LANCASTER CITY COUNCIL

Promoting City, Coast & Countryside

Committee: **AUDIT COMMITTEE**

Date: **WEDNESDAY, 22 APRIL 2009**

Venue: **MORECAMBE TOWN HALL**

Time: **6.00 P.M.**

A G E N D A

1. **Apologies for Absence**

2. **Minutes**

   Minutes of the Meeting held on 21st January, 2009 (previously circulated).

3. **Items of Urgent Business authorised by the Chairman**

4. **Declarations of Interest**

5. **Investments in Icelandic Institutions - Update** (Pages 1 - 130)

   Report of the Head of Financial Services

6. **Risk Management** (Pages 131 - 173)

   Report of the Head of Financial Services

7. **Internal Audit Monitoring** (Pages 174 - 178)

   Report of the Internal Audit Manager.

8. **Results of Internal Audit Work** (Pages 179 - 186)

   Report of the Internal Audit Manager.

ADMINISTRATIVE ARRANGEMENTS

(i) Membership

Councillors Malcolm Thomas (Chairman), Jon Barry, Abbott Bryning, Roger Dennison, Janice Hanson, Geoff Knight and Keith Sowden

(ii) Substitute Membership

Councillors Shirley Burns, Tina Clifford, Tony Johnson, Karen Leytham, Geoff Marsland, Ian McCulloch, Sylvia Rogerson, Peter Robinson and Paul Woodruff

(iii) Queries regarding this Agenda

Please contact Sharon Marsh, Democratic Services - telephone (01524) 582096 or email smarsh@lancaster.gov.uk.

(iv) Changes to Membership, substitutions or apologies

Please contact Members' Secretary, telephone 582170, or alternatively email memberservices@lancaster.gov.uk.

MARK CULLINAN,
CHIEF EXECUTIVE,
TOWN HALL,
DALTON SQUARE,
LANCASTER LA1 1PJ

Published on 9th April 2009

Agenda Item 5

AUDIT COMMITTEE

Investments in Icelandic Institutions - Update
22 April 2009

Report of Head of Financial Services

PURPOSE OF REPORT
This report provides the Committee with an update on actions taken since it last considered this matter back in November, and includes the Audit Commission's and the Treasury Select Committee's recently issued reports for Members' consideration.
This report is public.

RECOMMENDATIONS

(1) That the report be noted.

(2) That the Committee indicates whether there are any further specific aspects of the attached reports they wish to be considered, as part of any subsequent review of the internal control and governance arrangements for the Council's treasury management function.

1 **Report**

1.1 At the special Audit Committee meeting held last November, in considering details of the Council's Icelandic investments Members resolved that a report be requested regarding any future changes in investment policy and also that updates be provided to each meeting of Full Council.

1.2 With regard to the latter point, updates have been included in each of Cabinet's budget reports to Council. These have included recent briefings provided by the Local Government Association (LGA); the latest of which is included at ***Appendix A*** for information. Initially these briefings were provided weekly but given the timing of new information becoming available, these are now produced monthly.

1.3 As yet, there is no further information available on which to make an informed view regarding exactly how much of the total amounts owing (£6M plus £260K accrued interest to October 2008) will be returned. Now that the budget exercise for 2009/10 is completed, as reported to Council it is intended that formal updates will be included through the usual reporting routes (i.e. in particular through quarterly PRT meetings). Monthly updates from the LGA to Group leaders will continue.

1.4 With regard to reporting on future changes in investment policy, the Council's treasury management framework has been updated significantly for 2009/10 and prior to it being finally approved by Council on 04 March, it was also considered by both Cabinet and Budget and Performance Panel.

1.5 Since then, the Audit Commission has released its report on Icelandic investments (English authorities) and the Treasury Select Committee has also very recently released a report "*Banking Crisis: The impact of the failure of the Icelandic banks".* This is one of a series of reports that the Committee is publishing as part of its broader inquiry into the banking crisis.

1.6 Copies of both the Audit Commission's and the Select Committee's reports are attached for Members' information. It is clear that further information, advice and guidance will follow in due course, from the Audit Commission and from other bodies such as the Chartered Institute of Public Finance and Accountancy (CIPFA). In view of this, and the actions already taken in updating the current year's treasury management framework, at this stage it is recommended only that Members indicate whether there are any further specific aspects of the reports they wish to be considered, in reviewing the internal control and governance arrangements surrounding the function.

1.7 Once the Audit Commission and CIPFA have completed their deliberations, a further review of the Treasury Management Framework will be completed for Members' consideration. This will pick up on any points raised at this meeting, as well as any other external reports etc. that may be issued by other bodies in the meantime. It should be noted that at present, general responsibility for scrutinising the treasury management framework proposals rests with Budget and Performance Panel, rather than the Audit Committee. Given the Audit Commission's recommendations, it is envisaged that this aspect will be considered further in due course.

2 Options and Options Analysis (including risk assessment)

This report is primarily for information and no options are put forward.

CONCLUSION OF IMPACT ASSESSMENT
(including Diversity, Human Rights, Community Safety, Sustainability and Rural Proofing)
No implications directly arising or quantifiable at this time.

FINANCIAL IMPLICATIONS
In terms of the legal advice obtained through the LGA, to date the City Council's share of costs amounts to £1,501.91. This will be funded from the existing Contractor / Consultancy budget in Financial Services.

DEPUTY SECTION 151 OFFICER'S COMMENTS
This report has been prepared by the s151 Officer.

LEGAL IMPLICATIONS
Legal Services have been consulted and have no further comments.

MONITORING OFFICER'S COMMENTS
The Monitoring Officer has been consulted and has no further comments.

BACKGROUND PAPERS Treasury Management Framework 2009/10	**Contact Officer:** Nadine Muschamp **Telephone: 01524 58**2117 **E-mail:** nmuschamp@lancaster.gov.uk **Ref:**

promoting better local government

From the Chairman and Chief Executive of the Association
Councillor Margaret Eaton
John Ransford

To Group Leaders and Chief Executives
All councils with exposure to Icelandic banks

20 March 2009

Dear Colleague

'File on Four' report
Many of you will have heard or read about the recent 'File on Four' report on council finances and investments in Icelandic banks, which included suggestions about councils' likely recovery from the banks. The information quoted was provided by an individual not involved in the administration processes for any of the banks and does not accord with information that is publicly available about potential recovery. We would advise councils to discount the forecast made on the programme; this update provides further information about progress and potential recovery from each of the banks councils invested in.

Individual bank update
The next creditor meetings for **Landsbanki** and **Glitnir** will take place during week beginning 30 March. As outlined in our previous update, the key issue in relation to both banks is the issue of preferential status for depositors, including local authorities. There are positive signs that depositors will be treated as having preferential creditor status under Icelandic legislation (as is the case in other jurisdictions such as the US). If this is the case, councils are likely to recover a very significant part of their deposits through this route (or even all of it, in the case of Glitnir). However, the position is not yet confirmed and it is likely to be several months before it is resolved. The expectation is that the issue will need to be tested in the courts, and draft legislation is before the Icelandic parliament which should enable this to happen once it is passed.

Through our lawyers Bevan Brittan we are continuing to monitor this issue and, under the direction of the relevant local government creditor committees, will take appropriate action as necessary.

The administration process for **Heritable** is ongoing. As stated in previous updates, the administrator has advised that he expects to make a material payment to

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creditors. Further information about the administration will be made available to creditors in the statutory report required in April.

There remains significantly less clarity about possible recovery from **Kaupthing, Singer and Friedlander**, although the administrator has advised that he expects a dividend will be payable. A meeting of the statutory creditor committee was held on 16 March. The committee were updated on payments and activity by different parts of the business, as well as on a Bank of England trust account holding some £150m of deposits made with KS&F between 2 -7 October 2008. A fuller update will be provided to creditors in the statutory report due by 21 April.

Audit Commission and other reports
We are anticipating that the Audit Commission will be publishing its report into local authority treasury management and Icelandic banks on 26 March. We will share further information with council finance officers and media teams as soon as possible.

We understand that the CLG Select Committee report into local authority treasury management is unlikely to be published until after Easter.

Dialogue with government
We have had further dialogue with Treasury officials and their advisers at meetings in London and Reykjavik, and they have continued to provide useful information about processes taking place in Iceland and their dialogue with the Icelandic government / IMF. A further meeting has been scheduled for the end of April.

If you have any queries about any of the information in this update, please get in touch.

