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**Local authority
investments**

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Report, together with formal minutes

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Communities and Local Government Committee

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Summary

The collapse of Icelandic financial institutions in the autumn of 2008 brought to light not only the surprisingly large amounts of money invested by local authorities, but also the fact that local authorities had invested nearly £1 billion in Iceland, funds that were consequently at risk. This prompted us to launch an inquiry into the esoteric world of local authority investments, in order to understand current practice, to study the roles and responsibilities of various groups and individuals involved, and to make recommendations intended to limit the exposure of local authority funds to such risk in future.

The economic events of recent months are ones that few experts and fewer non-experts predicted. However, the unusual nature of the financial situation of the time should not be used as an excuse for failures that occurred in local authority financial arrangements. This inquiry has exposed a degree of misunderstanding, misinformation and complacency on the part of some crucial players, both within local authorities and in the wider financial sector, which contributed to the putting of taxpayers' money at unnecessary risk. The focus of the Report is to ensure that the future tightening of procedures and better understanding of local authority finance leads to local authority money being invested more prudently, safely and—ultimately—profitably.

1 Introduction

It is important that treasury management policies adequately reflect risk and in particular security, liquidity and yield risk, in that order of importance. No treasury management transaction is without risk and management of risks is the key purpose of the treasury management strategy.¹

*The general policy objective is that local authorities should invest **prudently** the surplus funds held on behalf of their communities.²*

1. Treasury management is the management of an organisation's cash flows, its banking, money market and capital market transactions. It is also the effective controlling of risks connected with those activities and the pursuit of optimum performance, consistent with those risks.³ The quotations above from CIPFA and from the Government exemplify the key principles of treasury management: that local authorities need to ensure, firstly, that their investments are safe; secondly, that they have sufficient liquidity and accessibility; and thirdly, that they provide acceptable returns.

2. The investment of surplus funds is just one part of the treasury management function. Local Government Association (LGA) argues in its written evidence to this inquiry that the specific circumstances surrounding the nearly £1 billion invested in Icelandic financial institutions by local authorities should be seen within the wider context of almost unprecedented events: that “of an entire banking system of a highly developed European country unexpectedly collapsing.”⁴ The LGA claims that local authorities were in the same position as other ‘sophisticated creditors’, including international banks and bondholders, UK banks and building societies, charities, universities and housing associations.⁵

3. The Audit Commission and the LGA stress that only a small percentage of total deposits are at risk.⁶ However, a small percentage of many billions of pounds is still a large amount of money and for some individual authorities the sums at risk were a significant proportion of total reserves. Nearly £1 billion of public money is not an amount that anyone can afford to disregard. We decided to study the complex workings of treasury management within local authorities, in order to explain how local authorities invest their money, who they ask to help them invest their money, and how successful both they and the system are in protecting public money. This inquiry has examined local authorities' ability to *manage the risk* of their investments.

¹ CIPFA, Treasury Management Panel Bulletin, *Treasury Management in Local Authorities – Post Icelandic Banks Collapse*, March 2009, page 1.

² Local Government Investments, Guidance under section 15(1)(a) of the Local Government Act 2003, paragraph 14.

³ CIPFA, *Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes*, April 2001, p 1.

⁴ Ev 100

⁵ *Ibid*

⁶ LAI 23, paragraph 48 and Audit Commission, *Risk and return, English local authorities and Icelandic Banks, Cross-cutting National report, March 2009*, p 19.

4. We were advised on this inquiry by Rita Hale OBE, former director of Rita Hale and Associates, a local government finance consultancy, and Professor Tony Travers of the London School of Economics. We would like to thank them for their invaluable contribution.⁷

⁷ Rita Hale declared that she had no relevant interests; Professor Travers declared the following interests: Board Member (unpaid) Centre for Cities, Honorary member (unpaid) CIPFA, Honorary Member (unpaid) IRRV, irregular research and consultancy undertaken for a number of public and private sector bodies—non permanent (paid), regular (paid) contributions to several national and regional publications—including *the Times*, *Guardian*, *Daily Telegraph*, *Financial Times*, *Evening Standard*, *Local Government Chronicle*, and *Public Finance*.

2 An overview of the current practice of treasury management

Relevant primary and secondary legislation

5. As any individual investor should know, no investment is without risk. As Guildford Borough Council remarked in its written evidence to this inquiry, “What has happened in Iceland has been, if nothing else, a sharp reminder about the relationship between risk and return.”⁸

6. The responsibility to manage local authority investments is part of what is known as “treasury management”, which CIPFA defines as:

the management of the organisation’s cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks.⁹

7. The framework of treasury management within which local authorities must operate is made up of various pieces of legislation, guidance and best practice. Until 2004, local authorities had to invest in a Government-approved list of banks and other bodies (known as ‘counterparties’), a system described by Rt Hon John Healey, Minister for Local Government, as “inflexible, [...] unwelcome, and ultimately [...] ineffective.”¹⁰ Despite the fact that the list was ‘government approved’, it was still possible for councils to lose money: most memorably in the case of the Western Isles Council, when one bank on the approved list—the Bank of Credit and Commerce International (BCCI)—collapsed in 1991. The collapse of BCCI prompted the then Treasury and Civil Service Select Committee to publish a Report which highlighted the essential principle which should guide local authority treasury management: “In balancing risk against return, local authorities should be more concerned to avoid risks than to maximise returns.”¹¹

8. The Government decided that a more flexible system with less detailed regulation was required. From 2004, therefore, a new system of local government capital control was introduced, including new arrangements that allowed councils greater freedom to make their own decisions about where to lend money. That system has its statutory basis in the Local Government Act 2003. This Act gives local authorities a clear power to invest “(a) for any purpose relevant to its functions under any enactment, or (b) for the purposes of the prudent management of its financial affairs”¹², requiring local authorities to self-regulate their capital finance, borrowing and investment activities. Statutory Instrument (SI) 3146/2003—the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003—develops the controls and powers in the Act and requires local authorities to have regard to the CIPFA Prudential Code for Capital Finance.

⁸ Ev 51

⁹ CIPFA, *Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes*, April 2001, p 1.

¹⁰ Q 317

¹¹ Ev 68

¹² Ev 112

9. The Office of the Deputy Prime Minister's informal commentary on its formal statutory guidance under Section 15(1)(a) of the Local Government Act 2003 states that:

the general policy objective is that local authorities should invest **prudently** the surplus funds held on behalf of their communities. The [formal statutory] guidance recommends that priority should be given to security and liquidity. However, that does not mean that authorities should ignore yield. It will be appropriate to seek the highest rate of return consistent with the proper levels of security and liquidity.¹³

10. The commentary notes that local authority investments are split into two types: specified and non-specified. Specified investments are those that are invested in institutions that offer high security and high liquidity. Such investments must be in sterling, must mature within one year and must be made in high credit-rated financial institutions, as measured by the three credit rating agencies: Fitch, Standard & Poor's and Moody's. Non-specified investments are riskier investments that mature after any period longer than 365 days. The reason for splitting the two types of investments is to manage risk, the first type being deemed to be safer than the second. The informal commentary on the Government guidance does not itself impose limits, but states that local authorities should define the limits to be held in such investments at any time of the year.¹⁴

11. According to the Government guidance, the core principles that local authorities should follow when investing money are:

- to make the deposits secure,
- to ensure they have sufficient liquidity for their daily demands,
- finally, to produce the highest available yield, once the first two considerations have been met.

The security of investments is ascertained by the assessment and management of the **risk** involved. The guidance also stipulates that local authorities must have regard to the Treasury Management (TM) Code of Practice, published by the Chartered Institute of Public Finance and Accountancy (CIPFA).

The Chartered Institute of Public Finance and Accountancy (CIPFA) Codes

12. The Chartered Institute of Public Finance and Accountancy (CIPFA) is one of the leading professional accountancy bodies in the UK and the only one that specialises in the public services.¹⁵ It publishes the Treasury Management (TM) Code of Practice, which is given legislative weight by the 2003 Act. Subsequent to the Act, CIPFA published a Prudential Code for Capital Finance in Local Authorities and also updated and revised the guidance notes that complement the TM Code of Practice. The section below describes the

¹³ Local Government Investments, Guidance under section 15(1)(a) of the Local Government Act 2003, paragraphs 14 and 15.

¹⁴ *Ibid*, para 22.

¹⁵ Ev 61

requirements of the CIPFA Codes; their effectiveness is examined in more detail in Chapter 9.

The Treasury Management Code of Practice

13. The Treasury Management Code of Practice is described by CIPFA in its written evidence as follows:

The Code sets out the procedure and policies local authorities should follow in the organization and operation of their treasury management functions.¹⁶

The Code makes three recommendations for the adoption of policies and practices to secure local authorities' best practice in treasury management:

- To put in place formal and comprehensive objectives, policies and practices, strategies and reporting arrangements to ensure the effective management and control of TM activities.
- To demonstrate thorough policies and practices that effective management and control of risk are prime objectives of TM activities.
- To acknowledge that the pursuit of best value in TM, and the use of suitable performance measures, are important in order to secure business and service objectives, and that within the context of effective risk management, TM policies and practices should reflect this.

In order to achieve these three recommendations there are, according to CIPFA, specific practices that local authorities should adopt, including the creation of a TM policy statement; the setting up of reporting procedures, including an annual strategy; the delegation of responsibility for execution of decisions to a responsible officer; and the delegation of responsibility for the monitoring of its TM policies and practices to a relevant committee of the authority.¹⁷

The Prudential Code for Capital Finance

14. The Prudential Code sets out the framework within which local authorities manage their investment requirements, as established by the Local Government Act 2003. Its key objectives are

To ensure, within a clear framework, that the capital investment plans of local authorities are affordable, prudent and sustainable—or, in exceptional cases, to demonstrate that there is a danger of not ensuring this, so that the local authority concerned can take timely remedial action.¹⁸

¹⁶ Ev 63

¹⁷ CIPFA, *Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes*, April 2001, section 4 and 5.

¹⁸ CIPFA, *The Prudential Code for capital finance in local authorities*, 2003, p 3.

15. The Prudential Code requires the full Council to set certain limits on the level and type of borrowing before the start of the financial year and gives directions for the setting up of “prudential indicators”, against which local authorities can monitor and measure their performance. The first such indicator in the Prudential Code is the adoption of the CIPFA Treasury Management Code of Practice.¹⁹ According to CIPFA’s written memorandum, if these prudential indicators are implemented, local authorities’ treasury management decisions should be “affordable, prudent and sustainable”.²⁰

Annual Investment Strategy (AIS)

16. The CIPFA TM Code of Practice recommends that the local authority receive reports on its treasury management policies and activities, including, as a minimum, an annual strategy.²¹ The updated guidance notes to the TM Code, “Treasury Management in the Public Services: Guidance Notes for Local Authorities including Police Authorities and Fire Authorities”, place greater emphasis on the Annual Investment Strategy, which is central to the ODPM guidance on the 2003 Act. The CIPFA guidance notes stress that the AIS should state the local authority’s policy on the use of credit ratings, the procedures for determining and limiting the use of riskier (non-specified) investments and the liquidity of investments. The AIS must be approved and, if necessary, amended by the full council, and should be publicly available.²²

Local authority officials’ roles and responsibilities

17. Local authorities are required under Section 151 of the Local Government Act 1972 to appoint an officer who is responsible for the proper administration of their financial affairs. He or she is often referred to as the Section 151 Officer and is responsible for, amongst other things, treasury management.²³ Local authority financial teams are discussed in Chapter 4.

Scrutiny of treasury management by elected officials

18. The Section 151 Officer must report to the Audit Committee on the council’s Treasury Management Performance for the previous year, and on its Treasury Management Strategy and Policy, including the annual investment strategy, for the following year. The Treasury Management Code of Practice recommends in Treasury Management Practice (TMP) 6 that local authorities adopt the following statement:

This organisation will ensure that regular reports are prepared and considered on the implementation of its treasury management policies; on the effects of decisions taken and transactions executed in pursuit of those policies; on the implications of changes,

¹⁹ Ev 66

²⁰ CIPFA, *The Prudential Code for capital finance in local authorities*, 2003, p 3.

²¹ CIPFA, *Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes*, April 2001, section 5.

²² CIPFA, *Treasury Management in the Public Services: Guidance notes for local authorities including police authorities and fire authorities*, section 3.1.7 (3).

²³ CIPFA, *Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes*, April 2001, p 17.

particularly budgetary, resulting from regulatory, economic, market or other facts affecting its treasury management activities; and on the performance of the treasury management team.²⁴

TMP6 goes on to state that the council should expect to receive, as a minimum: an annual report on the strategy and plan for the coming year; and an annual report on the previous year, citing “the effects of the decisions taken and the transactions executed in the past year, and on any circumstances of non-compliance with the organisation’s treasury management policy statement and TMPs.”²⁵

19. The guidance notes to the TM Code of Practice describe the role of councillors in scrutinising treasury management in greater detail. Noting that the detail included in the annual reports at the start and at the end of the year will vary according to an organisation’s circumstances,²⁶ it explains:

Whatever form the reports take, they should ensure, as a minimum, that those with ultimate responsibility for the treasury management function appreciate fully the responsibility for the treasury management policies and activities, and that those implementing policies and executing transactions have properly fulfilled their responsibilities with regard to delegation and reporting.²⁷

20. The effectiveness of councillors’ scrutiny of treasury management is assessed in Chapter 5.

External service providers

21. Most local authorities do not carry out their treasury management duties completely in-house, but employ private sector external service providers to supply expert assistance. These include treasury management (TM) advisers, external fund managers and brokers. Many employ treasury management advisers who aid them, to a lesser or greater degree, in their treasury management activities. The four main treasury management advisers for local authorities are Arlingclose, Butlers, Sector and Sterling, all of whom gave written evidence to our inquiry and three of whom gave oral evidence.²⁸ External fund managers may also be retained to manage local authorities’ investments directly, observing the limits set out in the council’s Annual Investment Strategy. Additionally, while some local authorities will deal directly with counterparties in setting up investments, others employ treasury management brokers to carry out the transactions on behalf of the local authorities. Brokers cannot and do not offer treasury management or investment advice, but simply act as an intermediary. The CIPFA guidance notes gives the following advice about external service providers:

²⁴ CIPFA, *Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes*, April 2001, p 17.

²⁵ *Ibid*

²⁶ *Ibid*, p 39.

²⁷ *Ibid*

²⁸ Ev 52, Ev 75, Ev 117 and Ev 146.

These relationships need to be managed proactively in order to secure the optimum benefit for an authority. They should be subjected to regular review and, in accordance with standing orders, to formal invitations to tender for services, if best value is to be obtained.²⁹

22. Issues surrounding external service providers, in particular treasury management advisers, are explored in Chapter 7.

²⁹ CIPFA, *Treasury Management in the Public Services: Guidance notes for local authorities including police authorities and fire authorities*, p 11.

3 Local authorities' investments and reserves

23. Supplementary evidence from the Department for Communities and Local Government (CLG) describes why local authorities have reserves:

The requirement for local authorities to hold financial reserves is acknowledged in statute. Reserves are one component of an authority's medium-term financial planning—other components include revenue spending plans, income forecasts, potential liabilities, capital investment plans, borrowing and council tax levels. These decisions are inter-linked. This means that, to ensure prudent financial management, some authorities will need to maintain reserves at higher levels than others.³⁰

24. The main reasons for holding reserves are for cash flow purposes, as insurance reserves and a contingency provision against risks. CLG's supplementary evidence highlights this point:

Holding adequate reserves is important for contingency planning, and the capacity of authorities to respond to unexpected events—such as the 2007 flooding, and the collapse of the Icelandic banks—without affecting their ability to deliver key services, pay staff and meet their contractual obligations.³¹

25. Local authorities use money earned in interest raised from these investments and reserves to help fund their spending on services. In its written evidence, Bournemouth Borough Council, for example, states that it has invested £80 million and is budgeting on a return of some £4.8 million for 2008–09.³² It comments:

This is a significant figure in our Budget and any reduction in the amount because of a restriction in our investment strategy would have a major impact on our services or council tax charge.³³

26. This example shows the pressure that local authorities are under to invest not only wisely and prudently, but also so that maximum returns are achieved. It also illustrates the large amount of money that local authorities have available for investment: Torbay Council, for example, has “annual gross expenditure in excess of £300 million and currently has some £90 million invested in the money market.”³⁴

27. When news of the potential loss of local authority money first hit the headlines, the general public was surprised at the large amount of money involved. According to CIPFA, in 2006–07 local authorities in Great Britain managed around £63 billion of debt and £28

³⁰ Ev 114

³¹ *Ibid*

³² Bournemouth Borough Council submitted written evidence in 2008, so this budgeted return might have changed.

