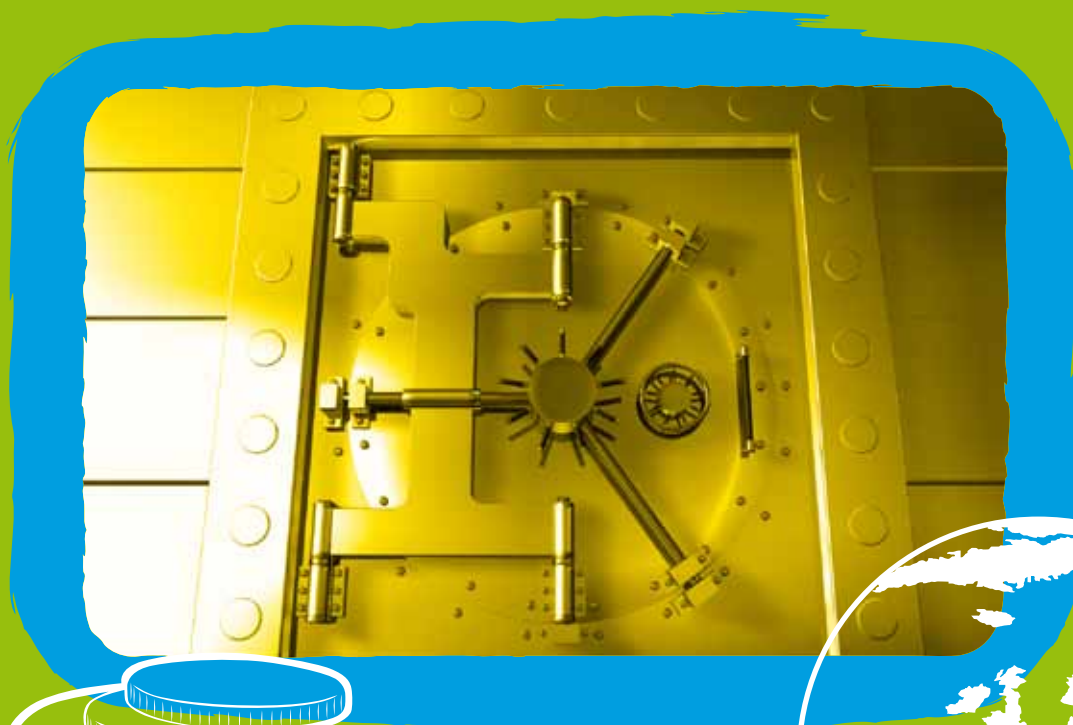


Risk and return

English local authorities and the
Icelandic banks



Cross-cutting
National report
March 2009

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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

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Preface

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

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

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

The Audit Commission itself made deposits totalling £10 million in two Icelandic banks. We have reviewed our own approach, identified weaknesses and taken action. The lessons were captured in an internal audit report and an external review which were published on the Commission's website.¹

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

¹ <http://www.audit-commission.gov.uk/reports/NATIONAL-REPORT.asp?CategoryID=%26ProdID=8D06A805-9DB6-4BAB-BE17-8D0089352F9E>

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 owned institutions.

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

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

Summary

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 authorities negligently deposited money after credit ratings for Icelandic banks were downgraded below acceptable levels.

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.

Introduction

- 1 The world is experiencing an economic downturn of exceptional proportions. The origins of the credit and manufacturing crunch can be traced back to the US and the sale of risky mortgages, as well as to the creation of ever more complex financial products, designed by the international banks to package and sell on debt and risk.
- 2 In February 2007, several large American commercial banks, including Citibank, Merrill Lynch and Morgan Stanley, reported losses associated with mortgage defaults. By summer 2007, what had previously been seen as America's problem became international, as banks around the world began to realise that they too, had bought debt and risk associated with the American sub-prime mortgage market. The banks began to restrict new lending as they wrote off billions of dollars of losses.
- 3 During the summer and autumn of 2007, central banks in the US, UK and Europe attempted, unsuccessfully, to overcome the credit crunch by making billions of dollars available to banks that were facing funding problems. Nonetheless, the credit crunch intensified and claimed a number of casualties during spring 2008, including UK high street bank, Northern Rock, and US commercial bank, Bear Stearns. As 2008 progressed, the banking crisis deepened, world stock markets fell and economies contracted. In September 2008, the US government took the unprecedented step of rescuing Freddie Mac and Fannie Mae, the country's largest mortgage lenders. The same month saw the collapse of Lehman Brothers, the take-over of Merrill Lynch and Halifax Bank of Scotland; and the nationalisation of Bradford and Bingley.
- 4 Iceland was the first and, so far, only country, to see the collapse of its entire banking sector. In early October 2008, Iceland's three largest commercial banks, Glitnir Bank hf, Kaupthing Bank hf and Landsbanki Islands hf, together with their UK registered subsidiaries, Heritable Bank plc and Kaupthing, Singer & Friedlander Ltd, went into administration. Press reports suggest that the failure of the Icelandic banks has put at risk approximately £11 billion in deposits made by UK investors, in addition to the £4.3 million refunded to retail depositors by compensation schemes.

- 5** One hundred and twenty-seven English local authorities are among the many UK public sector institutions that have funds in one or more of the Icelandic banks. Between them, these 127 local authorities have deposits totalling more than £954 million. While this money is not necessarily lost, it is too early to say how much will be recovered, or when and on what terms it will be repaid. Deposits made by the local authorities are not covered by any central government guarantee scheme.
- 6** Of course, banking and financial crises are nothing new; nor is this the first time that local authorities have faced losses following the failure of a bank. Most notably, in 1991, 32 UK local authorities faced losses totalling £90 million following the closure of the Bank of Credit and Commerce International (BCCI). While BCCI creditors have so far recovered 86.5 per cent of their losses, it took more than five years before any repayment dividends were made. A total of seven dividends have now been paid, the most recent in December 2008. The liquidators say that at least one further dividend will be paid, but the amount and timing are uncertain.
- 7** The repercussions of the collapse of the Icelandic banks have raised questions about the stewardship of funds held by local authorities. Management of these funds is part of treasury management, a small but important function within authorities. Treasury managers are charged with maintaining the security and liquidity of an organisation's cash assets, while generating a yield or return on that money.
- 8** With the benefit of hindsight, we now know that the risk of a banking failure was greater than most people had anticipated. Nevertheless, there are lessons to be learned from the collapse of the Icelandic banks. Treasury managers could and should have been aware that there were risks associated with making investments and that, in particular, there were risks associated with investing in some institutions. Good treasury managers recognised those risks and managed them appropriately. Others either did not appreciate the risks, or underestimated their significance.

Introduction

- 9** This report examines local authorities' arrangements for placing and managing cash on deposit. The report aims to help local authorities to learn lessons from the recent economic events and improve their treasury management processes. This report does not cover local authorities' treasury management arrangements for borrowing or managing debt. Nor does it review the performance of external treasury advisers, brokers or credit rating agencies. Research for this review was carried out between December 2008 and March 2009. Details of the study methodology can be found in Appendix 1.
- 10** There are five key messages.
- Local authorities have used interest from cash deposits as a valuable source of income.
 - The sums of money involved are large and invested widely. On 7 October 2008, 451 local authorities had invested £31 billion, more than 40 per cent of it overseas.
 - Almost 3.1 per cent of all deposits were held in the failed Icelandic banks. One hundred and twenty-seven local authorities held deposits, but delivery of services has not, as yet, been affected.
 - The national treasury management framework is broadly right, but weaknesses in the detail have contributed to poor practice. In particular, there is little recognition that risks associated with placing deposits with different banks may be highly correlated because they are in the same group, country or sector. Additionally, the government's investment guidance gives too much weight to credit ratings at the expense of using a range of information sources.
 - Local treasury management arrangements vary. The best organisations balance risk and reward and arrangements include: regular review and scrutiny of policy and procedure; appropriately trained staff and engaged elected members; and the use of a wide range of information including, but not limited to, credit ratings.

11 This report has five chapters:

- Chapter 1 – Local authorities are custodians for large sums of public money
- Chapter 2 – Local authorities and the Icelandic banks
- Chapter 3 – The treasury management framework
- Chapter 4 – Treasury management in local authorities
- Chapter 5 – Conclusions

12 Further advice and guidance will be available to download from the Audit Commission's website in summer 2009.

1 | Local authorities are custodians for large sums of public money

13 This chapter considers the sums of public money held, managed and invested by local authorities.

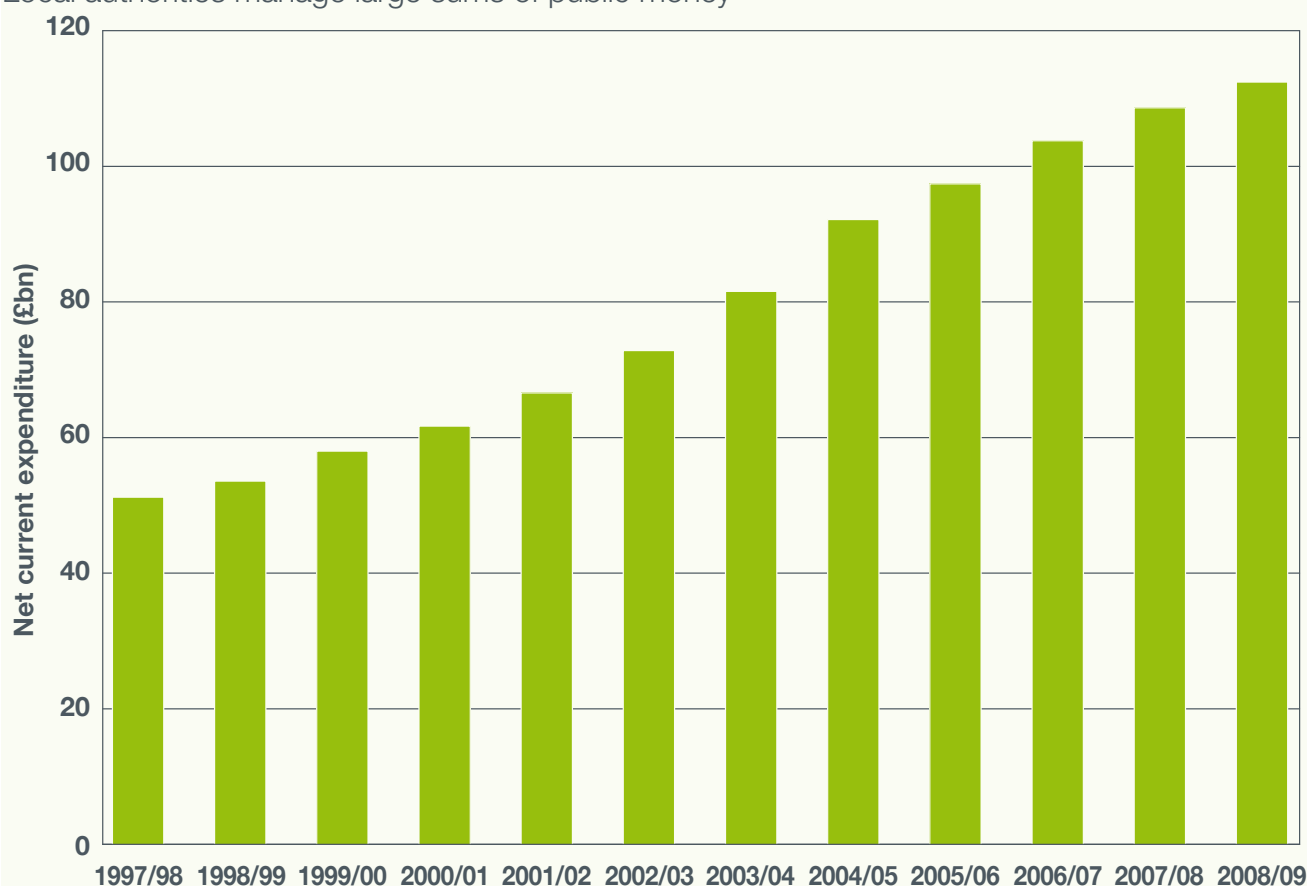
Local authorities manage large sums of public money

14 Local authorities manage large sums of public money.¹ The amounts have increased in recent years (Figure 1). For example, in 1997/98, net expenditure on services was £51 billion and in 2008/09 expenditure will be in the region of £112 billion.