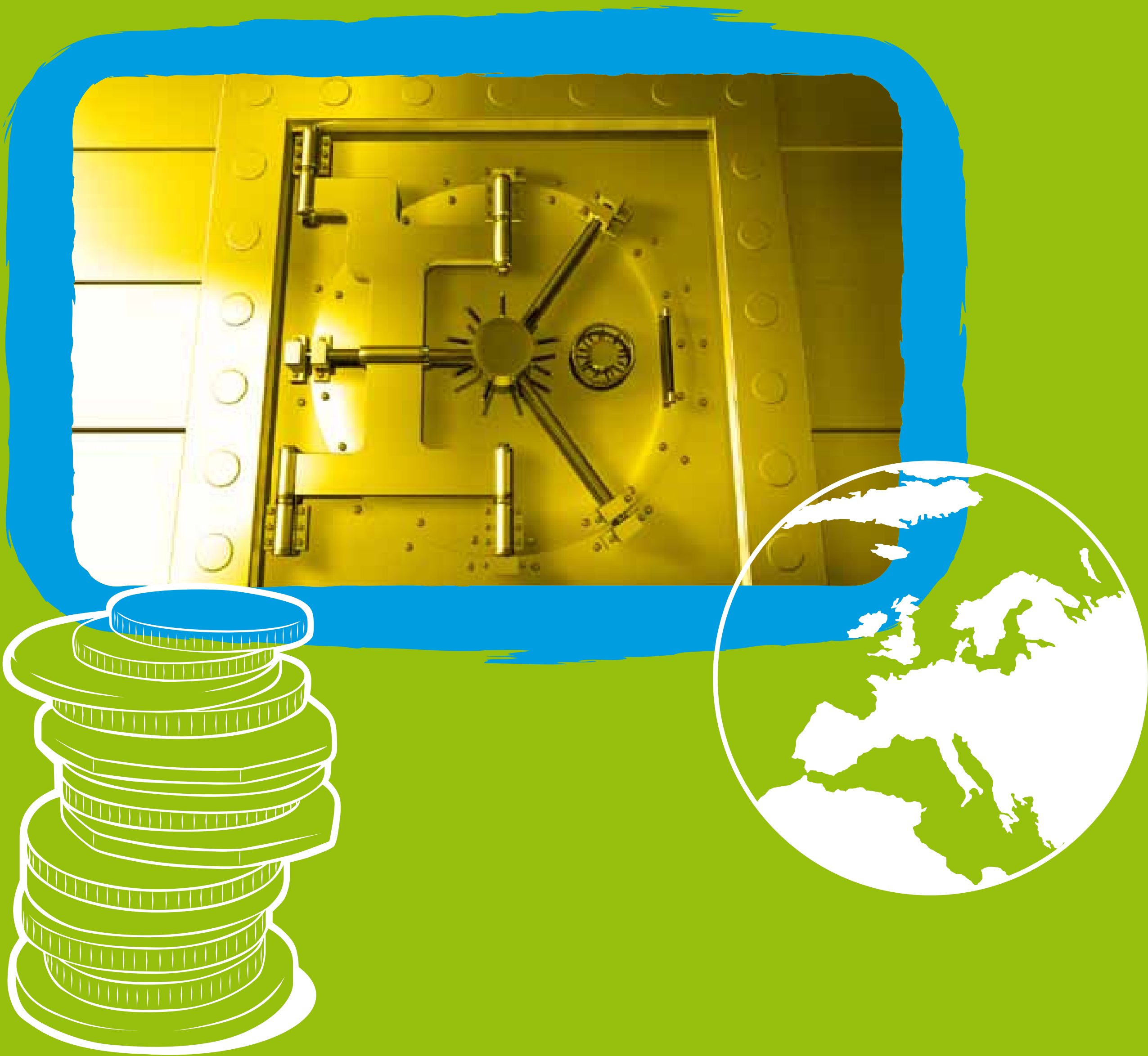
Yours sincerely

Margaret Eaton
Chairman

John Ransford
Chief Executive

Risk and return

English local authorities and the Icelandic banks



Cross-cutting

National report

March 2009

audit commission

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

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

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

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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

Contents

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.[I]

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.

I 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.

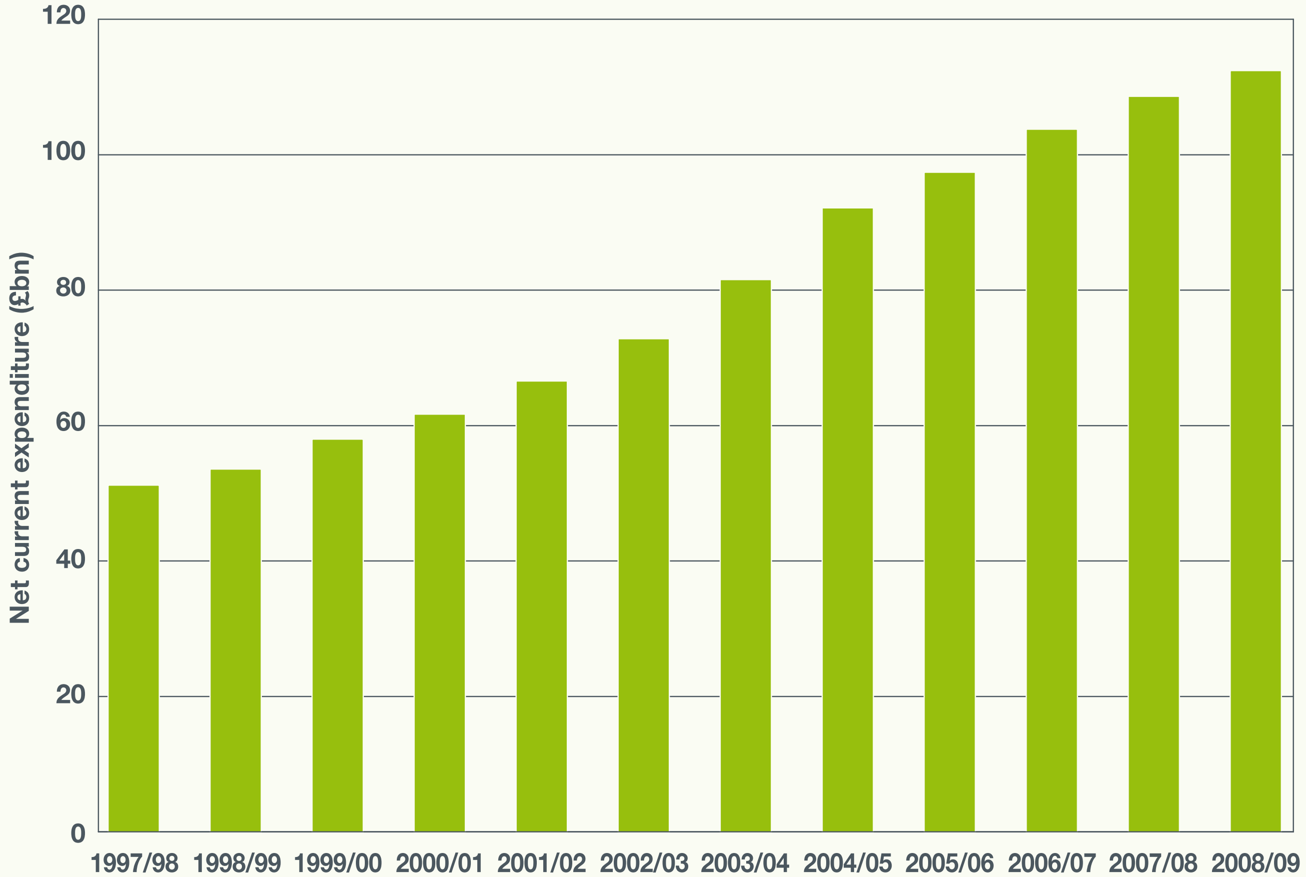
Local authorities manage large sums of public money

14 Local authorities manage large sums of public money.[I] 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

I 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

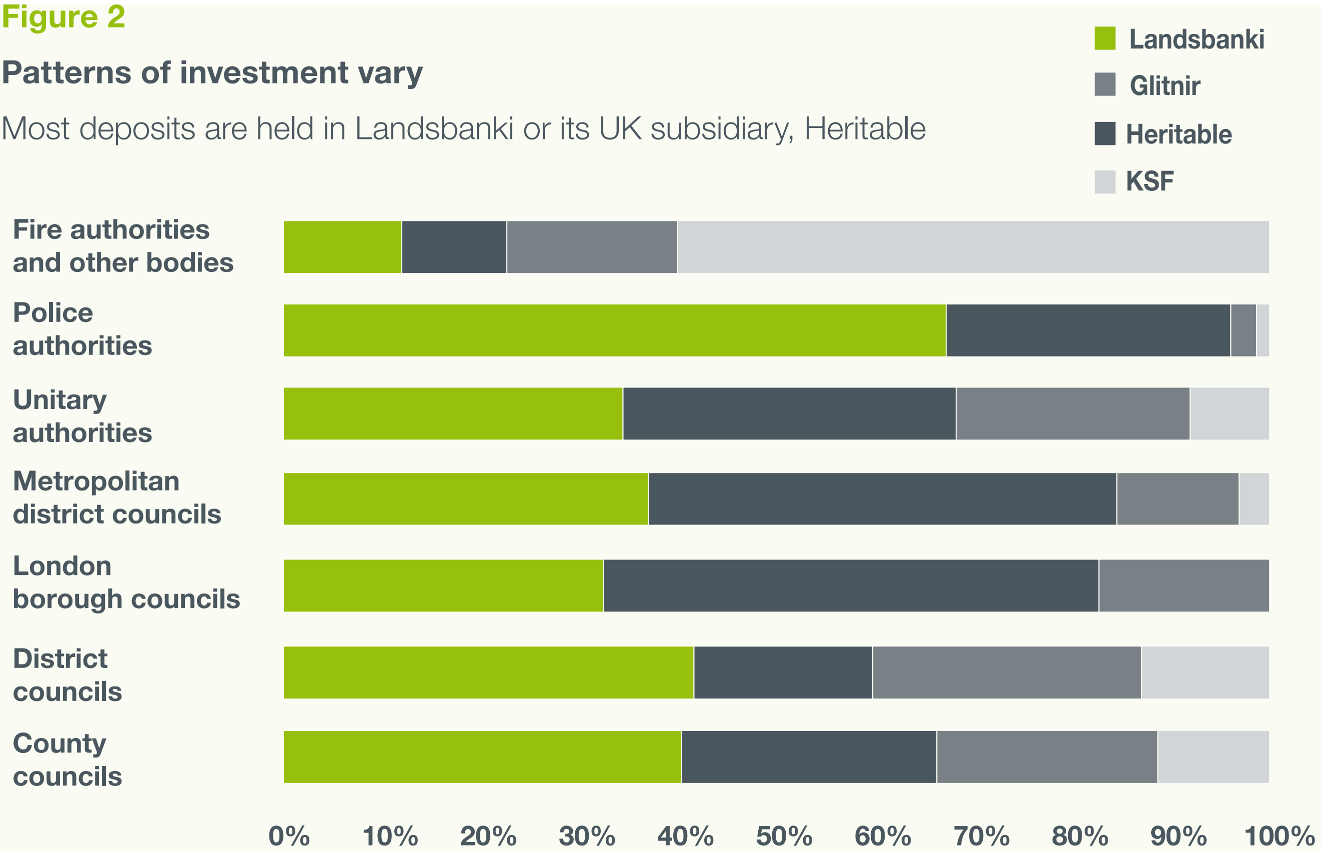
Where is the money?

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.[I] 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).

