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AUDIT COMMITTEE

CARLISLE CITY COUNCIL

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Committee Report

Public

Date of Meeting: **22 June 2009**

Title: **TREASURY MANAGEMENT - ACTIONS ARISING FROM THE HOUSE OF COMMONS SELECT COMMITTEE'S REPORT ON LOCAL AUTHORITY INVESTMENTS**

Report of: **The Director of Corporate Services**

Report reference: **CORP26/09**

Summary:
To consider 'Local Authority Investments', the report of the House of Commons Select Committee on Communities and Local Government.

Recommendations:
It is recommended that:
The report be received and welcomed as a further broad endorsement of the current level of practice and performance in local authority treasury management.

The conclusions and recommendations in 'Local Authority Investments', as discussed in paragraph 3 of the report, be noted and agreed and in particular the recommendation that the Audit Committee should embrace within its terms of reference specific responsibility for the scrutiny of the treasury management function.

Contact Officer: David Steele **Ext:** 7288

Note: in compliance with section 100d of the Local Government (Access to Information) Act 1985 the report has been prepared in part from the following papers: 'Local Authority Investments' (House of Commons Communities and Local Government Committee); 'Risk and Return' (Audit Commission); Sundry City Council reports on treasury management.

CITY OF CARLISLE

To: The Chairman and Members of the Audit Committee CORP26/09

22 June 2009

TREASURY MANAGEMENT – ACTIONS ARISING FROM THE HOUSE OF COMMONS SELECT COMMITTEE'S REPORT ON LOCAL AUTHORITY INVESTMENTS

1. Introduction

1.1 Elsewhere on the agenda, a report (Corp 11/09) is presented on 'Risk and Return' which discusses the study that the Audit Commission carried out on the Icelandic bank crisis and English local authorities.

1.2 At the same time as 'Risk and Return' was being prepared, the Communities and Local Government Committee of the House of Commons was undertaking its own examination into the field of local authority investments. This report entitled 'Local Authority Investments' has only just (11 June) been published but it covers similar ground to 'Risk and Return' and reaches some similar conclusions. It is therefore considered appropriate to discuss 'Local Authority Investments' at the same time.

2. 'Local Authority Investments'

2.1 The Communities and Local Government Committee held a series of public hearings in January and February at which various expert witnesses gave evidence on issues relating to local authority treasury management and in particular the investment aspect of the function. Organisations who appeared before the committee included representatives of the local authority associations, CIPFA, the Audit Commission, various treasury management advisers to local authorities and the Minister for Local Government (John Healey) himself. In addition, written submissions were received from a large number of interested parties.

2.2 The outcome of the committee's deliberations is a report which complements 'Risk and Return' but which adds to it, mainly through the evidence gathered from its three public hearings. The report raises, in particular, questions relating to the role played by the various firms of treasury advisers. Between them, they have contracts with the vast majority of local authorities and there are aspects of the report which will not make for comfortable reading for these organisations.

2.3 The Audit Commission, too, does not escape criticism over its approach, in national terms, to the treasury management function and the extent to which it could be at risk through the impact of external events. The conclusions and recommendations of 'Local Authority Investments' are reproduced in full in the Appendix to this report but the following paragraph appends some brief comments on these conclusions and recommendations in so far as they might affect this authority.

3. Comment on the Conclusions and Recommendations of 'Local Authority Investments'

3.1 Local Authorities' Investments and Reserves

The Committee concludes that it would be inappropriate to restrict local authority investment options. This is similar to the conclusion of 'Risk and Return' that the national treasury management framework is 'broadly right'. The system may, therefore, need tweaking but not a complete overhaul.

3.2 Local Authorities' Financial Teams

Practice and performance in carrying out the treasury management function will necessarily vary between authorities. There is an acknowledged need to ensure that all authorities have the necessary level of expertise to properly carry out the treasury function. Attention is drawn, in particular, to the problems some district councils may face with limited staffing and other resources. There may, therefore, be proposals to encourage an element of shared service though such an initiative would need to be carefully thought through.