Figure 1

Expenditure in local authorities

Local authorities manage large sums of public money



Source: Audit Commission

¹ Local authorities in this report include councils, police authorities, fire and rescue authorities, waste authorities, passenger transport executives, passenger transport authorities and pension authorities.

- 15** Local authorities hold some money in reserve to manage cash flow and to meet predicted liabilities. The Local Government Finance Act, 1992 (Ref. 1) requires local authorities to consider the level of reserves required when setting budgets and council tax. CIPFA advises that local authorities consider the establishment and maintenance of reserves when reviewing medium-term financial plans and when preparing annual budgets (Ref. 2). CIPFA's guidance indicates that reserves are necessary, but recognises the different circumstances of each local authority and rejects the idea of a generally prescribed optimum or minimum level of reserves.
- 16** The level of reserves held by local authorities has more than doubled in recent years. In 2008, the Audit Commission reported that English local authorities held £12.6 billion or 13 per cent of their annual expenditure in reserves in March 2008, compared with £5.5 billion or 8 per cent five years earlier (Ref. 3).
-
- Local authorities draw an income from surplus cash**
- 17** Local authorities draw an income from surplus cash, by placing it on deposit in bank or building society accounts, or in money market investments. The amounts invested have doubled in the past decade; and at the end of March 2008, local authorities held deposits totalling £29 billion, compared with £15 billion in March 2000. On 7 October 2008, 451 local authorities held deposits worth £31 billion (Table 1).

1 | Local authorities are custodians for large sums of public money

Table 1

Local authorities held deposits worth £31 billion on 7 October 2008

Local authorities invest surplus cash

Local authority	Deposits (£bn)
County councils	6.9
District councils	6.1
London borough councils	6.0
Unitary authorities	3.7
Metropolitan district councils	3.6
Fire authorities and other bodies	3.0
Police authorities	1.7
Total	31.0

Source: Audit Commission

18 The sums on deposit on 7 October 2008 far exceeded reported reserves. The money invested came from a number of sources, including reserves and other cash arising from, for example, the disposal of assets and the normal timing differences between receipt of income and expenditure. Additionally, some funds will have come from money borrowed in advance of need in order to take advantage of favourable interest rates, or from not repaying debt despite having the cash to do so.

19 For example, one local authority took advantage of favourable interest rates by investing money that had been borrowed up to three years in advance of planned capital expenditure. It reported building up substantial amounts of additional funds using this strategy. The same local authority recently changed its approach as market rates no longer favour having large amounts of borrowing. However, the authority intends to reintroduce a strategy of borrowing in advance of need if and when favourable conditions arise.

20 Interest earned from investments is an important source of income for local authorities. Indeed, applying a typical interest rate of 5.9 per cent to total deposits suggests that local authorities earned around £1.8 billion in income from interest in 2008/09. For some small local authorities, budgeted income from interest has equalled the amount realised from council tax receipts in recent years.

21 It is both practical and prudent for local authorities to draw an income from their surplus cash. But, as custodians of large sums of public money, local authorities must exercise due diligence. In particular, the recent falls in interest rates mean that income from interest earned on cash deposits is likely to decline in the current and, possibly, future years. However, interest costs on borrowed funds are typically fixed. Consequently local authorities that have borrowed in advance of need will now be experiencing significant net interest costs due to significantly lower returns on cash investments, where there was a positive contribution during 2008. Local authorities will need, therefore, to manage budgets and medium-term financial plans accordingly; and they must ensure that an appropriate balance is struck between protecting capital and maximising interest returns.

2 | Local authorities and the Icelandic banks

22 This chapter considers local authorities' exposure to the failed Icelandic banks. It considers the scale of the sums at risk and discusses local authorities' responses to the warning signs.

A short history of the Icelandic banks

23 The rise and fall of the Icelandic banking sector can be traced back to political and financial decisions taken in the mid to late 1990s, when the Icelandic economy began a period of rapid growth, particularly in heavy industries associated with cheap, clean, renewable energy, such as aluminium smelting. At the same time, the Icelandic government began a programme of privatisation of state assets, which included deregulating the financial sector, creating an independent Central Bank of Iceland, and privatising the commercial banks.

24 The three largest commercial banks, Glitnir Bank hf (Glitnir), Kaupthing Bank hf (Kaupthing) and Landsbanki Islands hf (Landsbanki), evolved quickly into major international operators, funded largely by borrowing money on the international wholesale markets. Some commentators raised concerns at the high levels of borrowing, and rising domestic debt and inflation rates. But, to others, these were offset by perceived strong financial regulators, low unemployment and a fully funded pension system. However, the markets reacted negatively, leading to a fall in stock prices and a drop in the value of the Icelandic krona in early 2006.

25 The commercial banks and the Central Bank of Iceland responded by developing a recovery plan that was based on:

- gaining foreign deposits to back assets acquired abroad;
- creating, by acquisition, international subsidiaries, such as UK-based Heritable Bank plc (Heritable) and Kaupthing, Singer and Friedlander Ltd (KSF); and
- raising domestic interest rates.

26 The recovery plan appeared to be a success and, by late 2007, between them Glitnir, Kaupthing and Landsbanki had enabled Icelandic companies, such as Baugur, to acquire foreign assets worth almost nine times the value of the Icelandic economy. However, financial commentators began to voice concerns that the banks had expanded too quickly, that they had borrowed too much foreign currency and that they would face problems refinancing their debts, particularly in the face of a global credit crunch. Indeed, by March 2008, the cost to the Icelandic banks of insuring debt was among the highest in the world at between 7 and 9 per cent of debt. In contrast, other European banks were paying an average of 1.5 per cent.

- 27** Commentators continue to debate the precise circumstances surrounding the collapse of the Icelandic banks. Many argue that the trigger was the decision of the US government to allow Lehman Brothers, the US bank, to collapse in September 2008. What is clear, however, is that the credibility of the Central Bank of Iceland as a lender of last resort was called into question, given the level of debt in comparison with the size of the domestic economy. Concerns were also raised about the ability of the banks to repay the number of short-term deposits that were due to mature.
- 28** The consequence was that, once again, financial share prices fell and the value of the Icelandic krona dropped, but this time so sharply that the banks faced short-term funding problems. The Icelandic government made preparations to nationalise Glitnir partially on 29 September 2008 and suspended trading in some financial shares on 6 October 2008. But on 7 October 2008, before arrangements for nationalisation could be completed, Glitnir and Landsbanki went into receivership, closely followed by Kaupthing on 8 October 2008. On the same day, the UK government froze UK-based assets of the Icelandic banks.

The scale of UK deposits in Iceland

- 29** The Icelandic banks attracted many UK investors and their failure has put at risk more than £11 billion. Government guarantee schemes and other initiatives mean that around £4.3 billion has already been returned to individual depositors. But public sector bodies, charities, universities and private sector institutions hold deposits that are not covered by government guarantee schemes. While the absolute sums of money at risk are difficult to quantify, it is estimated that public sector institutions hold deposits of at least £1 billion, charities hold around £120 million; and press reports suggest that private sector institutions, including a number of building societies, hold deposits of at least £10 billion. This money is not necessarily lost, but it is too early to say how much will be recovered, or when and on what terms it will be repaid.

2 | Local authorities and the Icelandic banks

English local authorities hold deposits totalling £953.53 million

30 English councils, police, fire and rescue, passenger transport, national parks, pensions^I and waste authorities hold deposits worth £953.53 million in two of the three failed Icelandic banks (Glitnir and Landsbanki) or their UK subsidiaries

(Heritable and KSF) (Table 2). Of the 127 local authorities that are affected, councils have the largest exposure, with 105 holding deposits worth more than £793 million. The other 22 are police, fire and rescue and passenger transport, national parks, pension and waste authorities, which between them hold deposits of almost £160 million (Appendix 2).

Table 2

Local councils hold most deposits

Of the 127 local authorities with Icelandic deposits 105 are local councils

Local authority	Number affected and as percentage of number of type of authority	Deposits (£m)
County councils	15 (44%)	269.77
District councils	58 (24%)	231.05
London borough councils	11 (33%)	152.61
Unitary authorities	13 (28%)	105.40
Police authorities	12 (32%)	84.51
Fire authorities and other bodies ^{II}	10 (16%)	77.91
Metropolitan district councils	8 (22%)	32.28
Total	127 (26%)	953.53

Source: Audit Commission

^I This does not include pension funds administered by local authorities.

^{II} Fire and rescue authorities, passenger transport bodies, national parks, pension authorities and waste authorities.

- 31** Local authorities manage large and diverse investment portfolios. It is, therefore, important to consider the sums at risk in context. On 7 October 2008, local authorities held deposits in 144 different organisations, or counterparties. Almost 3.1 per cent of all investments were deposited in the Icelandic banks or their UK subsidiaries.
- 32** Local authorities' combined exposure to the collapse of the Icelandic banks amounts to less than 1 per cent of the planned spend of all local authorities for 2008/09. However, the exposure of individual local authorities varies and, for some, the impact could be significant. In cash terms, the largest single exposure is in a county council, which holds deposits of £48.9 million. But both large and small authorities have been hit. When deposits are standardised to adjust for size, 30 organisations have sums at risk that exceed 5 per cent of gross revenue expenditure (GRE), of which 27 are district councils, two are passenger transport bodies and one is a police authority.^I Four district councils hold deposits that exceed 20 per cent of GRE (Appendix 2).
- 33** Local authorities have a statutory obligation to plan and deliver a balanced budget. Consequently, any losses arising from placing deposits in the Icelandic banks would normally need to be provided for as soon as they could be reliably estimated. Such losses would ordinarily be charged to the general fund, in full, in the year they were identified, either by raising additional income or by reducing expenditure. A statutory override (Ref. 4), which makes amendments to the 2003 Capital Finance Regulations, will come into effect on 31 March 2009. The measure will allow local authorities to defer recognition of any potential losses arising from investments until 2010/11.
- 34** Unless further statutory changes are made, local authorities will need to account for any losses in the medium term. There is no evidence as yet that the sums at risk in the Icelandic banks will lead to service cuts or to council tax rises and it is unlikely that the performance of local government will be affected in the short or medium term. But the level of reserves held by each local authority will affect its ability to recover from the impact of the Icelandic banks' failure. Eighteen local authorities have sums at risk that exceed 100 per cent of their reserves;^{II} and 14 of the local authorities so affected are district councils (Appendix 2).

^I Sums at risk were compared to the GRE, a broad measure of spending.

^{II} CIPFA: Memorandum – Estimated unearmarked and earmarked general reserves (excluding schools' reserves, housing revenue account and pension funds) as at 1 April 2008.

