Extract from Treasury Select Committee Report on the Banking Crisis: The impact of the failure of the Icelandic banks - Treasury

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4 Charities and local authorities

The local authorities

64. In the week beginning 6 October 2008, a number of Icelandic banks went into administration. As we have discussed, the Government took action to safeguard the interests of UK retail creditors of these banks. As the crisis unfolded a number of organisations not covered by the Government's guarantee began to identify how much money they had lost. It quickly became clear that a large number of local authorities had invested money with the Icelandic banks.[124]

ADVISED TO INVEST?

65. On 17 October, the Local Government Association (LGA) reported that 123 authorities had deposited an estimated £919.6m in Icelandic banks and their UK licensed subsidiaries.[125] Deposits were held by councils, fire and rescue, and passenger transport, national parks, pensions and waste authorities. The Audit Commission put the value of deposits as high as £953.53m, a figure which represented a little over 3 per cent of the local authorities' deposits. [126] According to the Audit Commission, 30 organisations had sums at risk that exceeded five % of gross revenue expenditure.[127] Kent County Council had the highest amount deposited with £48.9m held in Icelandic banks.[128] When asked if local authorities were advised to invest public money offshore, Councillor Richard Kemp, Deputy Chairman, LGA, told us that "there was no advice not to".[129]

66. Under the Local Government Act 2003, each local authority must take its own decisions on how and where to invest its funds and must have regard to the Chartered Institute of Public Finance and Accountancy (CIPFA) Prudential Code for Capital Finance in Local Authorities. CIPFA also publishes a Treasury Management Code, which sets out the procedures and policies that each authority should follow.[130] The LGA informed us that local authorities should spread their investment risks with 5% or at the very maximum 10% of total investments invested in one institution or sovereign.

67. Many local authorities employ private sector advisors, who have specialised knowledge and skills in understanding money markets. The main private-sector advisors to local authorities in the United Kingdom (Arlingclose, Butlers and Sector) have recently given evidence to the Communities and Local Government (CLG) Committee. Their evidence offered several accounts of what happened in relation to the advice given on Icelandic banks and we look forward to the CLG Committee's forthcoming report on local authority investments.[131]

RELIANCE ON CREDIT RATING AGENCIES

68. When we asked who was to blame for the loss of local taxpayers' money, Councillor Kemp told us that he believed that there had been "a series of

failures within the system". We were told that the LGA had sought investment advice from "ministers, from Parliament, from regulators, from the credit reference agencies, a whole variety of people".[132]

69. Some local authorities apparently continued to invest in the Icelandic banks and their UK subsidiaries as they continued to receive "relatively high ratings" from the credit ratings agencies[133] up until the afternoon of 30 September.[134] Councillor Merrick Cockell, Chairman, London Councils, told the CLG Committee that local councils "have to rely on credit rating agencies". He argued that the purpose of credit rating agencies was to "provide the sort of advice which non-experts, and indeed experts, require, looking … at the detail of financial institutions and working out whether they are safe or less safe bets."[135] The Building Societies Association agreed that ratings were a "useful tool", but cautioned that their track record in enabling investors to avoid credit losses in the banking crisis had been unimpressive.[136] What is very surprising is that after April 2008 the credit rating agencies began downgrading the ratings of Glitnir and Kaupthing and the Fitch ratings agency produced a damning special report on Iceland on 22 May 2008, yet some local authorities persisted in placing new investments in these institutions. Even after a very significant downgrade in September 2008 which extended to Landsbanki, seven local authorities persisted in depositing sums amounting to £32.8m over the next few days, in breach of treasury management policies. [137]

70. We will consider the wider issues of the extent to which the credit rating agencies were implicated in the banking crisis in a future report.

PLEA FOR ASSISTANCE

71. Councillor Kemp told us that the Government had helped local authorities in the short term "by allowing us to withdraw concerns about Iceland from the equivalent of our balance sheet for this financial year so we do not have to take it into account".[138] The LGA was asking for "capitalization of the money because some councils would find it very difficult to pay their sums back in one year, if the crunch came to it". The Government had refused to allow councils to spread the capitalization of their lost assets across a period of years.[139] Councillor Kemp concluded that local authorities had "invested properly on the advice of all those people, including the Chancellor and we should have our money back".[140]

72. **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 decisions 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.**