³³ Ev 72

³⁴ Ev 151

billion of investments. CIPFA provided the following table in its written evidence to show the breakdown of local authority investments as at March 2007:

Extract from CIPFA Capital Finance and Treasury Management Statistics 2006–07

As at 31 March 2007 £M	Externally Managed Funds	Cash deposits – banks/ building societies	Other Internally Managed Funds	Total	Interest Earned
London	661	6,255	66	6,982	384
English Counties	465	4,891	129	5,485	283
English Districts	1,437	3,543	451	5,431	288
English Mets/Unitaries	518	4,139	401	5,058	326
Wales Unitaries	63	1,121	12	1,196	67
All England & Wales*	3,719	21,018	1,155	25,892	1,460
Scotland	438	1,147	380	1,965	93
Total	4,157	22,165	1,535	27,857	1,553

* Includes Joint Passenger Transport Authorities, Fire and Civil Defence Authorities, Waste Disposal Authorities and Police Authorities³⁵

28. These amounts have increased since 2006–07, according to the Audit Commission. The Audit Commission's report *Risk and Return: English local authorities and the Icelandic banks* was published in March 2009. This report states:

- On 7 October 2008, 451 authorities had investments of over £31 billion;
- The total of deposits far exceeded the level of reserves, because some of the deposits included borrowed money;
- In 2008–09, interest was around £1.8 billion, just under 2% of total income;
- In a small number of district councils, income from interest was of the same order as income from council tax;
- Interest rates fell between October 2008 and March 2009, putting pressure on some budgets.³⁶

29. Although the 2004 investment guidance gave local authorities greater powers to invest in alternative instruments, CIPFA states that, as at 31 March 2008, over 90% of local authorities' cash investments were in cash deposits with banks and building societies.³⁷ Where a local authority chooses to invest depends on its Annual Investment Strategy. The

³⁵ Ev 62

³⁶ Audit Commission, *Risk and return, English local authorities and Icelandic Banks, Cross-cutting National report, March 2009*, p 3.

³⁷ Ev 62

LGA describes why local authorities might choose different types of financial institutions in which to invest:

- a) Not all financial institutions are rated by rating agencies, smaller UK building societies are typically not rated. Some authorities will still include these, recognising the extent of FSA regulation of this sector, but will lend them less money and only for shorter periods (e.g. 180 days).
- b) Authorities that have larger cash holdings will have higher amounts they will deposit with individual institutions.
- c) Some authorities will have money that is not needed in the near future, and they may decide to deposit some of that for longer periods, meaning they may place a greater emphasis on long as well as short-term ratings.
- d) Some authorities may choose to have slightly wider range of institutions to place deposits with, others may choose to only list institutions that have the very highest ratings.
- e) The number of institutions available is reducing as a result of mergers and takeovers of banks.³⁸

30. There is also variation in the amount of money that individual authorities have available for investment. This variation depends on a number of factors, including what type of authority it is. The LGA explains in its written evidence that unitary authorities and county councils might have large cash holdings because “they may be holding funds on behalf of schools or social services clients, they may be planning a major redevelopment project and their holdings are needed to finance that project.”³⁹ Contrastingly, district councils may have smaller budgets, but with significant cash holdings because they have built up capital receipts (usually because of the sale of housing stock) or they have collected business rates and council tax for upper tier authorities that they subsequently pass on in line with an agreed payment schedule. The LGA explains that “this may mean some small authorities may temporarily hold significant funds from major business ratepayers in their areas—e.g. airports and power stations.”⁴⁰

Where should local authorities invest their money?

31. As our opening quotation states, “no treasury management transaction is without risk and management of risks is the key purpose of the treasury management strategy.”⁴¹ Treasury management guidance stresses the need for local authorities to take into account the risks surrounding security, liquidity and yield. In order to satisfy those three requirements, giving priority to security and liquidity, where should local authorities invest their money? Clearly, the three criteria need to be balanced against each other.

³⁸ Ev 97

³⁹ *Ibid*

⁴⁰ *Ibid*

⁴¹ CIPFA, Treasury Management Panel Bulletin, *Treasury Management in Local Authorities – Post Inlandic Banks Collapse*, March 2009, page 1.

32. Primarily, local authorities' investments should be secure. If security were the only consideration, local authorities would simply look for the safest options, such as higher-rated institutions and the Debt Management Agency Deposit Account Facility (DMADF), which is backed by the Government. This was the approach advocated by Arlingclose, one of four main local authority treasury management advisers, late last year, in response to the financial crisis. Arlingclose's written evidence argues that "it was important that local authorities received advice and responded to the clear emergence of a crisis rather than to carry on regardless."⁴² Mr Horsfield, Director of Arlingclose, reiterated this to us in oral evidence:

On 29 September we issued a note saying, "Do not invest in any banks or building societies with any of your funds, put it in the DMADF" [...] because it was that serious at that point in time from our perspective.⁴³

33. However, and notwithstanding Arlingclose's advice at that particular time, there are other considerations which local authorities must take into account in deciding where to invest, and which the Government must take into account when setting the framework for their investments and in giving guidance. In written evidence, CIPFA notes that local authorities:

play a key role in wholesale money markets and their impact on market liquidity is seen as vital in the current economic climate. It should also be recognised that the £1.6 billion earned in interest by English, Scottish and Welsh local authorities annually is used in support of services. Any reduction in that income would result in further pressure on local authority budgets at a time when authorities are faced with difficult decisions about service and council tax levels. It should be noted that at present the only 'secure' counterparty investment open to local authorities is through the Debt Management Office's deposit facility which pays much lower rates of interest or government stocks which have an underlying price risk unless held to maturity.⁴⁴

34. Local authorities, then, must also consider:

- liquidity: the ability of the authority to access their money when required, and
- yield: the revenue obtained from appropriate investment of their reserves.

Furthermore, given the scale of councils' investments, the Government itself needs to consider the potential effect on the UK financial sector were local authorities to withdraw from all but the very safest investments. As the Building Societies Association notes:

At a time when the Government wants banks to continue lending to business, and building societies to continue lending to homebuyers, taking away a substantial part of their funding base would be entirely counterproductive.⁴⁵

⁴² Ev 54

⁴³ Q152

⁴⁴ Ev 65

⁴⁵ Ev 121

35. The Society of Local Authority Chief Executives and Senior Managers (SOLACE) sums up the considerations in response to our question of whether local authorities' investment should be placed in Government stock:

To do so would remove a huge amount of liquidity from the banking and building societies. The Government would need to recognise the potential impact of this on local authority funding and therefore council taxes. It would also significantly reduce funding from investment returns currently used to support service delivery. This would result in reduced services or increased council taxes.⁴⁶

36. Investing in Government stock only, though certainly ensuring security, would severely limit local authorities' investment options, hamper the role they play in financial markets, and be unlikely to provide the required liquidity and return. The more realistic approach is the one which obtains at present: to allow riskier investments which provide good levels of liquidity and return, but to have in place a responsive, flexible network of advice, guidance and scrutiny which ensures a proper spread of risk.

37. We conclude that it would be inappropriate to seek to restrict local authorities' investment options. Although interest rates are now at historically low levels, returns on investments are usually an important source of local authorities' revenues and investment by local authorities an element in the health of the UK financial sector. The primary consideration of local authority investment, as emphasised by CIPFA, should remain security and liquidity; but yield should not be neglected. The risk involved in seeking yield should be mitigated by robust and responsive Codes, guidelines and best practice.

⁴⁶ Ev 57

4 Local authorities' financial teams

38. We now consider the capacity and competence of local authorities to handle the large sums of public money which are at their disposal for investment.

Audit Commission's report *Risk and Return*

39. The Audit Commission published a report in March 2009, *Risk and Return: English local authorities and the Icelandic banks*, which addressed treasury management practice in English local authorities, in the context of the specific circumstances surrounding the Icelandic banking collapse. It collected data from appointed auditors of English local authorities, visited 37 English local authorities to examine treasury management practices and studied 30 sets of treasury management documentation and 179 counterparty lists. It found variations in the standards of local treasury management arrangements, from the best local authorities, which “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”⁴⁷ to those less satisfactory local authorities, which “have weak governance; depend exclusively on credit ratings; and have staff who are inadequately trained.”⁴⁸

40. The Audit Commission specifically considered the actions of those local authorities which have funds at risk in Icelandic banks. The Commission's report sets out the timeline of the downgrading of the Icelandic banks. On 30 September, credit rating agency Fitch downgraded all three of the banks concerned to adequate grade, and Moody's downgraded Glitnir to adequate grade. Also on this date, Glitnir was partially nationalised.⁴⁹ The Commission highlighted and severely censured seven local authorities, which had deposited money into the Icelandic banks after 30 September and, in some instances, had breached their local treasury management policies:

⁴⁷ Audit Commission, *Risk and return: English local authorities and Icelandic banks, Cross-cutting national report*, March 2009, p 4.

⁴⁸ *Ibid*, p 4.

⁴⁹ *ibid*, p 28.

Local Authority	Amount Deposited	Date
London Borough of Havering	£2 million	1/10/2008
Kent County Council	£3.3 million £5 million	1/10/2008 2/10/2008
Redcar and Cleveland Borough Council	£4 million	1/10/2008
Restormel Borough Council	£3 million	1/10/2008
Bridgnorth District Council	£1 million	2/10/2008
South Yorkshire Pensions Authority	£10 million	2/10/2008
North East Lincolnshire Council	£3 million £1.5 million	2/10/2008 3/10/2008

Source: Audit Commission "Risk and Return", table 3

41. The table shows a total of £32.8 million invested by seven local authorities from 1 to 3 October 2008 at a time when the Icelandic banks' credit ratings had been downgraded.⁵⁰ It shows that two local authorities—Kent County Council and North East Lincolnshire Council—placed separate investments on two consecutive days, amounting to £12.5 million. The report highlights explanations given by local authorities for these breaches:

Not opening an e-mail from the treasury advisor that warned of the rating change; using a different approved lending or counterparty list to that used by the treasury adviser; and an officer placing a deposit that exceeded the local authority's investment limit for a single transaction.⁵¹

42. We endorse the Audit Commission's censure of these rudimentary mistakes in organisations responsible for investing large amounts of public money. However, as the Commission's research has found, those seven authorities were not necessarily the only local authorities at fault. The Commission found:

[...] differences in the behaviours displayed by local authorities that were non-investors in the Icelandic banks, those whose deposits matured between 1 November 2007 and 7 October 2008, and those that have funds at risk. Non-investors generally had more effective governance and scrutiny arrangements and took more measured approaches to managing risk than either local authorities whose deposits matured between 1 November 2007 and 7 October 2008 or those that have funds at risk.⁵²

43. It is important to note that three-quarters of councils were not exposed to Icelandic banks at all. However, the Commission suggested that some authorities that avoided

⁵⁰ Audit Commission, *Risk and return: English local authorities and Icelandic banks, Cross-cutting national report*, March 2009, p 28.

⁵¹ *Ibid*, p 29.

⁵² Audit Commission, *Risk and return: English local authorities and Icelandic banks, Cross-cutting national report*, March 2009, p 45.

potential losses in the Icelandic banks “were lucky”⁵³ and, given the fact that the Audit Commission itself did not place the auditing of treasury management as a high priority,⁵⁴ there is no reason to suppose that lapses in treasury management practice were confined only to those local authorities with money at risk.

The investment capabilities of local authorities

44. In its written evidence, the Local Government Association defends local authorities, noting that:

Most authorities had no exposure to Icelandic banks at the point of their collapse, and the evidence is a number of authorities were reducing their exposure to Icelandic banks as deposits matured over summer 2008.⁵⁵

The Audit Commission’s report to some extent upholds this view, acknowledging that the best local 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.⁵⁶

However, it also concludes that the less effective authorities “have weak governance; depend exclusively on credit ratings; and have staff who are inadequately trained.”⁵⁷

45. We have not, of course, been in a position to carry out a thorough review of local authority treasury management function along the lines of the Audit Commission’s inquiry. We have nevertheless received evidence which backs up the Commission’s conclusions. Not surprisingly, perhaps, we did not receive many written submissions from those local authorities that have money at risk in Iceland. We did, however, receive evidence from two councillors at Westminster City Council, for example, which gives an overview of changes that occurred in that council’s treasury management policy in March 2008. Those changes included creating new rules for handling medium term funds, including removing the limit of no more than 10% of total reserves in a single institution in ‘specified investments’.⁵⁸ The evidence goes on to describe Westminster City Council’s investments in Iceland, which started at the end of 2006 and continued to 2008, with a total of £9.85 million being invested in Iceland up until 29 August 2008. This was at a time when many investors and non-investors alike were aware of the fact that Iceland was not a safe place in which to invest.⁵⁹

⁵³ Audit Commission, *Risk and return: English local authorities and Icelandic banks, Cross-cutting national report*, March 2009, p 46.

⁵⁴ Q 302

⁵⁵ Ev 99

⁵⁶ Audit Commission, *Risk and return: English local authorities and Icelandic banks, Cross-cutting national report*, March 2009, p 4.

⁵⁷ *Ibid*

⁵⁸ Ev 58

⁵⁹ The details of warnings about Icelandic banks will be discussed in detail in Chapter 7.

46. After the collapse of the Icelandic banks, Westminster City Council commissioned KPMG to carry out an independent review of its treasury management practices. The review's findings identified inconsistencies or omissions in the investment strategy, ambiguities within the in-house treasury team and a counterparty breach (where the council had exceeded its own counterparty limit with a building society in September 2008).⁶⁰ Other local authorities with investments in Icelandic banks have carried out similar reviews, with similar findings.⁶¹

47. CIPFA Scotland describes how local authorities as investors are classified:

[...] under the Market in Financial Instruments Directive (MiFID), local authorities are generally categorised as Professional Clients not as Retail Clients. This is indicative of the greater level of understanding of the money markets which local authorities should have, and their greater resources to retain the services of professional advisers where appropriate. Local Authorities should therefore be in a position to make value judgements on the risk incurred in their investments.⁶²

48. The Iceland affair has shown clearly that a number of local authorities fell short of the competence expected of professional clients. As the Audit Commission points out in "Risk and Return":

During 2008, confidence in the creditworthiness of some of the Icelandic banks changed relatively rapidly and between January and September 2008, a number of credit rating downgrades were announced, which should have prompted treasury managers to review the creditworthiness of the Icelandic banks.⁶³

Had all local authorities stopped placing deposits in the Icelandic banks in April 2008, the total amount of funds at risk when the banks collapsed in October would have been £389 million instead of £954 million.⁶⁴

49. It is obvious from our written evidence, and from the research carried out by the Audit Commission, that there are some local authorities with excellent treasury management services, but there are also local authorities with a less effective service. One of the objectives of the CIPFA Codes and Codes of Practice should be to ensure that all local authorities are aware of the level of expertise which is necessary to run a successful treasury management operation, and have all the checks and balances in place to ensure adequate monitoring, on an ongoing basis, of both the framework within which its treasury management team operates and the individual decisions which are made on a day-to-day basis. We welcome CIPFA's review of its codes, prompted by the events of last autumn, and recommend that it bear these principles in

⁶⁰ KPMG, *Westminster City Council: Review of Investment Strategy and Internal Control*, 9 December 2008, p 3.

⁶¹ Examples include: Price Waterhouse Coopers (PWC), 'Kent County Council: Review of Treasury Management procedures', December 2008 (www.kent.gov.uk); PWC, 'Hertfordshire County Council: Review of Treasury Management procedures', February 2009 (www.hertsdirect.org).

⁶² Ev 94

⁶³ Audit Commission, *Risk and return: English local authorities and Icelandic banks, Cross-cutting national report*, March 2009, p 21.

⁶⁴ *ibid*, p 27.

mind as it undertakes that review. We make some specific suggestions about how the Codes could be improved later in this Report.⁶⁵

District councils and the pooling of resources

50. The question arose during our inquiry of whether there was a particular issue for district councils. Mr Antill, representing the Society of District Council Treasurers as a member of its Executive Committee, told us that district councils are smaller than other local authorities, and that this can have an effect on treasury management:

In district councils we do not have an awful lot of expertise. It is often relying on a very small team, so external advice is fundamental, particularly that of the credit agencies.⁶⁶

He went on to note that potential losses in a district council's investments have a larger effect on its budget:

I can see the Government having difficulty protecting the investment...but I do think this is unprecedented, certainly in my limited experience, and I think it will be difficult for local authorities. If impairment means that we have to suffer the losses to our revenue accounts, ie over one year, that is going to be extremely difficult for any authority to manage, but for a district council to write its losses off over one year will be exceptionally difficult. I think we need help on that front.⁶⁷

51. The Iceland affair seems to suggest that it is this latter point—the effect on district councils' budgets if something does go wrong, rather than the likelihood of something going wrong in the first place—which is more significant. As the Audit Commission's report points out, 44% of county councils had deposits with Icelandic banks, compared with just 24% of district councils. Written evidence from the District Councils Chief Executive Network defends district councils, stating:

Often the first comment made in almost any situation is that smaller authorities (districts) have a particular problem due to 'capacity'. I fear that sentiment has also circulated around the issue of Icelandic banks. The evidence shows that the smaller authorities (districts) far from having a question over capacity would seem to have proven themselves to be the type of authority least likely to have been caught out.⁶⁸

52. However, the Audit Commission's report highlights that 30 authorities have investments in Iceland that exceed 5% of their gross revenue expenditure: district councils make up 27 of those 30. Although there are fewer district councils than county councils with investments at risk in Iceland, those district councils that *do* have investments at risk have large investments compared to their gross revenue expenditure. This substantiates Mr Antill's argument that those district councils with Icelandic investments face a harder prospect in writing off any losses than do the larger councils with their larger revenue budgets.