2 | Local authorities and the Icelandic banks

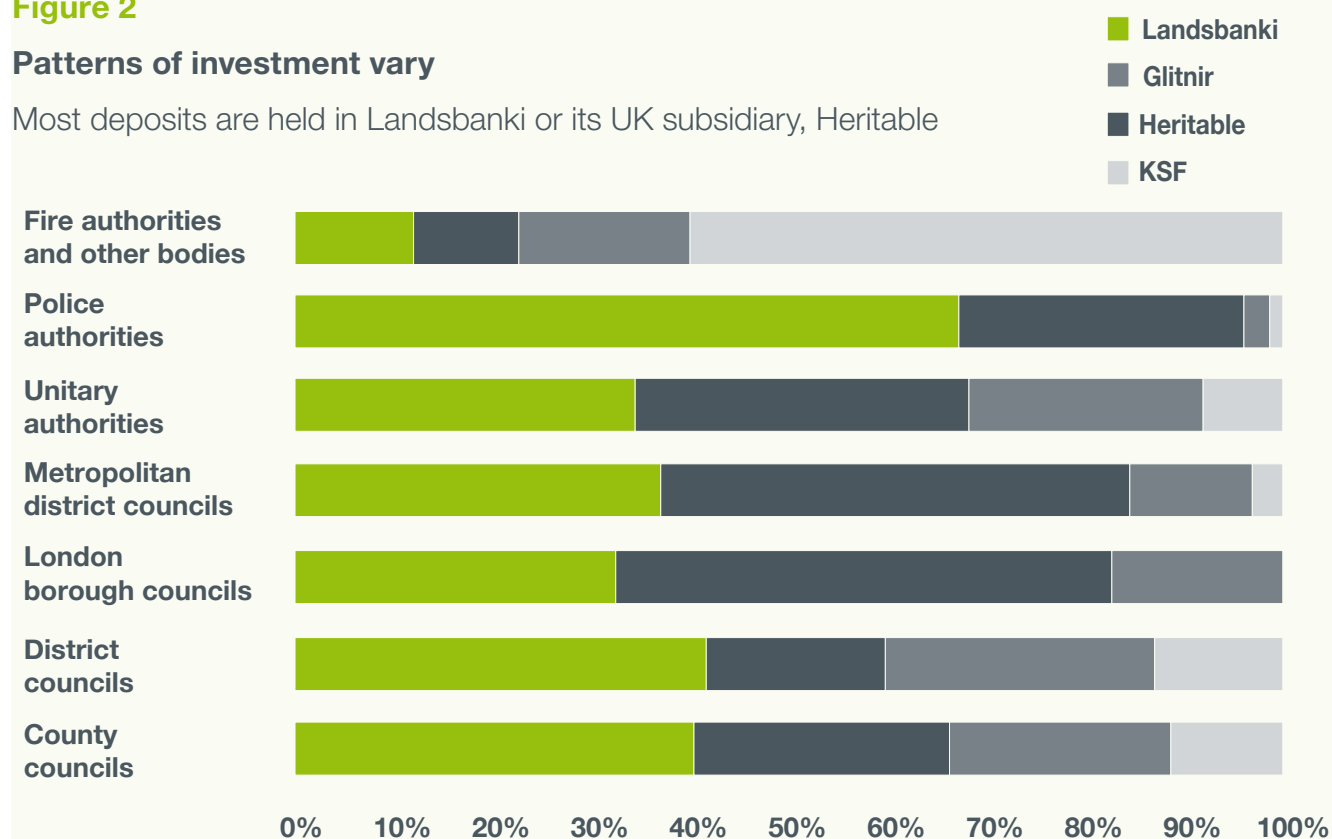
Where is the money?

35 Local authorities hold 60 per cent of their Icelandic deposits in the Icelandic banks themselves, rather than in their UK subsidiaries. Overall, most deposits (38 per cent) are held in Landsbanki (which was Iceland's second largest commercial bank) and almost 21 per cent of deposits are held in Glitnir. No deposits are held in Kaupthing (which was Iceland's largest bank) (Figure 2).

Figure 2

Patterns of investment vary

Most deposits are held in Landsbanki or its UK subsidiary, Heritable



Source: Audit Commission

There were warning signs and most local authorities heeded them

- 36** Local authorities, along with other investors, judge creditworthiness using credit ratings, which give an indication of the likely ability of an organisation to repay a loan along with any interest owed. Three agencies, Fitch, Moody's, and Standard and Poor's, hold 95 per cent of the global market share of the credit ratings business.¹ A variety of credit ratings exist to describe creditworthiness. For example, different credit rating scales exist to describe the risks associated with making short-term (defined differently by each of the rating agencies, but generally around a year) and long-term investments. Details and standardised descriptions of these can be found at Appendix 3. Fitch was the only agency to produce credit ratings for all of the Icelandic banks.
- 37** Concerns about the stability of the Icelandic economy were first raised during 2006 and continued into 2007. These concerns were neither abated nor heightened during 2007; and while there were some suggestions that the Icelandic banks were at risk from domestic economic uncertainty, the credit ratings of individual banks generally remained stable until early 2008.
- 38** But 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 (Figure 3).

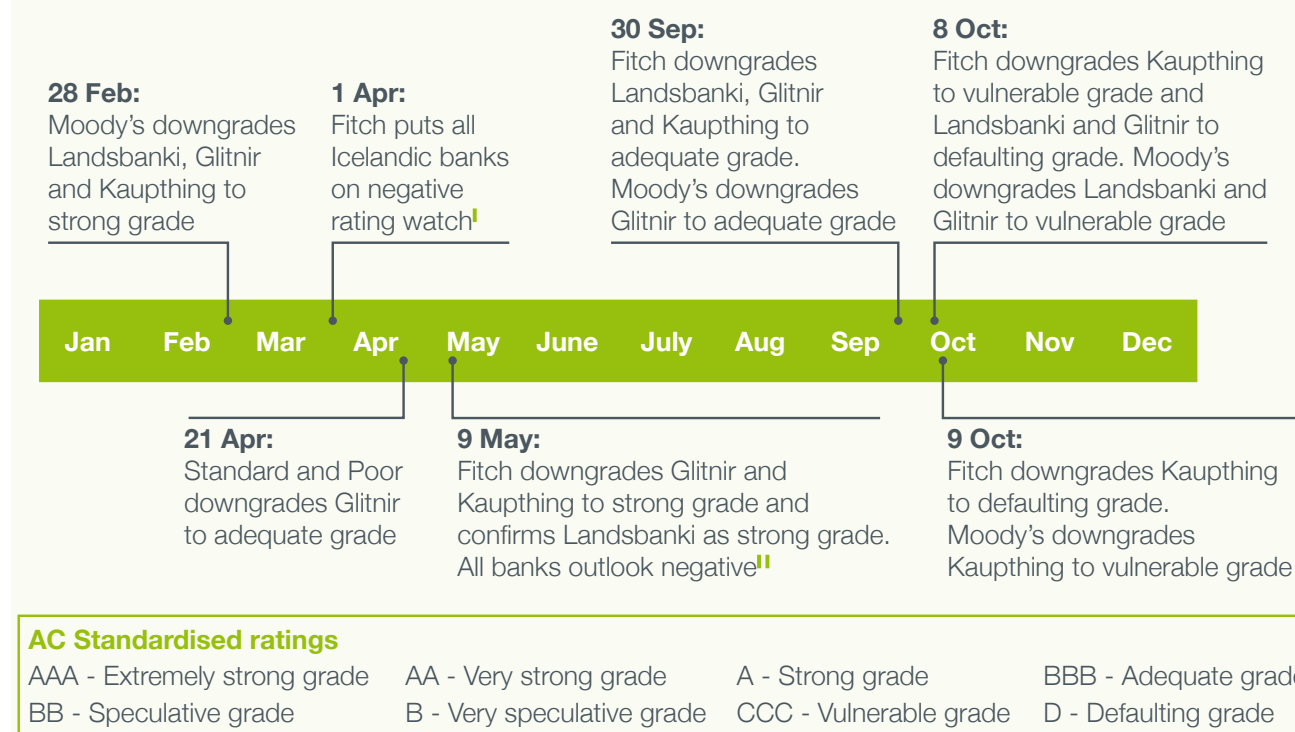
¹ Variances 32, ENSAE, December 2007.

2 | Local authorities and the Icelandic banks

Figure 3

Credit ratings fell during 2008

A variety of credit ratings were downgraded



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

^{II} A negative rating outlook indicates that a credit rating may change in the next one to two years www.fitchratings.com

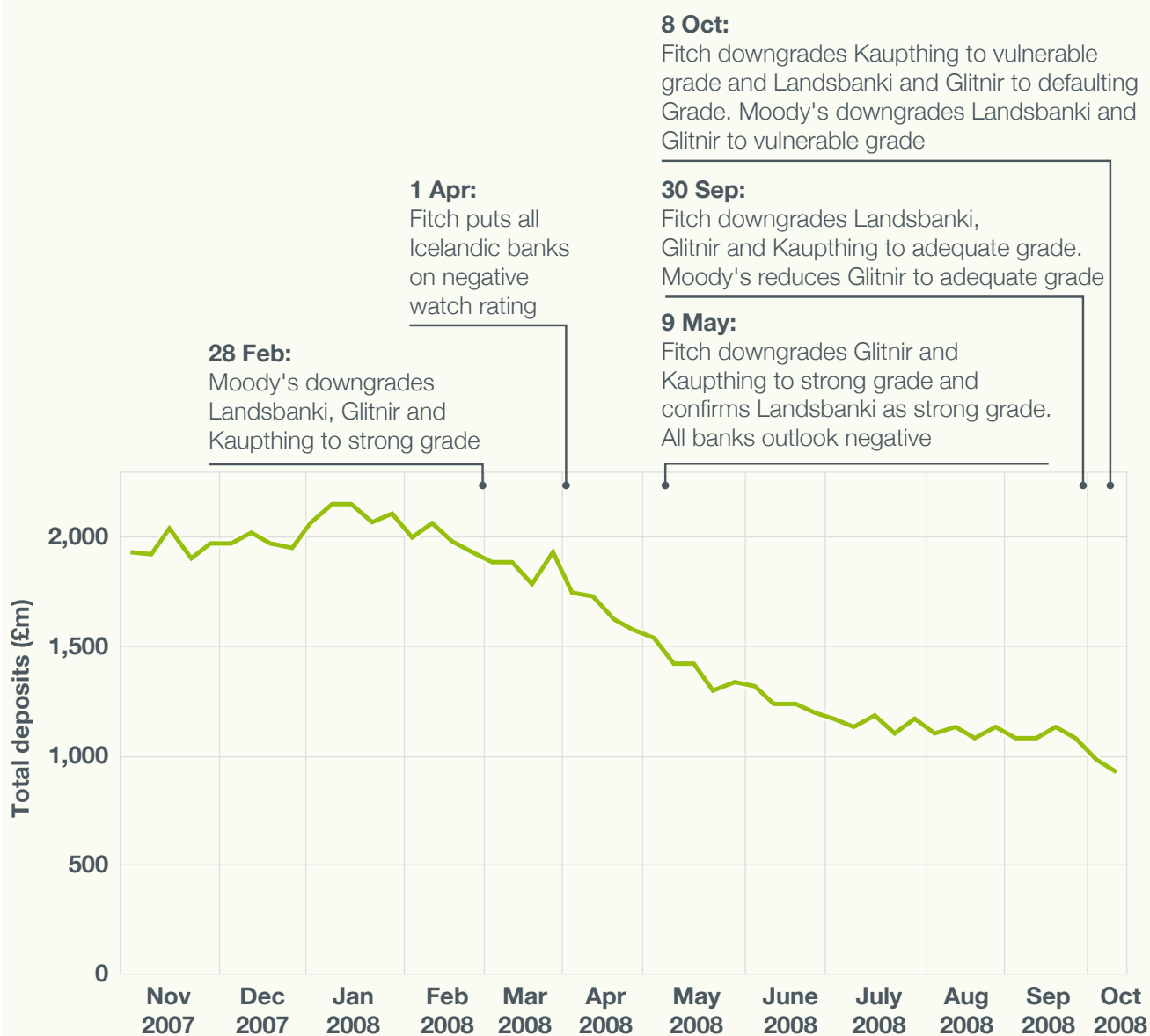
- 39** As a group, local authorities heeded the warning signs and anticipated the downward shift in credit ratings. Some 56 per cent of local authorities either never invested in the Icelandic banks, or made no deposits after 31 October 2007. Furthermore, between November 2007 and 6 October 2008, 18 per cent of local authorities removed all their deposits in the Icelandic banks as they matured.
- 40** The value of local authority deposits held in the Icelandic banks declined by more than half, from more than £2 billion in January 2008, to £953.53 million in October 2008, when the Icelandic banks ceased trading (Figure 4). The number of new deposits also fell and, in particular, declined sharply after April 2008, by which time Moody's had downgraded credit ratings for Landsbanki, Kaupthing and Glitnir and Fitch had placed all three banks on a negative ratings watch pending a review of their financial risk profiles.

