When banks collapse

Executive summary

- Last year the three main Icelandic banks went bust, taking with them millions of pounds belonging to English local authorities. Various agencies and organisations have since issued guidance and recommendations to prevent a repeat of the episode.

A number of key events are etched on the memories of treasury managers in local government. The collapse of BCCI in 1991 and the Hammersmith and Fulham swaps case in 1992 (relating to activity during the mid-1980s) are two of the biggest. The question is, will last year's collapse of the Icelandic banks ultimately have equally profound consequences for local authorities? There is no doubt that there has been a massive media and public scrutiny reaction to the news that councils had £1bn invested in Icelandic banks – funds which are now at risk.

In due course, parliament's Communities and Local Government Select Committee will conclude its review of local authority investments. As well as suggesting improvements in the way local authorities invest, it seems likely to include recommendations about how effective democratic overview and scrutiny of investment decisions can be secured. It is perhaps this distinctive characteristic of local authority investment that puts it at the forefront of public commentary, while other institutions with money at risk in Iceland remain below the press radar.

Local authorities are responsible for stewarding and, where appropriate, investing large sums of public money. As a result they are heavily regulated in the way they can invest surplus cashflows arising from cash-backed reserves, the sale of capital assets and working capital surpluses. There is direct regulation through government investment guidance and via the treasury management code issued by CIPFA (Chartered Institute of Public Finance and Accountancy). The current framework was introduced following the collapse of BCCI Bank and has therefore been in place for an extended period.

In the meantime the Audit Commission has recently issued its Risk and Return report. Its main conclusions are relatively positive: "The Commission finds that the majority of councils acted properly in managing their investments and were alert to the risks."

However, the headlines were grabbed by the commission's controversial decision to describe the investment decisions of seven councils as negligent.

Inevitably, there are lessons and areas for improvement arising from the Iceland crisis. Indeed, on the day the Audit Commission report was issued, CIPFA published a bulletin outlining a number of changes and initiating a consultation process on a revised treasury management code.

So what does the Audit Commission study imply for future practices? And how do its conclusions affect the bulk of local authority investment?

From the outset the review puts the money currently at risk in the collapsed Icelandic banks into context. As at October 2008, 451 local authorities had total investments of more than £31bn, earning total interest of £1.8bn for 2008/09. The £1bn at risk is therefore equivalent to about 3% of total investments, or just over half the annual investment income.

The report acknowledges that, overall, local authorities did react to the emerging signs of trouble in the Icelandic bank crisis, with total deposits halving from their level of £2bn in January 2008: "As a group, local authorities heeded the warning signs and anticipated the

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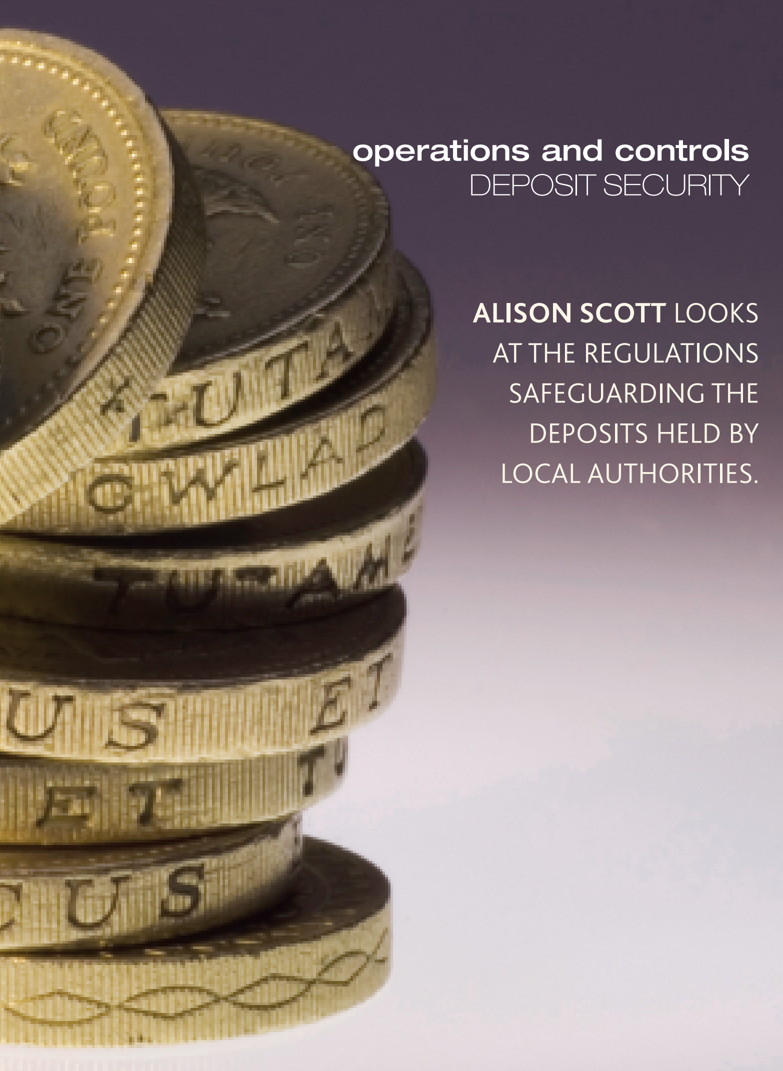

operations and controls
DEPOSIT SECURITY

ALISON SCOTT LOOKS AT THE REGULATIONS SAFEGUARDING THE DEPOSITS HELD BY LOCAL AUTHORITIES.

downward shift in credit ratings. Some 56% of local authorities either never invested in the Icelandic banks, or made no further investments after 31 October 2007. Furthermore, between November 2007 and 6 October 2008, 18% of local authorities removed all their deposits in the Icelandic banks as they matured."

