

# Risk

---

# and return

---

English local authorities and the  
Icelandic banks



**Cross-cutting**

**Summary**

March 2009

 **audit**  
commission

**The Audit Commission is an independent watchdog, driving economy, efficiency and effectiveness in local public services to deliver better outcomes for everyone.**

**Our work across local government, health, housing, community safety and fire and rescue services means that we have a unique perspective. We promote value for money for taxpayers, auditing the £200 billion spent by 11,000 local public bodies.**

**As a force for improvement, we work in partnership to assess local public services and make practical recommendations for promoting a better quality of life for local people.**

**© Audit Commission 2009**

**This document is available on our website at:  
[www.audit-commission.gov.uk](http://www.audit-commission.gov.uk)**

**If you require a copy of this document in large print, in Braille, on tape, or in a language other than English, please call: 0844 798 7070. If you require a printed copy of the full report, please call: 0800 50 20 30  
or email: [audit-com-publications@capita.gov.uk](mailto:audit-com-publications@capita.gov.uk)**

**For further information on the work of the Commission please contact:**

**Audit Commission,  
1st Floor, Millbank Tower,  
Millbank, London SW1P 4HQ  
Telephone: 020 7828 1212  
Fax: 020 7976 6187  
Textphone (minicom): 020 7630 0421  
[www.audit-commission.gov.uk](http://www.audit-commission.gov.uk)**

**We welcome your feedback. If you have any comments on this report, are intending to implement any of the recommendations, or are planning to follow up any of the case studies, please do get in touch:  
please email [nationalstudies@audit-commission.gov.uk](mailto:nationalstudies@audit-commission.gov.uk)**

---

# Summary

---

## **Local authorities invest large sums of public money**

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

---

## **Deposits were widely spread**

- On 7 October 2008, local authorities held deposits in 144 different organisations.
- Fifty-seven per cent of funds were held in UK organisations, the remainder in banks whose owners were based in 24 other countries.
- More than 20 per cent of deposits were in Irish institutions.

---

# Summary

---

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

- Icelandic deposits amount to about 3 per cent of the total on deposit.
- One hundred and twenty-seven authorities are affected.
- Thirty have funds greater than 5 per cent of gross revenue expenditure at risk.
- Councils are not expecting to cut services or increase council tax significantly as a direct result.

---

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

- The total on deposit halved between April and September 2008.
- The number of new deposits fell, but net new deposits after 1 April 2008 exceeded £500 million.
- Seven local authorities deposited money after credit ratings in Icelandic banks were downgraded below acceptable levels, failing, in the Commission's view, to take reasonable steps to ensure they were using up-to-date information, and hence putting public money at risk.

---

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

- Statutory guidance gives weight to credit ratings, but not to other relevant information.
- The Chartered Institute of Public Finance and Accountancy (CIPFA) guidance gives insufficient attention to risks which may be inter-related, for example banks in the same group or country.
- More guidance is needed about how to manage the full range of risks.

---

## **Local authority treasury management is of variable quality**

- The best authorities:
  - explicitly balance risk and reward;
  - review and scrutinise policies and procedures regularly;
  - have well trained staff and engaged elected members; and
  - use a wide variety of information.
- Poorer authorities:
  - have weak governance;
  - depend exclusively on credit ratings; and
  - have staff who are inadequately trained.

---

# Recommendations

---

## **Central government should:**

- Review and revise the weaker aspects of the national framework highlighted in this report, especially the weight given to credit rating;
- Enable and require the Debt Management Office (DMO) to provide deposit accounts to public bodies if those bodies cannot achieve the security they require in the market; and
- Review the cost of early repayment of debt to the Public Works Loans Board to ensure that the structure introduced in November 2007 is not acting against the wider public interest by encouraging authorities to hold unnecessarily large deposits.

---

## **CIPFA should:**

- Revise and tighten its code of practice for treasury management to take account of the findings in this report;
- Make more explicit the element of the prudential code that allows loans to be drawn down ahead of actually spending the money. Loans should be drawn down only after risks are fully assessed;
- Continue to work with the Association of Corporate Treasurers to develop appropriate training and qualification for those working in treasury management in local authorities; and
- Coordinate information sharing between local authorities to enable them to learn from one another. Any benchmarking activities should, as a minimum, highlight measures of security and liquidity of funds as well as yield.

---

# Recommendations

---

## **Local authorities should:**

- Set the treasury management framework so that the organisation is explicit about the level of risk it accepts and the balance between security and liquidity and the yield to be achieved. At the highest level, the organisation should decide whether it has:
  - appetite and capability to be able to manage risk by placing funds with financial institutions; or
  - no appetite and/or insufficient capability to manage the risk of placing funds in the market, and should instead place funds with the UK government's Debt Management Office;
- Ensure that treasury management policies:
  - follow the revised CIPFA code of practice;
  - are scrutinised in detail by a specialist committee, usually the audit committee, before being accepted by the authority; and
  - are monitored regularly;
- Ensure elected members receive regular updates on the full range of risks being run;
- Ensure that the treasury management function is appropriately resourced, commensurate with the risks involved. Staff should have the right skills and have access to information and external advice;
- Train those elected members of authorities who have accountability for the stewardship of public money so that they are able to scrutinise effectively and be accountable for the treasury management function;

- 
- Ensure that the full range of options for managing funds is considered, and note that early repayment of loans, or not borrowing money ahead of need, may reduce risks;
  - Use the fullest range of information before deciding where to deposit funds;
  - Be clear about the role of external advisers, and recognise that local authorities remain accountable for decisions made; and
  - Look for economies of scale by sharing resources between authorities or with pension funds, while maintaining separation of those funds.