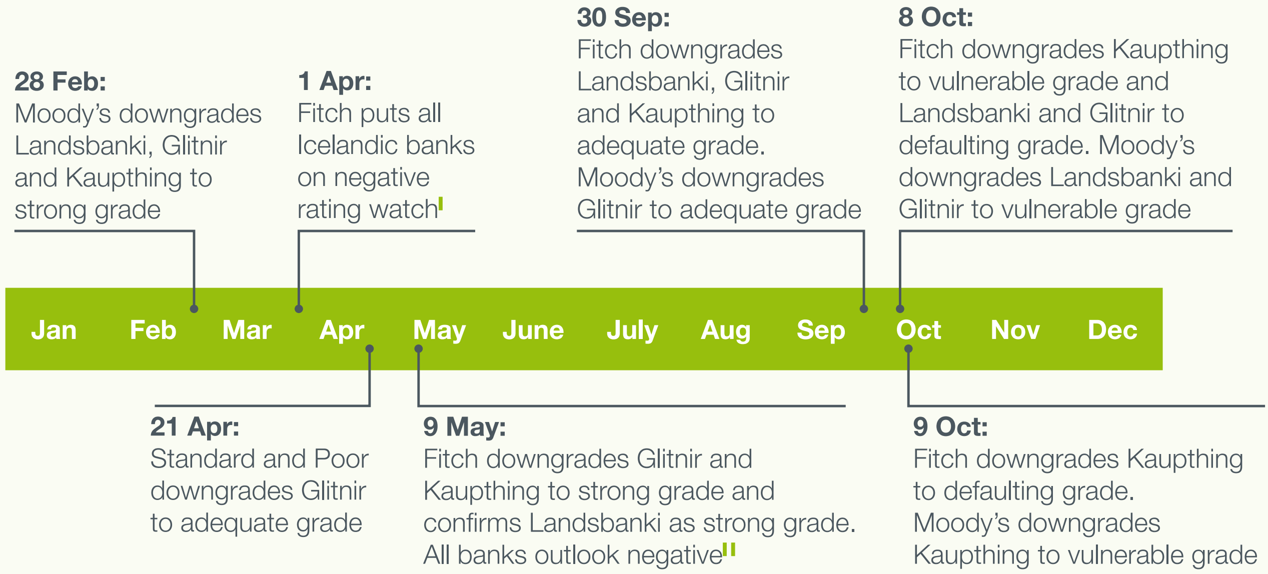
I Variances 32, ENSAE, December 2007.

2 Local authorities and the Icelandic banks

Figure 3

Credit ratings fell during 2008

A variety of credit ratings were downgraded



AC Standardised ratings

AAA - Extremely strong grade	AA - Very strong grade	A - Strong grade	BBB - Adequate grade
BB - Speculative grade	B - Very speculative grade	CCC - Vulnerable grade	D - Defaulting grade

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

I A ratings watch indicates that there is a heightened probability of a rating change in the short term www.fitchratings.com

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.

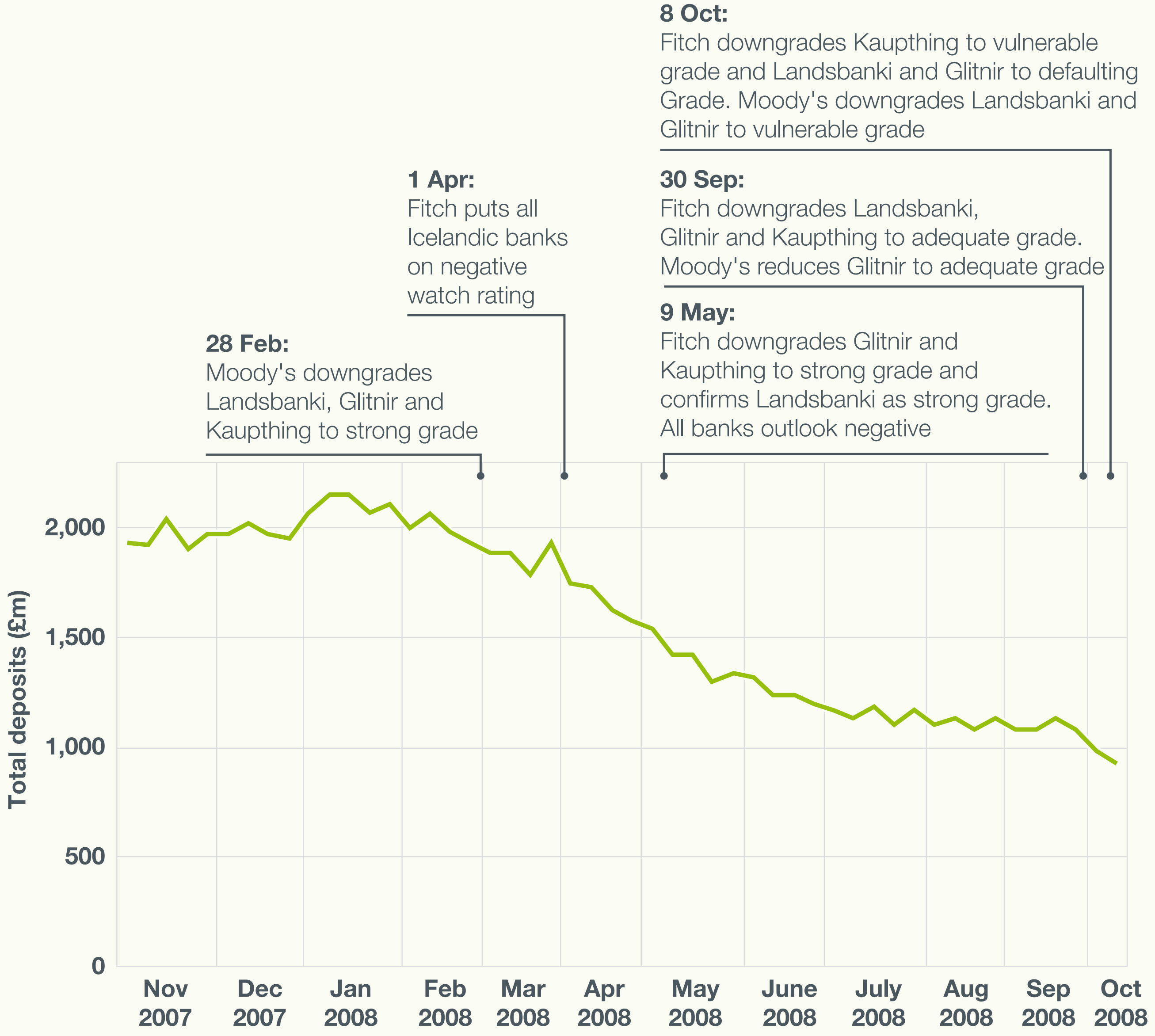
40 The value of local authority deposits held in the Icelandic banks declined by more than half, from more than £2 billion in January 2008, to £953.53 million in October 2008, when the Icelandic banks ceased trading (Figure 4). The number of new deposits also fell and, in particular, declined sharply 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).

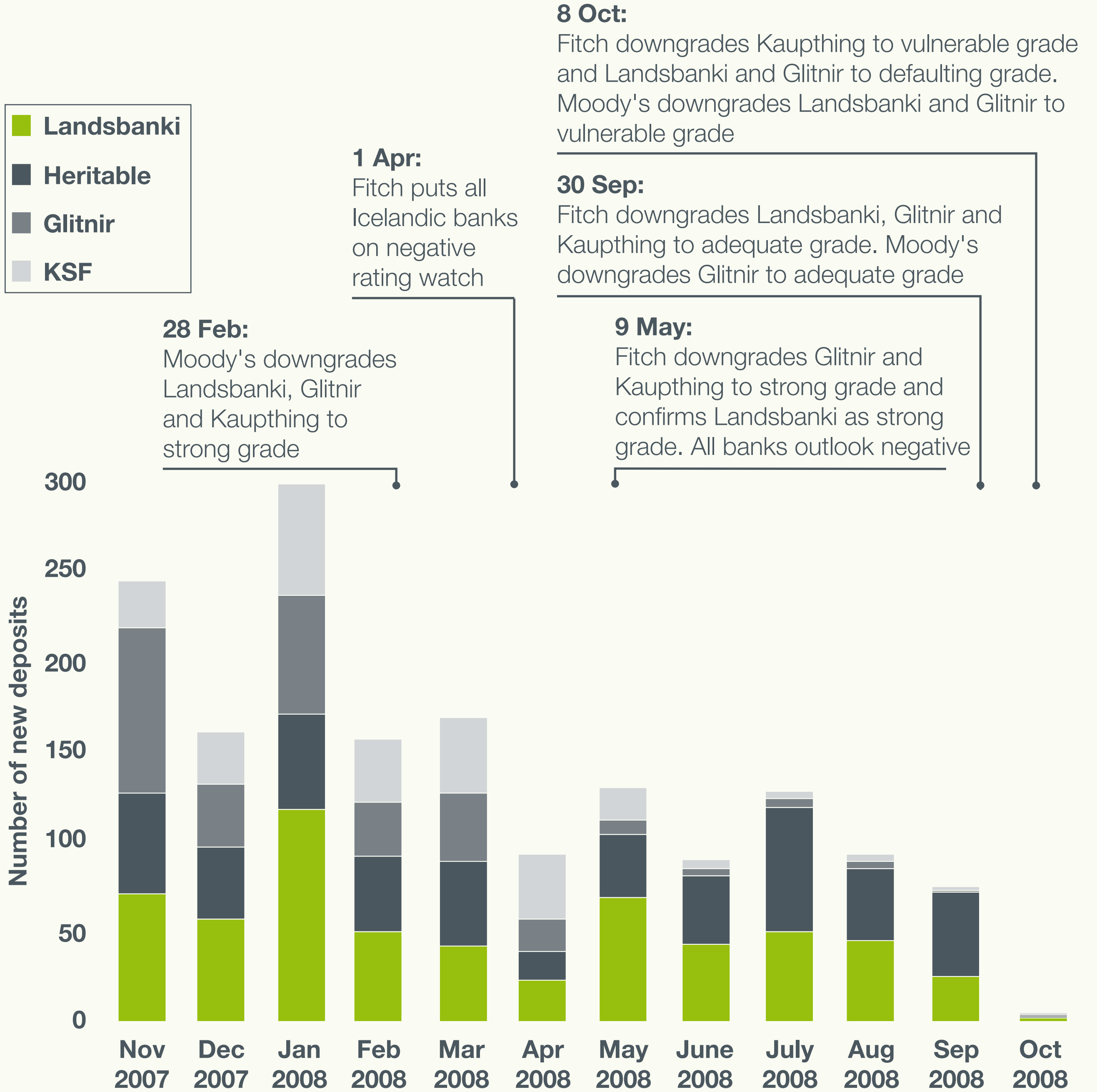
42 However, the picture is complicated. For example, in May 2008, Fitch downgraded the ratings of Glitnir and Kaupthing and placed them on negative outlook, meaning that further rating changes were possible in future. At the same time, the credit rating of Landsbanki was confirmed as A (strong grade). 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 2008[I]

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

I 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.

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.

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.

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.[I]

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.