2 | Local authorities and the Icelandic banks

Figure 4

Local authorities heeded the warning signs

Deposits in Icelandic banks halved between January and October 2008



Source: Audit Commission

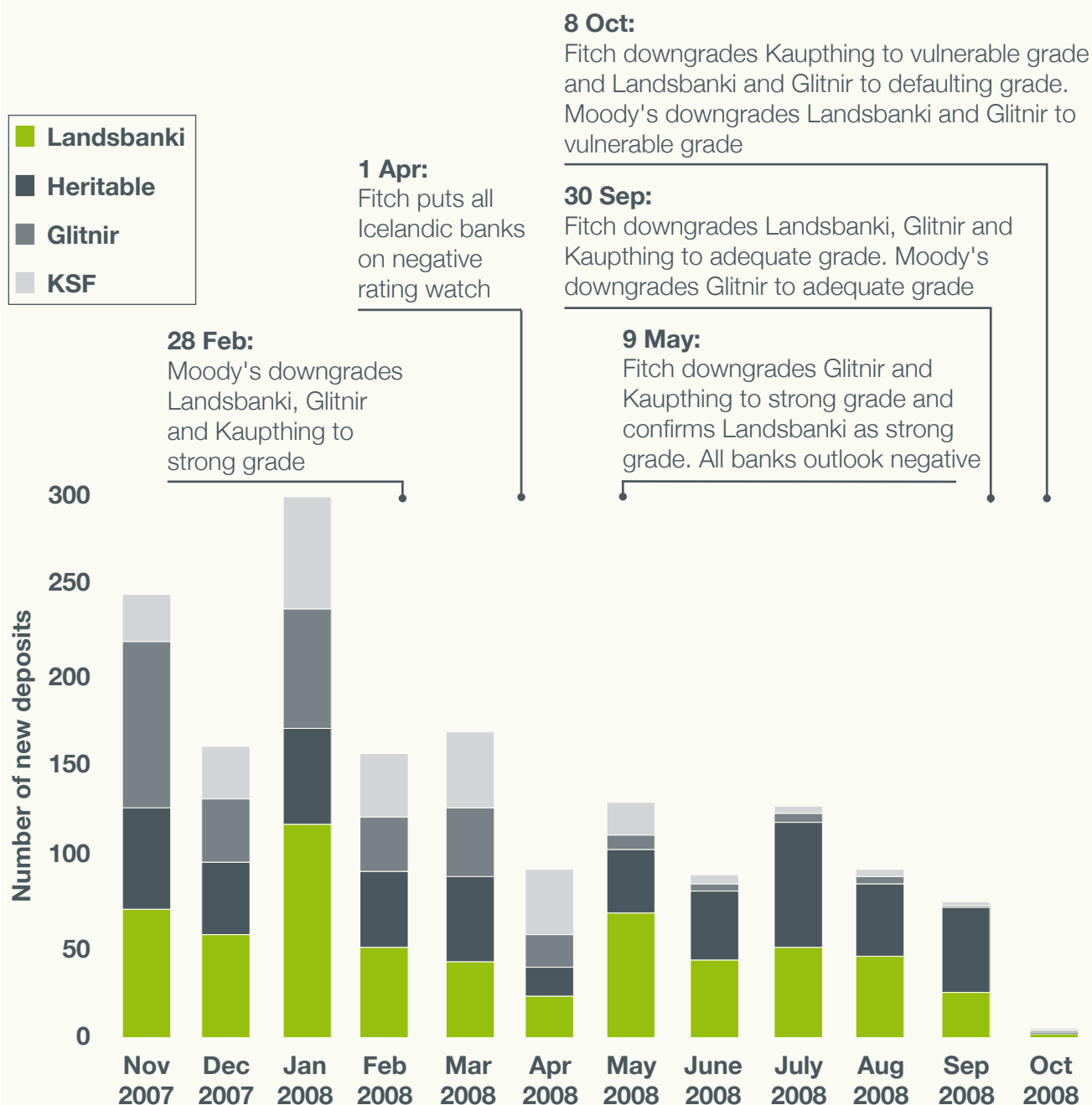
- 41** Local authorities with investments in the Icelandic banks generally responded to less favourable credit ratings by removing funds as they matured and by reducing the number of new deposits that they made. They also reacted to emerging differences in credit ratings between the Icelandic banks by reducing the number of new deposits placed in those banks with the lowest credit ratings. By April 2008, Moody's had downgraded the credit ratings of the Icelandic banks and Fitch had placed the Icelandic banks on a negative rating watch and the number of new deposits fell from 168 in March 2008 to 93 (Figure 5).
- 42** However, the picture is complicated. For example, in May 2008, Fitch downgraded the ratings of Glitnir and Kaupthing and placed them on negative outlook, meaning that further rating changes were possible in future. At the same time, the credit rating of Landsbanki was confirmed as A (strong grade). Local authorities responded by increasing the total number of new deposits to 130, placing 104 of them in Landsbanki or its UK subsidiary, Heritable.

2 | Local authorities and the Icelandic banks

Figure 5

Local authorities responded to changes in credit ratings

The total number of new deposits declined during 2008



Source: Audit Commission

- 43** Large sums of money were deposited in the Icelandic banks from April onwards. Between April and October 2008, 84 local authorities deposited almost £564 million that was due to mature after October 2008. 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.
- 44** Local authorities responded to the changing credit ratings by making fewer new deposits. But they 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. One local authority broke a deposit following the credit rating downgrade but at a cost of £38,000. Another local authority considered breaking a deposit, but the penalty, between 20 and 50 per cent of the principal sum, was too expensive.

2 | Local authorities and the Icelandic banks

Some local authorities missed the warning signs

45 Some local authorities continued to place deposits despite the change in credit ratings and continued to place new deposits in Glitnir or KSF. Indeed, a small number of local authorities missed the significant changes to the credit ratings of all the Icelandic banks that were made on 30 September 2008, when the banks were downgraded to BBB (adequate grade); and Glitnir was partially nationalised. Seven local authorities deposited a further £32.8 million between them over the next few days (Table 3).

Table 3

Some local authorities missed all the warning signs

£32.8 million was negligently deposited on or after 1 October 2008¹

Local authority	Amount deposited (£m)	Date deposited
London Borough of Havering	2.0	01/10/2008
Kent County Council	3.3	01/10/2008
Redcar and Cleveland Borough Council	4.0	01/10/2008
Restormel Borough Council	3.0	01/10/2008
Bridgnorth District Council	1.0	02/10/2008
Kent County Council	5.0	02/10/2008
South Yorkshire Pensions Authority	10.0	02/10/2008
North East Lincolnshire Council	3.0	02/10/2008
North East Lincolnshire Council	1.5	03/10/2008

Source: Audit Commission

¹ In some cases, a contractual agreement to place the deposit may have been made before 30 September.

- 46** These deposits breached local treasury management policies. The explanations for the breaches include:
- not opening an email from the treasury adviser 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 institution.

3 | The treasury management framework

47 This chapter considers the national framework and guidance used by local authorities to develop treasury management arrangements. It also discusses the role of staff, elected members and external auditors in managing and assuring treasury in local authorities.

The national framework

48 Local authorities manage surplus cash as part of their broader treasury management responsibilities. CIPFA defines treasury management as:

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

49 Local authorities have restricted freedoms with regard to the investment of surplus funds. The rules are prescribed by statute and are laid out under section 15(1)(a) of the Local Government Act 2003 (Ref. 5). Local authorities are also required to have regard to supplementary guidance provided by the Office of the Deputy Prime Minister (ODPM; now Communities and Local Government) (Ref. 6) and by CIPFA (Refs. 7 and 8). CIPFA’s guidance is defined as a proper practice for these purposes. Pension and trust funds are covered by a separate regulatory regime and are not discussed or considered here.

50 Local authorities operate within a national investment framework that is broadly sound and CIPFA helpfully describes the practices that define good treasury management. In summary, local authorities are expected to:

- define local investment limits and guidelines in an annual investment strategy prior to the start of each financial year and ensure that it is approved by the full council (or equivalent);
- prepare an annual treasury management strategy and plan prior to the start of each financial year; and
- prepare an annual report after the year-end.

51 The investment framework requires that local authorities should invest prudently and should primarily seek to safeguard public funds rather than to maximise returns. Due consideration must, therefore, be given to:

- security: the creditworthiness of the counterparty; and
- liquidity: how readily available cash is; the term of the investment.

52 Local authorities also consider yield, or the rate of return on their investments. Security and liquidity take priority over yield, but local authorities may seek the highest yield possible, once security and liquidity have been assured.

- 53** The treasury management framework used by local authorities generally appears to work well. Both the government and CIPFA guidance, rightly, emphasise an approach to investments based on identifying and managing risk. But weaknesses in the guidance have contributed to poor practice in some areas of treasury management and there is scope to provide additional support and guidance to local authorities.
- 54** In particular, the government's investment guidance places undue weight on credit ratings at the expense of other information sources. Credit ratings are a useful indicator of likely performance and, therefore, a credible means of judging and managing risk. However, while ratings are an important piece of information, they do not give the whole picture. Their use should be supplemented with other information.
- 55** The government's guidance advises local authorities to manage risk by making two different types of investment:
- Specified investments, considered to offer high security and liquidity. They are short term. That is they mature within one year, are made in sterling and are placed in institutions with high credit ratings.
 - Non-specified investments, considered to be riskier. They are longer-term investments and/or investments made with institutions that are not highly credit-rated.
- 56** While the guidance states clearly that credit ratings are not the only means of assessing risk, organisations are left to define high credit ratings locally; and no advice on other potentially useful sources of information is provided. It may be appropriate to reconsider the definition of short term. A revision downwards to six or even three months might be pertinent in recognition that the longer the term of a deposit, the greater the risk of the bank being unable to repay at maturity.
- 57** While the types of risk that organisations need to consider and manage are described, the potential correlation between related risks is not acknowledged. For example, the CIPFA guidance highlights the need to address counterparty risk and to create a diverse investment portfolio. But 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.

