‘RISK AND RETURN’

English Local Authorities and the Icelandic Banks

Summary

Audit Commission
Cross-cutting National Report March 2009

Preface

The collapse of the Icelandic banks in October 2008 highlighted the large sums of public money on deposit with financial institutions outside as well as inside the UK. This report tells the story of English local authority deposits in Icelandic banks and their UK subsidiaries, in which £954 million is now known to be at risk.

Against that background, the report looks at treasury management in local authorities in which there are strengths as well as weaknesses.

The findings have the benefit of hindsight, reflecting what we now know about the risks of lending to and by banks. Yet some treasury managers – the good ones – spotted risks at the time and took action. The lessons and recommendations here are not just applicable at times of financial turbulence. Those accountable for public funds must be ever vigilant.

The Audit Commission itself made deposits totalling £10 million in two Icelandic banks. We have reviewed our own approach, identified weaknesses and taken action. The lessons were captured in an internal audit report and an external review which were published on the Commission's website.

The Commission's own exposure does not compromise our duty to understand what went wrong nor lessen our ability to analyse and comment. We have access to local authorities, financial knowledge and independence and so are well placed to present this review, with the aim of improving the management of taxpayers' money.

Summary

Local authorities invest large sums of public money

• On 7 October 2008, 451 authorities had investments of over £31 billion.

• The total of deposits far exceeded the level of reserves; some of the deposits included borrowed money.

• In 2008/09, interest was around £1.8 billion, just under 2 per cent of total income.

• In a small number of district councils, income from interest was similar to that from council tax.

• Interest rates fell between October 2008 and March 2009, putting pressure on some budgets.

Deposits were widely spread

• On 7 October 2008, local authorities held deposits in 144 different organisations.

• Fifty-seven per cent of funds were held in organisations, the remainder in banks whose owners were based in 24 other countries.

• More than 20 per cent of deposits were in Irish institutions.

Local authorities had £954 million in Icelandic banks when they went into administration

• Icelandic deposits amount to about 3 per cent of the total on deposit.

• One hundred and twenty-seven authorities are affected.

• Thirty have funds greater than 5 per cent of gross revenue expenditure at risk.

• Councils are not expecting to cut services or increase council tax significantly as a direct result.

Some local authorities reacted to warning signals about Icelandic banks, but not all

• The total on deposit halved between April and September 2008.

• The number of new deposits fell, but net new deposits after 1 April 2008 exceeded £500 million.

• Seven local authorities deposited money after credit ratings in Icelandic banks were downgraded below acceptable levels, failing, in the Commission's view, to take reasonable steps to ensure they were using up-to-date information, and hence putting public money at risk.

The national treasury management framework is broadly right, but has weaknesses

• Statutory guidance gives weight to credit ratings, but not to other relevant information.

• The Chartered Institute of Public Finance and Accountancy (CIPFA) guidance gives insufficient attention to risks which may be inter-related, for example banks in the same group or country.

• More guidance is needed about how to manage the full range of risks.

Local authority treasury management is of variable quality

• The best authorities:

- explicitly balance risk and reward;
- review and scrutinise policies and procedures regularly;
- have well trained staff and engaged elected members; and
- use a wide variety of information.

• Poorer authorities:

- have weak governance;
- depend exclusively on credit ratings; and
- have staff who are inadequately trained.

Recommendations

Central government should:

• Review and revise the weaker aspects of the national framework highlighted n this report, especially the weight given to credit rating;

• Enable and require the Debt Management Office (DMO) to provide deposit accounts to public bodies if those bodies cannot achieve the security they require in the market; and

• Review the cost of early repayment of debt to the Public Works Loans Board to ensure that the structure introduced in November 2007 is not acting against the wider public interest by encouraging authorities to hold unnecessarily large deposits.

CIPFA should:

• Revise and tighten its code of practice for treasury management to take account of the findings in this report;

• Make more explicit the element of the prudential code that allows loans to be drawn down ahead of actually spending the money. Loans should be drawn down only after risks are fully assessed;

• Continue to work with the Association of Corporate Treasurers to develop appropriate training and qualification for those working in treasury management in local authorities; and

• Coordinate information sharing between local authorities to enable them to learn from one another. Any benchmarking activities should, as a minimum, highlight measures of security and liquidity of funds as well as yield.

Local authorities should:

• Set the treasury management framework so that the organisation is explicit about the level of risk it accepts and the balance between security and liquidity and the yield to be achieved. At the highest level, the organisation should decide whether it has:

-appetite and capability to be able to manage risk by placing funds with financial institutions; or

-no appetite and/or insufficient capability to manage the risk of placing funds in the market, and should instead place funds with the UK government's Debt Management Office;

• Ensure that treasury management policies:

-follow the revised CIPFA code of practice;
-are scrutinised in detail by a specialist committee, usually the audit committee, before being accepted by the authority; and
-are monitored regularly;

• Ensure elected members receive regular updates on the full range of risks being run;

• Ensure that the treasury management function is appropriately resourced, commensurate with the risks involved. Staff should have the right skills and have access to information and external advice;

• Train those elected members of authorities who have accountability for the stewardship of public money so that they are able to scrutinise effectively and be accountable for the treasury management function;

• Ensure that the full range of options for managing funds is considered, and note that early repayment of loans, or not borrowing money ahead of need, may reduce risks;

• Use the fullest range of information before deciding where to deposit funds;

• Be clear about the role of external advisers, and recognise that local authorities remain accountable for decisions made; and

• Look for economies of scale by sharing resources between authorities or with pension funds, while maintaining separation of those funds.

The Audit Commission will:

- Ask auditors to follow up this report as part of their use of resources work for 2008/09 and future years;

- Work with CIPFA to ensure that the lessons in this report and the research on which they are based are included in the revised treasury management guidance; and

- Work with others to produce guidance and tools for those in councils with a need to understand the treasury management function.