I 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

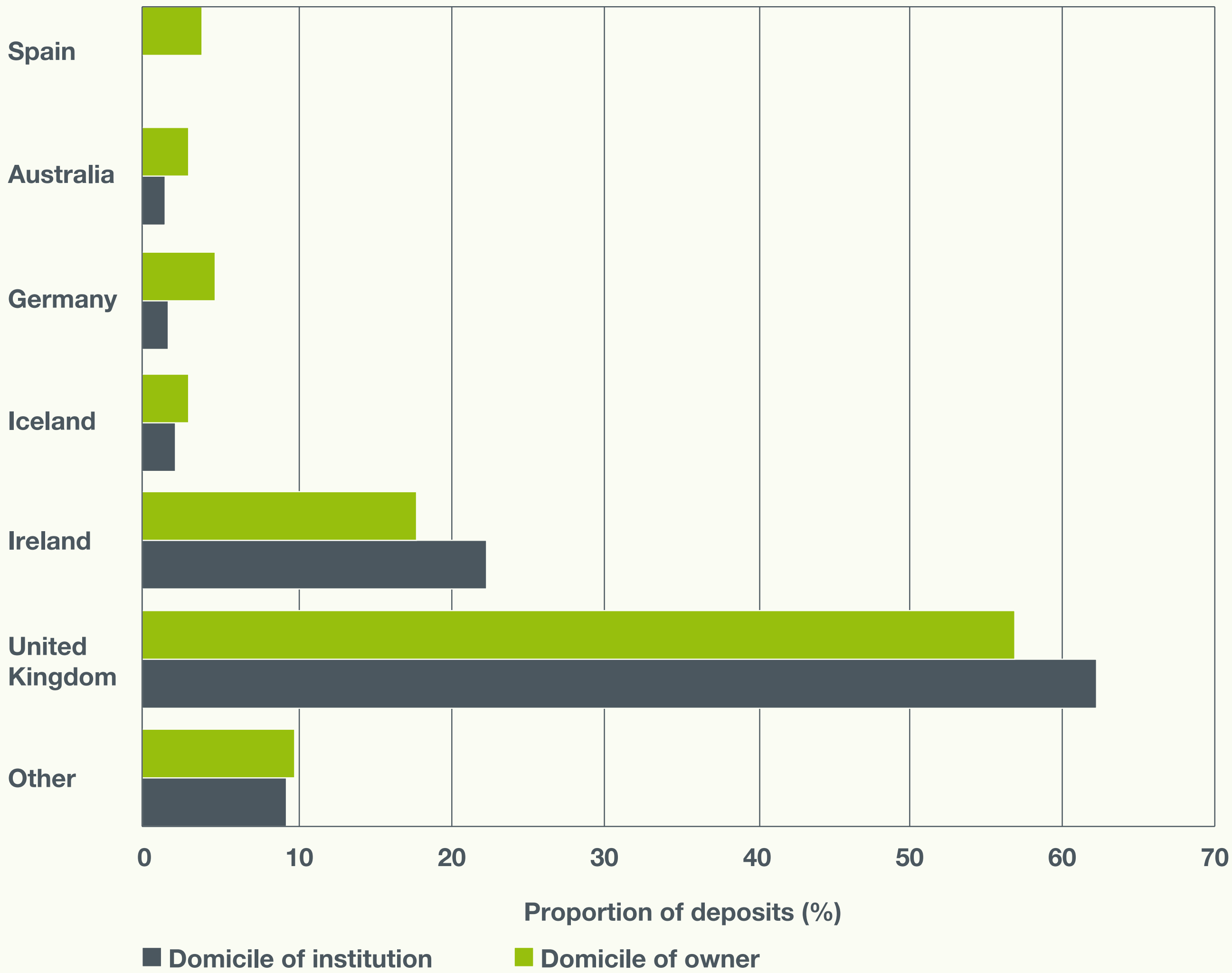
92 On 7 October 2008, local authorities held deposits in 25 different countries. More than £19.4 billion (63 per cent) was deposited in institutions registered in the UK, of which £17.7 billion (57 per cent) was deposited in institutions owned by UK companies. Almost 43 per cent of funds was deposited 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: • 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: • 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. Have gaps in understanding regarding the use of credit rating agencies, including: • 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	Elected member oversees finance function, takes an interest in the treasury policy and challenges assumptions built into the limits and minimum credit criteria. 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.	Elected members do not engage in the treasury policy and, instead, leave it to the experts in finance. Failure to question policies year-on-year and mechanistically using their advisers' policy template.
Use of information	Extensive. Includes actively researching counterparties and the markets.	Limited. Overly reliant on a single information source, for example emails from a treasury adviser. 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.
Relationship with counterparties	Know the bankers that they are investing with.	Excessive reliance on brokers means that some local authorities do not have direct contact with their banking counterparties.
Reliance on yield	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.	Highest returns available in market place are sought. Some (overt or covert) pressure to maximise returns to balance budgets.

Characteristic	Non-investors	Investors
Achievement of security and liquidity	Carry out scenario testing to ensure that the sensitivity of the portfolio to the market is understood. Normal expectation is for specified investments of six months or less.	Rely on advisers for many aspects of credit risk and interest rate risk. 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.
Resource management, staff development and expertise	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. Actively encourage networking and training. Staff gather information about the markets and counterparties that includes: • 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.	Reliant on advisers for market and credit information. 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. Weak knowledge of products and markets. Take few steps to train and develop staff.

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 Advisery 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 Policy 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)[i]	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

i 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

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House of Commons

Treasury Committee

Banking Crisis: The impact of the failure of the Icelandic banks

Fifth Report of Session 2008–09

Strictly embargoed until 0001 hrs Saturday 4 April

HC 402

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Banking Crisis: The impact of the failure of the Icelandic banks

Fifth Report of Session 2008–09

Report, together with formal minutes

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Summary

The failure of the Icelandic banks in October 2008 had potentially severe consequences for depositors. In this report, we consider three sets of such depositors: local authorities, charities and UK citizens who deposited in the Isle of Man and Guernsey subsidiaries of the Icelandic banks. We consider the case for the provision of assistance by the UK Government to these depositors. We do not accept that there is a need to provide assistance to the local authorities. We recommend that, on this occasion only, all charities should be compensated for losses incurred as a consequence of the failures of the Icelandic banks. Finally, we agree that the overarching principle should be that the UK Government cannot provide cover for deposits held by British citizens in jurisdictions outside the direct control of the United Kingdom. As such, while we acknowledge the severe distress of those UK citizens suffering due to the Icelandic banking failure, we can only recommend that the UK authorities work with the Isle of Man and Guernsey authorities to resolve these issues.

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1 Introduction

Iceland, the UK and its Crown Dependencies

1. Iceland has suffered a major economic crisis in recent times triggered by the failure of its over-extended banking system. Prior to the collapse of Iceland's three largest banks, Glitnir, Landsbanki and Kaupthing, their combined debt exceeded six times the nation's GDP of €14 billion.[1] The banks had branches and subsidiaries in the UK, the Isle of Man and Guernsey, as well as across Europe. This report considers the circumstances that led to the failure of these banks, the actions taken by the UK Government to safeguard British citizens' savings, and those whose funds have not been safeguarded.

2. Whilst this Report discusses the arrangements undertaken by the Icelandic authorities and the Crown Dependencies to provide compensation to savers within their jurisdictions, it is important to note that the recommendations here are made solely to the UK Government. The very distinctive nature of the impact of the failure of the Icelandic banks seemed to us to justify a separate report on this issue.

3. Our report is based on evidence submitted to our wider inquiry into the banking crisis. Our terms of reference for that inquiry included: "evaluating the impact of European Union directives on financial stability, including 'passporting'" and "the protection of UK citizens investing funds in non-UK jurisdictions".

4. We took evidence from Mr Ziggy Sieczko, Spokesman, Kaupthing Singer Friedlander Isle of Man Action Group, Councillor Richard Kemp, Local Government Association, Mr Neil Dickens, Landsbanki Guernsey Depositors Action Group, Mr Chris Cummings, Director General, Ms Amanda Davidson, Deputy Chair, Association of Independent Financial Advisers (AIFA), and Dr John Low, Chief Executive, Charities Aid Foundation (CAF), Tony Shearer, former Chief Executive of Singer & Friedlander, Hon James Anthony (Tony) Brown MHK, Chief Minister, Isle of Man, Mr Mark Shimmin, Chief Financial Officer, Treasury, Isle of Man, Mr John R Aspden, Chief Executive of the Financial Supervision Commission, Isle of Man, Deputy Lyndon Trott, Chief Minister of Guernsey, and Mr Peter Neville, Director General, Guernsey Financial Services Commission. We also put questions to the Rt. Hon Alistair Darling MP, Chancellor of the Exchequer, Mervyn King, Governor of the Bank of England and Lord Turner, the Chairman of the Financial Services Authority (FSA). We are grateful to all our witnesses and also to those submitting written evidence and questions. We should also like to thank our specialist adviser, Professor Geoffrey Wood of Cass Business School, City University London, for his invaluable advice.

5. Iceland has a population of 319,756 people which places it in size of population somewhere between Coventry and Wakefield. This volcanic island is not especially abundant in natural resources and historically has ranked amongst the poorest countries in

1 BBC News, *Waking up to reality in Iceland*, 27 January 2009.

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Western Europe. Its economy has traditionally depended heavily on the fishing industry. Iceland joined the European Economic Area in 1992 which enabled its economy to diversify. It was only at the beginning of this decade that Iceland began to transform itself into a global financial force. In 2007, Iceland was ranked as the most developed country in the world according to the United Nations' Human Development Index. However, this development was disproportionately dependant on Iceland's financial services.[2]

6. The demise of Iceland's economy has been sudden and dramatic. In 2008 its over-extended banking system collapsed. The nation's currency was strongly devalued (see Chart 2) and the national debt soared. The fall of the Icelandic banking system sent shock waves through the world's financial community. The fact that the fate of Icelandic banks had an impact on millions of savers in the UK, as well as on numerous local authorities, wholesale depositors and charities testifies to the trans-national basis of the modern banking system. It also points to the complexity of the regulatory framework.