While overall councils read the warning signs and acted to withdraw funds, the report recognises there were varying practices between individual local authorities. It identifies that the best authorities:

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

In the light of this, the commission's recommendations focus to a large extent on the need to bring all councils up to the standard of the best.

The Audit Commission recommends that all authorities start by questioning whether they have the skills, capacity and appetite to manage risk by placing funds with financial institutions. If the answer is no, then they should instead place funds with the UK government's Debt Management Office, which makes a deposit facility available to local authorities, although generally at lower interest rates than available in the markets. It should, of course, be recognised that this does not absolve local authorities from their treasury management responsibilities. It merely minimises one area of risk.

Much debate has ensued about local authorities' reliance on credit ratings and their treasury management advisers. Recommendations for government and CIPFA guidance make it clear that local authorities should be using a wide range of information and not just relying on credit ratings. Ratings will, however, remain an important factor in decision-making as a transparent indicator of the financial strength of an institution. It is hoped that, as we move forward,

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THERE IS A DEMAND FOR A MORE SPECIALIST QUALIFICATION IN PUBLIC SECTOR TREASURY MANAGEMENT. CIPFA IS WORKING WITH THE ACT TO OFFER A NEW JOINT QUALIFICATION. THIS WORK IS WELL DEVELOPED AND THE NEW QUALIFICATION IS DUE TO BE LAUNCHED IN JUNE.

improved regulation of the credit rating agencies will bring new rigour and credibility to this process.

Because it is public money being invested, lending lists are open to public scrutiny and subject to challenge. They therefore need to be compiled by reference to evidence-based criteria. At the same time treasury managers must devote time to keeping abreast of day-to-day market developments and intelligence and using the knowledge gained to inform their decision-making.

Local authorities' use of treasury management advisers is a more contentious area and led to a lively session of the select committee. Local authorities contract with firms to provide treasury management advice; however, they receive no direct recommendations as to where to invest, but help in determining their overall investment strategies and details of credit ratings for the institutions with which they decide to invest. The debate on the role of advisers is likely to rumble on and the Audit Commission report draws the sensible conclusion that authorities need to be clear about the role of their external advisers and recognise that councils themselves remain accountable for decisions made.

A number of recommendations cover how elected local councillors can be more fully involved in treasury management decisions and how they can be equipped for the task. Since the collapse of BCCI, the introduction of the CIPFA treasury management code, the government's investment guidance and the prudential code mean that the annual investment strategy and treasury management strategy for a local authority are approved at the meeting of full council that agrees the budget for the next year.

This means that all councillors should be aware of the organisations being invested in and the maximum amounts that can be put with each of them. The Audit Commission recommends that such decisions are scrutinised in detail by a specialist committee, usually the Audit Committee, before being accepted by the authority, and that training is provided to committee members to enable them to carry out this function confidently and effectively.

Approval by full council is a good discipline but there is a danger that the council's budget report may overshadow treasury management matters and receive less attention than is ideally required. The best authorities will ensure that key figures are brought in within the main budget report and that the strategy is subject to discussion either beforehand within the executive committee or subsequently by overview and scrutiny.

It is important to recognise here that the executive committee is a decision-making committee. CIPFA suggests a clear role for the audit committee, which is the key financial overview and scrutiny committee, in reviewing treasury management strategies as it is a key focus for building the financial understanding and knowledge of elected councillors.

Moving forward, councillors must develop the skills they need, not to duplicate the work of the professionals on whom they should be able to rely, but to be able to understand the potential investment risks the authority is taking and to ask the right questions.

The final key area in which the Audit Commission makes recommendations concerns the skills and capabilities of those carrying out treasury management in local authorities and the need to ensure that the treasury management function is appropriately resourced and that staff have the right skills and access to information and advice. Once again this is an area of significant variation within local authorities. Some have strong treasury departments with extensive in-house expertise while others are more reliant on a mixture of fewer staff, for some of whom treasury management may only be part of their job, and external advice.

The CIPFA qualification includes treasury management as part of its overall syllabus. The institute also provides support through a whole range of publications and events, and the CIPFA Treasury Management forum. It has been recognised for some time, however, that there is a demand for a more specialist qualification in public sector treasury management. To this end CIPFA is working with the ACT to offer a new joint qualification. This work is well developed and the new qualification is due to be launched in June.

As a result of the Icelandic bank collapse, the recent Audit Commission report and the select committee report when that is published, it seems unlikely that there will be wholesale changes to the way treasury management operates in local authorities. However, it is hoped that a stronger, more confident and better-trained treasury management function will emerge that will be the subject of improved engagement with and scrutiny by elected members.

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