3 | The treasury management framework

- 58** There is scope for the treasury management practices recommended by CIPFA to be tightened. In particular, further advice and guidance could be offered to help local authorities:
- set a credit limit;
 - define a high or strong credit rating;
 - conduct research into individual counterparties;
 - put in place adequate controls, such as segregation of duties of trade execution from checking, reconciliation and compliance; and
 - specify the role of elected members in the governance and scrutiny of treasury management.

Treasury management functions in local authorities

- 59** Local authorities must strike an appropriate balance between protecting capital and realising income from investments. In practice, this means that local authorities must put in place appropriate controls that enable treasury managers to make a systematic assessment of risk and reward, including the potential for loss. Therefore, local authorities must put in place a framework that clearly states how much risk will be tolerated; and that ensures appropriate reporting and oversight, commensurate with the agreed risk appetite.
- 60** Treasury staff need to understand and interpret local risk tolerance, or appetite for risk, which necessitates a clear separation of duties between those executing deals and those monitoring compliance. However, while the guidance issued by CIPFA clearly specifies how to delegate duties, there is little to inform local interpretation of risk tolerance. In particular, the guidance does not outline how the function should be managed and monitored in order to provide an appropriate assessment of risk. Instead, these arrangements are left to individual local authorities.
- 61** In addition, the CIPFA guidance requires that staff involved in treasury management are appropriately qualified and that ongoing training is provided to maintain expertise, knowledge and skills. There is, however, no specification of the level of qualification required. As yet, there is no standard qualification or training course that is geared specifically to the needs of staff responsible for treasury management functions in local authorities.
- 62** The treasury management framework also sets out responsibilities for elected members. The full council (or equivalent) is required to approve the annual report and the treasury management strategy and plan before the start of the next financial year. At the same time, elected members are expected to consider a review of performance in the previous year.

- 63** Some authorities have made provision for elected members to carry out detailed scrutiny of the treasury management function. However, this is often left to chance and can be dependent on elected members having a financial background. While at least one local authority provides training in treasury management for its elected members, this initiative is not widespread. There is scope for elected members to be more engaged in the scrutiny of the treasury management activities. Some guidance has recently been published (Ref. 9), but there is a need to provide elected members with more support and assistance to enable them to exercise their responsibilities effectively.
- 66** It is a fundamental principle that public auditors should be independent of those who are responsible for the stewardship and use of public money. The Audit Commission's primary statutory function is to appoint auditors on behalf of the taxpayer and preserve their independence. This is essential if taxpayers are to trust auditors' judgements and conclusions.
- 67** 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. Nor can they substitute their judgement on risk or second guess specific investment decisions by managers, as these are properly the responsibility of management.

The role of external auditors

- 64** Public audit is an essential element in the process of accountability for public money. The Audit Commission's appointed auditors provide independent assurance on whether public money has been properly safeguarded and accounted for, and how well it has been used in the delivery of services.
- 65** 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.
- 68** Both appointed auditors, in planning the audit to meet their statutory and professional responsibilities, and the Commission, when mandating elements of the annual audit programme, 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. This risk-based approach also serves to reduce the cost and burden of audit for audited bodies.

3 | The treasury management framework

- 69** Following the development of the CIPFA *Code of Practice on Treasury Management* (the CIPFA Code) in light of the events surrounding the collapse of BCCI in the early 1990s, neither the Commission nor appointed auditors perceived treasury management to be a significant risk. Indeed the view was that this was generally a well managed function.
- 70** In carrying out their audits of the 2007/08 accounts, auditors would not have had cause to draw attention to potential risks relating to investments in Iceland, and neither the opportunity nor the powers to intervene. They can only intervene in extreme circumstances, primarily if they believe unlawful acts are imminent.
- 71** In giving their annual value for money conclusions and making use of resources assessments, auditors reviewed the treasury management arrangements put in place by an authority. This involved the auditor satisfying him or herself that an authority had put in place arrangements to comply with the CIPFA Code. The CIPFA Code was considered the appropriate standard, as it not only represents generally accepted best practice in this area but is defined in regulations as a proper practice to which authorities should have regard.
- 72** Once the news of the collapse of the Icelandic banks broke, the Commission immediately issued guidance to those auditors who had yet to complete their audits of the 2007/08 accounts, on the implications for their opinion on the accounts. The Commission also asked all auditors to review use of resources assessments in relation to financial standing and, in a number of cases, auditors chose to revise their assessments on the basis of the new evidence available to them.
- 73** Auditors continue to monitor the situation locally. Many of the authorities that have money at risk in the Icelandic banks have already commissioned independent reviews of their practice, which have made recommendations. Auditors will consider whether the authorities' responses are appropriate and whether they need to take any action themselves, for example in terms of public reporting.
- 74** The Commission will also ask all auditors to follow up the findings from this study at the local level over 2009/10, whether an authority had investments in Iceland or not, to ensure that the appropriate lessons are learned by all authorities. This report will inform auditors' work on their value for money conclusions and use of resources assessments for 2008/09, which will be issued in September 2009.

4 Treasury management in local authorities

75 This chapter considers how local authorities fulfil their treasury management functions and, in particular, how cash deposits are invested and managed.

Local treasury management policy meets national requirements

76 All local authorities have, as required, adopted the CIPFA *Code of Practice for Treasury Management in Local Authorities*. They use the Code to govern the way that surplus funds are invested. Local authorities also produce an annual investment strategy in accordance with the requirements laid out in the Local Government Act 2003.

77 Most policies refer to the statutory framework and to the need to prioritise security and liquidity above yield. Policies also, rightly, make it clear that investments will be used to generate income. But good policies emphasise local accountability and responsibility, the criteria within which it is appropriate to maximise yield, and also define the rules for determining:

- a high credit rating;
- the maximum periods for which funds may be invested;
- the total principal sums invested with counterparties at any point in time;
- the criteria for choosing investment counterparties with adequate security;
- the types of investment; and
- an appropriate balance between short-term and longer-term deposits.

78 The quality and content of individual policies varies markedly. For example, 21 per cent of treasury management policies do not specify what a high credit rating is. Thirty-two per cent of policies do not outline how frequently ratings should be monitored and 29 per cent do not specify procedures to deal with a rating change that means counterparties no longer meet local thresholds. In some cases, policies have been formulated using a template supplied by treasury advisers. In others, policies contained wording copied verbatim from the CIPFA Code of Practice guidance, with little evidence that due consideration has been given to local policy or priorities.

4 Treasury management in local authorities

79 In general, treasury management policies are reviewed and revised as part of an annual process and are not considered in between. But policies tend to be rolled over from year to year and, consequently, most have been unchanged for some years. A small number of policies have been revised in response to the Icelandic banking crisis. But in most cases, policies for 2008/09 have not altered; instead, operational changes have been made, such as revisions to counterparty lists or deposit limits.

80 However, treasury management policies for 2009/10 are being revised. Local authorities intend to include, for example, refined credit rating criteria, such as more clearly defined limits for investing abroad, limits for investing in banking groups, and support ratings.¹

81 Treasury advisers are consultancy firms that provide information to local authorities. Most local authorities use one or more external firms of treasury advisers to provide expert information and guidance. Treasury advisers play a variety of roles in helping to draw up local treasury management policy and strategy, including:

- assisting an authority to develop its treasury management policy;
- helping an authority to develop approved lending, or counterparty, lists;
- providing information on the creditworthiness of counterparties;
- advising on the criteria to take into account when determining which organisations to include on counterparty lists;
- advising on the investment instruments that should be used;
- advising on the maximum sums that should be invested in each organisation, ratings criteria, investment limits and the duration of deals; and
- advising on borrowing, borrowing limits and when to refinance at lower interest rates.

¹ Fitch defines support ratings as the potential for a bank's owner or a central bank to provide support should the bank get into difficulty www.fitchratings.com/corporate/fitchResources.cfm?detail=1%26rd_file=spprt

82 In the best authorities, policy is developed locally and information provided by treasury advisers is used as reference material alongside information gathered from other sources. Few local authorities gather information directly from credit rating agencies and, instead, rely on information provided by their treasury advisers. However, a direct relationship with one or more of the credit rating agencies is not, on its own, an indicator of good performance.

Local authorities specify risk thresholds

83 In line with best professional practice, local authorities manage risk by developing counterparty lists that specify minimum credit ratings and other thresholds. The thresholds vary between local authorities in accordance with local policy and appetite for risk. As a minimum, counterparty lists specify:

- the group of institutions that comprise a counterparty list;
- the minimum credit ratings for each counterparty;
- the length of time that money will be invested; and
- the maximum sums that will be invested with different types of institution.

84 The counterparty lists developed by local authorities with more highly developed arrangements for assessing and managing risk are also likely to specify thresholds for determining an appropriate split between investments in UK and non-UK banks, together with the maximum amounts that can be deposited in banks with the same owner (group limits). These local authorities are also likely to manage counterparty lists actively, in anticipation of bank mergers. The more risk-aware local authorities do not judge risk by relying solely on a single credit rating or a single credit rating agency. Instead, they consider the credit ratings quoted by one agency alongside those quoted by others.

85 The local authorities that managed risk most effectively were those that specified additional measures of risk in conjunction with long and short-term credit ratings. For example, the Icelandic banks met one local authority's credit rating threshold, but failed to make the counterparty list because they did not meet the support ratings threshold.

86 The best local authorities use a range of knowledge and information to judge risk and set credit rating thresholds before developing counterparty lists. The same local authorities also use a range of information before making investment decisions, including information gathered from treasury advisers, the financial press, and other sources, such as Reuters and Bloomberg. However, just over half of local authorities (51 per cent) relied solely on information provided by treasury advisers.

4 Treasury management in local authorities

- 87** Some local authorities ask treasury advisers to compile and manage counterparty lists on their behalf. Outsourcing arrangements can be beneficial: for example, to small local authorities with limited capacity. However, the role of treasury advisers does not extend to assuring compliance with good practice in treasury management. Hence, such arrangements need appropriate management, oversight and scrutiny. For instance, one local authority failed to adopt a revised counterparty list prepared by its treasury adviser. The revised list did not include the Icelandic banks. Instead, the local authority continued to place deposits in accordance with an outdated counterparty list, which included the Icelandic banks.
- 88** Local authorities also make use of brokers who act as an intermediary between the authority and the lender. They do not provide advice but enable depositors to access a wide range of banks. Brokers perform a useful role, but authorities may sometimes benefit from a direct relationship with counterparties. And brokers should not be used as a source of advice on individual investments.

Local authorities manage risk by diversifying their investments

- 89** The pattern of deposits held on 7 October 2008 suggests that local authorities were, in general, making appropriate judgements regarding risk and return:
- Most funds were invested for terms of one year or less, of which £12.6 billion (41 per cent) was deposited on terms of between one day and six months and £12.2 billion (39 per cent) was deposited for more than six months, but less than one year. Less than 20 per cent of deposits (£6.1 billion) were placed for more than one year.
 - Most funds (38 per cent) were deposited in AA-rated, very strong grade, institutions; 14 per cent of funds were deposited in A-rated, strong grade institutions; and 2 per cent of funds were deposited in the small number of AAA-rated, extremely strong grade, institutions. The remaining funds were placed in building societies. Most building societies do not have credit ratings. Instead, judgements of creditworthiness are made based on the size of the building society.