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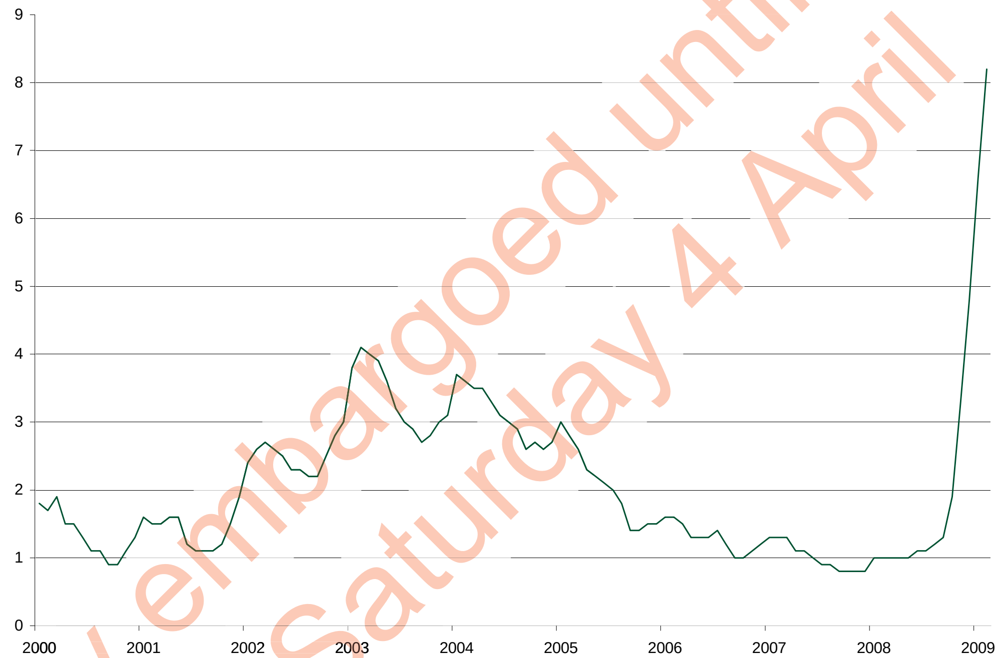
2 http://hdr.undp.org/en/media/hdr_20072008_en_indicator_tables.pdf

2 A crisis in Iceland

The economy of Iceland

7. In June 2007, an International Monetary Fund (IMF) report concluded that “The medium-term prospects for the Icelandic economy remain enviable”.[3] However, the same report sounded a cautionary note, highlighting “Iceland’s large current account deficits, the rapid growth in indebtedness, and persistently high consumer price inflation”.[4] Other economic indicators also suggested Iceland’s economy was doing well around this time. Iceland’s 2007 GDP per capita was US$ 37,700, which compared favourably with other European countries and was above the OECD average; as Chart 1 shows, unemployment was also low.[5]

Chart 1: Registered unemployment rate in Iceland



Source: Statistics Iceland

Crisis and the need for IMF support

8. From the spring of 2008 the British authorities were aware of Iceland’s deteriorating position. It was reported that at the April meeting of the IMF in Washington the Bank of England was approached by the Central Bank of Iceland for assistance.[6] Throughout the summer articles in the financial press drew attention to concerns about the Icelandic banks

3 International Monetary Fund, Iceland-2007 Article IV Consultation Concluding Statement, June 11, 2007, para 1

4 *Ibid*, para 2

5 Using current purchasing power parity; OECD, *OECD in Figures 2008*, pages 12-13

6 Central bank of Iceland press release, Currency swap agreements and attempts to reinforce the foreign exchange reserves, 9 October 2008

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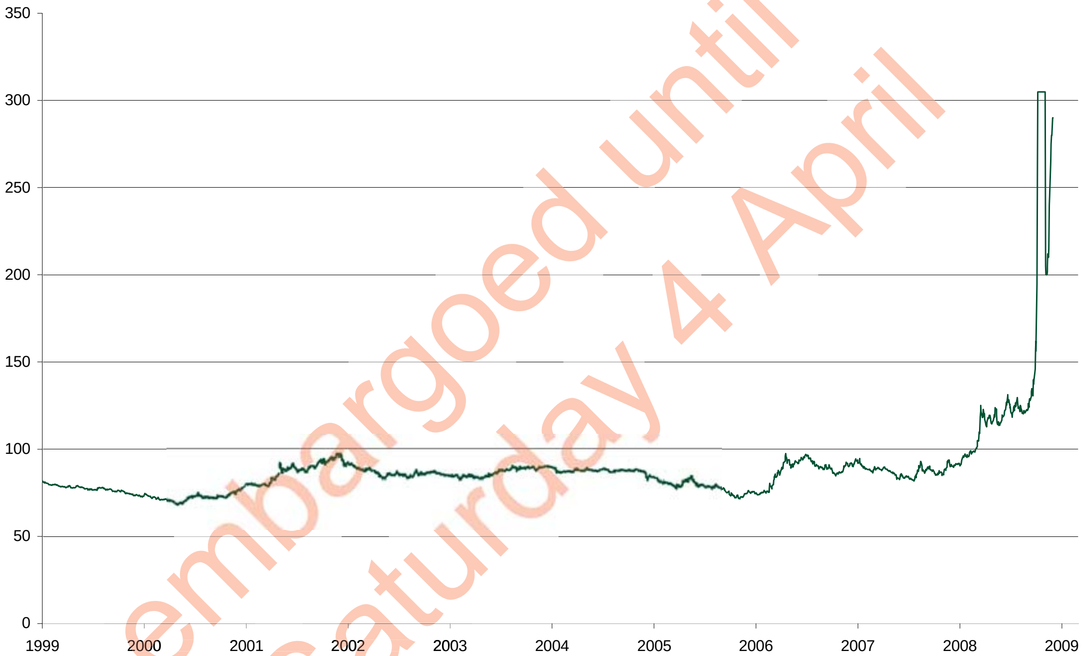
and highlighted the inadequacy of the potential compensation arrangements. On 22nd July we specifically asked the then Economic Secretary to the Treasury whether British depositors in Iceland banks were guaranteed to get their money bank: she replied "I am satisfied that the law exists to guarantee them, yes."[7]

9. By the end of 2008, the economic position of Iceland had considerably deteriorated. Chart 1 shows how unemployment rose markedly towards the end of 2008 and into 2009. In February 2009, registered unemployment in Iceland was 8.2%. This compares with August 2007, where registered unemployment was 0.9%.[8] Chart 2 highlights another sign of this new weakness in the economy, as the Icelandic Króna suffered a significant fall in value against the Euro. This weakness started in early 2008 but increased in severity as the year progressed.

Chart 2: The exchange rate between the Icelandic Króna and the Euro (Króna/Euro)



Source: European Central Bank

10. With the economy in such a vulnerable state and with the potential for an even more damaging run on the currency, the Icelandic Government requested assistance from the IMF.[9] On 24 October 2008, the IMF announced that it had "reached a referendum agreement on an economic program supported by an SDR 1.4 billion (about US$2.1 billion) loan under a two-year Stand-By Arrangement" with Iceland.[10] On 19 November

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7 Treasury Committee, Seventeenth Report of Session 2007-08, *Banking Reform*, HC 1008, Ev 34

8 Icelandic Directorate of Labour, *The Labour Market in February 2009*, 11 March 2009; Icelandic Directorate of Labour, *The Labour Market in August 2008*, 10 September 2008

9 www.iceland.org/info/iceland-imf-program

10 IMF press release, IMF Announces Staff Level Agreement with Iceland on US$2.1 Billion Loan, Press Release No. 08/256, 24 October 2008

2008, the IMF executive board approved this arrangement.[11] In an update completed on 24 December 2008, but published on 11 February 2009, the IMF stated that “The crisis is producing the expected sharp economic contraction, but despite the liberalization of all current account transactions, pressures towards currency depreciation appear to have abated somewhat”.[12] But what vulnerability in the Icelandic economy had caused this transformation for its near-term outlook?

The expansion of the Icelandic banks

Structure of the Icelandic regulatory system

11. The central Icelandic financial regulator is the Financial Supervisory Authority (known by the initials FME[13]). The IMF described the FME as “an integrated supervisory authority responsible for the supervision of credit institutions, insurance companies, securities markets, and pension funds”.[14] The FME, according to its annual report, had at “mid-year 2007 … a staff of 54 (45 full-time employees), including temporary and summer employees”.[15] The Central Bank of Iceland produced a Financial Stability Report.[16]

12. Close cooperation between the FME and the Central Bank of Iceland was the subject of a Cooperation Agreement signed on 28 March 2003.[17] Cooperation was also governed by a Memorandum of Understanding between the Office of the Prime Minister, Ministry of Finance, Ministry of Commerce, Financial Supervisory Authority and Central Bank of Iceland.[18] Its objective was defined as follows:

> Since its establishment in the beginning of 1999, the Financial Supervisory Authority (Fjármálaeftirlitið, FME) has cooperated closely with the Central Bank on tasks related to financial stability, including contingency plans for meeting conceivable financial shocks. Over the past two years, the Office of the Prime Minister, Ministry of Finance, Ministry of Commerce, FME and Central Bank have also been engaged in informal consultation on the same issues. The purpose of this Memorandum of Understanding (MoU) is the formal confirmation of their consultation in this area, in an effort to sharpen their division of tasks, prevent duplication and enhance transparency. This MoU does not override the respective signatories’ scope for independently deciding measures on the basis of their roles and responsibilities.[19]

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11 IMF press release, IMF Executive Board Approves US$2.1 Billion Stand-By Arrangement for Iceland, Press Release No.08/296, 19 November 2008

12 IMF, *Iceland: Stand-By Arrangement - Interim Review Under the Emergency Financing Mechanism*, 11 February 2009

13 From the Icelandic, Fjármálaeftirlitið

14 IMF, *Iceland, Financial System Stability Assessment Update*, 19 August 2008, para 49

15 Financial Supervisor Authority, *The Icelandic Financial Market*, Annual Report 2007, page 9

16 Central Bank of Iceland, *Decision by the Board of Governors*, 27 November 2006

17 Central Bank of Iceland, *Cooperation Agreement between the Financial Supervisory Authority and Central Bank of Iceland*, 28 March 2003

18 Central Bank of Iceland, *Financial Stability 2006*, page 93

19 *Ibid.*

The Memorandum of Understanding also created an advisory group on financial sector conditions and contingency plans, which was to meet at least twice a year, comprising representatives from the Office of the Prime Minister, Ministry of Finance, Ministry of Commerce, FME and Central Bank.[20]

Structure of the Icelandic banks

13. In its annual report for 2007, the FME states that there were five commercial banks operating in Iceland.[21] Of these, the three largest were Glitnir, Landsbanki and Kaupthing,[22] which held about 85% of total banking assets just before the collapse.[23] The IMF stated in a report completed in August 2008 that these three banks "dominate the [Icelandic] banking system, with total consolidated assets exceeding 900 percent of GDP".[24] It provided further detail, noting a potential for further weakness in the banks:

> Consolidated assets of the three main Icelandic banks (Glitnir, Kaupthing, and Landsbanki) increased from 100 percent of GDP in 2004 to 923 percent at end 2007, reflecting expansion overseas. By end-2007, almost 50 percent of the three banks' assets were held abroad, with 75 percent of their borrowing dependent on wholesale markets. The consolidated financial reports show their capitalization and liquidity ratios above regulatory requirements. However, the quality of bank capital is uncertain and a large share of the banks' liquidity is held in assets that under current conditions, are primarily used for repos with central banks.[25]