3.3 Scrutiny of the Treasury Management Function

This report endorses the view of the Audit Commission and of CIPFA that all authorities should have an Audit Committee and that scrutiny of the treasury function should be a part of its brief. Training has already been arranged on this issue for the Audit Committee and it is suggested that the annual treasury management reports that are produced, including the Investment Strategy, should also be considered by the Audit Committee. There is also a suggestion in the report that the Audit Committee should consider having at least one external member among its membership.

3.4 Credit Rating Agencies

The agencies do play an important role in assessing investment counterparties but their role has perhaps been overemphasised in previous guidance from CIPFA and indeed from the government. There is a need to be more aware of other considerations and sources of information in framing investment policies.

3.5 Treasury Management Advisers

This is the longest section of the conclusions and recommendations part of 'Local Authority Investments'. Some of the advisers did not have a very comfortable time when they appeared before the committee and this was essentially over the issue as to whether or not they provided investment advice to their clients or merely investment information. The City Council has been a client of Sector, who are the market leaders, for over twenty years although the name and ownership of the company has at times altered over this period. While the authority is happy with the services Sector provide, it has always acknowledged that responsibility for any decisions made rests with the council and not with Sector. The Audit Commission has now been tasked with carrying out a value for money study of the services that these firms provide. The Financial Services Authority, who also do not escape censure in the report, and CIPFA are also encouraged to take a more active part in reviewing the role and reliability of treasury management advisers.

3.6 Audit Commission

The report accuses the Commission of complacency in its attitude to local authority treasury management and accordingly holds it partly responsible for the potential loss of local authority funds in Icelandic banks. There is already some evidence that the Audit Commission has revised its approach to the local authority treasury function. Equally, it is doubtful if any local authority has not at least reviewed its own policies and practices in the light of the Icelandic banking collapse.

3.7 The CIPFA Codes

The report recommends that issues such as use of advisers, credit ratings etc are more specifically covered by CIPFA in any revised guidance that it may issue.

3.8 Central Government and Local Authority Treasury Management

The government has indicated its willingness to revise the current investment guidance that is provided to authorities. The report does not, however, attribute any blame to the government itself for what happened over Iceland and endorses the approach it has taken to assist authorities while avoiding the 'moral hazard ' argument if they were simply to be totally baled out.

4. Conclusion

4.1 This is, on the whole, a welcome report which sheds more light on a local authority function that is not always properly understood but which can have a huge impact, both positively and negatively, on an authority's financial performance. At present, all Icelandic deposits are merely 'at risk' and the current indications are that the bulk of the principal sums that are frozen will eventually be repaid. It is, though, unlikely that many authorities will receive 100% of these deposits, quite apart from the loss of considerable amounts in interest foregone.

4.2 The financial conditions world wide were quite exceptional in 2008 and local authorities, particularly those who were caught up in the Icelandic banking collapse, were inevitably affected by the events of last year. About a quarter of all UK local authorities had at least one investment in an Icelandic bank but there are lessons to be learnt for all authorities as well as a number of other organisations who are separately identified in the report

4.3 The Audit Committee of a local authority has been identified in both 'Risk and Return' and 'Local Authority Investments' as having a role to play in the scrutiny of the treasury management function of a local authority. Training to this end has already been organised and the Committee is asked to endorse this addition to its remit.

5. Recommendations

It is recommended that:

5.1 The report be received and welcomed as a further broad endorsement of the current level of practice and performance in local authority treasury management.

5.2 The conclusions and recommendations in 'Local Authority Investments', as discussed in paragraph 3 of the report, be noted and agreed and in particular the recommendation that the Audit Committee should embrace within its terms of reference specific responsibility for the scrutiny of the treasury management function.