⁶⁵ See Chapter 9

⁶⁶ Q78

⁶⁷ Q119

⁶⁸ EV 151

53. District councils in particular might therefore wish to consider ways in which they can mitigate the risks inherent in investing relatively large amounts proportionate to their gross revenue expenditure. The Audit Commission's report, highlighting the difficulties faced by some smaller local authorities, accentuates the need for properly resourced treasury management teams:

Some smaller local authorities have been unable to allocate sufficient resource to treasury management functions, with a consequent failure to understand the markets and counterparties properly. Local authorities are now recognising that safeguarding invested cash requires an adequate level of resource; and many have either allocated extra resource, or are now considering how best to allocate extra resource to this function.⁶⁹

54. One way of allocating such extra resources is by the pooling of resources with other local authorities. We received evidence from various local authorities about the benefits of sharing expertise between different public bodies. Leeds City Council describes the following arrangement:

Leeds is also able to consider issues affecting investment and treasury management by engaging and debating issues in various forums including West Yorkshire Treasury Managers meetings, Core Cities treasury management meetings, SIGOMA meetings and quarterly strategy meetings held with the Councils own treasury advisers. Issues are also regularly discussed with the broking community and various banks.⁷⁰

55. Failures that occurred during the Icelandic crisis might have been lessened, had the expertise of local authorities been shared. The Investment Management Association, for example, commented on the fact that many bodies, not only local authorities, did not realise who owned the banks in which they invested:

Aside from Icelandic banks still being on lists seen by firms last year, other comments have highlighted the prevalence of errors in identifying the ultimate ownership of banks. This is an issue not limited to local authorities; evidence given to the Treasury Select Committee on deposit protection has noted the difficulty of identifying even which banks are in the same group. Work could be done here to assist local authorities.⁷¹

56. Speaking on behalf of district councils, Mr Antill told us that he welcomed the chance for local authorities joining together in order to pool resources:

We would welcome any extra advice or help they can give and I think it is a fair point about districts working together and perhaps sharing expertise more. I think it has drawn our attention perhaps to the need to do that.⁷²

⁶⁹ Audit Commission, *Risk and return: English local authorities and Icelandic banks, Cross-cutting national report*, March 2009, p 43.

⁷⁰ Ev 88

⁷¹ Ev 141

⁷² Q 114

Such an arrangement would still enable each individual authority or other public body to remain responsible and accountable for the adoption of its own strategy and policy and for performance. **We recommend that the Government, CIPFA and the LGA study ways in which local authorities, particularly smaller ones, could join together to share expertise and pool treasury management resources. The sharing of information and expertise, such as identifying banks that are in the same financial group, might have lessened the failures that occurred during the Icelandic crisis.**

5 Scrutiny of the treasury management function

57. People decide to enter local politics for many and varied reasons, but the scrutiny of treasury management is probably not at the top of many councillors' lists or, indeed, a primary concern of voters. However, the proper monitoring of local authorities' treasury management functions is one of the most difficult and most important of a council's overview and scrutiny responsibilities. Much evidence in this area was given by Howard Knight, co-author of the booklet *Treasure your Assets*, published by the Centre for Public Scrutiny, which aims to give a jargon-free guide to the scrutiny of local authority financial investments. In written evidence, Howard Knight sums up the effects of the rules and regulations surrounding treasury management:

Implicitly, by addressing those recommendations and requirements, a public body should be addressing explicitly the issue of whether it has in place the ability and capacity to be an efficient, effective and responsive client for treasury management.⁷³

58. Before giving oral evidence to us, Mr Knight carried out a survey among a number, though not a representative sample, of authorities, talking to relevant councillors—leader, cabinet member for resources, Chair of the Audit Committee, and Chair of Resources, Overview and Scrutiny Committee—about their role in the oversight of treasury management practices. That survey found that many councillors were not scrutinising effectively the treasury management policies and performance of their authorities:

In most authorities, TM strategy and policy papers have received what I would describe as relatively perfunctory scrutiny [...] In most councils (and the Audit Commission) it appears that TM was treated rather mundanely, with the legislative requirement to approve the TM strategy and policy seen as a necessary hurdle to be leaped rather than an opportunity for significant challenge.⁷⁴

59. This point had already been recognised by the Minister before he came to give evidence to us. Giving evidence, he said:

The question [...] is: is the scrutiny sufficient and is the capacity of members, and actually the capacity of some senior officers, sufficient to scrutinise these decisions? There may well be a case for a couple of things in this area and these are matters that we are considering at the moment. There may well be a case for better support and training for certain members in relation to this sort of function. There may well be a case for encouraging all local authorities to have audit committees, an arrangement that some do, that the system of Audit Commission's comprehensive performance assessment and use of resources judgment tends to encourage but it is by no means uniform and universal.⁷⁵

⁷³ Ev 129

⁷⁴ Ev 126

⁷⁵ Q 332

60. According to the CIPFA Toolkit for Audit Committees, there is no statutory obligation for a local authority to establish an audit committee. It describes the benefits of having an audit committee:

Effective audit committees help raise the profile of internal control, risk management and financial reporting issues within an organisation, as well as providing a forum for the discussion of issues raised by internal and external auditors.⁷⁶

Some local authorities have audit committees as part of their scrutiny structures, but CIPFA writes about the distinction between auditing and scrutiny:

The role of scrutiny is to review policy and challenge whether the executive has made the right decisions to deliver policy goals. This is different from the role of the audit committee which exists to provide independent assurance that there are adequate controls in place to mitigate key risks and to provide assurance that the authority, including the scrutiny function, is operating effectively.⁷⁷

The Toolkit also states that it is perfectly legitimate to co-opt somebody other than a member to be a member of the audit committee.⁷⁸ It also points out that the Audit Commission has supported the introduction of audit committees in local government, and published a paper in 1996 called “Called to account—the role of audit committees in local government”.

Training

61. CIPFA, in written evidence, cites developments to improve professional financial management skills for staff employed by local authorities, but does not mention improving training for elected members. Mr Antill, Director of Resources at Tewkesbury Borough Council and representing the Society of District Council Treasurers as a member of its Executive Committee, told us that:

we need to make sure members are properly briefed and trained because some of these transactions are very complex and I think it is our responsibility as finance people to make sure that our members get adequate training as well.⁷⁹

62. Councillor Cockell, Chairman of London Councils, also told us about the need for elected members to be better trained because

there is a lack of knowledge by elected members, particularly, I think, younger members coming in. In the past we had a lot of members who perhaps were accountants, who had a City background, a financial background. I see that becoming more difficult, even in the centre of London, to recruit those sorts of people, so certainly I think we should be looking at being able to, not turn out councillors who are

⁷⁶ CIPFA, *A toolkit for local authority audit committees*, 2006, p 4.

⁷⁷ *Ibid*, p 4.

⁷⁸ *Ibid*, p 16.

⁷⁹ Q 82

experts in the City and can out-expert the experts we are paying for and the treasury teams but, shall we say, know the right questions to ask.⁸⁰

63. The results of Howard Knight’s survey tend to reinforce Mr Antill and Cllr Cockell’s point. They show that, in relation to training, only a minority of the relevant members had had additional training and development in treasury management.⁸¹ Mr Knight commented on the fact that councillors have to undertake specialist training before they become members of Planning and Licensing Committees, but no such requirement is needed in order to become members of the relevant committees concerned with treasury management.⁸² He cites the best training courses being provided by outside organisations, such as CIPFA or Local Government Futures, which “[give] elected members the confidence, knowledge and skills to ask the awkward and challenging questions”.⁸³

64. Howard Knight suggests that a requirement for elected member development and training should be incorporated into CIPFA’s Treasury Management Code of Practice, and such development and training should be monitored by local authorities’ Audit Committees. The Code, he proposes, should have explicit guidance, including benchmarking and checklists “in relation to the necessity of securing sufficient client capacity.”⁸⁴

The Annual Investment Strategy

65. The focus of elected members’ scrutiny of the treasury management function is the Annual Investment Strategy (AIS). As explained above, the AIS concentrates on the security and liquidity of investments, containing a list of approved counterparties and the upper limits of investments with any single counterparty, details of how the authority plans to use credit ratings, and its policy in relation to the management of investments. The AIS must be approved and, if necessary, amended by the full council.⁸⁵

66. In relation to the Annual Investment Strategy, CLG’s written evidence states that “the system allows elected members to decide just how much detailed scrutiny they wish to undertake.”⁸⁶ As we have already seen, often that has been not much—though in the light of the Iceland experience, that may change. Sterling’s written evidence states that

[...] the Annual Investment Strategy is only one of a growing number of financial matters to be approved by the Council before the start of each financial year, and it is often relegated to an appendix of the report which sets the budget and Council Tax for the coming year. Elected members are naturally more interested in budget allocations and Council Tax, arguably leading to a rather more limited scrutiny of matters such as the Annual Investment Strategy. This area is clearly likely to receive additional

⁸⁰ Q216

⁸¹ Ev 124

⁸² Ev 125

⁸³ *Ibid*

⁸⁴ Ev 129

⁸⁵ CIPFA, *Treasury Management in the public services : Guidance notes for local authorities including police authorities and fire authorities*, p 10.

⁸⁶ Ev 113

attention and debate this year, and a number of Councils have now promoted the Annual Investment Strategy to a report of its own.⁸⁷

67. The particular question arose during our inquiry of the infrequency of councillors' review of the annual investment strategy. Of special concern was the fact that officials working in the finance office of a local authority could make decisions during the course of the year, within the wide limits set by the annual investment strategy, which would not be scrutinised by councillors for at least 12 months. The problem, and a possible solution, are summed up in the exchange below with the Minister:

Mr Hands: I certainly think there is a strong case for making the frequency of reporting far more frequent. At the moment [...] the council will take an investment decision at the beginning of a financial year which will not then ultimately be reported to members, and there is nothing in the rules it has to be reported to members until perhaps as much as 14 months afterwards when it comes before the annual council meeting which is reviewing the investment strategy of the previous year. I think there is all kinds of room there [for irregularities to occur]: anything from rogue officers who are making unauthorised investments [...] [to] local authority officers taking a position on an Icelandic bank, or whatever it might be, [...] without anybody knowing about it. I think there is scope for more frequent reporting to members than an annual review which will typically be lagging by over three months anyway.

John Healey: In terms of more frequent monitoring and reporting, perhaps systematic end of year scrutiny, probably you have a strong point there.⁸⁸

Conclusion

68. **We endorse the Minister's suggestion and recommendations by CIPFA and the Audit Commission that all local authorities should have an Audit Committee with specific responsibility for the scrutiny of the treasury management function. Guidance to local authorities to that effect should be given through appropriate amendment to the CIPFA Codes.**

69. **Members of audit committees need to take their responsibilities for that scrutiny seriously and need to ensure that they are properly trained. The CIPFA Treasury Management Code of Practice should make explicit the need for specific training in treasury management to be undertaken by those councillors with responsibility for overseeing treasury management arrangements, and the Audit Committee should be charged with ensuring that it is available and with monitoring its adequacy.**

70. **Guidance from CIPFA also notes that it is open to an authority to appoint someone other than an elected member and from outside the authority either to serve on or to chair the audit committee.⁸⁹ The co-option of external members to audit committees in this manner offers an additional opportunity to local authorities to enhance the**

⁸⁷ Ev 146

⁸⁸ Q334

⁸⁹ CIPFA, *A toolkit for local authority audit committees*, 2006.

expertise available to the authority in the scrutiny of its treasury management function, and we encourage all local authorities to consider taking advantage of it.

71. Meanwhile, whether a local authority has an Audit Committee or not, elected members should ensure that they pay proper attention to scrutiny of the Annual Investment Strategy (AIS), and of the decisions which are taken under it. We recommend that CIPFA, in reviewing its Codes, consider what further guidance is necessary to local authorities to ensure that elected members are given—and take—appropriate opportunities to scrutinise their AIS. We also recommend that CIPFA develop and include in its revised Codes more rigorous requirements for reporting to elected members on decisions taken by officials under the AIS.

6 Credit rating agencies

72. The role of credit rating agencies (CRAs) was discussed in much of our evidence, both written and oral. The Government’s statutory guidance on local government investments describes the need for specified investments to be invested with the Government, a local authority, a parish council or community council or “with a body or in an investment scheme which has been awarded a high credit rating”.⁹⁰ It also explains that local authorities’ Annual Investment Strategies should state:

- a) how **high credit rating** is to be defined for the categories of investments which the local authority intends to use in the financial year;
- b) how and how frequently credit ratings are to be monitored and what action is to be taken when ratings change.⁹¹

There is nothing in either the Government guidance or in the CIPFA Codes that advises local authorities on the way in which credit ratings are to be interpreted.

73. Local authorities use the information provided by the three credit ratings companies, Fitch, Moody’s, and Standard & Poor’s. We invited all three to submit written evidence, receiving responses from Fitch and Moody’s. These agencies assess the risk of financial and other institutions. Moody’s written evidence describes the way in which bonds (defined as bonds and other type of financial instrument rated by Moody’s)⁹² are rated:

In the most basic sense, all bonds perform in a binary manner: they either pay on time, or they default. If the future could be known, we would need only two ratings for bonds: “**Default**” or “**Won’t Default**”. Because the future cannot be known, credit analysis resides in the realm of opinion. Therefore, rather than being simple “default/won’t default” statements, our ratings are opinions about the risk of outcomes in the future with degrees of uncertainty.⁹³

74. Moody’s memorandum goes on to describe what credit ratings can and cannot do, and quotes its Code of Conduct:

Credit ratings are Moody’s current opinions of the relative future credit risk of entities, credit commitments, or debt or debt-like securities [...] Credit Ratings do not address any other risk, including but not limited to: liquidity risk, market value risk, or price volatility. Credit Ratings are not statement of current or historical fact. Credit Ratings do not constitute investment or financial advice, and Credit Ratings are not recommendations to purchase, sell, or hold particular securities.⁹⁴

⁹⁰ Local Government Investments, Guidance under section 15(1)(a) of the Local Government Act 2003, paragraph 12.

⁹¹ *Ibid*, paragraph 13.

⁹² Ev 143

⁹³ *Ibid*

⁹⁴ *Ibid*

Therefore, according to Moody's memorandum, credit ratings are a matter of opinion rather than fact; and do not, in themselves, constitute advice, though they may be cited to justify or support advice. Fitch also outlines what is defined as a rating:

Ratings are based on information obtained directly from issuers, other obligators, underwriters, their experts, and other sources Fitch believes to be reliable. Fitch does not audit or verify the truth or accuracy of such information, and has undertaken no obligation to so audit or verify such information or to perform any other kind of investigative diligence into the accuracy or completeness of such information. If any such information should turn out to contain misrepresentations or to be otherwise misleading, the rating associated with that information may not be appropriate and Fitch assumes no responsibility for this risk.⁹⁵

75. Mr Weaver described the fallibility of credit rating agencies:

The information they provide is part of the whole picture. It is not the whole picture. Credit rating agencies are not regulators, they are not auditors. They are fallible. Their pronouncements need to be studied and understood but not slavishly followed and it is important that the treasury management team in a council is taking a wider view than simply relying on a single set of businesses, frankly, not agencies. They are not agencies of government, they are businesses selling information and they are fallible; they are not infallible.⁹⁶

We would add to those limitations the fact that credit ratings can be slow to change and lag financial and economic developments.⁹⁷

76. The evidence from the Society of Local Authority Chief Executives and Senior Managers (SOLACE) shows how the fallibility described by Mr Weaver came to affect local authorities' investments in Icelandic banks:

Icelandic Banks passed all the tests and had reasonable credit ratings. The real problem is that neither the Banks nor Credit Rating Agencies had adequate information on the liabilities explicit or implicit in derivative instruments such as collateral debt obligations or credit default swaps.⁹⁸

77. Mr Horsfield of Arlingclose suggested that an over-reliance on credit ratings left some people and institutions unaware of the real risks. Commenting on the fact that Moody's credit rating of the Icelandic banks rose to AAA, the top rating, he said that that resulted in Arlingclose being wary of the credit rating system and being wary of Iceland:

From our perspective, that [the Moody's re-rating] influenced our decision on the reliance on ratings because it seemed to us to be so out of kilter with what other indicators in the market on those institutions in Iceland were telling us. You could not reconcile the two.

⁹⁵ Ev 153

⁹⁶ Q 88

⁹⁷ The Treasury Select Committee, *Banking Crisis: reforming corporate governance and pay in the City*, Ninth Report of the Session 2008–09, HC 519, para 189.

