that follow the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice on Treasury Management.
- 1.3 The specific risk is that an organisation that the Council makes a loan to fails to repay that loan. This was an identified risk in the Finance Service Risk Register, with highest assessment of impact.
- 1.4 A prime requirement of the code is that there is risk management in place to protect the Council's externally invested cash. There are four principal controls that operate to control the risk of counter party failing to repay a loan.
  - ❖ A list of approved counter parties (pre-agreed organisations, mainly financial organisations, with whom it is acceptable to make loans),
  - ❖ Placing maximum limits on the total sums invested with any one counter party at any one time (to spread risk and to limit the impact of the risk),
  - ❖ The credit rating of the approved counter parties (to determine their credit worthiness),
  - ❖ Limiting the length of time that a loan is made for (to restrict the time that the investment is exposed to the risk).

These in combination with responding quickly to events, act to manage and restrict the Councils exposure to a counter party failing to repay a loan.

## **2. Transaction – Making the Loan**

- 2.1 On the 15<sup>th</sup> September 2008, there was a cash flow forecast prepared by the Accountancy Assistant. This predicted that there would be a credit balance of approximately £4M. This is a common occurrence for this time of year and the middle of the month, when there are major income sources from Central Government, without matching outflows of expenditure.
- 2.2 The cash flow management system was used to match the credit balance with certain payment events (for example payments to Calico, salary payments etc) that were not yet matched with other income

sources. In this way it was established that there was £2M that could be placed through the broker with suitable approved borrowers.

- 2.3 In addition the cash flow system gave the day that the loan would need to be repaid, as the funds would be required to meet expenditure on a specific day. Thus we were able to offer two £1M loans one for 23 days (to the 8<sup>th</sup> October 2008) and another for 17 days (to the 2<sup>nd</sup> October 2008). At this point the control of “period of loan” is effective. The policy requires all loans to be less than 3 months. It should be recognised that although this did not prevent the loss, the short period of the loan was close to preventing the loss, and if the loan was for 2 days less it may have been repaid.
- 2.4 The Senior Accountant, who is experienced in Treasury Management, determined that this was an acceptable approach and this complied with the policy requirements. So effectively made the decision that the loans could be offered.
- 2.5 This decision to make the loan includes consideration as to which counter parties can be dealt with. That is which of our approved counter parties have a gap of at least £1M between the approved list maximum limits and the level of existing loans. Landsbanki HF Islands was available at the time to take a loan of up to £1.5M (they had repaid a loan the previous week, on the 10/9/08 for £1M).
- 2.6 So it is at this point that the other three controls operate. Landsbanki HF Islands at the time were on our approved list, they had an approved limit available and they had a credit rating from Fitch, (a credit rating agency) that was at an acceptable level (F1 – the highest rating).
- 2.7 The broker was contacted and was asked to arrange the two £1M loans. It is thought that the broker also asked whom we could transact with at the time and was told that Landsbanki was an acceptable counter party for £1M. The broker has a copy of our counter party list but would be unaware of the availability of loans within the maximum.
- 2.8 In response the broker could only place one loan for £1M with Landsbanki for the 23 days, and was unable to place the other loan. The Senior Accountant agreed this and the broker was instructed to make the loan and faxed details to the Council of the transaction. The other £1M was placed with the Council’s bankers, HSBC.
- 2.9 It was stated that relatively low value (£1M is low value in this market) and short period loans are difficult to make as there are few of our approved counter parties which are willing to take this type of loan, as it is not worth the transaction costs for the counter party.
- 2.10 The transfer of the monies was made with the normal processing operation, involving an additional three people including the Director of Resources, who finally authorised the transfer. The primary aim of these controls is not directly connected with Counter Party failure, but more

with ensuring that the money is being transferred to the appropriate account. However this would act as a check if Landsbanki were not on the Approved list or if the amount was higher than the limit as the Director of Resources would react to this non-compliance with the policy.

- 2.11 It is possible that the authoriser could prevent the final transfer of funds, or indeed any staff involved in this process. Exercising this control at this point in the process would leave the Council exposed to the legal risk of breach of contract, as the deal via the broker has a legal contract status.

### **3. Transaction - Repayment**

- 3.1 The loan was expected to be repaid on the 8<sup>th</sup> October, however on the 30<sup>th</sup> September, one of the two available credit ratings for Landsbanki was downgraded. We were notified of this on the 1<sup>st</sup> October, and were advised not to make further loans to this bank. However there was concern about the existing loan but a reduced credit rating would not prevent the bank trading and it was still expected that the loan would be repaid on time.
- 3.2 There was the a crisis in Icelandic Banking which resulted in the Icelandic Government replacing Landsbanki management board on the 7th October. On the 8<sup>th</sup> October the loan was not repaid.
- 3.3 Further action has been taken to pursue the recovery of this loan and is on going, but this has not been considered as part of this Audit.

### **4. Immediate Control Changes.**

- 4.1 The Head of Finance or Director of Resources now review the loan transaction prior to the Council contacting via the broker. This has moved the responsibility for the loan and increases the effectiveness of the authorisation control. This has been introduced because of the instability in the Financial Markets.
- 4.2 The impact of this has been not to make loans to certain banks, which were on the approved counter party list. These are currently considered to be an unacceptable risk for Council loans, or would not be subject to the same protection or guarantees that could be afforded to the other organisations. This is to be confirmed via a new list, which is to be approved by members.
- 4.3 The market conditions at the time the loan was made were more stable; currently the financial markets are unstable and volatile. In this new risk environment it is difficult to reduce our risk to counter party failure without an up to date and informed knowledge (even not loaning the money out creates a risk, as the money would be concentrated in our own bank). The Council needs to protect its financial assets in this volatile environment. Consideration needs to be given to the potential for

central governments to protect or guarantee full repayment of any Council loan.

### **Recommendation**

R1 There should be information obtained whether the approved counter parties have or could be covered by suitable guarantees that a full refund of the Council's principal sums will be made should that counter party fail. This should make reference to Central Government or similar guarantees.

## **5. Other Areas for Consideration**

- 5.1 There have been reports in the press about some organisations that had removed Icelandic Banks from their approved counter party lists and thus were not exposed to the risks. In addition there were reports of concerns about the Icelandic banking system earlier in the year in particular referring to the use of Credit Default Swap information.
- 5.2 The scope of the Audit does not include the application of Treasury Management risk & controls in other organisations, and it is not part of the scope of this current audit to give a full opinion on alternative risk indicators. It should be noted that there are a wide range of credit assessments and advice available for different purposes and that all Councils have different Treasury Management systems and requirements. Still that did not prevent a large number of Councils and other prudent organisations (charities etc) being hit by this event.
- 5.3 The Council did react to the changes in the Banking environment in its review of the Approved Counter Parties list in December 2007/February 2008. There was a reaction to the risk of Icelandic banks and this both reduced our exposure by halving the limit for Landsbanki HF Islands and removed our exposure to some other Icelandic Banks. This review exercise was carried out using external advisors. Without this action it is likely that there would have been a higher amount invested.
- 5.4 The Council uses two sources of credit worthiness (Fitch and Standard & Poor's) and will only accept a high (F1 or A1) credit rating for a group of counter parties. There was only the Fitch credit rating available to the Council for Landsbanki (as included in the approved list that was reported in February 2008). There was no Standard & Poor's credit rating produced for Landsbanki. The credit rating is a source of risk information, which appears to be in far more common use than Credit Default Swap information.

### **Distribution List**

Chief Executive Officer