Expansion of the financial sector outside Iceland

14. As Chart 3 shows, Iceland's external debt position has climbed to over 800% of its GDP. The majority of this is related to the liabilities of the Icelandic banking system. In the view of Jónas Fr. Jónsson, former director of the Financial Supervisory Authority (FME), "the expansion by Icelandic banks abroad commenced for real in mid 2004 when Kaupthing acquired FIH in Denmark".[26] FIH was a major Danish commercial bank which became Kaupthing's largest subsidiary. Before then, he described there being only "some minor foreign ventures" by Icelandic banks.[27]

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20 Central Bank of Iceland, *Financial Stability 2006*, page 94

21 Financial Supervisory Authority, *The Icelandic Financial Market, Annual Report 2007*, page 45

22 In Iceland, its official name is Kaupþing Banki hf.

23 Ingimundur Fridriksson, Central Bank of Iceland, *The banking crisis in Iceland in 2008,*6 February 2009

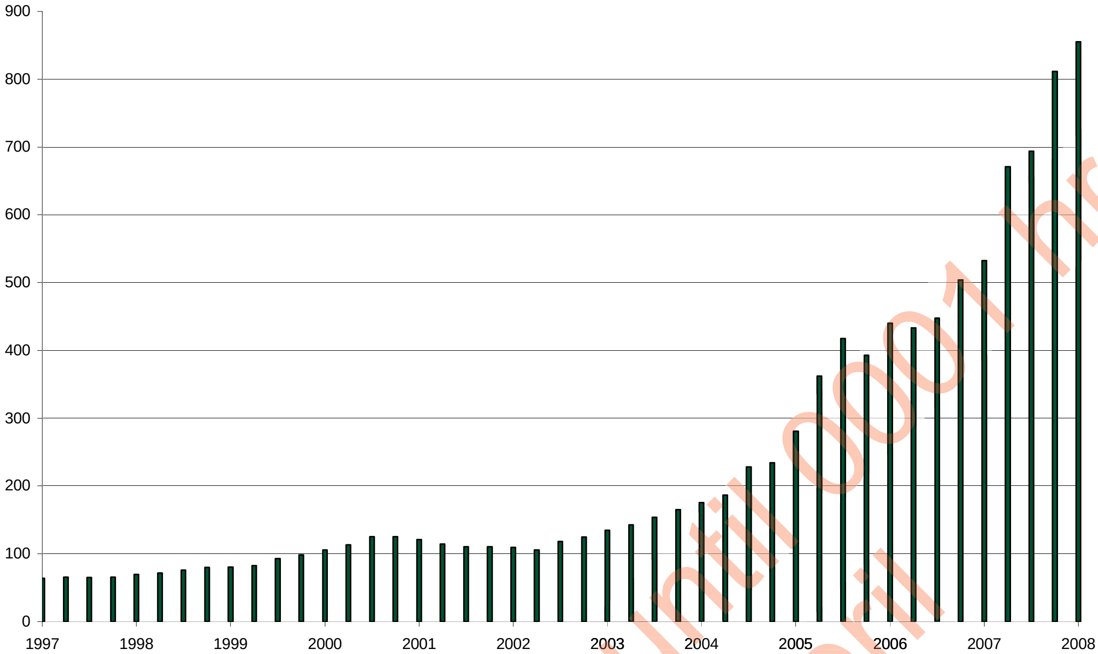
24 IMF, *Iceland, Financial System Stability Assessment Update*, 19 August 2008, para 7

25 *Ibid*., para 9

26 Financial Supervisory Authority, Expansion of Icelandic financial companies abroad and the effects on FME's operations, Speech by Jónas Fr. Jónsson, 11 June 2007; www.kaupthing.com

27 Financial Supervisory Authority, Expansion of Icelandic financial companies abroad and the effects on FME's operations, Speech by Jónas Fr. Jónsson, 11 June 2007

Chart 3: External debt position of Iceland (percentage of GDP)



Source: Central bank of Iceland

15. In 2007, as Chart 4 shows, there was a marked increase in deposits from overseas customers held by the Icelandic Deposit Money Banks.[28] Ingimundur Fridriksson, Governor of the Central Bank of Iceland until February 2009, provided some explanation. Late into 2005 and in early 2006, the Icelandic banks began to come under criticism for their "growth pace, risk appetite, low deposit ratios and high dependence on borrowed funds, as well as cross ownership, lack of transparency, and so on".[29] In response, the Icelandic banks:

> greatly enhanced their information disclosure to the global marketplace, thus improving transparency in their operations. They sought to reduce cross-ownership, improve their liquidity position and capital ratios, and took the first steps toward increasing the share of deposits on the liabilities side of their balance sheets. They were strongly encouraged to do so by rating agencies and numerous foreign financial analysts, among others. Landsbanki launched its Icesave deposit accounts in the United Kingdom toward the end of 2006. The banks also sought out new credit markets for example in the US which was wide open at the time for issuers with favourable credit ratings.[30]

16. The amount of deposits taken abroad increased as the disruption to global credit and interbank lending markets continued. Ingimundur Fridriksson, explained that "retail deposits in branches and subsidiaries abroad grew quickly and soon became an important

28 The deposit money banks include commercial banks, savings banks, postal giro and the saving departments of co-operatives; OECD, *Main economic indicators, sources and definitions*

29 Ingimundur Fridriksson,Central Bank of Iceland*, The banking crisis in Iceland in 2008*, 6 February 2009

30 *Ibid.*

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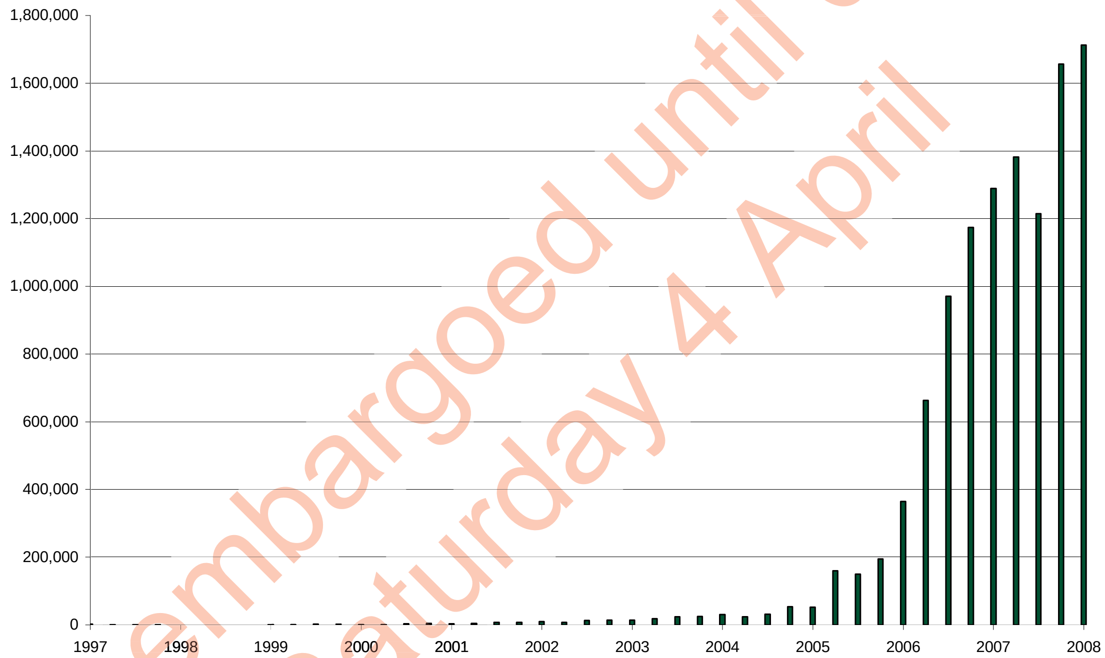
source of funding for two of the banks, particularly in 2007 and early 2008. But the bond markets remained virtually closed to them as the year 2008 progressed."[31] Despite the closure of the bond markets to the Icelandic banks, their management remained confident of the supply of funding via deposits. Ingimundur Fridriksson reported that the Icelandic banks "were so confident about their success that, at meetings held over the course of 2008, some of their leaders voiced the expectation that it should be easy for them to fund all of their outstanding bonds and other debt for the coming years through deposit business in Europe".[32] Dr Jon Daniellson of the LSE told us that "the reason why these [Icelandic] banks came to this country [the UK] was because they could not borrow elsewhere, they could not borrow from other banks".[33]

Chart 4: Foreign deposits at Deposit money banks (Millions Króna)



Source: Central Bank of Iceland

The impact of membership of the European Economic Area

17. The increased presence of Icelandic banks abroad was aided by European level agreements. Since 1994 Iceland has been a part of the European Economic Area (EEA). Under this arrangement, Iceland gained access to the European Internal Market, allowing Icelandic banks to conduct business across the EEA ("Passporting"). The FME then acted as the 'home' regulator, while, in the case of an Icelandic bank operating in the UK, the Financial Services Authority would act as the 'host' regulator. However, the legal status of

31 Ingimundur Fridriksson, Central Bank of Iceland, *The banking crisis in Iceland in 2008*, 6 February 2009

32 *Ibid.*

33 Treasury Committee, *Banking Crisis: Oral Evidence*, Session 2008-09, HC 144-I, Q 716. All references to oral evidence in this Report (in the form Q … or Qq …) refer to evidence published in that Volume unless otherwise stated.