⁹⁸ Ev 56

Arlingclose's written evidence makes a more damning, general case against an over-reliance on credit ratings:

We believe that the blind reliance on credit ratings supplied on an incremental and mechanistic basis is the main reason why local authorities have money at risk with Icelandic institutions. There was ample and readily available information that presented, at the very least, a requirement to adopt a cautionary stance. Unfortunately, this was at best—and quite remarkably in our opinion—unavailable and, at worst, it was ignored.⁹⁹

This argument finds some support in the conclusions of the Audit Commission's report "Risk and Return", which notes that some evidence suggests that those local authorities that used a narrower range of information—credit ratings alone—rather than using a wider source of information, such as reading around the subject and studying the market intelligence from a "a range of sources and broker information", were more likely to invest in the Icelandic financial institutions.¹⁰⁰

78. The evidence and argument above should not, however, be taken as an indication that we consider the credit ratings themselves to be the main reason for local authorities' potential losses in the Icelandic banks. As the Audit Commission's report "Risk and Return" points out, there was a general wariness about Icelandic banks during 2008 and

Confidence in the creditworthiness of some of the Icelandic banks changed relatively rapidly and between January and September 2008, a number of credit rating downgrades were announced, which should have prompted treasury managers to review the creditworthiness of the Icelandic banks.¹⁰¹

79. Neither do we conclude that local authority treasury managers should disregard credit ratings altogether. CIPFA states in its written evidence that

[...] whilst local authorities will continue to use other sources of information they have available, an approach encouraged by CIPFA itself, and despite recent criticism about the agencies' response to changing financial climates, it should be recognised that the ratings agencies remain a key accepted view of an organisations' financial standing and it is unlikely that local authorities themselves would have the resources or knowledge to carry out their own detailed credit analysis.¹⁰²

80. Rather, we consider that there is room for further guidance to local authorities on the appropriate place of credit ratings in decisions about investments. Indeed, CIPFA has already recognised as much. CIPFA's Treasury Management Panel recently (March 2009) published a bulletin, "Treasury Management in Local Authorities—Post Icelandic Banks Collapse", which explains the way in which credit ratings should be used by local authorities:

⁹⁹ Ev 53

¹⁰⁰ Audit Commission, *Risk and return: English local authorities and Icelandic banks, Cross-cutting National report*, March 2009 and Ev 134.

¹⁰¹ Audit Commission, *risk and return: English local authorities and Icelandic banks, Cross-cutting National report*, March 2009, p 21.

¹⁰² Ev 64

There has been much debate about the role of credit ratings and their use by local authorities. Credit ratings remain a key source of information but it is important to recognise that they do have limitations. Authorities are advised to have regard to the ratings issued by all three main agencies [...] and to make their decisions on the basis of the lowest rating. Ratings should be kept under regular review and ‘ratings watch’ notices acted upon.¹⁰³

One of the reasons why the problems which led to money being placed at risk in the Icelandic banks arose was because of the over-reliance placed on the ratings awarded by the credit rating agencies, which is the only measure of “investment quality” mentioned in the informal commentary to the Government guidance.

81. The lack of information about the appropriate use of credit ratings in the Government guidance and in the CIPFA Codes is an omission. Some local authorities have relied too heavily on credit ratings, without appreciating that they should be viewed within the context of other financial and economic information and advice. We welcome the new guidance from the CIPFA Treasury Management Panel, but believe that there is room to go further. We recommend that the Government revise the informal commentary on its statutory guidance, to include information about the appropriate use of credit ratings. We also recommend that the CIPFA Codes include guidance to local authorities on the nature of credit ratings, highlighting the risks of over-reliance on them. Credit ratings should not be used in isolation as a justification for the soundness of an investment and local authorities should be made aware of the fact that credit ratings should be viewed within the context of wider financial and economic information and advice.

¹⁰³ CIPFA, Treasury Management Panel, *“Treasury Management in Local Authorities – Post Icelandic Banks Collapse*, March 2009, p 3.

7 Treasury management advisers

Introduction

82. Many local authorities employ private sector advisers—“treasury management advisers”—who have specialist knowledge and skills in understanding money markets. As *Treasure Your Assets* states:

Local authorities can and do make their own investment decisions, but, given the potentially specialised knowledge and skill required to understand the money markets, many employ an external firm of advisers to advise in the decision making of which counterparties to invest in and borrow from. Such advisers will give regular advice on the current prevailing market, their assessment of the likely future course of interest rates etc.¹⁰⁴

83. However, this definition of the role of treasury management advisers is not one that is fully accepted by some of the treasury management advisers themselves, as we discovered in an oral evidence session. The lack of clarity about the type of service being offered has led to confusion about the role of those advisers in the events leading to the collapse of the Icelandic banks, and prompted us to inquire further into the role of treasury management advisers.

What do treasury management advisers advise on?

84. CIPFA’s written evidence acknowledges that “local authorities place varying levels of reliance on the advice of these advisers depending upon their own level of internal skills and knowledge.”¹⁰⁵ It is perfectly understandable that different local authorities should contract for differing levels of service from treasury management advisers, according to their local circumstances—and that, as one of the treasury management adviser firms pointed out in a supplementary memorandum to us, the fees charged by those advisers should reflect the level of service contracted for.¹⁰⁶ However, the evidence given to our inquiry, particularly that given in oral evidence from the three treasury management advisers themselves, highlighted a discrepancy between what many local authorities thought they were being provided with, and what some of the advisers themselves claimed to be providing to their clients.

85. Sterling states in its written evidence its view of what treasury management advisers do, and do not, provide:

There is some confusion in the media about the role of local authorities’ treasury consultants. Their role includes:

¹⁰⁴ The Centre for Public Scrutiny (CfPS), *Treasure your assets: a jargon free guide to scrutiny of local authority financial investments*, December 2008, p 17.

¹⁰⁵ Ev 64

¹⁰⁶ Ev 82

- a) helping authorities to meet their obligations under the legislation and codes of practice, including the production of an Annual Investment Strategy;
- b) keeping authorities up to date with changes to relevant public credit ratings;
- c) explaining how the Bank of England, PWLB and money market work;
- d) providing information on the pros and cons of various investment and borrowing options;
- e) assisting with the use of risk management techniques;
- f) helping authorities to account for investment and borrowing decisions, and;
- g) training officers and members on the above.

Consultants do not:

- a) pass on unfounded rumours about market participants, which would be in contravention of the Financial Services and Markets Act 2000, or;
- b) tell authorities which investments they should or should not make.¹⁰⁷

86. In oral evidence, Mr Anthony, Managing Director of Butlers, explained the services that Butlers offers:

We do offer advice in a number of areas, for example in accountancy, capital finance issues, economic analysis, interest rate forecasting, and in addition we do run training courses, but it is quite clear on the counterparty issue that we act as a pass through of information. We do not provide advice on counterparties.

Sector's representative, Mr Whelan, gave a similar answer:

I would like to make it quite clear that we do not provide advice to local authorities on which specific financial institutions or sovereign states to place their funds. We provide rating information from the major international rating agencies through to the local authorities. We try to help and standardise information because quite often the rating agencies use different terminology to describe the same outcome. This information then becomes part of a broader authority decision-making process into which our input is one part of that process, but we have no further part in that process.¹⁰⁸

These advisers suggest, essentially, that they are an intelligence service, and a limited one at that (the reference to “unfounded rumours” in Sterling's evidence seems to suggest that they do not even weigh up and analyse the available information—a very different business from passing on supposedly privileged information). If this is their role, then it seems relatively poor value for money. However, the evidence we received suggested that this is not the role which many authorities thought they were contracting for.

¹⁰⁷ Ev 148

¹⁰⁸ Q 130

87. Howard Knight suggested that treasury management advisers were back-peddalling on what they did for local authorities, switching from the claim that they give “advice” to the suggestion that what they offer is “specialist information”.¹⁰⁹ Mark Horsfield from Arlingclose was the only treasury management advisor who agreed that it was his role to provide both specialist information and advice:

In terms of investment advice, which I suppose is the key area the Committee is interested in, we do believe we give investment advice. That is what we are mandated to do and our clients tell us that they want access to information that they do not have access to themselves. We gather information, consider it and form a view from a wide range of sources, not simply the credit rating agencies.¹¹⁰

88. The LGA provided useful supplementary evidence on the varied contracts that exist between local authorities and the two treasury management adviser firms Sector and Butlers. There is evidence from those contracts that both Sector and Butlers are expected by local authorities to give advice, not just provide information. The following, for example, is an excerpt from a contract between a district council and Butlers:

Advice will be given with regards to the internal management of funds. In conjunction with our interest rate forecasts we will provide advice on the period of investment. Advice will also be given on the use of both Specified and Non Specified investments. In addition we will give specialist advice on specific investment instruments that comply with the Councils’ attitude to risk. The investment service will include performance monitoring of all products and an agreed exit strategy for existing instruments.¹¹¹

89. Similarly, the LGA quote a contract between a district council and Sector, entitled a “Mandate for Treasury Consultancy and Investment Advisory Services”, which states that Sector will provide:

Advice on investment counterparty credit worthiness, including the provision of prudent parameters established in the light of information from the UK’s leading credit rating agency, various other analysts as appropriate and associations.¹¹²

90. Reading Borough Council has been a client of both Sector and of Arlingclose. The Council sent us internal documents relating to their treasury management activities, with copies of e-mails from both Sector and Arlingclose. One exchange between Reading and Sector in June 2006 is particularly relevant because it discusses the provision of advice specifically about with whom the council should invest its reserves (the so-called “counterparties”). In one e-mail, Reading Borough Council asked for the following advice:

Historically we rarely had more than £10-£20m to lend and this list [of counterparties] was adequate. Now we are in a position that because of borrowing to finance future programmes/restructure debt we have around £100m lent out, and our list is proving

¹⁰⁹ Q 16

¹¹⁰ Q 128

¹¹¹ Ev 104

¹¹² Ev 105

restrictive. In addition from benchmarking we have noted that our performance lags most authorities by 0.1% or so (equivalent to up to £100k pa, though probably more typically £30–40k).

The brokers we deal with have been asking us to consider reviewing our list for some time, and [...] we are minded to do so, but would appreciate your comments on what we propose.

91. Sector responded 13 days later with the following e-mail:

I have looked at your proposed lending list [...] The list looks fine and I have the following comments after checking the institutions against our own Creditworthiness application.

Other UK Institutions

We recommend that Bradford and Bingley and Northern Rock are not lent to [for] more than three months.

Overseas Banks

With the exception of DEPFA (3 months) we recommend lending to those highlighted for in excess of a year, the two Swiss banks you mention do not appear on our list but I have checked on the Fitch website and agree their ratings.

Building Societies

Again we recommend no longer than three months however the regulatory environment, as you say, may mean that you take a slightly different view to us. Derbyshire and Leeds/Holbeck are not rated but again fall into the top 10 due to asset size.

I hope this helps but if you need further input do not hesitate to contact me.¹¹³

92. Reading Borough Council does take responsibility for its investment strategy. It stated in its written evidence:

We have always taken the view that whilst it is the role of advisers to guide and help, ultimately the authority must control and own the process. Ultimately treasury activity is carried out by a small team within the finance function with the staff handling day to day transactions having clear guidance on what can be done on a day to day basis.¹¹⁴

However, the exchange shows that, at least in 2006, Sector was giving advice on specific investments and advising Reading Borough Council **not** to invest in certain financial institutions for more than three months. This contradicts the impression that Mr Whelan sought to give us about Sector in oral evidence.¹¹⁵

¹¹³ E-mail exchange between Reading Borough Council and Sector (Evidence not reported).

¹¹⁴ Ev 74

¹¹⁵ Q130, quoted in paragraph 86.

Specific examples of advice relating to Icelandic investments

93. The following table, reproduced from written evidence given by Martin Hickman, Consumer Affairs correspondent at *The Independent*, summarises, for each treasury management advisor, the number of local authorities each advise, the proportion of the total local authority exposure to Iceland each client group held, and the total amount exposed. It also includes the statistics for the local authorities with no external treasury management advisor, for reference.

Butlers	Claims to advise 144 UK councils: 31% of total Number with investments in Icelandic banks: 51% Proportion of total UK council exposure to Iceland: 53% Scotland £22.5m, Wales £0, England £447m	TOTAL: £469.5m
Sector Treasury Services	Claims to advise 250 UK councils: 53% of total Number with investments in Icelandic banks: 46 Percentage of total UK council exposure to Iceland: 35% Scotland £23m, Wales £49.7m, England £240.4m	TOTAL: £313.5m
Sterling Consultancy Services	Will not disclose number of UK councils it advises Number with investments in Icelandic banks: 3 Percentage of total UK council exposure to Iceland: 2% Scotland £3.7m, Wales £0, England £13.5m	TOTAL: £17.2m
No external advisor	Number of UK councils without advisers: at least 16 Number with investments in Icelandic banks: 16 Percentage of total UK council exposure to Iceland: 1% Scotland £0, Wales £0, England £13m	TOTAL: £13m
Arlingclose	Claims to advise 40 (now 50 after Icelandic collapse) UK councils: 9% Percentage of total UK council exposure to Iceland: 0 Number with investments in Icelandic banks: 0	TOTAL: £0

Source: Ev 130

94. These figures were submitted to us as written evidence and also appeared in an article in *The Independent* on 19 January 2009. We have not sought to verify the figures, but Mr Anthony of Butlers said in oral evidence, “No, you cannot dispute the amounts, they are there for everybody to see”.¹¹⁶

95. Sterling’s written evidence defends local authorities’ investments in Iceland, pointing out that the Icelandic banks were some of only a limited number of banks willing to accept small deposits that many local authorities wanted to make (many highly-rated banks only accept deposits in excess of £25 million); and that the Icelandic banks paid “high, but not exceptional,” rates of interest on deposits and “local authorities typically lend their cash to whichever approved counterparty is paying the highest rate of interest, subject to an internal limit per counterparty”.¹¹⁷ Sterling goes on to argue that local authorities’ decision to invest in Iceland might not have hindered them financially:

There is around £1 billion of local authority cash tied up in Icelandic banks, representing approximately 3% of all local authority investments. It is interesting to

¹¹⁶ Q 159

¹¹⁷ Ev 148

note that since market interest rates have been substantially higher than yields on low-risk government bonds for the past two years, local authorities will, in aggregate, have received in the region of £1 billion additional investment income over this period by investing on the money market. It can therefore be argued that individual local authorities who have 3% or less of their total investments tied up in Icelandic banks have not lost out financially from the episode, even if the eventual amounts recovered are low. It follows that those authorities who have a substantially greater proportion invested in Iceland (and in some cases this is more than 10%) have lost out. This is as a direct result of the failure to diversify their investment portfolios adequately.¹¹⁸

96. Arlingclose, however, advised its clients not to invest in Icelandic institutions from early 2006.¹¹⁹ It gave the following information in its written memorandum of the signals early in 2006 that led to this advice:

What were the concerning signals?

- Widespread newspaper articles (going right back to early 2006) of potential problems with the Icelandic economy.
- An analysis of the Icelandic economy from 2006 onwards indicated that it was an economy under stress. The value of its currency was deteriorating, inflation was sharply higher and its official interest rates were in double digits and rising. As an economy its growth had been fuelled largely from the expansionary activities of its banks which resulted in liabilities dwarfing economic output and the value, therefore, of any potential government guarantee.
- Numerous pieces of research released by investment banks signalling potential problems with Iceland and its banks. This research kept on coming and its outlook took on an increasingly pessimistic tone.
- One of the credit rating agencies introduced, in early 2007, a new ratings methodology that inexplicably resulted in the Icelandic banks being given the highest available rating. This brought widespread derision from the financial markets to the extent that the methodology and the ratings were removed shortly thereafter. This again raised sharp questions about the reliance on credit ratings as a sole barometer of risk.
- Direct communication with the specific institutions about which we had concerns did not allay Arlingclose's fears.
- The credit default swap (CDS) market provides investors with the ability to insure against a corporate or sovereign failure. CDS priced Iceland and its banks at levels that contradicted the credit ratings.¹²⁰

97. Neither Butlers nor Sector stated in their written evidence whether or, if so, when they advised their clients not to invest in Icelandic institutions. When pressed on this matter in

¹¹⁸ Ev 148

¹¹⁹ Ev 52

¹²⁰ Ev 53

oral evidence, they once again relied on the distinction they were seeking to draw between “advice” and “information”. When questioned about whether Butlers advised its clients to withdraw their investments from Iceland, Mr Anthony said, “No, we do not provide advice, we just give out information.”¹²¹ When questioned on whether Sector advised against investing in Iceland, Mr Whelan responded:

No, we did not. We passed on the downgrades from the credit rating agencies as they came through to local authority clients on a timely basis. We do not give specific advice in this area.¹²²

98. The Committee received written evidence from Plymouth City Council, which has £13 million at risk in Icelandic institutions (5% of its total portfolio).¹²³ Its treasury management advisor at the time was Sector, from whom they commissioned a specific review of the council’s investment strategy in June 2008 because of general concerns being aired in the money market.¹²⁴ Plymouth’s written submission highlighted reassurances given by Sector at that time. Sector’s report stated:

The Council’s lending list is very robust and takes into account consideration of the rating criteria, amount limits and also duration limits, which is exactly what Sector recommends from authorities that are looking to place money with any institution.¹²⁵

Those reassurances appear to us to constitute advice, not just information. Plymouth’s Audit Committee document of 18 December 2008 notes that it has since replaced Sector as its treasury management advisor.¹²⁶

Service provided by treasury management advisers: conclusion

99. Responsibility for local authorities’ investment decisions lies, and must continue to lie, with the local authorities themselves. However, the claim by some treasury management advisers that they give information only, not advice, on investment counterparty creditworthiness to local authorities is, in our view, misleading.