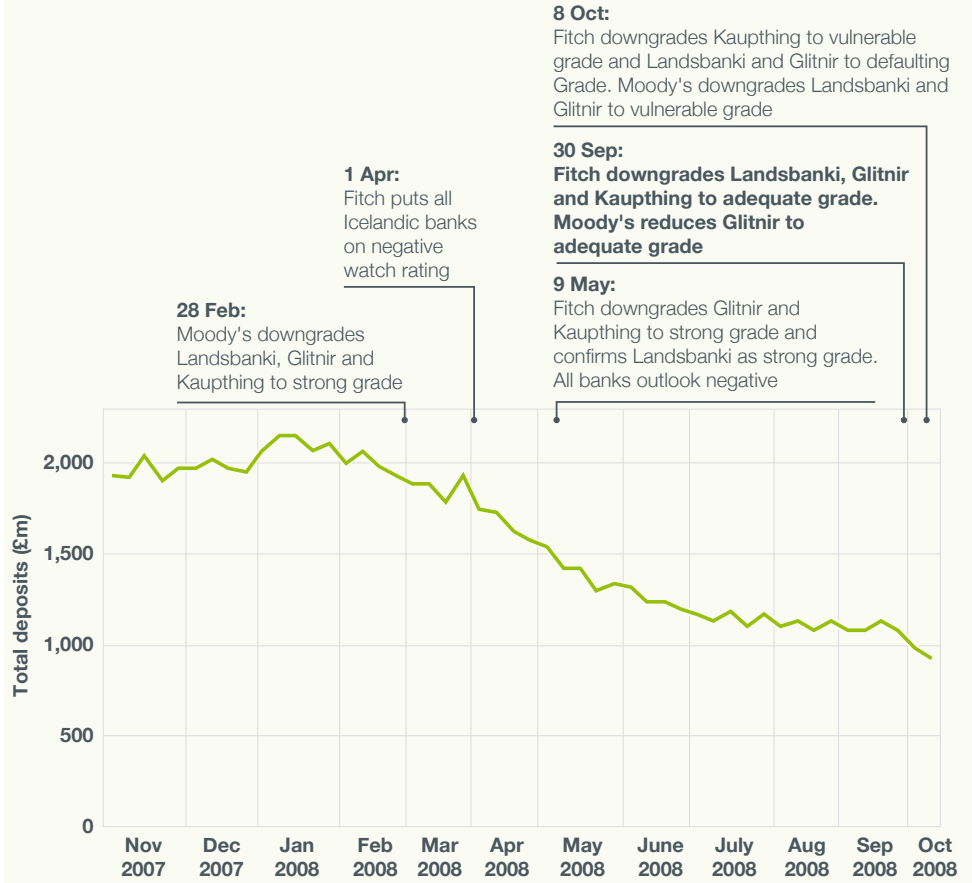
---

### **The Audit Commission will:**

- Ask auditors to follow up this report as part of their use of resources work for 2008/09 and future years;
- Work with CIPFA to ensure that the lessons in this report and the research on which they are based are included in the revised treasury management guidance; and
- Work with others to produce guidance and tools for those in councils with a need to understand the treasury management function.

## Local authorities heeded the warning signs

Deposits in Icelandic banks halved between January and October 2008.



Source: Audit Commission

## Credit ratings fell during 2008

A variety of credit ratings were downgraded

### 28 Feb:

Moody's downgrades Landsbanki, Glitnir and Kaupthing to strong grade

### 1 Apr:

Fitch puts all Icelandic banks on negative rating watch<sup>1</sup>

### 30 Sep:

Fitch downgrades Landsbanki, Glitnir and Kaupthing to adequate grade. Moody's downgrades Glitnir to adequate grade

### 8 Oct:

Fitch downgrades Kaupthing to vulnerable grade and Landsbanki and Glitnir to defaulting grade. Moody's downgrades Landsbanki and Glitnir to vulnerable grade



### 21 Apr:

Standard and Poor downgrades Glitnir to adequate grade

### 9 May:

Fitch downgrades Glitnir and Kaupthing to strong grade and confirms Landsbanki as strong grade. All banks outlook negative<sup>1</sup>

### 9 Oct:

Fitch downgrades Kaupthing to defaulting grade. Moody's downgrades Kaupthing to vulnerable grade

### AC Standardised ratings

AAA - Extremely strong grade

AA - Very strong grade

A - Strong grade

BBB - Adequate grade

BB - Speculative grade

B - Very speculative grade

CCC - Vulnerable grade

D - Defaulting grade

Source: Audit Commission adaptation of credit ratings produced by Fitch, Moody's, and Standard and Poor's

- I A ratings watch indicates that there is a heightened probability of a rating change in the short term [www.fitchratings.com](http://www.fitchratings.com)
- II A negative rating outlook indicates that a credit rating may change in the next one to two years [www.fitchratings.com](http://www.fitchratings.com)

Copies of the full report are available at: [www.audit-commission.gov.uk](http://www.audit-commission.gov.uk) or to order a printed copy telephone: 0800 502030 quoting stock code: LNR3514.



**Audit Commission,  
1st Floor  
Millbank Tower,  
Millbank  
London SW1P 4HQ**

**Telephone: 020 7828 3131**

**Fax: 020 7976 6187**

**Textphone (minicom): 020 7630 0421**

**[www.audit-commission.gov.uk](http://www.audit-commission.gov.uk)**

Stock code: LSY3515