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the Icelandic entity in the UK changes the level of supervision undertaken by the home and host regulators. As the FME explains:

- "A branch, is supervised by the home authority, i.e. a UK branch of an Icelandic bank is supervised by the FME. The responsibility of the FME is similar as the operation would take place domestically.
- A subsidiary, is supervised by the host authority, i.e. a UK subsidiary of an Icelandic bank is supervised by the FSA. However, the consolidated operation is supervised by the FME.
- A representative office is of promotional nature and used to introduce the company to the respective market and establish a connection between the bank and prospective clients. It does not provide direct financial services and is generally under the supervision of the home authority whereas the host authority monitors its conduct".[34]

18. This access to the internal market encouraged the growth of the Icelandic banks into other European countries' financial services markets. Ingimundur Fridriksson explained how membership of the EEA had aided the Icelandic banks:

> This rapid growth [in Icelandic banks] was facilitated by Iceland's membership in the European Economic Area (EEA) through which the country had created for its financial system a regulatory framework that was rooted in the directives adopted by the European Union. Among other things, this meant that operating licences granted to Icelandic financial companies extended not only to Iceland but to all other EEA states. For example, they were permitted to operate branches anywhere in the EEA. The European regulatory framework gave the Icelandic banks the same operational flexibility all over the EEA as they enjoyed in Iceland.[35]

Expansion into the UK

19. The United Kingdom was one of the areas where the Icelandic banks expanded their operations. Different banks used different methods to enter, leading to a complex, sometimes confusing, set of ownership structures which we outline below. Landsbanki Islands hf UK retail banking operations were conducted under the trading name "Icesave".[36] Landsbanki Islands hf operations in the UK were branches and therefore their organization was regulated by the FME, rather than the UK's Financial Services Authority. Landsbanki Islands hf also operated a subsidiary in the UK, Heritable Bank, which was regulated by the FSA.[37]

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34 Financial Supervisory Authority, Expansion of Icelandic financial companies abroad and the effects on FME's operations, Speech by Jónas Fr. Jónsson, 11 June 2007

35 Ingimundur Fridriksson,Central Bank of Iceland, *The banking crisis in Iceland in 2008*, 6 February 2009

36 FSA Register, www.fsa.gov.uk/register

37 Landsbanki, *Annual Report 2007*, page 67

20. Meanwhile, one of the other Icelandic banks, Kaupthing Bank hf, took over Singer and Friedlander, a UK-listed investment bank in July 2005, forming Kaupthing Singer and Friedlander.[38] Kaupthing Singer and Friedlander was a subsidiary of Kaupthing Bank hf, and was therefore regulated by the FSA, and covered by the UK depositor protection scheme, the Financial Services Compensation Scheme (FSCS). Then, in January 2008, Kaupthing launched its own UK retail savings market presence "Kaupthing Edge", via Kaupthing Singer and Friedlander.[39]

21. Both the Icesave and Kaupthing Edge brands were competitive in attracting deposits in the UK retail savings market. For instance, on 9 July 2008, a Kaupthing news release stated that "Kaupthing Edge continues to lead savings market with fixed-term accounts".[40] It went on to say that "Kaupthing Edge, which launched into the UK savings market in February this year, is committed to offering savers competitive returns on their money and has consistently offered great rates across its suite of products".[41] Newspapers and price-comparison websites also carried stories which mentioned the rates offered by both Kaupthing and Landsbanki.[42]

Table 1: Icelandic Bank structure.

Icelandic parent bank	UK operations	Trading or brand name for UK retail depositors	Status in UK	Lead Regulator
Kaupthing Bank hf	Kaupthing Singer and Friedlander	Kaupthing Edge	UK Subsidiary	FSA
Landsbanki Islands hf	Landsbanki Islands hf	Icesave, Landsbanki	Branch	FME
	Heritable Bank		UK Subsidiary	FSA

The offshore entities

22. The Icelandic banks also maintained subsidiaries in offshore financial centres. This Report is particularly concerned with those subsidiaries of the Icelandic banks that operated in Guernsey and the Isle of Man. On its takeover of Singer and Friedlander in the UK, Kaupthing also took over Singer and Friedlander's Isle of Man operations. Kaupthing in its 2007 Annual Report described its Isle of Man operations as offering "a comprehensive range of private banking services tailored principally for overseas residents,

38 Kaupthing Bank, *Kaupthing Bank 2007 Annual Report*, page 90

39 *Ibid.*, page 6

40 Kaupthing Singer and Friedlander, News Release, Kaupthing Edge continues to lead savings market with fixed-term accounts, 9 July 2008

41 *Ibid.*

42 *Financial Mail on Sunday*, Lock up your cash before rates drop, 24 August 2008; *Independent on Sunday*, Are houses all he needs to be set up for life?, 17 August 2008; *Express on Sunday*, Keep on top of easy access rates, 31 August 2008; *Birmingham Post*, Good deal on account, 9 August 2008

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expatriates and internationally mobile clients".[43] Originally, KSF(IOM) was a subsidiary of KSF(UK) until January 2007 when, as stated by the Isle of Man Financial Services Commission "ownership of KSF(IOM) changed from it being a subsidiary of KSF(UK) to a sister of KSF(UK) and owned directly by Kaupthing Bank hf".[44]

23. Both Kaupthing and Landsbanki increased their presence in offshore jurisdictions to increase their deposit bases. The Isle of Man operations of the Derbyshire Building Society were transferred to Kaupthing Singer and Friedlander (Isle of Man) Limited on 17 January 2008.[45] Kaupthing stated that the takeover "was in line with the Bank's strategy to increase deposits within the Bank".[46] Landsbanki Islands hf acquired the Guernsey subsidiary of the Cheshire Building Society in September 2006, renaming it Landsbanki Guernsey Ltd in the same month.[47] Landsbanki Islands hf stated that its Guernsey subsidiary's role was to provide "retail savings products for the UK offshore savings market".[48]

24. An important element of reassuring customers affected by these takeovers was the provision of parental guarantees, provided by the parent companies of these offshore subsidiaries, should those subsidiaries fail. In the case of the Guernsey takeover, the Guernsey Financial Services Commission "obtained a letter of comfort from the parent company Landsbanki Islands hf in support of the liabilities of [Landsbanki Guernsey Ltd]".[49] At the time of the takeover by Kaupthing Singer and Friedlander (IOM) of the Derbyshire Building Society's Isle of Man operations, a similar parental guarantee was given.[50]

The takeover of Singer and Friedlander

25. The takeover of Singer and Friedlander was undertaken when Mr Tony Shearer was Chief Executive. He provided both written and oral evidence to us on the takeover, in which he described his disquiet with the takeover at the time, and how he had alerted the authorities to those misgivings. His concerns had surfaced when Kaupthing had become a major shareholder in Singer and Friedlander, and yet had refused the opportunity to meet the Singer and Friedlander board. He noted that "[Kaupthing] ran their business in a very strange way, and certainly when I went to Reykjavik and spent a couple of days in Reykjavik in 2004 I realised it was a very different operation".[51] He outlined his concerns to us:

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43 Kaupthing Bank, *Kaupthing Bank 2007 Annual Report*, page 97

44 Treasury Committee, *Banking Crisis: Written Evidence*, Session 2008-09, HC 144-II, Ev 303. All references to written evidence in this Report (in the form Ev …) are to such evidence published in HC (2008-09) 144-II or HC (2008-09) 144-III unless otherwise stated.

45 Isle of Man Government, PUBLIC NOTICE - BANKING ACT 1998—The Derbyshire (Isle of Man) Limited, trading as Derbyshire Offshore, 17 January 2008

46 Kaupthing Bank, *Kaupthing Bank 2007 Annual Report*, page 97

47 Ev 369

48 Landsbanki, *Annual Report 2007*, page 67

49 Ev 369

50 Q 1345

51 Q 1376

> The first reason was just an inspection of [Kaupthing's] public accounts. Just looking at the accounts, particularly the accounts for December 2004, revealed a number of things in those published accounts which caused me concern and those were things that I passed on to the FSA. The second thing was meeting the people themselves. I had met them both in London and in Reykjavik and meeting with the people themselves caused me to form a judgment that these were not people that I wanted to work with.[52]

Mr Shearer went on to explain that what had worried him was the inexperience of the management team at Kaupthing, as well its lack of diversity.[53]

26. Despite his reservations about the deal, the guidance Mr Shearer received from his advisors was that his duty was to support the takeover:[54]

> The advice that I was given from my recollection was that I had to put the interests of the shareholders over my own, so this was not an opportunity for me or any of the other executives to negotiate new packages or new anything. Given that this was a cash offer that should clearly be recommended to shareholders at the level it was, we had to do everything we could to facilitate that and make it go through.[55]

However, despite this, he felt it necessary to tell the FSA of his concerns for two reasons. First, he felt he had a duty to do so.[56] Secondly, should the deal have been rejected by the FSA because the incoming personnel were not "fit and proper", Mr Shearer's fear was that "we would all have looked incredibly stupid".[57] In all, Mr Shearer believed that "the FSA had sufficient information about Kaupthing that they should never have approved the change of control, and if they were to do so they should have made extensive further enquiries".[58] According to Mr Shearer, he was not alone in voicing his concerns. He told us that the Chairman of the Audit Committee, the Finance Director and the Head of the Bank had all had a meeting with the FSA when he was present.[59]

27. When asked about the evidence of Mr Shearer, Mr Hector Sants, Chief Executive Officer for the FSA, replied that he looked over the files the FSA had on this episode, and that the FSA's notes of the meeting "did not make any comments about the fitness and propriety of senior management" of Kaupthing.[60] Turning to the concerns raised by Mr Shearer over the public accounts of Kaupthing, Mr Sants felt that Mr Shearer's conduct, in bringing these matters to the FSA's attention had been an entirely appropriate course of

52 Q 1368

53 Q 1378

54 Advisors to Singer and Friedlander were Slaughter and May, and Kazenove, the investment bank (Q 1414)

55 Q 1416

56 Qq 1368, 1390

57 Q 1390

58 Ev 299

59 Q 1398

60 Q 2293

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action. But he suggested the response of the FSA was bound by the European system of regulation:

> He and his colleagues were highlighting a number of issues which were in the public domain which absolutely are appropriate issues to highlight in the context of a change of control, certainly very appropriate in the context of the way that we would be looking at these issues going forward. Having said that, even at that time in 2005 each one of these issues was then brought up with the lead regulator. I have to say the reality of the situation here, to be quite clear, is the lead regulator in this case was the FME, it is the Icelandic bank, and we are obliged to take their word as to what is the situation; it is not for us to question another EEA regulator. They addressed those points and, indeed, in the case of cross-holdings had made a capital assessment mitigation for it. The issues were addressed and we had proper responses from the lead regulator, which we are obliged to take at face value.[61]

28. **We think it laudable that Mr Shearer brought to the attention of the Financial Services Authority his concerns around the takeover of Singer and Friedlander by Kaupthing. While the Financial Services Authority appears to have investigated these concerns, this episode shows the paramount need for the Financial Services Authority to be open to those that may wish to contact it to register their disquiet over problems they encounter in financial markets. We also note with great concern the impotence of the FSA to tackle directly the concerns brought to its attention as a consequence of its lack of any jurisdiction, which we discuss below.**

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61 *Ibid.*

3 What happened in October 2008?

Iceland's liquidity crisis

29. In October 2008, three major Icelandic banks collapsed over three days triggering a systemic crisis, the first in any advanced economy since the end of the Second World War.[62] Iceland's economic difficulties had become evident from spring 2008 from evidence such as the Fitch Special Report on Iceland published on 22 May 2008 which showed that conditions had tightened in the global credit market.[63] The extent of the deterioration became clear on 29 September 2008 when the Icelandic Government was forced to take a 75% stake in the country's third-largest bank, Glitnir, after it experienced short-term funding problems. At that time the Icelandic banks were reportedly exposed to loans totalling six times the country's total GDP.[64] The shock of the collapse of the American investment bank Lehman Brothers had resulted in a lack of liquidity in the world's credit markets which had left the Icelandic banks unable to refinance loans.