100. The involvement of treasury management advisers in local authority treasury management will only be valuable if local authorities understand the level of service they require, and if the advisers themselves are clear about the level of service they are providing. Treasury management advisers must decide, define and communicate what services they are providing clients, particularly in relation to the provision of “information” and/or “advice”. The local authority itself nevertheless remains ultimately responsible for any investment made, and CIPFA should warn local

¹²¹ Q 141

¹²² Q 143

¹²³ Plymouth City Council Audit Committee, “Icelandic Investments and Treasury Management”, Audit Committee, 18 December 2008, p. 4 (www.plymouth.gov.uk).

¹²⁴ Ev 108

¹²⁵ *Ibid*

¹²⁶ Plymouth City Council Audit Committee, “Icelandic Investments and Treasury Management”, Audit Committee, 18 December 2008, p. 4 (www.plymouth.gov.uk).

authorities about over-reliance on treasury management advisers, whose services have been shown to be variable and, in some cases, inadequate.

101. In our view, the evidence we have received suggests both that local authorities believed they were receiving a different level of advice from the advice that their providers thought they were giving, and that local authorities **need** a different level and quality of advice. The Audit Commission could play a useful role here. As its preface states, the Commission’s report “Risk and Return” tells “the story of English local authority deposits in Icelandic banks and their UK subsidiaries.” The “story” includes a brief definition of treasury management advisers,¹²⁷ but omits any criteria for evaluating their services. The Commission could provide a valuable service to local authorities by considering the range of services that treasury management advisers provide and advising on what level of service may be appropriate depending on the in-house capability of the local authority, the amount of money that it has available for investment and its appetite for risk. **We recommend that the Audit Commission carry out a value for money study of the services that local authorities have received from treasury management advisers, with a view to advising local government on the value that they offer in the differing circumstances applying to individual authorities.**

Treasury management advisers and the CIPFA Codes

102. The CIPFA Codes say very little about treasury management advisers, brokers and credit rating agencies. Treasury Management Practice 11 describes the potential benefit of external service providers of treasury management services and recommends that local authorities

[...] ensure that the terms of their appointment and the methods by which their value will be assessed are properly agreed and documented, and subject to regular review. And it will ensure, where feasible and necessary, that a spread of service providers is used, to avoid over-reliance on one or a small number of companies.

This description is fine as far as it goes, but in the light of our discussion of the services provided by treasury management advisers, it is clear that the CIPFA Codes need to be more explicit on the use of external service providers.

103. The Minister, the Rt Hon John Healey MP, told us that he would like to see “clearer guidance on appropriate use of expertise whether that is internal or external.”¹²⁸ He later accentuated this point when asked again about local authorities relying on treasury management advisers who claimed to pass on little more than credit ratings:

That is what I had in mind when I suggested there may be a case for clearer guidance and possible a reflection of the CIPFA Treasury Management Code of the use of expertise both internal and external. I think the sort of evidence the Committee has taken on that front [...] suggests those authorities who were not over-reliant simply

¹²⁷ Audit Commission, *Risk and Return: English local authorities and Icelandic banks, Cross-cutting National report*, March 2008, p 36.

¹²⁸ Q 333

and singly on credit ratings information have been less likely to make these investments.¹²⁹

104. There is no guidance in the CIPFA Treasury Management Code for those local authorities with no specialist staff and which therefore rely on external advice. John Healey commented on this fact, saying:

That is an area which you may have heard from CIPFA they are looking at. It is certainly an area I am interested in and looking at.¹³⁰

105. We recommend that the CIPFA Codes give more detailed advice to local authorities on the services which they may expect to receive from treasury management advisers, and how to use them effectively. The guidance should make clear that such advisers may give varying types and levels of information or advice.

Potential conflicts of interest

106. It is vital that companies marketing their services as treasury management advisers to local authorities should be entirely transparent about the basis of their fees and the sources of revenue, including commissions, which they might offset against their charges. Butlers, Sector and Sterling are all subsidiaries of parent financial companies: Butlers is a subsidiary of ICAP; Sector is a subsidiary of Capita; and Sterling is a subsidiary of Sterling International Brokers Limited. Concern has been raised about the provision of a financial advisory service by one part of an organisation, while another part of the same organisation—a broker—is placing investments for local authorities and thereby earning commission on those investments.

107. The CIPFA Treasury Management Code of Practice describes brokers as “money-broking companies, whose role it is to act as intermediaries, making introductions between the prospective parties to transactions.”¹³¹ Brokers do not offer advice on which counterparties local authorities should invest in. Instead, “they may provide information already in the public domain, but may not interpret it.”¹³² The Code recommends that, if local authorities decide to employ brokers, they should have no fewer than two and they should have a competitive tendering process every few years.¹³³

108. Guildford Borough Council’s submission explains why there is concern about the relationships between local authorities, treasury management advisers and brokers. Noting reports that investments by some local authority finance officers have managed to outperform not only the benchmark set in their authority’s Annual Investment Strategy, but even the performance of some professional fund managers, it comments:

¹²⁹ Q 337

¹³⁰ Q 339

¹³¹ CIPFA, *Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes*, April 2001, p 42.

¹³² *Ibid*

¹³³ *Ibid*

[...] this is an important feature in this debate i.e. the lack of appreciation of the risk being taken. In some cases this has been with the support of their treasury advisers and reflects a potentially far muddier area where advisers may have links to companies and/or affiliations with organisation that earn commissions from the borrowing/investment activity of the local authorities. This gives rise to potential conflicts of interest.¹³⁴

109. Butlers' website, describing its position within the ICAP plc Group, makes a virtue of the fact that local authorities would have 'the whole of the Group' at their disposal:

Butlers is a consultancy company specialising exclusively in the provision of a wide range of financial services to the UK public sector [...] Within the ICAP plc Group, the world's leading financial broking organisation, Butlers operates independently. The ICAP plc Group has been working with local authorities and other public sector organisations since the 1930s, initially in its capacity as money broker but later through the more specialist advice of Butlers itself. The resources of the whole of the Group would be at the Council's disposal.¹³⁵

110. In oral evidence, Mr Anthony, representing Butlers, agreed that the provision of an advice service by a company in the same group as a broker could lead to the perception of a conflict of interest, but maintained that:

[...] the company makes it absolutely certain that those conflicts of interest are not breached and we do operate the Chinese walls. We have absolutely no idea what the other side of the business gets up to. They do not know what we get up to. We do not know what our clients are doing with respect to their dealings with ICAP at all.¹³⁶

In supplementary written evidence, Butlers reiterates the existence of 'walls' within the ICAP group and maintains the following:

As Mr Anthony stated at the hearing, there are clear Chinese (and physical) walls in place within ICAP Group. Indeed we have been told by ICAP that in respect of our clients in 2008 only 16% of Icelandic investments were placed through ICAP's deposit broking desk.¹³⁷

Mr Whelan described the practice at Sector:

We do not have a conflict of interest, we do not receive commission on any time deposits for any financial institution, local government or any other type of body at all.¹³⁸

111. Mr Horsfield of Arlingclose argued that "it is important to be demonstrably independent and we took the decision at a very early stage to demonstrate that independence."¹³⁹ Arlingclose's supplementary evidence elaborates this point:

¹³⁴ Ev 50

¹³⁵ www.butlerasset.com

¹³⁶ Q 197

¹³⁷ Ev 82

¹³⁸ Q 198

Arlingclose's treasury advisory fees are clear and unambiguous. Arlingclose avoids conflicts of interest by deliberately **not** taking fees from brokers or financial institutions—its treasury advisory fees are paid by clients for advice and for advice only. Arlingclose's founding partners consciously took the decision to develop this business model after having worked in the industry for many years, observing practices which they did not and still do not believe are in local authority's clients' best interests.¹⁴⁰

112. Arlingclose's supplementary evidence also discusses the commission received by some other treasury management advisers:

Since Arlingclose developed its treasury advisory services in 2004 there have been occasions when it has been approached by financial institutions with offers to pay Arlingclose fees on a range of investment and debt products. These institutions have offered to pay Arlingclose a fee of between two and five basis points. On each occasion Arlingclose has declined these offers in order to demonstrably maintain its independence. In Arlingclose's opinion and experience, third party relationships and transactions can be poorly disclosed in Standard Terms of Business (STOB), meaning that local authority clients are not fully aware of the scale of commissions that can be obtained. Nor are clients aware that commissions received as a result of these kinds of arrangements can easily exceed the fees that are charged by the treasury management advisers to their clients.¹⁴¹

113. This evidence raised concerns about the potentially inappropriate relationships between local authority finance officers, advisers and brokers. We also received supplementary evidence from Martin Hickman, consumer affairs correspondent of *The Independent*, citing a conversation with a senior representative in a financial company in the City of London. It should be noted that, although Mr Hickman states that specific companies, individuals within those companies and individual transactions were named in the conversations with his source, he has not investigated those claims and, as such, they are unsubstantiated.¹⁴² In the course of this conversation, Mr Hickman was told:

That local authority investment officers placing tens of millions of pounds of investments in banks were poorly trained and motivated.

That some local authority officers placing investments had enjoyed extensive hospitality provided by companies profiting directly from those investments.

That brokers actively touted for business, dealing directly with local authority finance officers to discuss the placement of funds.

That brokers received from banks substantial commission (sometimes running into hundreds of thousands of pounds) for placing local authority funds with those banks.

That brokers share this commission with advisers unbeknownst to local authority clients.

¹³⁹ Q 198

¹⁴⁰ Ev 56

¹⁴¹ *Ibid*

¹⁴² Ev 132

That advisers actively advise local authority clients to place funds with particular institutions in order that they would receive a share of this broking commission.

That together advisers and brokers hold conference calls with local authority finance officers in which they (advisers and brokers) act in concert to give such advice.¹⁴³

114. The Audit Commission's report "Risk and Return" contained a sentence which added to our concern about this issue. It highlighted the fact that many local authorities did not manage their existing investments in Iceland well, meaning that some money was put at risk which might not have been:

[Local authorities] did not manage deposits that had not yet matured as actively. It is sometimes possible to break a deposit before maturity. This is not a regular occurrence; some banks charge a fee or a penalty to return funds, but others do not. There was a general reluctance to break deposits, or ignorance of the facility. However, some local authorities did consider the possibility of breaking deposits, but were told by their brokers that this would not be possible.¹⁴⁴

115. We asked the Audit Commission whether this paragraph was suggesting that local authorities were told by brokers that it was not possible to break a deposit before maturity, when actually it was possible. The Commission responded:

None of the authorities who were part of our fieldwork sought a second opinion on breaking deposits after a broker had told them that breaking would not be possible. Therefore, we cannot be certain that the information given by a broker was incorrect. However, we do know that some deposits were redeemed before the contracted maturity date.¹⁴⁵

116. All four local authority treasury management advisers state that they are regulated by the Financial Services Authority (FSA). We invited the FSA to submit written evidence to this inquiry. That evidence describes the roles and responsibilities of the FSA, which is an independent non-governmental body, given statutory powers by the Financial Services and Markets Act 2000 (FSMA). It is accountable to Treasury Ministers and, through them, to Parliament, but is operationally independent of Government and funded solely by the firms that it regulates. The FSMA gives the FSA four statutory objectives:

- To maintain confidence in the financial system
- To promote public understanding of the financial system
- To secure the appropriate degree of protection for consumers
- To reduce the extent to which it is possible for a business to be used for a purpose connected with financial crime.

¹⁴³ Ev 132

¹⁴⁴ Audit Commission, *Risk and Return: English local authorities and Icelandic banks, Cross-cutting National report*, March 2009, p 27.

¹⁴⁵ E-mail received from the Audit Commission, 09.04.09.

117. We asked the FSA to tell us what it means in practice that a company is regulated by the FSA. It replied with the following supplementary evidence:

The FSA website contains information on the different approaches that we use for the firms we regulated. This can be found at the following link—<http://www.fsa.gov.uk/Pages/Doing/Regulated/supervise/index.shtml>.¹⁴⁶

118. We then asked what steps the FSA had taken to regulate treasury management advisers and received the following answer:

In general FSA conduct of business rules about advice only cover regulated investment advice and firms that are FSA authorised. The definition of what is and is not regulated investment advice, and who does/does not need to be regulated, is set out by the Treasury in the Regulated Activities Order. How the FSA's conduct of business rules apply to regulated advice depends on the exact circumstances of the situation, who is giving the advice, who is receiving it and whether any exemptions apply. Generally speaking, financial advisers giving advice about deposits are not regulated. This is because the Treasury has not included advice of this sort in the list of activities regulated by the FSA. Further information on the regulated activities is available on the following link—<http://www.fsa.gov.uk/Pages/Doing/Do/index.shtml>¹⁴⁷

119. These answers from the FSA are unhelpful to the point where we wonder whether they might constitute deliberate obfuscation. We strongly suspect that the clear answer to our question of what steps the FSA has actually taken to regulate treasury management advisers is “none”. Given the large sums of public money which are at stake in local authority treasury management, we consider this to be an abrogation of responsibility on the part of the FSA. Treasury management advisers do not advise local authorities only; they also advise other public sector bodies, including the National Health Service, housing organisations and universities, which adds to the importance of ensuring that such advisers are properly regulated.¹⁴⁸

120. The Financial Services Authority (FSA) should take a more active role in the regulation of treasury management advisers. The evidence which we have examined has raised concerns about potential conflicts of interest and questions as to whether there are any financial transactions between treasury management advisers and brokers that might compromise the independence of advice being given to local authorities. There is a strong case for a full investigation by the FSA of the services provided by local authority treasury management advisers. We recommend that such an investigation be carried out as soon as possible.

Conclusion

121. Our examination of the role of treasury management advisers in the Icelandic debacle has raised wider questions about their influence on local authorities' treasury

¹⁴⁶ Ev 106

¹⁴⁷ *Ibid*

¹⁴⁸ www.butlerasset.com; www.sector-group.com; www.arlingclose.com.

management practice. First, there is confusion, and perhaps some deliberate ambiguity, about what services they offer. It is clear to us that some local authorities believed that they could place reliance on their treasury management advisers in a way that some of the treasury management advisers themselves now seek to argue was misguided. Second, there is concern about the independence of treasury management advisers that may be part of companies that will benefit from the investment decisions of the local authorities that they advise. Third, there is a lack of clarity about the extent to which local authorities can assume that treasury management advisers are properly regulated. While local authorities must ultimately take responsibility for their investment decisions, a range of regulatory and advisory bodies appear to us to have been complacent in their approach to the role of treasury management advisers. The Audit Commission, CIPFA and the FSA must all re-examine the role and reliability of treasury management advisors and their discharge of duties of care for local authorities in managing this aspect of treasury management.

8 The Audit Commission

What is the Audit Commission's role in relation to local authorities?

122. The Audit Commission appoints the external auditors who are responsible for auditing all local authorities. The Audit Commission's written evidence states that these auditors:

have a responsibility to satisfy themselves that the audited body has put in place proper arrangements to secure economy, efficiency and effectiveness in its use of resources, in accordance with criteria specified by the Commission. These arrangements are defined by the statutory *Code of Audit Practice* to include the audited body's arrangements for managing its financial and other resources, including arrangements to safeguard the financial standing of the audited body.¹⁴⁹

123. As the Audit Commission's supplementary evidence points out, its work is necessarily retrospective, because the auditors focus on a local authority's annual accounts, and the financial management system and processes that were used during that year.¹⁵⁰ The appointed auditors cannot and do not advise on a local authority's treasury management strategy or policies "as they may subsequently have to review the effects of their implementation."¹⁵¹ Additionally, auditors are "mindful of the need to adopt a proportionate approach and to target audit work on the areas where the risks that something might go wrong are highest."¹⁵² This chapter explores whether the Audit Commission targeted work on treasury management sufficiently during 2007 to 2008, at a time when the banking world was subject to increased volatility, which consequently made treasury management an area of, arguably, greater risk.

Auditing practice

Risk of treasury management

124. The Chief Executive of the Audit Commission, Mr Bundred, told us in oral evidence:

Before the Icelandic banking collapse [...] we did not regard local authority treasury management as an area that was poorly managed or at great risk.¹⁵³

Mr Evans, the Managing Director of the Audit Commission, reiterated this point:

When auditors were planning their audits for 2007–08, frankly treasury management as an issue was not on their risk radar. Post-BCCI and the development of the CIPFA Treasury Management Code, it was generally thought that treasury management was a

¹⁴⁹ Ev 133

¹⁵⁰ Ev 135

¹⁵¹ *Ibid*

¹⁵² *Ibid*

¹⁵³ Q314

function that was well managed. The specific issues around Iceland did not feature until spring 2008.¹⁵⁴

125. In similar vein, the Audit Commission's supplementary evidence makes the following remarks about their lack of concern about Icelandic investments:

When auditors were planning their audits in 2007, they had no reason to consider treasury management to be a significant risk. Only a few experts in investments were drawing attention to the potential weakness of the Icelandic banks before the spring of 2008, and many not until the autumn.¹⁵⁵

126. The Audit Commission's case, therefore, is that there is nothing which it could reasonably have been expected to do which might have prevented, or restricted, the potential losses of local authorities in the Icelandic banks. We agree to this extent: there is an array of organisations, including the Treasury, the Department for Communities and Local Government, the Financial Services Authority, the Chartered Institute for Public Finance and Accountancy, rating agencies and treasury management advisers, which had varying responsibilities to regulate, warn, advise, give information or audit and which, to a greater or lesser degree, failed to warn local authorities of the risks involved in investing in Icelandic banks. However, the question is not whether the Audit Commission could or should have foreseen the failure of the Icelandic banks, but whether it should have been more aware of risks to treasury management generally, and acted accordingly.