- 90** In general, there is a pay-off between risk rating and yield. The AAA-rated, extremely strong grade institutions offer maximum security for investments in return for lower yield. On the other hand, an A-rated, strong grade institution, offers less security, but higher yield. Local authorities were, therefore, making judgements balancing risk and return.
- 91** However, the management of risk and return varied between local authorities, and suggests that different authorities were willing to take different amounts of risk. All local authorities held deposits in A-rated, strong grade, institutions; and 97 per cent of local authorities held deposits in AA-rated, very strong grade, institutions. In contrast, 38 per cent of local authorities held deposits in AAA-rated, extremely strong grade institutions.

Local authorities hold most of their deposits in UK banks and building societies

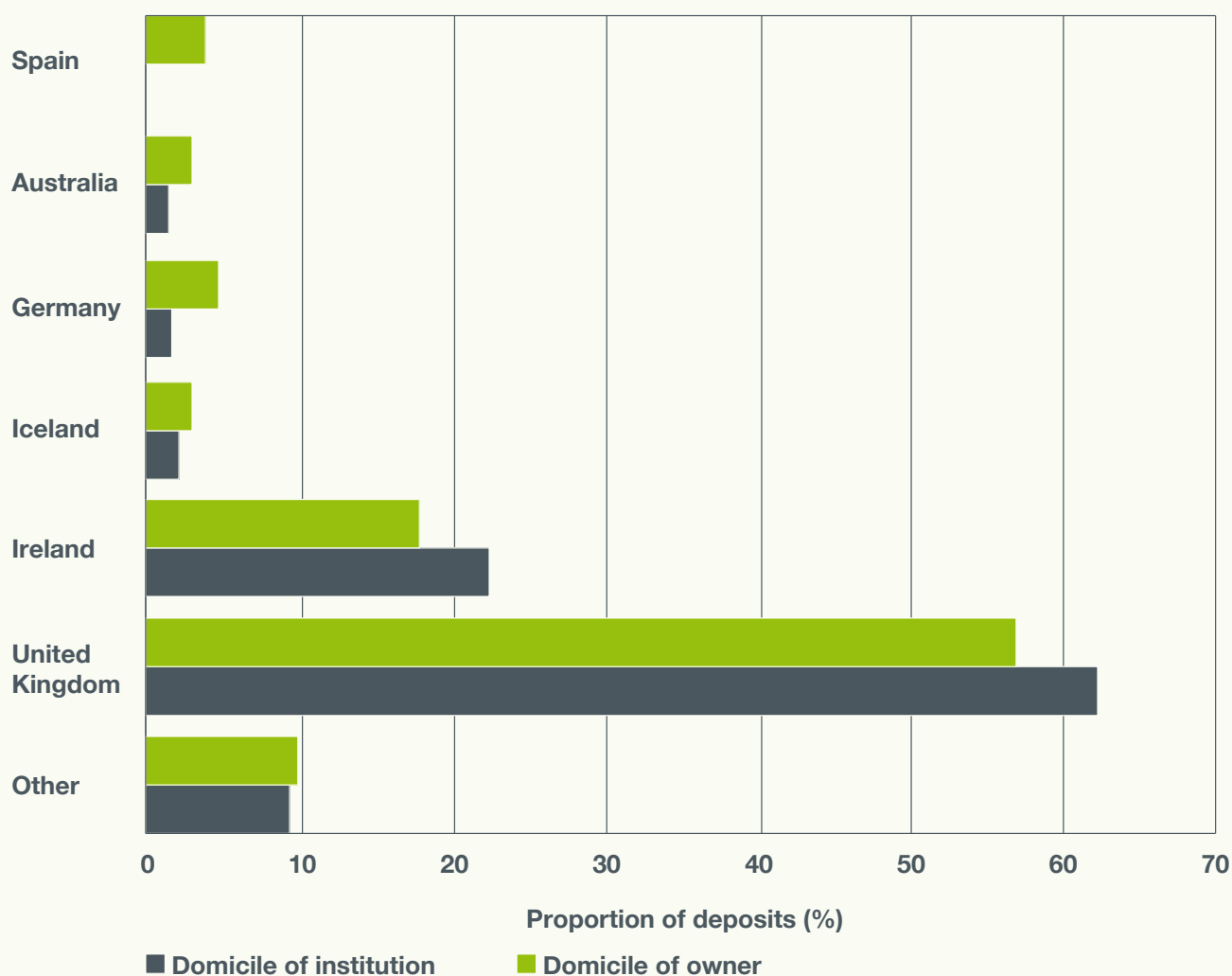
- 92** On 7 October 2008, local authorities held deposits in 25 different countries. More than £19.4 billion (63 per cent) was deposited in institutions registered in the UK, of which £17.7 billion (57 per cent) was deposited in institutions owned by UK companies. Almost 43 per cent of funds was deposited overseas or in institutions that were not owned by UK-based companies. More than 20 per cent of funds (£6.99 billion) was deposited in banks based in the Republic of Ireland. The remainder was deposited in financial institutions across Europe, the United States, the Middle East, the Far East and Australia (Figure 6).

4 Treasury management in local authorities

Figure 6

Most funds are placed in institutions owned and based in the UK

Fifty-seven per cent of funds is held in UK-owned banks



Source: Audit Commission

- 93** On 7 October 2008, local authorities held 61 per cent of their deposits in banks and just over half of that amount (35 per cent) in building societies. The remainder was invested in money market funds, other local authorities and in other types of account, including instant access call accounts and the Debt Management Deposit Account Facility (DMDAF). The DMDAF is operated by the government's DMO. It offers local authorities the facility to place deposits in an AAA-rated, extremely strong grade body, but with a significantly reduced yield. The amount deposited in the DMO on 7 October 2008 was £580 million, or 1.9 per cent of the total on deposit that day.
- 94** Local authorities have tightened their criteria for identifying counterparties since the collapse of the Icelandic banks. They have set higher credit rating thresholds in addition to reducing the maximum sums that will be invested in each institution. Local authorities are finding it increasingly difficult to place deposits within the higher thresholds and many are relying increasingly on the DMDAF. After the collapse of the Icelandic banks, many local authorities wanted to open DMDAF accounts but, for operational reasons within the DMO, account opening often took six weeks or longer.
- 95** There is no requirement for the DMO to maintain the DMDAF. The operational notice that governs the facility allows the DMO to suspend or terminate it at any time, potentially without notice. However, it would be useful if the DMO were to guarantee the DMDAF as a place of safety and security for local authority funds.

Local authorities consider yield when setting budgets

- 96** Each local authority makes its own assumptions about investment income and the extent of local authorities' reliance on interest receipts varies. Where investment targets are set, most local authorities assume income from interest at between 1 and 5 per cent of net budget. However, in two local authorities, budgeted income from interest earned in 2008/09 equated to almost a quarter of annual spend. The spending plans of some local authorities will be materially affected by reduced rates of return from invested funds as a result of interest rate cuts. Indeed, one local authority has already cut services as it overestimated investment returns in 2007/08, during which time interest rates were rising.

4 Treasury management in local authorities

- 97** While there is no direct evidence that local authorities prioritise yield above financial security and liquidity, some treasury teams experience pressures to ensure that investments perform well. For example, local authorities benchmark their treasury management functions. A key indicator is investment returns in comparison with an average interest rate, and treasury teams are encouraged to out-perform the benchmark where possible. Staff in two local authorities considered that they could not afford to use the DMO or to place deposits of less than three months, which generally offer lower rates of return. Staff at a third local authority reported that investments were made in the Icelandic banks in the light of the high interest rates offered and local pressures to maximise revenue.
- 98** Benchmarking is a useful and beneficial means of assessing performance. However, a focus on benchmarking yield, to the exclusion of other aspects of treasury management such as security and liquidity, may lead to an undesirable concentration on yield. If benchmarking of the treasury management function is required, a broad range of performance indicators, including security and liquidity, should be monitored.
- 99** Reliance on interest receipts has reduced since the collapse of the Icelandic banks and local authorities have adjusted their income assumptions downwards. There is also evidence of a broader shift in attitude and a reinterpretation of the relationship between security, liquidity and yield. In the past, local authorities were more willing to risk security in return for yield. Current attitudes towards risk management reflect an increasingly cautious approach that focuses on protecting capital, sometimes at the expense of yield.
- 100** However, extreme caution costs money and it may not be appropriate for all future deposits to be made only with AAA-rated, extremely strong grade institutions. Such decisions are a matter of local choice and local authorities need to set and communicate policy that describes the local risk appetite and the local thresholds for managing the trade off between risk and reward.

Local treasury management practices and staff qualifications vary

- 101** There are variations in local treasury management arrangements. Some local authorities manage the whole of their investment portfolio; others divide responsibilities and manage simple investments such as bank term deposits and cash funds and outsource other, more complex activities, including managing gilts and certificates of deposit, as well as property portfolios. A small number of local authorities rely almost entirely on external fund managers.
- 102** 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.
- 103** In some cases, county councils look after funds for police and fire authorities. This arrangement is potentially a good way of reducing costs. However, if this approach is adopted, there needs to be clear separation of funds, which should be managed in line with the policy of the owner of the deposits rather than the manager.
- 104** Local authority staff working in treasury management hold a variety of general accountancy qualifications, including CIPFA; Association of Chartered Certified Accountants; the Chartered Institute of Management Accountants; and the Association of Accounting Technicians. Treasury managers from two of the 37 case study sites hold, or are studying for, specific treasury management qualifications, including those awarded by the Association of Corporate Treasurers.
- 105** There are currently few training and development opportunities specifically designed for local authority treasury management staff. While the best local authorities actively encourage staff to seek further training and to identify and access networking opportunities where possible, the lack of training opportunities means that staff are very dependent on on-the-job learning and development. The quality of such training will vary and may mean that poor or outdated practices persist in some local authorities. General financial awareness is an indicator of good treasury management. Indeed, the most effective staff tend to be those who manage more than one type of investment portfolio, such as pension funds or school reserves, or who work closely with managers responsible for pension funds.

4 Treasury management in local authorities

106 Local authorities need to determine the level of resources they need to manage the function in accordance with advice provided by the director of finance or equivalent. In some cases, decisions will be made to outsource some or all responsibilities. Such decisions should take full account of the relative costs and benefits. It is for the local authority to specify the type of support it needs and at what level and, having let a contract, to monitor performance against this specification and satisfy itself that it is getting good value for money from the arrangement. When outsourcing is used, the accountability for public money, however, remains with the authority.

Governance and scrutiny

107 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.

108 The national framework requires that treasury management arrangements are considered annually at a meeting of the full council, or equivalent. However, such meetings generally afford little time for discussion and debate and the contribution of elected members is weak. Full council meetings are, therefore, unlikely to be the best place for a detailed review of policy and performance. Other bodies, particularly audit committees, should, therefore, play a more prominent role providing an oversight of treasury management policy and practice. In addition, a backward-looking, annual review of policy is not sufficient to ensure that treasury management arrangements are functioning effectively.

109 Few elected members have received training or have backgrounds that enable them to scrutinise or challenge effectively. In some local authorities, this means that officers seek to exclude elected members from discussions. In others, elected members are content to delegate responsibility for treasury management to the officers. Local authorities need to develop a governance framework of reporting and review alongside the annual review process and should work to improve the level of awareness and engagement of all elected members. As a minimum, such arrangements would include:

- an elected member (or equivalent) with responsibility for all aspects of finance, including treasury management;

- regular awareness-raising briefings to other elected members about treasury management, investment strategies and approaches for managing risk;
- inclusion of treasury management in the annual programme of internal audit reviews;
- reporting to the council, cabinet (or equivalent) and audit committee on a regular basis, in addition to the annual review;
- arrangements for producing management information that enables and prompts a user to consider security and liquidity as well as yield; and
- maintenance of a list of all current deposits available for scrutiny at any time.