ANGELA BROWN
Director of Corporate Services

Contact Officer: David Steele Ext: 7288

Appendix A

‘Local Authority Investments’ Conclusions and Recommendations

1. Local Authorities’ Investments and Reserves

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

2. Local Authorities’ Financial Teams

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

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

2.3 We recommend that the Government, CIPFA and the LGA study ways in which local authorities, particularly smaller ones, could join together to share expertise and pool treasury management resources. The sharing of information and expertise, such as identifying banks that are in the same financial group, might have lessened the failures that occurred during the Icelandic crisis. (Paragraph 56)

3. <u>Scrutiny of the Treasury Management Function</u>

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

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

3.3 Guidance from CIPFA notes that it is open to an authority to appoint someone other than an elected member and from outside the authority either to serve on or to chair the audit committee. The co-option of external members to audit committees in this manner offers an additional opportunity to local authorities to enhance the expertise available to the authority in the scrutiny of its treasury management function, and we encourage all local authorities to consider taking advantage of it. (Paragraph 70)

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

4. Credit Rating Agencies

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

5. Treasury Management Advisers

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

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

5.3 We recommend that the Audit Commission carry out a value for money study of the services that local authorities have received from treasury management advisers, with a view to advising local government on the value that they offer in the differing circumstances applying to individual authorities. Paragraph 101)

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

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

5.6 Our examination of the role of treasury management advisers in the Icelandic debacle has raised wider questions about their influence on local authorities' treasury management practice. First, there is confusion, and perhaps some deliberate ambiguity, about what services they offer. It is clear to us that some local authorities believed that they could place reliance on their treasury management advisers in a way that some of the treasury management advisers themselves now seek to argue was misguided. Second, there is concern about the independence of treasury management advisers that may be part of companies that will benefit from the investment decisions of the local authorities that they advise. Third, there is a lack of clarity about the extent to which local authorities can assume that treasury management advisers are properly regulated. While local authorities must ultimately take responsibility for their investment decisions, a range of regulatory and advisory bodies appear to us to have been complacent in their approach to the role of treasury management advisers. The Audit Commission, CIPFA and the FSA must all re-examine the role and reliability of treasury management advisers and their discharge of duties of care for local authorities in managing this aspect of treasury management. (Paragraph 121)

6. <u>The Audit Commission</u>

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

6.2 The Audit Commission took it for granted that treasury management was a well-managed function, and, consequently, was not an area of concern for auditors. Even if it could not reasonably have been expected to foresee the collapse of a country's entire banking system, the Audit Commission should have been aware of the greater risk to treasury management as a result of the prevailing financial climate and should have adjusted its practice accordingly. The Audit Commission failed to realise that treasury management was becoming an increasingly risky area and, in that respect, it must share some of the blame for the potential loss of funds in the Icelandic banks. If it had viewed treasury management within the increasingly volatile economic context, it would have put treasury management higher in its auditing procedures, and if it had done that, it is possible that less public money would now be at risk. We recommend that the Audit Commission review its own auditing procedure and prioritisation of the areas of local authority activity it chooses to audit, in order to ensure that such complacency does not happen in future. (Paragraph 135)

7. <u>The CIPFA Codes</u>

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

8. Central Government and Local Authority Treasury Management

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

8.2 We agree with the Government's approach to assisting those local authorities that have funds at risk in the failed Icelandic banks, which we consider to be an appropriate way of protecting the council tax payer whilst avoiding the "moral hazard" inherent in an unconditional, open-ended guarantee of local authorities' investments. The Government will have to monitor closely the amount of money that local authorities eventually get back from Iceland to ensure that any actual losses do not seriously disadvantage either local council tax payers or local service users. However, democratically accountable local authorities are ultimately responsible for their investments and it is they who should take the consequences—whether in the budget or at the ballot box—of their investment decisions. (Paragraph 152)

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

8.4 The majority of stakeholders in treasury management agree that the cost of early repayment of debt to the PWLB needs to be reviewed. We add our voice to those recommending that the Government carry out an urgent review of the arrangements for early repayment of debt to the PWLB. (Paragraph 166)