The Audit Commission's own investments in Iceland

127. Evidence of the Audit Commission's complacency in respect of treasury management can be seen most clearly in the management of its own funds. The Commission has £10 million invested in Icelandic financial institutions: it has £5 million invested in Landsbanki, which was due to mature on 29 April 2009, and £5 million invested with its subsidiary, Heritable, due to mature on 29 June 2009. An internal audit review and a review by independent treasury experts at KPMG were commissioned by the Audit Commission to study the circumstances surrounding its own investments. The internal review drew the following conclusions:

- the Audit Commission made a deposit with one bank (Heritable)—a subsidiary of Landsbanki—without taking account of the increased risk created by that bank's reliance on a guarantee from Landsbanki;
- the Audit Commission relied on short-term credit ratings issued by Fitch to support investment decisions, without considering the long-term negative outlook warnings in respect of other Icelandic banks or other sources of information, including press speculation at the time;
- the process of investment had become too routine and was not scrutinised at a senior level.¹⁵⁶

¹⁵⁴ Q302

¹⁵⁵ Ev 137

¹⁵⁶ Audit Commission, *Internal audit review: investments in Icelandic banks*, 2008, p 1.

128. These conclusions are remarkably similar to some of those reached by the Audit Commission itself in the review of local authority treasury management practice referred to earlier in this Report, *Risk and Return*. For example:

- [...] The risks associated with seemingly different institutions may be highly correlated because they are in the same group, sector or country. These are not acknowledged [...]¹⁵⁷
- [...] Credit ratings are a useful indicator of likely performance and, therefore, a credible means of judging and managing risks. However, while ratings are an important piece of information, they do not give the whole picture. Their use should be supplemented with other information [...]¹⁵⁸
- [...] While officers from the best local authorities tend to be proactive in seeking feedback on treasury management policy and compliance, the governance and scrutiny of treasury management arrangements is generally poor [...].¹⁵⁹

129. The Audit Commission's belief that treasury management was a low-risk, well-managed function has therefore been shown to have been misguided. Measures could and should have been taken both by the Commission and by local authorities themselves to ensure that their own treasury management was being properly run. The Commission's responsibilities, however, go wider than merely the management of their own funds. Its defence that only a few experts were drawing attention to weaknesses in the Icelandic banks before spring 2008 misses the point, which is that the financial climate generally had become far more volatile and that the risk inherent in investment had therefore become greater.¹⁶⁰ Local authorities, with their £30 billion and more of investments, were exposed to that additional risk, and the Audit Commission—which claims that its “primary focus will always be safeguarding the interests of taxpayers”¹⁶¹—should have recognised as much.

What could the Commission have done?

130. The question remains of the extent to which the Audit Commission—even had it not considered treasury management to be low-risk—could and should have taken steps which might have minimised the risks which local authorities were running. The Audit Commission maintains that it audits retrospectively and cannot advise local authorities specifically on their treasury management policies. Mr Bundred, the Commission's Chief Executive, told us “it is not the role of the Audit Commission to give advice to local authorities about their investment decisions.”¹⁶² In its supplementary written evidence, the Commission explains why it would be inappropriate to give such advice:

¹⁵⁷ Audit Commission, *Risk and Return: English local authorities and Icelandic banks, Cross-cutting National report*, March 2009, p 31.

¹⁵⁸ *Ibid*

¹⁵⁹ *Ibid*, p 44.

¹⁶⁰ For some discussion of the changes in the financial climate, see the Seventh Report of the Treasury Committee, Session 2008-09, *Banking Crisis: dealing with the failure of the UK banks* (HC 416), paras 14-17.

¹⁶¹ Audit Commission website, <http://www.audit-commission.gov.uk/aboutus/>.

¹⁶² Q288

Auditors cannot comment or advise on an authority's treasury management strategy or policies, as they may subsequently have to review the effects of their implementation. Neither can they substitute their judgement on risk or second guess specific investment decisions by managers, as these are properly the responsibility of management.¹⁶³

The supplementary evidence also argues that:

The focus of auditors' work is a local authority's annual accounts and the financial management systems and processes that underpin them. Their work is therefore essentially retrospective.¹⁶⁴

131. We accept that it would be inappropriate for auditors to attempt to advise local authorities directly on their investment decisions. However, the Commission's contention that the nature of audit, being a retrospective judgement, meant that it could not have done anything to alert local authorities to the greater risks of treasury management is undermined by guidance it issued to its appointed auditors following the Icelandic banking collapse. In its supplementary evidence, the Audit Commission explained that the vast majority of local authority audits for 2007/8 were completed before the Icelandic banking collapse: of those local authorities with Icelandic deposits, only nine audits were outstanding at 7 October 2008.¹⁶⁵ However, subsequent to the news of the collapse of the Icelandic banks, the Audit Commission issued guidance to the auditors of those nine local authorities "on the implications [of the fact that they had money at risk] for their opinion on the accounts."¹⁶⁶ This seven-page document guides the auditor through the questions that should be asked about any investments that the local authorities might have made, and concludes with the following questions that auditors should ask when evaluating local authorities' investment arrangements:

Were all the deposits made in 2007–08 in compliance with the council's investment policy?

When were the deposits made? Was appropriate action taken as information became available and in the light of appropriate professional advice?

Is the investment policy consistent with a performing strongly score? E.g. was it subject to effective scrutiny and review, by those with appropriate skills and understanding? Is a limit set for investing in all institutions on the counterparties list (including subsidiaries, and so recognising the interdependence between Heritable and parent company Landsbanki)? Do the limits relate to the council's cash basis? Is there a clear assessment of risk to prevent over concentration of investment in a single bank? Who has responsibility for authorising deposits—does the officer have sufficient seniority and a relevant qualification? Does the strategy require consideration of long term credit ratings in addition to short term credit ratings? Credit ratings should be applied appropriately, accompanied by judgment/horizon scanning/independent advice. Is

¹⁶³ Ev 135

¹⁶⁴ *Ibid*

¹⁶⁵ Ev 137

¹⁶⁶ Ev 139

there evidence of this, e.g. was the risk associated with the higher returns for these deposits assessed?

Are decisions subject to effective scrutiny and are investments monitored on a regular basis?¹⁶⁷

132. Notwithstanding the Audit Commission’s disclaimers about what auditors can and cannot do, the guidance issued after the Icelandic banking collapse shows that there were questions that auditors could properly have asked to ensure that local authorities were following agreed treasury management procedures. If the Audit Commission’s auditors had followed this guidance as normal practice before the Icelandic banking collapse, local authorities might have been alerted to some of the failures in treasury management procedure which, in some cases, led to funds being put at risk.

133. This conclusion is supported by consideration of the position of one of the seven local authorities named in *Risk and Return*. Bridgnorth District Council invested £1 million in Iceland on 2 October 2008. Bridgnorth maintains that it was working within its delegated power and that its independent auditors, appointed by the Audit Commission to audit the council, confirmed that the investment had been appropriately made and that there was nothing untoward.¹⁶⁸ Council leader Elizabeth Yeomans made these comments, following publication of the Audit Commission’s report:

I am very concerned that the Audit Commission has criticised the council in a national report, when its own auditors have satisfied themselves that we acted reasonably.¹⁶⁹

134. Our point is not to question the Audit Commission’s view of the manner in which Bridgnorth acted on 2 October 2008. Our point is to demonstrate that the auditing practice was not adequate for the prevailing financial climate: auditors could and should have been required to satisfy themselves that authorities had suitable treasury management policies in place *and* that they were being followed correctly. As *Risk and Return* has subsequently demonstrated, this was clearly not the case in Bridgnorth, despite the clean bill of health given that authority by its auditor.

Conclusion

135. The Audit Commission took it for granted that treasury management was a well-managed function, and, consequently, was not an area of concern for auditors. Even if it could not reasonably have been expected to foresee the collapse of a country’s entire banking system, the Audit Commission should have been aware of the greater risk to treasury management as a result of the prevailing financial climate and should have adjusted its practice accordingly. The Audit Commission failed to realise that treasury management was becoming an increasingly risky area and, in that respect, it must share some of the blame for the potential loss of funds in the Icelandic banks. If it had viewed

¹⁶⁷ Audit Commission, extracts from weekly auditor communication (WAC) 41/2008, *Guidance to auditors on treasury management and Icelandic deposits*, 2008, p 6.

¹⁶⁸ <http://news.bbc.co.uk/1/hi/england/shropshire/7965124.stm>

¹⁶⁹ *Ibid*

treasury management within the increasingly volatile economic context, it would have put treasury management higher in its auditing procedures, and if it had done that, it is possible that less public money would now be at risk. We recommend that the Audit Commission review its own auditing procedure and prioritisation of the areas of local authority activity it chooses to audit, in order to ensure that such complacency does not happen in future.

9 The CIPFA Codes

136. The CIPFA Codes are summarised in Chapter 2. CIPFA’s written evidence reaches the following conclusions on its Treasury Management Code of Practice:

- The overall framework for local authority treasury management remains based on sound principles. However the application of the Code should continue to be developed and strengthened in line with developing best practice and current work being carried out by CIPFA.
- No treasury management activity is without risk and determining what level of risk is acceptable should be at the heart of local authorities’ treasury management policies. Treasury management policies should be designed to minimise the risk of capital loss but cannot eliminate it entirely.
- Clear governance arrangements are in place to ensure treasury management decisions are made in a public and transparent way with the full knowledge and approval of councils. Where individual authorities have not acted in accordance with the arrangements, procedures and protocols exist to deal with them.
- Greater regulatory control of local authority investments would be a response fraught with difficulties and potentially direct service implications; the framework should continue to be based upon professional decision making, ensuring that local authorities have access to the best possible advice to assist them in this role.¹⁷⁰

137. When giving oral evidence on 19 January, the Chief Executive of CIPFA, Mr Freer, said that the CIPFA Code of Practice would be reviewed, “irrespective of whether things appear to be going well or badly. That is just a part of the discipline of having an effective code of practice”.¹⁷¹ In the course of the inquiry, the Committee wanted to examine whether the CIPFA Codes were fit for purpose. Were last year’s investment problems due to local authorities’ failure to follow the Codes properly, amongst other factors, or were the CIPFA Codes themselves inadequate?

138. Throughout the report, we have highlighted instances where the CIPFA Codes are insufficient or inadequate and made recommendations for their improvement. These include the following issues:

- That counterparty lists need to be regularly reviewed and that local authorities should set a limit on the amount of money to be invested in a any one counterparty, foreign country or financial group.
- That there should greater emphasis on the training and expertise of in-house financial staff.

¹⁷⁰ Ev 62

¹⁷¹ Q 32

- That the Government, CIPFA and the LGA should study ways in which local authorities, particularly smaller ones, could join together to share expertise and pool treasury management resources.
- That all local authorities should be encouraged to have a dedicated Audit Committee to take responsibility for the scrutiny of TM policy and practice, with co-opted members who have treasury management experience.
- That the Treasury Management Code of Practice should make explicit the need for specific training in treasury management to be undertaken by those councillors with responsibility for overseeing treasury management arrangements. Such training should be monitored by the Audit Committee of each local authority.
- That proper, detailed scrutiny of Annual Investment Strategies should take place to ensure that local authorities are taking appropriate measures to mitigate risks in their investment strategies.
- That the Codes should ensure that local authorities are made aware of the proper use of credit ratings within the wider context of financial and economic information and advice.
- That the Codes need to give more guidance on the varying types of information or advice given by treasury management advisers to local authorities, especially those with no internal specialist staff.

Annual Investment Strategies

139. The one remaining aspect of the CIPFA Codes which we have not examined elsewhere in this report is the requirement for a local authority to produce an Annual Investment Strategy (AIS). Butlers argues that the current framework in respect of AISs does not need to change:

Changes to a predominantly sound system may inhibit the freedoms and flexibilities which local authorities need. The present difficulties stem from world-wide turmoil, not an inefficient framework of risk management. We see little merit in placing further restrictions on the Annual Investment Strategies of local authorities.¹⁷²

140. However, the Society of County Treasurers suggests that beneficial changes could be made to the requirements for AISs without inhibiting local freedom and flexibility:

It is a moot point as to whether greater regulation in this area is desirable or necessary. However any extension should be limited to an increase in the number of specific areas that need to be covered in the Annual Investment Strategy Statement without being prescriptive as to how each area is to be resolved. This will increase both transparency and member control of cash investment processes but retain the ability of local councillors to put in place procedures and investments that best meet local needs.¹⁷³

¹⁷² Ev 76

¹⁷³ Ev 87

The Society lists the following areas that could be made explicit in an annual investment strategy statement:

The use, or not, of an external advisor;

Schemes of delegation and the role of the Section 151 officer;

The use of and procedures regarding credit rating agencies.¹⁷⁴

141. The three areas that the Society of County Treasurers cite are three areas where practice has been found to be deficient, to a greater or lesser degree, in our inquiry. **We recommend that CIPFA add to the issues that need to be covered in a local authority's annual investment strategy (AIS) the use, or not, of an external advisor; schemes of delegation and the role of the Section 151 officer; and the use of and procedures regarding credit rating agencies. The guidance need not be prescriptive about the way in which the AIS should address these issues, but it should ensure that proper attention is paid to these previously under-scrutinised areas.**

¹⁷⁴ Ev 87

10 Central Government and local authority treasury management

CLG statutory guidance

142. The Minister for Local Government, Rt Hon John Healey MP, giving oral evidence to our inquiry, said:

I am pleased the Committee is doing this inquiry. It will help the work we are doing in revising our approach to investment guidance and the framework we have in place, which I intend to confirm after the Committee has made its recommendations so we can take those into account as part of that.¹⁷⁵

143. As set out earlier in this report, the structure of the present treasury management framework is constituted by primary legislation, the Local Government Act 2003; by secondary legislation, the Local Authorities (Capital Finance and Accounting)(England) Regulations 2003 [SI 3146]; and the CLG statutory guidance. The informal, accompanying commentary to the guidance, which has no statutory force, is the document that fleshes out the guidance. The CLG written evidence states that:

The guidance document is presented in two parts. One is the **formal statutory guidance** to which authorities are required by law to have regard. The other is a purely **informal commentary** and this has no statutory backing. The advantage of this structure is that the formal guidance can be kept concise, while the informal commentary can provide explanatory material and additional suggestions in more user-friendly terms.¹⁷⁶

144. CLG defends its guidance:

There have been no indications that the guidance is deficient. Contrary to recent statements in the media, the guidance definitely does *not* encourage authorities to maximise the return from their investments. It makes clear that authorities' overall aim should be to safeguard the funds they hold in trust for their communities and ensure the money can be accessed readily whenever needed. The informal commentary (though not the statutory guidance itself) then adds that, when these objectives have been properly addressed, authorities may reasonably turn their attention to the yield from their investments.¹⁷⁷

145. **We welcome the Government's willingness, as expressed by the Minister for Local Government in evidence to us, to revise its approach to investment guidance, and we trust that it will look closely again at that guidance in the light of the conclusions of this Report, especially at the issues surrounding the use of credit ratings. However, the failures in treasury management identified by our inquiry and by the Audit**

¹⁷⁵ Q 315

¹⁷⁶ Ev 113

¹⁷⁷ *Ibid*

Commission’s work have for the most part occurred not because of CLG’s guidance, but because of local authorities not following the guidance properly.

Should the Government protect local authorities’ money at risk in Iceland?

146. On 24 November 2008, CLG sent us a briefing note explaining the impact of the banking failure on local authorities and the help that the Government was offering local authorities. It listed three priorities: to help local authorities to get their money back; to offer help to any local authority facing severe short-term difficulties; and to consider the potential medium-term impact of any losses.¹⁷⁸

147. The Minister for Local Government, Rt Hon John Healey MP, discussed the impact of the banking failure on local authorities in the Local Government Finance debate in the House on 4 February 2009. There, he confirmed that the Government would take steps to ensure that any potential losses would not affect council budgets or council tax levels during the next year:

I also recognise the concerns of local authorities that have made investments in Icelandic banks. They have money that is clearly at risk, but it is not lost, and I want to help to minimise the problems for those authorities.¹⁷⁹

148. The question remained of whether the Government should go further, and protect local authorities’ investments in the same way that it has protected individuals’ savings. Our written evidence on this question was mixed. Some, such as the Society of County Treasurers, argued that, if it were to do so, the Government would need either to increase regulation or to reduce returns.¹⁸⁰ Others thought the events leading up to the collapse were so extraordinary, local authorities should be helped by the Government. This is a view held by the Society of Local Authority Chief Executives (SOLACE), for example, which argues that

Not doing so means that local authorities are left inexplicably unsupported (with costs ultimately borne by individuals through the Council Tax) whilst private institutions such as banks are provided with significant levels of public support.¹⁸¹

149. An alternative approach is to defer the impact of impairments for local authorities. We have already quoted the appeal of Mr Antill from Tewksbury Borough Council (which has £1 million invested in Iceland), representing the Society of District Council Treasurers, who in evidence to us argued that the scale of losses to his authority’s revenue account would be very difficult to manage over one year, and asked for help “on that front”.¹⁸²

¹⁷⁸ DAR 07-08, BP1, para 4 and 6, <http://www.publications.parliament.uk/pa/cm200708/cmselect/cmcomloc/memo/annual/contents.htm>

¹⁷⁹ HC Deb, 4 February 2009, col 902.

