



Japan Local Government Centre, London

Monthly Report for April 2009 (Britain) – Icelandic banking crisis

Background

This report follows earlier monthly reports on the Icelandic banking crisis of 2008 and its impact on local authority finances in the UK related to council reserves invested in two of Iceland's three largest banks (or their UK subsidiaries). In particular it concentrates on the inquiries undertaken by the Audit Commission and the House of Commons Treasury Select Committee and their reports of March and April 2009. Finally, it gives an update on the state of the frozen deposits of UK local authorities as of April 2009.

Audit Commission report: *Risk and return – English local authorities and the Icelandic banks*

The Audit Commission, the public corporation which audits local government, fire, police, housing and health services in England, published its examination of English local authorities' deposits in Icelandic banks in March 2009. The report argues that the majority of councils acted properly in managing their investments and were alert to the risks. However, it also identifies some examples of negligence during the days leading up to the collapse of the Icelandic banks on 7 October 2008. The most common reason given for those local authorities who were less cautious was their over-reliance on credit ratings agencies and external advisers, to the exclusion of other information. Seven local authorities breached guidance issued by the Chartered Institute of Public Finance and Accountancy (CIPFA), and their own treasury management protocols, by investing £32.8 million in Icelandic banks in October 2008. The breaches included one council that failed to open an email warning of a ratings change, one using out of date information and another exceeding its own limit for deposits in a single bank.

The report found that:

- *Of the total of £31 billion that all 451 local bodies had invested in the UK and abroad on 7 October 2008, 3.1% was in Icelandic banks*
- *One in four (127) local authorities share £954 million at risk in Icelandic banks, as follows:*
 - *15 county councils (44%) deposited £270 million*
 - *58 district councils (24%) £231 million*
 - *11 London borough councils (33%) £153 million*
 - *13 unitary authorities (28%) £105 million*

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- 12 police authorities (32%) £85 million
- 10 fire authorities and other bodies (16%) £78 million
- Eight metropolitan district councils (22%) £32 million
- Local authorities earned approximately £1.8 billion in interest from short term deposits during 2008-2009
- For some, income from interest has equalled that from council tax
- 18 local authorities have more money at risk than they have in their reserves

The report recommended in conclusion:

- the need for a review of CIPFA guidance, which will inform internal and external audit guidelines
- training for staff and councillors so that they can question and interpret external and internal advice (including credit ratings)
- monitoring of a wider range of information continually
- revision of the national framework to reassess the consideration given to liquidity, security and yield.

In response to the report, Local Government Association (LGA) Chairman Margaret Eaton said: *“The events of last October were part of a bigger financial crisis that affected not just councils but also other parts of the public sector as well as charities, businesses, individual savers and the Audit Commission itself. However, it is clear that some aspects of treasury management need to be done differently in the future.”* Separately, the LGA’s chief executive John Ransford wrote to Audit Commission chief executive Steve Bundred to express his dismay at the report’s naming and shaming of the seven local authorities which had breached the CIPFA guidance or their own protocols.

Treasury Select Committee Report: *Banking Crisis: The impact of the failure of the Icelandic banks*

The Treasury Select Committee, one of the departmental select committees of the House of Commons, published its fifth report of the 2008/09 parliamentary session in April 2009. The report considers the impact on those UK local authorities, charities and private citizens with deposits in Icelandic banks and argues that the banks’ failure had “potentially severe consequences” for these depositors. The committee considered the case for government assistance to depositors affected by the losses but did not accept that local authorities should be compensated by central government. It did however accept that there was a case for compensating charities in this instance. Finally, it also argued that as a general principle, there is no case for the UK government to provide cover for deposits held by UK citizens in banking systems other than those under the direct control of the UK.

The report considers the timeline concerning local authority investments and the release of credit rating agencies’ downgraded ratings, with some local authorities

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investing up until the very last moment before the banks collapsed. The report noted that under the Local Government Act 2003 and its Prudential Code for Capital Finance in Local Authorities, councils are required to invest reserves so as to seek the highest rate of return. It also noted that many UK local authorities utilise private sector financial advisers in order to benefit from their money markets expertise when deciding where to invest. The committee heard evidence from the LGA's Deputy Chair Cllr Richard Kemp concerning the quality of advice received regarding the investment of council reserves. Cllr Kemp also argued that the government should consider compensating local authorities for their losses. The report argued that while it acknowledged that some local authorities felt "hard done by" owing to their losses and the lack of government support, their own investments are their responsibility and it "would seem perverse to reward" local authorities which had failed to protect their investments.

In response to the report, the Chairman of the LGA Cllr Margaret Eaton said: *"There must be a consistent and fair approach to compensation. If charities are to be compensated why should there be no relief whatsoever for the council taxpayer? Councils provide vital services to society's most vulnerable people."*

Update

In April it was revealed that serious concerns had been raised by the Metropolitan Police Authority (MPA) over its investments in the failed Landsbanki but this had been withheld from the public. The MPA originally withdrew its £30m investment in Landsbanki in April 2008 on the advice of its treasurer. However, this money was subsequently reinvested without his knowledge and only revealed to him once the bank failed. £10m was invested in July 2008, with a further £20m invested in September 2008, 15 days before the bank failed. The authority's investment managers remained able to invest the funds as the bank was not removed from its approved list, despite the stated concerns of the treasurer. An internal inquiry into the decision was completed in November 2008, but its findings not released to the public until April 2009. An external inquiry by auditors KPMG in February 2009 found nine serious failings among the authority's managers over the affair.

Later in the month it was announced that administrators for Heritable (the UK subsidiary of Landsbanki), Ernst & Young, were considering allowing creditors to be repaid up to 80% of their deposits, which affects some £319m invested by local authorities. This announcement does not affect deposits in other banks, which remain frozen. Administrators for the Kaupthing, Singer & Friedlander bank said that they envisage being able to repay 50%, with some £86m invested by local authorities in this UK subsidiary. In response, the LGA said: *"This first step in getting council money back from the Icelandic banks will be a relief to taxpayers. The LGA, working with councils, has always expected to get the lion's share of this money back and is continuing to work flat out to make sure that the council taxpayer is top of the list for repayment."*

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