110 Local authorities also need to ensure that they have in place arrangements to test for compliance that include:

- segregation of duties between staff making deals from those checking them;
- regular (at least monthly) compliance checks; and
- regular spot checks.

Local authorities have different attitudes to risk

111 There are 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 (Table 4).

112 Non-investors tended to display a combination of one or more of: more risk averse; more risk aware; more effective users of information. Their treasury management policies indicated a cautious approach, which was reflected in high rating thresholds and/or the use of more than one type of credit rating. Others used additional information to supplement credit ratings and came to their own judgements about the suitability of potential counterparties. As early as the start of 2008, a small number of local authorities reacted proactively to increased risks in the markets. They adopted a more risk-averse approach by restricting counterparty lists to banks with the strongest credit profile.

4 Treasury management in local authorities

- 113** In contrast, local authorities with the largest sums at risk tended to have weak governance and scrutiny arrangements, were overly dependent on external advice and failed to consider adequately the risks associated with their decisions. For example, when comparing deposits made on the same day for the same amount of money and the same duration, on average, the Icelandic banks offered better interest rates than other banks with the same credit rating. On average, local authorities received an extra 0.065 per cent interest when they invested in Iceland in comparison with other, similarly rated institutions, equivalent to an extra £650 per year per million deposited.
- 114** Local authorities with deposits that matured between 1 November 2007 and 6 October 2008 displayed elements of the behaviours of local authorities that had never invested and those with funds at risk. In other words, deposits made in the Icelandic banks were returned because they had good judgement, were lucky, or both.

Table 4**Treasury management behaviours vary**

Local authorities without Icelandic deposits tended to exhibit more of the characteristics outlined in the left-hand column. Those with funds at risk tended to exhibit more of the characteristics outlined in the right-hand column.

Characteristic	Non-investors	Investors
Attitude to risk	Cautious. Recognise the need to own all risk-reward decisions and the need to maintain a questioning, challenging mindset.	Reactive. Conduct little research into the risks being taken.
Approach to risk management	Manage risk proactively: <ul style="list-style-type: none"> • invest funds with riskier counterparties only for short periods of time; • consider the possibility of breaking a deposit before maturity; • manage the counterparty list without waiting for a rating downgrade; and • consider country limits for counterparties. 	Manage risk reactively: <ul style="list-style-type: none"> • wait for rating agencies to change a rating before amending limits; and • regard policy as only relevant for new investments not existing ones.
Use of credit ratings	Recognise that credit ratings and comments from advisers are merely one source of information that can be used to build an understanding of risks in the markets and with counterparties.	Rely on a single short-term or long-term credit rating. Highly dependent on information provided by treasury advisers. <p>Have gaps in understanding regarding the use of credit rating agencies, including:</p> <ul style="list-style-type: none"> • which one(s) to use; • the measures to use (long-term/short-term and so on); and • what to do when a counterparty has different ratings with different credit rating agencies.

4 Treasury management in local authorities

Characteristic	Non-investors	Investors
Governance and scrutiny	<p>Elected member oversees finance function, takes an interest in the treasury policy and challenges assumptions built into the limits and minimum credit criteria.</p> <p>Finance staff proactively approach elected members and provide briefings on key issues relevant to the treasury policy, including risk limits. Elected members are able to provide robust challenge to the key policy parameters.</p>	<p>Elected members do not engage in the treasury policy and, instead, leave it to the experts in finance.</p> <p>Failure to question policies year-on-year and mechanistically using their advisers' policy template.</p>
Use of information	<p>Extensive. Includes actively researching counterparties and the markets.</p>	<p>Limited. Overly reliant on a single information source, for example emails from a treasury adviser.</p> <p>Reliant on benchmarking information that focuses on using lowest rate achieved on borrowings and highest rate achieved on cash investments, which encourages local authorities to take on more risk to show an improved placing in the benchmarks.</p>
Relationship with counterparties	<p>Know the bankers that they are investing with.</p>	<p>Excessive reliance on brokers means that some local authorities do not have direct contact with their banking counterparties.</p>
Reliance on yield	<p>Prioritise security and liquidity above yield. Maintain a balance between security, liquidity and yield by investing short term where risk dictates. For some, it is rare to invest for longer than three months.</p>	<p>Highest returns available in market place are sought. Some (overt or covert) pressure to maximise returns to balance budgets.</p>

Characteristic	Non-investors	Investors
Achievement of security and liquidity	<p>Carry out scenario testing to ensure that the sensitivity of the portfolio to the market is understood.</p> <p>Normal expectation is for specified investments of six months or less.</p>	<p>Rely on advisers for many aspects of credit risk and interest rate risk.</p> <p>Tend to invest for long terms in excess of one year in order to lock in yield, at the expense of being able to react should the credit profile of the counterparty change.</p>
Resource management, staff development and expertise	<p>Allocate the equivalent of least one full-time member of staff to the role of investing funds and performing research into counterparties and investment instruments.</p> <p>Actively encourage networking and training.</p> <p>Staff gather information about the markets and counterparties that includes:</p> <ul style="list-style-type: none"> • reviewing information and credit measures available from all rating agencies; • actively seeking out information available from newspapers and the internet; and • looking into other measures of risk. 	<p>Reliant on advisers for market and credit information.</p> <p>Ignorant of the commercial nature of their relationship with the banks and, therefore, of the potential to break deposits before term if conditions become unfavourable.</p> <p>Weak knowledge of products and markets. Take few steps to train and develop staff.</p>

Source: Audit Commission

5 | Conclusions

- 115** The chaos in the financial system that led to the collapse of the Icelandic banks had no recent precedent. But the collapse has revealed much about the way that local authorities look after their money.
- 116** Many authorities have acted prudently, used advice and information wisely and balanced their risks. Others have been less cautious, by following ratings exclusively and perhaps striving to achieve a high yield without due regard to the risks involved. And a small group of authorities has been negligent in their stewardship of public funds.
- 117** The consequence of this lack of caution has been the potential loss of large sums of public money. Had all authorities stopped depositing in Icelandic institutions after April 2008, then the amount of money at risk would have been over £500 million lower than is the case.
- 118** The overarching treasury management framework is the right one. Authorities should remain in control of their own funds within a national prescribed structure. The current structure has gaps, but the system can be adjusted rather than replaced. But if authorities are going to deposit in the commercial sector to benefit from the higher rates of interest available, they must ensure that their treasury management is properly resourced, managed and scrutinised. The full range of risks needs to be recognised and managed.
- 119** There is always the risk that a commercial bank will collapse. Local authorities may, as a consequence, lose money. But with a better approach to managing their deposits, the chances of suffering such a loss can be reduced.

Appendix 1 – Methodology

120 Research for this review was carried out between December 2008 and March 2009. The research comprised four elements:

- Collection of data from appointed auditors of English local authorities to determine the value of cash deposits held in banks, building societies and other institutions on 7 October 2008, together with details of deposits placed in the Icelandic banks since November 2007.
- Visits to 37 English local authorities, to examine treasury management arrangements. The local authorities were selected to include organisations that had deposits in one or more Icelandic bank, including UK subsidiaries, on 7 October 2008; organisations that had either never placed deposits in an Icelandic bank, or whose deposits had matured before 1 November 2007; and organisations that had placed deposits in an Icelandic bank since 1 November 2007, deposits that had matured prior to 7 October 2008.
- A desk-based review of 30 sets of treasury management documentation (including policy, strategy, annual investment strategies and annual reports); and 179 counterparty lists.
- A review of the national guidance on managing cash reserves and deposits.

121 Completed responses were received from auditors of 451 out of a total of 489 local authorities, representing 92 per cent coverage (Table 5).

Appendix 1 – Methodology

Table 5

A high coverage was achieved

Auditors submitted data returns for 92 per cent of local authorities

Local authority	Number of bodies	Coverage
County councils	34	33 (97%)
District councils	238	234 (98%)
London borough councils	33	33 (100%)
Metropolitan district councils	36	33 (92%)
Unitary authorities	47	44 (94%)
Police authorities	38	34 (89.5%)
Fire authorities and other bodies	63	40 (63.5%)
Total	489	451 (92%)

Source: Audit Commission

122 The three main commercial banks in Iceland collapsed in early October. Glitnir and Landsbanki went into receivership on 7 October 2008; and Heritable Bank froze all funds. Kaupthing went into receivership on 8 October 2008. For the purposes of our review, we have assumed that 6 October 2008 was the last day of normal trading.

123 Sarah Furlong project managed the study, supported by Agnieszka Scott. David Caplan was the project director. Leah Sparks, Mark Burkett, John Sandhu, Rosamund Chester, Laura Holloway, Ben Oxenham and Marcine Waterman provided additional support.

124 Deloitte LLP carried out the visits to authorities on behalf of the Audit Commission and collected information in a framework designed by the Commission. The work was performed by treasury management specialists who also provided advice to the Audit Commission on good practices in treasury management.

125 A project steering group assisted in developing the research framework and analysing the findings. The Commission's Local Government Financial Management Advisory group, whose members include representatives of local authorities, CIPFA and central government also provided comments.

126 The Commission thanks all those who were involved. However, the views expressed in this report are those of the Audit Commission alone.

Appendix 2 – Exposure to the failed Icelandic banks

Table 6

127 local authorities hold deposits in the failed Icelandic banks

Local authorities hold deposits totalling £953.53 million

Local authority	Value of deposits (£m)	GRE (£m) ⁱ	Value of deposits (%GRE)	Value of reserves (£m) ⁱⁱ	Value of deposits (% reserves)
Buckinghamshire County Council	5.0	720	0.7	39	13
Cheshire County Council	8.5	1037	0.8	37	23
Cornwall County Council	5.0	989	0.5	75	7
Dorset County Council	28.1	576	4.9	41	69
Gloucestershire County Council	12.5	895	1.4	47	27
Hertfordshire County Council	28.0	1641	1.7	50	56
Kent County Council	48.9	2000	2.4	107	46
Lancashire County Council	8.9	1663	0.5	82	11
Norfolk County Council	32.5	1579	2.1	61	53
Northumberland County Council	23.0	644	3.6	35	66
Oxfordshire County Council	5.0	978	0.5	39	13
Somerset County Council	25.0	822	3.0	21	119
Surrey County Council	18.5	1600	1.2	46	40
West Sussex County Council	12.9	1148	1.1	58	22
Wiltshire County Council	8.0	698	1.1	32	25

ⁱ GRE is defined as the gross expenditure figure shown in the net cost of services section of the income and expenditure account or equivalent. It has been used to provide a broad indication of the exposure of authorities adjusted for size. The GRE figures shown here are auditors' estimates for 2008/09.