¹⁸⁰ Ev 87

¹⁸¹ Ev 57

¹⁸² Q 119

150. In oral evidence, the Minister was quite clear about the fact that local authorities are “informed investors” and that “we should expect them to take responsibility for the investment decisions they take.”¹⁸³ He went on to describe local authorities’ duties, as informed investors, within the Government framework:

They operate within, in my view, a generally sound system of guidance. They have certain clear duties. It is reasonable to treat them as informed investors. It is part of the principle of the framework that we have, that local authorities should take responsibility for the decision they take.¹⁸⁴

151. This view was upheld by the Treasury Select Committee, which published its report *Banking Crisis: The impact of the failure of the Icelandic banks* in April 2009. It made the following recommendation with regard to local authorities:

We acknowledge that some local authorities will feel hard done by as a consequence of the limitations of Government support for them. Local authorities are required to take their own decision on the level of prudent, affordable capital investment. They have a duty to the taxpayer diligently to protect the money they are investing on their behalf. Some authorities have shown themselves to be better than others in this regard. Under these circumstances it would seem perverse to reward those authorities who failed to protect their investment with yet more money from the taxpayer.¹⁸⁵

While we agree with our colleagues’ conclusion, we also welcome the Government’s regulation under section 21(1) of the Local Government Act 2003, which will have the effect of deferring the impact of impairments for local authorities’ Icelandic banks investments (“relevant investments”) until the 2010–11 financial year. This will help local authorities to delay the effects of any loss. We also welcome the Minister’s commitment in evidence to us on 27 October 2008 that he would be prepared to consider the capitalisation of local authorities to help them through a period of revenue pressure;¹⁸⁶ although we note that a recent CLG guidance note, *Capitalisation directions 2009–10: policy and procedures*, offers less hope of Government assistance of that kind, stating that “there will normally be no case for the capitalisation of potential losses of investments in Icelandic banks or loss of interest in respect of those investments.”¹⁸⁷

152. We agree with the Government’s approach to assisting those local authorities that have funds at risk in the failed Icelandic banks, which we consider to be an appropriate way of protecting the council tax payer whilst avoiding the “moral hazard” inherent in an unconditional, open-ended guarantee of local authorities’ investments. The Government will have to monitor closely the amount of money that local authorities eventually get back from Iceland to ensure that any actual losses do not seriously disadvantage either local council tax payers or local service uses. However,

¹⁸³ Q 317

¹⁸⁴ Q 324

¹⁸⁵ Fifth Report of the Treasury Committee, Session 2008-9, *Banking Crisis: The impact of the failure of the Icelandic Banks*, HC (2008-09) 402, paragraph 72.

¹⁸⁶ Oral evidence given to the Committee’s inquiry into *Communities and Local Government’s Departmental Annual Report 2008* (Second Report of 2008-09, HC 238), Q125.

¹⁸⁷ *Capitalisation directions 2009-10: policy and procedures: A guidance note by Communities and Local Government*, para 2.1.4.

democratically accountable local authorities are ultimately responsible for their investments and it is they who should take the consequences—whether in the budget or at the ballot box—of their investment decisions.

Overview of local authority investment decisions

153. The CLG memorandum explains that the principle of delegation inherent in the Local Government Act 2003 Act means that the Government does not carry out detailed monitoring of local authority investment activities. However, it states that CLG:

[...] maintains regular liaison with the local authority associations, CIPFA and the Audit Commission on a wide range of financial institutions. Through this route it is able to form a view as to how the system is working.¹⁸⁸

154. When the Minister was asked about the way in which the Government liaises with other bodies about the oversight of local authority decisions, he responded:

The approach that I have tried to explain to the Committee we take as the central department responsible ultimately is not one of oversight of the particular investment that local authorities choose to make. We are clearly responsible for legislation. We are clearly responsible for the guidance which we introduced in 2004. The professional accountancy body, CIPFA, are responsible for the more practical, more detailed and more day-to-day advice standards and training.¹⁸⁹

155. This answer implies that the Minister is not aware of the fact that the CLG supposedly maintains regular contact with local authority associations, CIPFA and the Audit Commission.¹⁹⁰ It is crucial that these main bodies meet regularly, especially in the current economic time, to gauge how the system of treasury management is working. It is at least possible that more regular critical consideration of the scrutiny and oversight of the local authority treasury management function might have prompted the Audit Commission to take a less complacent attitude towards this important local authority function.

156. We seek reassurance that regular meetings at an appropriately senior level are held between the Audit Commission, the local authority associations, CIPFA and CLG to ensure that the treasury management system is kept under review. We also recommend that these meetings include links with the financial regulatory bodies—the Financial Services Authority and the Bank of England—to ensure consistent and up-to-date information is passed onto these bodies.

Public Works Loan Board

157. Many local authorities have both debt and investments. An individual might be advised to pay off their debts before thinking about investing, especially in times of low interest rates. Most local authorities' long-term debt is funded by borrowing from the Public Works Loan Board (PWLB). Local authorities have always accepted that if they

¹⁸⁸ Ev 113

¹⁸⁹ Q330

choose to repay debt early, they may have to pay a premium when current interest rates are lower than the interest rate charged on the original loan.

158. However, in written and oral evidence, there was widespread criticism of the PWLB: changes to the arrangements for the early repayment of PWLB loans from November 2007 meant that a more penal interest rate applied to premature repayments, which made the costs of repayment higher. This resulted in repaying those loans becoming too expensive for local authorities so that they found it more advantageous to hold cash on deposit alongside the debt, rather than to repay the debt. This has resulted in some local authorities having more cash to invest in the money market than might otherwise have been the case.

159. As the PWLB's work was mentioned so frequently in written evidence, we asked them to submit their own written evidence. That evidence starts by placing its function in its historical context:

The PWLB is an independent statutory body dating from the eighteenth century and in its present form from 1875. It is headed by Commissioners, who are unpaid. Their function is to consider loan applications from prescribed bodies and where loans are made to collect the repayments. Nowadays almost all loans are to local authorities only, for capital purposes. Since 2002 the secretariat of the PWLB has been a unit of the UK Debt Management Office (DMO), operating from its offices in the City.¹⁹¹

160. The Debt Management Office sets the PWLB's rates of interest according to methodologies agreed with the Treasury, designed to protect the National Loans Fund (NLF), which is the source and recipient of PWLB funds. The PWLB's written evidence goes on to describe the process:

It is because the Board in effect on-lends the Government's own borrowings that rates are set according to the Government's cost of borrowing, plus a small margin. The effect of this is that local authorities can borrow at rates close to those at which the Government itself may do so, but it also means that the range of instruments that the Board can offer is limited to the basic and standard. The Board's function is to provide capital finance to local authorities, not to be an active treasury management counterparty. While the Board is open to requests to make early repayments, its terms will not favour the borrower over the National Loans Fund. This is because there is a working assumption that the NLF continues to meet the cost of financing the amount outstanding.¹⁹²

161. The PWLB memo describes the changes that occurred with effect from November 2007: two rates were established, one for new advances and the other for early repayments. The difference is "to take account of intra-day volatility and to compensate the NLF for the risk posed by mismatches in timing and maturity by pricing, albeit imprecisely, the option that local authorities have to repay early at discretion."¹⁹³ The two sets of rates introduced were intended to remove pricing anomalies which in some instances created the potential

¹⁹¹ Ev 150

¹⁹² *Ibid*

¹⁹³ *Ibid*

for *ex ante* risk of loss to the NLF, but the package also included features which benefited borrowers by facilitating finer rates for advances.¹⁹⁴

162. Overwhelmingly, in written evidence, local authorities were critical of the PWLB's change to the way in which local authorities can borrow and prematurely repay loans. Leeds County Council states that the PWLB changes

restrict the effective management of the Council's long term debt portfolio and reduce the opportunities to fairly take advantage of movements in the markets and generate discounts and interest savings for the Council and, through Housing subsidy, the Government. It also limits the ability to come out of high rate loans.¹⁹⁵

Brighton and Hove City Council similarly argues that, under current arrangements, a local authority is effectively penalised for choosing to repay its loans:

The discount rate is below the cost of Government borrowing—effectively there is a net cost in repaying debt prematurely as opposed to investing in Government stock.¹⁹⁶

163. On the other hand, our oral evidence session with local authority representatives suggested that the changes the PWLB had made were not quite as unreasonable as some of the written evidence implied. Mr Weaver, Director of Financial Services at Worcester County Council and President of the Society of County Treasurers, responded this way to our questioning on the subject:

I think, looking at this through the eyes of the Public Works Loan Board, they probably felt local government—forgive me for putting it this way—was onto a very good thing in the way the old rules worked. I think they have redressed the balance and it is unfortunate and disappointing that it is less advantageous to local government now than it was.¹⁹⁷

He added that, certainly in the case of county councils, early repayments are still being made:

From a county perspective I think we were disappointed that the rescheduling opportunities, the early repayment opportunities have become more expensive, but, truth to tell, local councils have responded to that. We are seeing premature, early repayments being made and I suspect if the Public Works Loan Board were here they would say, 'If it ain't broke, don't fix it.'¹⁹⁸

The PWLB's written evidence confirms that local authorities are repaying their debt to the PWLB early, despite the extra expense:

DMO/PWLB stated at the time of the changes that they were not intended to remove local authorities' opportunities for restructuring debt, and so it has proved. For

¹⁹⁴ Ev 150

¹⁹⁵ Ev 89

¹⁹⁶ Ev 73

¹⁹⁷ Q124

¹⁹⁸ Q123

example, in January, albeit an exceptionally busy month, borrowers repaid 437 loans early, amounting to principal of £2,628 millions and thereby realising discounts of £21.2 millions.¹⁹⁹

164. Nevertheless, there remained a feeling that there was scope for the PWLB to move back at least to some extent in favour of local authorities. Mr Cross, Head of Finance at Reading Borough Council, highlighted the problem that a margin was introduced between borrowing rates and repayment rates. He told us:

Whether the margin is at the right level for the long term, I think some of us on the local government side would query. There has been some activity in the last six month, probably a lot more activity in the last six months, but it has taken some fairly extreme movements in the UK yield curve that we have seen in the last six months to lead to that activity.²⁰⁰

165. The PWLB itself states that it is aware of local authorities' concerns "particularly at the size of the spread at the long end of the rate curve," and remains open to suggestions on way in which it can improve its service to borrowers, while protecting the NLF from loss.²⁰¹ The Audit Commission's report into the Icelandic funds at risk, *Risk and Return*, recommends that the Government review the cost of early repayment of debt to the PWLB, "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."²⁰²

166. Local authorities should not be in a position where it is financially advantageous to pay off debts only when interest rates for deposits are low. As CLG explained in written evidence, "It is generally accepted that it would be unlawful to borrow with the *sole* purpose of investing at a profit and without any spending objective."²⁰³ By the same token, holding a significant amount of cash in investments, with all the inherent risk which we have discussed earlier in this report, whilst a local authority also has borrowings, will not necessarily be in the public interest. **The majority of stakeholders in treasury management agree that the cost of early repayment of debt to the PWLB needs to be reviewed. We add our voice to those recommending that the Government carry out an urgent review of the arrangements for early repayment of debt to the PWLB.**

¹⁹⁹ Ev 150

²⁰⁰ Q124

²⁰¹ Ev 150

²⁰² Audit Commission, *Risk and Return: English local authorities and Icelandic banks, Cross-cutting National report*, March 2009, p 5.

²⁰³ Ev 112

11 Conclusion

167. The Government Guidance and the CIPFA Codes both give priority to the secure and prudent investment of local authority funds. Only after investments are deemed to be safe, and to provide sufficient liquidity, can consideration be given to the yield of interest from such funds. Despite this emphasis on security and prudence, English local authorities placed nearly £1 billion of investments in Icelandic banks, funds that are consequently at risk. The financial crisis which caused the collapse of the Icelandic banks in October 2008 is extraordinary, if not unprecedented. However, there were plenty of warnings of Iceland being in financial difficulty—some going back to 2006, and certainly many more from the spring of 2008—and, while a number of local authorities acted on these warnings and took steps to withdraw their money, others did not.

168. There have been claims that the Government guidance encourages authorities to maximise returns from their investments. However, as this Report's opening quotes illustrate, the guidance and accompanying CIPFA codes do not do so, and we do not believe there is a systemic failure in treasury management within local authorities. The problems of October 2008 arose from a web of interconnecting circumstances: a combination of extraordinary financial crisis; complacency, lack of expertise and inaction; official guidance that was right in principle but in certain respects insufficiently helpful in detail; and confusion over the roles of external advisers and agencies and the weight that should be given to their advice and information.

169. The principles enshrined in the Government guidance and the CIPFA Codes are clearly correct, but these particularly testing times have shown that there is significant room for improvement in the guidance and codes of practice for local authorities. They need to be more explicit in certain areas in order to make the system more transparent; to explain where the responsibilities lie, both in executing and in overseeing treasury management, including more rigorous training and reporting; and to highlight the variations of service on offer by different external service providers.

170. There is evidence of a failure to follow appropriate procedures and conduct adequate scrutiny of the treasury management function. Some local authorities relied too heavily on credit ratings without any mediation or interpretation of these data and there is evidence of a lack of training and relevant expertise in the financial teams. Reporting mechanisms to elected members responsible for scrutiny were either insufficient or were not acted upon by those members. The Audit Commission did not pay sufficient regard to the heightened risk of treasury management in the evolving financial climate and did not give sufficient guidance to their auditors until after the Icelandic banking collapse.

171. However, it was the role of external service providers, specifically some of the treasury management advisers, which caused the Committee most concern. We found a discrepancy between what some of these advisers said they offer and what they provide in practice—some purporting to provide information only, others stating that they give direct and specific advice about investments. Unsurprisingly, there is some confusion among local authorities about what they can and should expect from these advisers. This confusion needs to be resolved: the Audit Commission can help by carrying out a study of what local authorities get for their money.

172. Our inquiry revealed a lack of awareness of the relationship between treasury management advisers, brokers and counterparties. It is not always understood how treasury management advisers are paid for their services—whether through charging local authorities, from receiving commission by counterparties or brokers, or a combination. While some advisers are independent, others are part of a larger financial company, a situation that may give rise to actual or perceived conflicts of interest. To allay these fears, the Financial Services Authority should investigate the services provided by local authority treasury management advisers as soon as possible and should take a more active role in their regulation.

173. The responsibility of treasury management lies with local authorities: they are informed investors. However, measures can and should be put in place to strengthen the existing system to assist local authorities, to clarify procedures and to minimise the scope for failure and error. We trust that this report, together with the work being done by CLG, by CIPFA and by the Audit Commission, will assist in ensuring that local authority investment meets the primary requirement of meeting the need for security and liquidity, while also providing best possible yield, in the interests of council tax payers and the public purse.

Conclusions and recommendations

Local authorities' investments and reserves

1. We conclude that it would be inappropriate to seek to restrict local authorities' investment options. Although interest rates are now at historically low levels, returns on investments are usually an important source of local authorities' revenues and investment by local authorities an element in the health of the UK financial sector. The primary consideration of local authority investment, as emphasised by CIPFA, should remain security and liquidity; but yield should not be neglected. The risk involved in seeking yield should be mitigated by robust and responsive Codes, guidelines and best practice. (Paragraph 37)

Local authorities' financial teams

2. We endorse the Audit Commission's censure of these rudimentary mistakes in organisations responsible for investing large amounts of public money. However, as the Commission's research has found, those seven authorities were not necessarily the only local authorities at fault. (Paragraph 42)
3. It is obvious from our written evidence, and from the research carried out by the Audit Commission, that there are some local authorities with excellent treasury management services, but there are also local authorities with a less effective service. One of the objectives of the CIPFA Codes and Codes of Practice should be to ensure that all local authorities are aware of the level of expertise which is necessary to run a successful treasury management operation, and have all the checks and balances in place to ensure adequate monitoring, on an ongoing basis, of both the framework within which its treasury management team operates and the individual decisions which are made on a day-to-day basis. (Paragraph 49)
4. We recommend that the Government, CIPFA and the LGA study ways in which local authorities, particularly smaller ones, could join together to share expertise and pool treasury management resources. The sharing of information and expertise, such as identifying banks that are in the same financial group, might have lessened the failures that occurred during the Icelandic crisis. (Paragraph 56)

Scrutiny of the treasury management function

5. We endorse the Minister's suggestion and recommendations by CIPFA and the Audit Commission that all local authorities should have an Audit Committee with specific responsibility for the scrutiny of the treasury management function. Guidance to local authorities to that effect should be given through appropriate amendment to the CIPFA Codes. (Paragraph 68)
6. Members of audit committees need to take their responsibilities for that scrutiny seriously and need to ensure that they are properly trained. The CIPFA Treasury Management Code of Practice should make explicit the need for specific training in treasury management to be undertaken by those councillors with

responsibility for overseeing treasury management arrangements, and the Audit Committee should be charged with ensuring that it is available and with monitoring its adequacy. (Paragraph 69)

7. **Guidance from CIPFA notes that it is open to an authority to appoint someone other than an elected member and from outside the authority either to serve on or to chair the audit committee. The co-option of external members to audit committees in this manner offers an additional opportunity to local authorities to enhance the expertise available to the authority in the scrutiny of its treasury management function, and we encourage all local authorities to consider taking advantage of it. (Paragraph 70)**
8. **Whether a local authority has an Audit Committee or not, elected members should ensure that they pay proper attention to scrutiny of the Annual Investment Strategy (AIS), and of the decisions which are taken under it. We recommend that CIPFA, in reviewing its Codes, consider what further guidance is necessary to local authorities to ensure that elected members are given—and take—appropriate opportunities to scrutinise their AIS. We also recommend that CIPFA develop and include in its revised Codes more rigorous requirements for reporting to elected members on decisions taken by officials under the AIS. (Paragraph 71)**

Credit rating agencies

9. **The lack of information about the appropriate use of credit ratings in the Government guidance and in the CIPFA Codes is an omission. Some local authorities have relied too heavily on credit ratings, without appreciating that they should be viewed within the context of other financial and economic information and advice. We welcome the new guidance from the CIPFA Treasury Management Panel, but believe that there is room to go further. We recommend that the Government revise the informal commentary on its statutory guidance, to include information about the appropriate use of credit ratings. We also recommend that the CIPFA Codes include guidance to local authorities on the nature of credit ratings, highlighting the risks of over-reliance on them. Credit ratings should not be used in isolation as a justification for the soundness of an investment and local authorities should be made aware of the fact that credit ratings should be viewed within the context of wider financial and economic information and advice. (Paragraph 81)**

Treasury management advisors

10. **Responsibility for local authorities' investment decisions lies, and must continue to lie, with the local authorities themselves. However, the claim by some treasury management advisers that they give information only, not advice, on investment counterparty creditworthiness to local authorities is, in our view, misleading. (Paragraph 99)**
11. **The involvement of treasury management advisers in local authority treasury management will only be valuable if local authorities understand the level of**

service they require, and if the advisers themselves are clear about the level of service they are providing. Treasury management advisers must decide, define and communicate what services they are providing clients, particularly in relation to the provision of “information” and/or “advice”. The local authority itself nevertheless remains ultimately responsible for any investment made, and CIPFA should warn local authorities about over-reliance on treasury management advisers, whose services have been shown to be variable and, in some cases, inadequate. (Paragraph 100)

12. We recommend that the Audit Commission carry out a value for money study of the services that local authorities have received from treasury management advisers, with a view to advising local government on the value that they offer in the differing circumstances applying to individual authorities. (Paragraph 101)
13. We recommend that the CIPFA Codes give more detailed advice to local authorities on the services which they may expect to receive from treasury management advisers, and how to use them effectively. The guidance should make clear that such advisers may give varying types and levels of information or advice. (Paragraph 105)
14. The Financial Services Authority (FSA) should take a more active role in the regulation of treasury management advisers. The evidence which we have examined has raised concerns about potential conflicts of interest and questions as to whether there are any financial transactions between treasury management advisers and brokers that might compromise the independence of advice being given to local authorities. There is a strong case for a full investigation by the FSA of the services provided by local authority treasury management advisers. We recommend that such an investigation be carried out as soon as possible. (Paragraph 120)
15. Our examination of the role of treasury management advisers in the Icelandic debacle has raised wider questions about their influence on local authorities’ treasury management practice. First, there is confusion, and perhaps some deliberate ambiguity, about what services they offer. It is clear to us that some local authorities believed that they could place reliance on their treasury management advisers in a way that some of the treasury management advisers themselves now seek to argue was misguided. Second, there is concern about the independence of treasury management advisers that may be part of companies that will benefit from the investment decisions of the local authorities that they advise. Third, there is a lack of clarity about the extent to which local authorities can assume that treasury management advisers are properly regulated. While local authorities must ultimately take responsibility for their investment decisions, a range of regulatory and advisory bodies appear to us to have been complacent in their approach to the role of treasury management advisers. The Audit Commission, CIPFA and the FSA must all re-examine the role and reliability of treasury management advisors and their discharge of duties of care for local authorities in managing this aspect of treasury management. (Paragraph 121)

The Audit Commission

16. Notwithstanding the Audit Commission's disclaimers about what auditors can and cannot do, the guidance issued after the Icelandic banking collapse shows that there *were* questions that auditors could properly have asked to ensure that local authorities were following agreed treasury management procedures. If the Audit Commission's auditors had followed this guidance as normal practice before the Icelandic banking collapse, local authorities might have been alerted to some of the failures in treasury management procedure which, in some cases, led to funds being put at risk. (Paragraph 132)
17. The Audit Commission took it for granted that treasury management was a well-managed function, and, consequently, was not an area of concern for auditors. Even if it could not reasonably have been expected to foresee the collapse of a country's entire banking system, the Audit Commission should have been aware of the greater risk to treasury management as a result of the prevailing financial climate and should have adjusted its practice accordingly. The Audit Commission failed to realise that treasury management was becoming an increasingly risky area and, in that respect, it must share some of the blame for the potential loss of funds in the Icelandic banks. If it had viewed treasury management within the increasingly volatile economic context, it would have put treasury management higher in its auditing procedures, and if it had done that, it is possible that less public money would now be at risk. We recommend that the Audit Commission review its own auditing procedure and prioritisation of the areas of local authority activity it chooses to audit, in order to ensure that such complacency does not happen in future. (Paragraph 135)

The CIPFA Codes

18. We recommend that CIPFA add to the issues that need to be covered in a local authority's annual investment strategy (AIS) the use, or not, of an external advisor; schemes of delegation and the role of the Section 151 officer; and the use of and procedures regarding credit rating agencies. The guidance need not be prescriptive about the way in which the AIS should address these issues, but it should ensure that proper attention is paid to these previously under-scrutinised areas. (Paragraph 141)

Central Government and local authority treasury management

19. We welcome the Government's willingness, as expressed by the Minister for Local Government in evidence to us, to revise its approach to investment guidance, and we trust that it will look closely again at that guidance in the light of the conclusions of this Report, especially at the issues surrounding the use of credit ratings. However, the failures in treasury management identified by our inquiry and by the Audit Commission's work have for the most part occurred not because of CLG's guidance, but because of local authorities not following the guidance properly. (Paragraph 145)

20. We agree with the Government's approach to assisting those local authorities that have funds at risk in the failed Icelandic banks, which we consider to be an appropriate way of protecting the council tax payer whilst avoiding the "moral hazard" inherent in an unconditional, open-ended guarantee of local authorities' investments. The Government will have to monitor closely the amount of money that local authorities eventually get back from Iceland to ensure that any actual losses do not seriously disadvantage either local council tax payers or local service users. However, democratically accountable local authorities are ultimately responsible for their investments and it is they who should take the consequences—whether in the budget or at the ballot box—of their investment decisions. (Paragraph 152)
21. We seek reassurance that regular meetings at an appropriately senior level are held between the Audit Commission, the local authority associations, CIPFA and CLG to ensure that the treasury management system is kept under review. We also recommend that these meetings include links with the financial regulatory bodies—the Financial Services Authority and the Bank of England—to ensure consistent and up-to-date information is passed onto these bodies. (Paragraph 156)
22. The majority of stakeholders in treasury management agree that the cost of early repayment of debt to the PWLB needs to be reviewed. We add our voice to those recommending that the Government carry out an urgent review of the arrangements for early repayment of debt to the PWLB. (Paragraph 166)

Formal minutes

Tuesday 12 May 2009

Members present:

Dr Phyllis Starkey, in the Chair

Mr Clive Betts
John Cummings
Andrew George

Emily Thornberry
Mr Neil Turner
David Wright

Local authority investments

Draft Report (*Local authority investments*), proposed by the Chairman, brought up and read.

Ordered, That the Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 173 read and agreed to.

Summary agreed to.

Resolved, That the Report be the Seventh Report of the Committee to the House.

Ordered, That the Chairman make the Report to the House.

Written evidence reported to the House and ordered to be published on 15 December, 9 February, and 16 and 30 March was ordered to be reported for printing with the Report.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

[Adjourned till Monday 18 May 2009 at 4.20 pm]

Witnesses

Monday 19 January 2009

	<i>Page</i>
Mr Howard Knight , independent consultant	Ev 1
Mr Steve Freer, Chief Executive, CIPFA and Mr Chris Bilsland, the Chamberlain of the City of London, attending in his capacity as Chair of the CIPFA Local Government Policy Panel	Ev 5

Monday 26 January 2009

Mr Mike Weaver, Director of Financial Services, Worcestershire County Council, representing the Society of County Treasurers as its President, Mr Peter Antill, Director of Resources, Tewkesbury Borough Council, representing the Society of District Council Treasurers as a member of its Executive Committee and Mr Alan Cross, Head of Finance, Reading Borough Council	Ev 12
Mr Mark Horsfield, Director, Arlingclose , Mr Chris Anthony, Managing Director, Butlers , and Mr David Whelan, Managing Director, Sector	Ev 18
Councillor Richard Kemp, Deputy Chair, the Local Government Association and Councillor Merrick Cockell, Chairman, London Councils	Ev 27

Monday 9 February 2009

Mr Jeremy Palmer, Head of Financial Policy, Building Societies Association , Mr Guy Sears, Director, Wholesale, Investment Management Association and Mr Richard Warne, Head of UK Institutional Business Development, Aviva Investors representing Investment Management Association	Ev 32
Mr Steve Bundred, Chief Executive and Mr Martin Evans, Managing Director (Audit), Audit Commission	Ev 37
Rt Hon John Healey MP, Minister for Local Government, Mr Graham Duncan, Acting Director, Local Government Finance and Mr Graham Fletcher, Local Government Accountancy adviser, Communities and Local Government	Ev 41

List of written evidence

1	Society of District Council Treasurers	Ev 47
2	Guildford Borough Council	Ev 48
3	Arlingclose	Ev 52
4	Arlingclose (supplementary)	Ev 56
5	The Society of Local Authority Chief Executives and Senior Managers (SOLACE)	Ev 56
6	Councillors David Boothroyd and Paul Dimoldenberg, Westminster City Council	Ev 57

7	Chartered Institute of Public Finance and Accountancy (CIPFA)	Ev 61
8	Bournemouth Borough Council	Ev 72
9	Brighton and Hove City Council	Ev 72
10	Reading Borough Council	Ev 73
11	Butlers	Ev 75
12	Butlers (supplementary)	Ev 81
13	Society of County Treasurers	Ev 85
14	Leeds City Council	Ev 87
15	CIPFA Scottish Directors of Finance Section and CIPFA Scottish Treasury Management Forum	Ev 92
16	Local Government Association	Ev 94
17	Local Government Association (supplementary)	Ev 102
18	Financial Services Authority	Ev 105
19	Financial Services Authority (supplementary)	Ev 106
20	Plymouth City Council	Ev 107
21	Communities and Local Government	Ev 110
22	Communities and Local Government (supplementary)	Ev 114
23	London Councils	Ev 115
24	Sector	Ev 117
25	Building Societies Association	Ev 118
26	Howard Knight	Ev 122
27	Howard Knight (supplementary)	Ev 124
28	Martin Hickman, Consumer Affairs Correspondent, <i>the Independent</i>	Ev 130
29	Martin Hickman, Consumer Affairs Correspondent, <i>the Independent</i> (supplementary)	Ev 132
30	The Audit Commission	Ev 132
31	The Audit Commission (supplementary)	Ev 135
32	Investment Management Association (IMA)	Ev 139
33	Moody's Investors Service	Ev 143
34	Sterling Consultancy Services	Ev 146
35	Public Works Loan Board (PWLB)	Ev 149
36	District Councils Chief Executive Network	Ev 150
37	Torbay Council	Ev 151
38	Fitch Ratings	Ev 153

List of unprinted evidence

The following memoranda have been reported to the House and published on the Committee's website, but to save printing costs they have not been printed and copies have been placed in the House of Commons Library, where they may be inspected by Members. Other copies are in the Parliamentary Archives, and are available to the public for inspection. Requests for inspection should be addressed to The Parliamentary Archives, Houses of Parliament, London SW1A 0PW (tel. 020 7219 3074). Opening hours are from 9.30 am to 5.00 pm on Mondays to Fridays.

Bridgenorth District Council

Blackpool Council

Hartlepool Borough Council

Norfolk County Council

Harrogate Borough Council

National Association of Local Councils

Sefton Council

Luton Borough Council

Society of London Treasurers

Stephen Gilbert

The Association of Corporate Treasurers (ACT)

Kent County Council

List of Reports from the Committee during the current Parliament

The reference number of the Government's response to each Report is printed in brackets after the HC printing number.

Session 2008–09

First Report	Work of the Committee in 2007–08	HC 120
Second Report	Communities and Local Government's Departmental Annual Report 2008	HC 238 (<i>Cm 7614</i>)
Third Report	Housing and the Credit Crunch	HC 101 (<i>Cm 7619</i>)
Fourth Report	Appointment of the Chair of the Infrastructure Planning Commission	HC 354
Fifth Report	New Towns Follow-Up—Government Response to the Ninth Report of the Committee, Session 2007–08	HC 253
Sixth Report	Balance of Power: Central and Local Government	HC 33-I & II
Seventh Report	Local authority investments	HC 164-I & II

Session 2007–08

First Report	Coastal Towns: the Government's Second Response	HC 69
Second Report	DCLG Annual Report 2007	HC 170 (<i>Cm 7335</i>)
Third Report	Local Government Finance—Supplementary Business Rate: the Government's Response	HC 210
Fourth Report	Work of the Committee in 2007	HC 211
Fifth Report	Ordnance Survey	HC 268
Sixth Report	Refuse Collection: Waste Reduction Pilots	HC 195
Seventh Report	Existing Housing and Climate Change	HC 432 (<i>Cm 7428</i>)
Eighth Report	The Supply of Rented Housing	HC 457-I & II (<i>Cm 7326</i>)
Ninth Report	New Towns Follow-Up	HC 889
Tenth Report	Community Cohesion and Migration	HC 369-I & II (<i>Cm 7489</i>)
Eleventh Report	Planning Matters—labour shortages and skills gaps	HC 517-I & II (<i>Cm 7495</i>)
Twelfth Report	The Provision of Public Toilets	HC 636 (<i>Cm 7530</i>)
First Special Report	Ordnance Survey: Government's Response to the Committee's Fifth Report of Session 2007–08	HC 516
Second Special Report	Refuse Collection: Waste Reduction Pilots—Government Response to the Committee's Sixth Report of Session 2007–08	HC 541
Third Special Report	Local Government Finance—Supplementary Business Rate: the Government Response: Government Response to the Committee's Third Report of Session 2007–08	HC 1200

Session 2006–07

First Report	The Work of the Committee in 2005–06	HC 198
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Second Report	Coastal Towns	HC 351 (<i>Cm 7126</i>)
Third Report	DCLG Annual Report 2006	HC 106 (<i>Cm 7125</i>)
Fourth Report	Is there a Future for Regional Government?	HC 352-I (<i>Cm 7119</i>)
Fifth Report	Refuse Collection	HC 536-I
Sixth Report	Equality	HC 468 (<i>Cm 7246</i>)
Seventh Report	Local Government Finance—Supplementary Business Rate	HC 719
Eighth Report	Local Government Finance—Council Tax Benefit	HC 718
First Special Report	Local Government Finance—Council Tax Benefit: Government's Response to the Committee's Eighth Report of Session 2006–07	HC 1037
Second Special Report	Refuse Collection: Government's Response to the Committee's Fifth Report of Session 2006–07	HC 1095

Session 2005–06

First Report	ODPM Annual Report and Accounts	HC 559 (<i>HC 1072</i>)
Second Report	Re-licensing	HC 606 (<i>Cm 6788</i>)
Third Report	Affordability and the Supply of Housing	HC 703-I (<i>Cm 6912</i>)
Fourth Report	The Fire and Rescue Service	HC 872-I (<i>Cm 6919</i>)
Fifth Report	Planning Gain Supplement	HC 1024-I (<i>Cm 7005</i>)
First Special Report	Government Response to the Committee's Fourth Report of Session 2004–05, on the ODPM Annual Reports and Accounts 2004	HC 407
Second Special Report	Government Response to the Committee's Eleventh Report of Session 2004–05, on the Role and Effectiveness of The Local Government Ombudsmen for England	HC 605
Third Special Report	Government Response to the Committee's Seventh Report of Session 2004–05, on the Role and Effectiveness of the Standards Board for England	HC 988
Fourth Special Report	Government Response to the Committee's First Report of Session 2005–06, on the ODPM Annual Report and Accounts 2005	HC 1072