ⁱⁱ Source: CIPFA Memorandum – Estimated unearmarked and earmarked general reserves (excluding schools' reserves, housing revenue account and pension funds) as at 1 April 2008; www.cipfastats.net/

Appendix 2 – Exposure to the failed Icelandic banks

Local authority	Value of deposits (£m)	GRE (£m) ⁱ	Value of deposits (%GRE)	Value of reserves (£m) ⁱⁱ	Value of deposits (% reserves)
Amber Valley Borough Council	1.0	64	1.6	6	17
Aylesbury Vale District Council	3.0	24	12.5	19	16
Bassetlaw District Council	8.0	74	10.8	3	267
Bolsover District Council	3.0	65	4.6	5	60
Braintree District Council	5.0	67	7.5	5	100
Breckland Council	12.0	66	18.2	7	171
Bridgnorth District Council	1.0	30	3.3	2	50
Burnley Borough Council	1.0	100	1.0	2	50
Cambridge City Council	9.0	136	6.6	27	33
Canterbury City Council	6.0	109	5.5	11	55
Charnwood Borough Council	1.0	74	1.4	3	33
Cheltenham Borough Council	11.0	99	11.1	14	79
Cherwell District Council	6.5	62	10.5	18	36
Chorley Borough Council	2.0	47	4.3	2	100
Colchester Borough Council	4.0	122	3.3	9	44
Cotswold District Council	2.0	38	5.3	4	50
Daventry District Council	8.0	34	23.5	8	100
Derwentside District Council	7.0	114	6.1	5	140
Dover District Council	1.0	83	1.2	5	20
East Lindsey District Council	4.0	77	5.2	15	27
East Staffordshire Borough Council	5.0	52	9.6	8	63
Epping Forest District Council	2.5	123	2.0	10	25
Exeter City Council	5.0	95	5.3	10	50
Gloucester City Council	2.0	85	2.4	6	33

Local authority	Value of deposits (£m)	GRE (£m) ⁱ	Value of deposits (%GRE)	Value of reserves (£m) ⁱⁱ	Value of deposits (% reserves)
Great Yarmouth Borough Council	2.0	94	2.1	2	100
Hertsmere Borough Council	1.0	53	1.9	18	6
High Peak Borough Council	2.0	57	3.5	5	40
Ipswich Borough Council	5.0	113	4.4	5	100
Lancaster City Council	6.0	109	5.5	5	120
Lewes District Council	1.0	79	1.3	6	17
Mid Devon District Council	1.1	35	3.1	1	110
Newark and Sherwood District Council	2.0	64	3.1	7	29
Newcastle Under Lyme Borough Council	2.5	56	4.5	13	19
North Wiltshire District Council	5.0	51	9.8	13	38
Nuneaton And Bedworth Borough Council	3.0	79	3.8	4	75
Oxford City Council	4.5	232	1.9	3	150
Purbeck District Council	2.0	23	8.7	2	100
Reigate and Banstead Borough Council	15.5	59	26.3	5	310
Restormel Borough Council	4.0	58	6.9	2	200
Rugby Borough Council	3.0	58	5.2	5	60
Rushmoor Borough Council	2.0	51	3.9	2	100
Sevenoaks District Council	1.0	51	2.0	17	6
South Hams District Council	1.3	47	2.8	8	16
South Oxfordshire District Council	2.5	51	4.9	47	5
South Ribble Borough Council	5.0	47	10.6	4	125
Stroud District Council	3.0	79	3.8	7	43
Surrey Heath Borough Council	4.0	37	10.8	15	27

Appendix 2 – Exposure to the failed Icelandic banks

Local authority	Value of deposits (£m)	GRE (£m) ⁱ	Value of deposits (%GRE)	Value of reserves (£m) ⁱⁱ	Value of deposits (% reserves)
Tamworth Borough Council	7.5	53	14.2	9	83
Tewkesbury Borough Council	1.0	34	2.9	2	50
Tonbridge and Malling Borough Council	1.0	54	1.9	23	4
Uttlesford District Council	2.2	38	5.8	1	220
Vale of White Horse District Council	1.0	56	1.8	1	100
West Lindsey District Council	7.0	35	20.0	7	100
West Oxfordshire District Council	9.0	41	22.0	13	69
Winchester City Council	1.0	74	1.4	10	10
Wychavon District Council	1.5	70	2.1	5	30
Wycombe District Council	2.5	108	2.3	32	8
Wyre Forest District Council	9.0	49	18.4	5	180
Dorset Fire Authority	1.0	27	3.7	Not available	Not available
East London Waste Authority	1.0	35	2.9	26	4
Kent and Medway Fire and Rescue Authority	1.6	75	2.1	9	18
Lancashire Combined Fire Authority	0.4	Not available	Not available	Not available	Not available
New Forest National Park Authority	0.5	Not available	Not available	2	25
South Yorkshire Passenger Transport Authority	5.0	127	3.9	Not available	Not available
South Yorkshire Passenger Transport Executive	6.0	105	5.7	Not available	Not available
South Yorkshire Pensions Authority	18.5	Not available	Not available	Not available	Not available
Transport For London	40.0	723	5.5	Not available	Not available

Local authority	Value of deposits (£m)	GRE (£m) ⁱ	Value of deposits (%GRE)	Value of reserves (£m) ⁱⁱ	Value of deposits (% reserves)
West Midlands Passenger Transport Authority	4.0	151	2.6	9	44
Barnet London Borough Council	27.4	782	3.5	22	125
Brent London Borough Council	15.0	911	1.6	19	79
City of Westminster Council	16.3	992	1.6	91	18
Haringey London Borough Council	37.0	1048	3.5	54	69
London Borough of Bromley	5.0	604	0.8	51	10
London Borough of Ealing	2.0	892	0.2	47	4
London Borough of Enfield	5.0	871	0.6	38	13
London Borough of Havering Council	12.5	581	2.2	31	40
London Borough of Hillingdon	20.0	801	2.5	12	167
London Borough of Sutton	5.5	460	1.2	18	31
Newham London Borough Council	7.0	1312	0.5	29	24
Bolton Metropolitan Borough Council	6.0	618	1.0	20	30
City of Wakefield Metropolitan District Council	9.0	737	1.2	11	82
Doncaster Metropolitan Borough Council	3.0	685	0.4	16	19
Gateshead Metropolitan Borough Council	4.5	537	0.8	88	5
Kirklees Metropolitan Council	1.0	1242	0.1	46	2
Rotherham Metropolitan Borough Council	3.8	634	0.6	33	12
Solihull Metropolitan Borough Council	3.0	418	0.7	23	13

Appendix 2 – Exposure to the failed Icelandic banks

Local authority	Value of deposits (£m)	GRE (£m) ⁱ	Value of deposits (%GRE)	Value of reserves (£m) ⁱⁱ	Value of deposits (% reserves)
Wirral Metropolitan Borough Council	2.0	890	0.2	30	7
Dorset Police Authority	7.0	132	5.3	16	44
Hertfordshire Police Authority	3.0	197	1.5	9	33
Humberside Police Authority	4.6	197	2.3	30	15
Kent Police Authority	11.1	351	3.2	36	31
Lancashire Police Authority	0.7	303	0.2	12	6
Metropolitan Police Authority	30.0	3511	0.9	Not available	Not available
Northumbria Police Authority	3.5	350	1.0	62	6
Surrey Police Authority	1.5	Not available	Not available	Not available	Not available
Sussex Police Authority	6.8	325	2.1	34	20
Thames Valley Police Authority	5.0	395	1.3	29	17
West Midlands Police Authority	5.4	634	0.9	52	10
West Yorkshire Police Authority	6.0	1148	0.5	17	35
Bracknell Forest Borough Council	5.0	262	1.9	11	45
Bristol City Council	8.0	978	0.8	38	21
North East Lincolnshire Council	7.0	370	1.9	39	18
North Lincolnshire Council	5.5	337	1.6	10	55
North Somerset Council	3.0	387	0.8	14	21
Nottingham City Council	41.4	925	4.5	49	84
Peterborough City Council	3.0	403	0.7	18	17
Plymouth City Council	13.0	607	2.1	15	87

Local authority	Value of deposits (£m)	GRE (£m) ⁱ	Value of deposits (%GRE)	Value of reserves (£m) ⁱⁱ	Value of deposits (% reserves)
Redcar and Cleveland Borough Council	6.0	420	1.4	9	67
Rutland County Council	1.0	80	1.3	2	50
Slough Borough Council	2.5	369	0.7	14	18
Stoke on Trent City Council	5.0	680	0.7	47	11
Wokingham Borough Council	5.0	285	1.8	13	38

Source: Audit Commission

Appendix 3 – Credit ratings

Table 7
Long and short- term credit ratings

Credit ratings may be confusing to laypeople, including elected members who may be charged with local governance.

Audit Commission grading (for the purpose of standardisation) ¹	Fitch		Moody's		Standard and Poor's	
	Long term	Short term	Long term	Short term	Long term	Short term
Extremely strong grade	AAA	F1+	Aaa	P-1	AAA	A-1+
Very strong grade	AA+	F1+	Aa1	P-1	AA+	A-1+
	AA	F1+	Aa2	P-1	AA	A-1+
	AA-	F1+	Aa3	P-1	AA-	A-1+
Strong, but susceptible to adverse conditions grade (strong grade)	A+	F1+ F1	A1	P-1	A+	A-1+ A-1
	A	F1	A2	P-1 P-2	A	A-1+
	A-	F1 F2	A3	P-1 P-2	A	A-1+ A-2
Adequate grade	BBB+	F2	Baa1	P-2	BBB+	A-2
	BBB	F2 F3	Baa2	P-2 P-3	BBB	A-2 A-3
	BBB-	F3	Baa3	P-3	BBB-	A-3
Speculative grade	BB+	B	Ba1	Not prime (NP)	BB+	B-1
	BB	B	Ba2	NP	BB	B-2
	BB-	B	Ba3	NP	BB-	B-3
Very speculative grade	B+	B	B1	NP	B+	-
	B	B	B2	NP	B	-
	B-	B	B3	NP	B-	-
Vulnerable grade	CCC	C	Caa1	NP	CCC+	C
	CCC	C	Caa2	NP	CCC	C
	CCC	C	Caa3	NP	CCC-	C
	CC	C	-	NP	CC	C
	C	C	Ca	NP	C	C
Defaulting grade	D	D	C	NP	D	D

Source: Audit Commission adaptation of information from Fitch, Moody's and Standard and Poor's

¹ Standardised gradings are based on the Standard and Poor's credit rating definitions www2.standardandpoors.com/portal/site/sp/en/eu/page.article/2,1,1,0,1204844424546.html?vregion=eu%26vlang=en%23ID233

Appendix 4 – Glossary of terms

Term	Description
Broker	An agent who handles orders to buy and sell. Brokers charge a commission that, depending upon the broker and the amount of the transaction, may or may not be negotiated.
Credit rating	A measure of the credit worthiness of an institution, corporation, or even a country. Credit ratings are calculated from financial history and current assets and liabilities. Typically, a credit rating tells a lender or investor the probability of the subject being able to pay back a loan.
DMA	The Debt Management Account – the account established in November 1999 through which the DMO's government debt and exchequer cash management transactions flow.
DMO	The United Kingdom Debt Management Office.
Liquidity	An assessment of how readily available an investment is; the length of term of an investment.
PWLB	Public Works Loan Board. The PWLB has been part of the DMO since July 2002.
Rating agency	Bodies that assess the financial strength of companies and governments, both domestic and foreign, particularly their ability to meet the interest and principal payments on their bonds and other debt.
Security	An assessment of the creditworthiness of a counterparty.
Treasury adviser	Consultancy firms that provide information to local authorities, including information regarding counterparty creditworthiness.
Yield	Interest, or rate of return, on an investment.

Appendix 5 – References

- 1 Local Government Finance Act 1992 (sections 32 and 43). HMSO, 1992.
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