The collapse of Glitnir and Landsbanki banks

30. The Central Bank of Iceland had been monitoring the liquidity of the Icelandic banks throughout 2008, tracking this "virtually on a daily basis" and keeping abreast of their refinancing and asset sales. It was well known that Glitnir had to meet a large foreign loan payment in mid-October. Glitnir planned to bolster its liquidity by selling assets. The Central Bank reviewed Glitnir's position in mid-September and concluded that Glitnir would be able to cover that payment with an asset sale that was virtually complete. [65]

31. On 15 September, Lehman Brothers filed for Chapter 11 bankruptcy protection.[66] This was the largest bankruptcy in US history [67] and started a tremor that would shake financial markets all over the globe.[68] As investors were forced to write off their Lehman-related investments, counterparty concerns caused large-scale redemption-driven asset sales. Banks and other financial firms were faced with frozen credit and money markets and falling equity prices, eroding their access to funds and shrinking their capital base.[69] The Lehman bankruptcy had triggered a widespread crisis of confidence. One of the consequences of Lehman's failure was that the sale of Glitnir assets, which had seemed

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62 A systemic banking crisis has been defined by the IMF as one where all or almost all of the banking capital in a country is wiped out. See International Monetary Fund, *Systemic banking crises: a new database,* IMF WP/08/224, 29 September 2008.

63 www.fitchratings.com

64 BBC News, Waking up to reality in Iceland, 27 January 2009

65 Ingimundur Fridriksson ,Central Bank of Iceland*, The banking crisis in Iceland in 2008*, 6 February 2009

66 BIS Quarterly Review, page 6, December 2008

67 Marketwatch, Lehman folds with record $613 billion debt, 15 September 2008

68 Ingimundur Fridriksson,Central Bank of Iceland*, The banking crisis in Iceland in 2008*, 6 February 2009

69 BIS Quarterly Review, Overview: global financial crisis spurs unprecedented policy actions, December 2008

close to completion, did not materialise. The bank was also unable to renew a bank loan that it had expected to extend without any difficulty and the bank therefore collapsed.[70]

32. Landsbanki Bank suffered difficulties a few weeks later. Landsbanki operated in the UK as a branch of the Icelandic bank which raised retail internet deposits under the Icesave brand.[71] Ingimundur Fridriksson, the then Governor of the Central Bank of Iceland later recorded concern that there was at this time substantial pressure on Landsbanki's deposit accounts in the UK and in response to this "the British Financial Services Authority (FSA) steadily tightened the demands it made on the bank".[72] In a meeting between the Icelandic Financial Supervisory Authority [FME] and the Directors of Landsbanki Islands hf on 6 October 2008, it became clear that the bank's situation "was serious"[73] and that it considered itself to fall under legislation passed by the Icelandic parliament that same day. The legislation stated that "should the FME evaluate the situation as extremely pressing, it can, inter alia, assume the powers of a shareholders' meeting, dismiss the Board of Directors and appoint a Receivership Committee".[74] Ingimundur Fridriksson judged that intervention from the Central Bank of Iceland to save Landsbanki would not have represented prudent use of its foreign exchange reserves as the amounts involved were "simply too large".[75]

33. On 6 October 2008, Iceland suspended trading in Iceland's six biggest financial shares on the OMX Nordic Exchange Iceland. At that time Geir H. Haarde, then Prime Minster of Iceland, offered an unlimited guarantee for all savers:

> I would like to diffuse all doubt that deposits by Icelanders and private pensions savings in all Icelandic banks are secure and the exchequer will ensure that such deposits are reimbursed to savers in full. No one need be in any doubt on this. The authorities will also ensure that the country's businesses have access to capital and banking services to the maximum extent possible.[76]

34. The Icelandic parliament, the Althing, passed emergency legislation which enabled the Government to intervene extensively in Iceland's financial system. The next day the Icelandic Government took control of the country's second and third largest banks, Landsbanki and Glitnir and reportedly sought to secure a €4bn loan from Russia as it attempted to avert a financial meltdown.[77]

35. On 7 October 2008, the FME took control of Landsbanki. A press release by the FME stated that all of Landsbanki's domestic branches and internet operations would be open

70 Ingimundur Fridriksson,Central Bank of Iceland*, The banking crisis in Iceland in 2008*, 6 February 2009

71 FSA, *The Turner Review, A regulatory response to the global banking crisis*, March 2009, page 38, Box 1.C

72 Ingimundur Fridriksson,Central Bank of Iceland*, The banking crisis in Iceland in 2008*, 6 February 2009

73 http://www.fme.is/lisalib/getfile.aspx?itemid=5670

74 Article 100 of the Act on Financial Undertakings, as amended by Law no. 125/2008.

75 Ingimundur Fridriksson,Central Bank of Iceland*, The banking crisis in Iceland in 2008*, 6 February 2009

76 Address by H.E. Geir H. Haarde, Prime Minister of Iceland, 6 October 2008 (See http://e24.no/spesial/finanskrisen/article2696518.ece)

77 *The Daily Telegraph*, Financial Crisis: Iceland gets €4bn Russian loan as banks collapse, 7 Oct 2008

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for business as usual, and that all domestic deposits were fully guaranteed.[78] The next day the Chancellor announced that the UK Government would protect all deposits in the Landsbanki UK Branch. The Landsbanki Freezing Order 2008, passed on 8 October 2008, froze the assets of Landsbanki in the UK, and assets belonging to the Central Bank of Iceland, and the Government of Iceland relating to Landsbanki. Landsbanki had around £4.5 billion of retail deposits outstanding in its UK branch at the time of failure. These deposits were legally covered by the Icelandic deposit insurance scheme up to a value of €20,887. [79] In addition, they were covered on a top-up basis by the UK Financial Services Compensation Scheme (FSCS), to which Landsbanki had chosen to opt in.

36. Faced with the unprecedented collapse of two of the major Icelandic banks, the Icelandic Government took action to ensure that the third major bank, Kaupthing, was able to meet its commitments; that bank was deemed likely to survive the storm. On the basis of this assumption, the Central Bank provided the troubled bank with a collateralized four-day loan which was expected to meet any demands made on it. However, shortly after the loan was agreed, action was taken by the Chancellor of the Exchequer and the FSA which would call into question the Icelandic Government's assessment of the bank.[80]

UK action against Landsbanki

37. Icesave, the online British arm of Iceland's second biggest bank Landsbanki, announced on 7 October 2008 that its customers could no longer withdraw or deposit money, as Landsbanki had been taken into receivership.[81] On that day, the FSA decided that Heritable, a subsidiary of Landsbanki, was not able to meet its obligations.

38. On the morning of 8 October, following a conversation with the Icelandic finance minister, the Chancellor told BBC Radio that "The Icelandic Government have told me, believe it or not, have told me yesterday they have no intention of honouring their obligations there".[82] The Chancellor was concerned that the Icelandic authorities had reneged on their obligations to ensure compensation could be paid.

39. Later that day the Chancellor told the House of Commons that he was expecting the Icelandic authorities to put Landsbanki into insolvency.[83] He also said that under such "exceptional circumstances" he would guarantee that "no depositor loses any money as a result of the closure of Icesave". He had therefore taken steps to "freeze assets of Landsbanki in the UK until the position becomes clearer".[84] These steps used powers

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78 FME, Based on New Legislation, the Icelandic Financial Supervisory Authority (FME) Proceeds to take Control of Landsbanki to ensure Continued Commercial Bank Operations in Iceland, 7 October 2008

79 FSA, *The Turner Review, A regulatory response to the global banking crisis*, March 2009,page 38,Box 1.C

80 Ingimundur Fridriksson,Central Bank of Iceland*, The banking crisis in Iceland in 2008*, 6 February 2009

81 Receivership is a type of corporate bankruptcy in which a receiver is appointed by bankruptcy courts or creditors to run the company.

82 BBC News, Extra help for Icesave customers, 8 October 2008

83 Insolvency can be defined as where an organization can no longer meet its financial obligations with its lender or lenders as debts become due.

84 HC Deb, 8 October 2008, col 279

conferred by sections 4 and 14 of Schedule 3 to the Anti-Terrorism, Crime and Security Act 2001, which requires that "the Treasury believe that action to the detriment of the United Kingdom's economy (or part of it) has been or is likely to be taken by certain persons who are the government of or resident of a country or territory outside the United Kingdom".[85]

Kaupthing's demise

40. In his statement on 8 October the Chancellor also announced that the FSA had determined that Kaupthing Singer & Friedlander [KSF] (a UK based subsidiary of the Icelandic Kaupthing Bank) did not "meet its threshold conditions, and was likely to be unable to continue to meet its obligations to depositors. The FSA had therefore concluded that KSF was in default for the purposes of the Financial Services Compensation Scheme".[86] The Chancellor announced that he had used powers under the Banking (Special Provisions) Act 2008 to transfer most of KSF's retail deposits to the Dutch bank, ING.[87] The rest of the business had been put into administration.[88] The transfer of the retail deposit books was supported by cash from HM Treasury and the Financial Services Compensation Scheme. A Treasury press release concluded that this was "the right course of action to protect savers, ensure financial stability, and safeguard the interests of the taxpayer".[89] Later that day, the Icelandic Government nationalised Iceland's biggest bank, Kaupthing.

Was the Chancellor to blame for the collapse of Kaupthing?

41. Press reports in October suggested that the then Icelandic Prime Minister Geir Haarde was "upset and shocked" that the UK Government had invoked "hostile" anti-terrorism legislation to freeze Icelandic banks' assets in the UK. Haarde argued that the Chancellor's statement on the BBC induced panic in the UK.[90] The Icelandic Government was widely reported in December to be preparing to take legal action against the UK over the collapse of Kaupthing.[91]

42. The Government of the Isle of Man's evidence to us highlighted that the UK freezing Order[92] made by HM Treasury against Landsbanki assets was "publicly construed by many as a freeze of Icelandic assets generally" and such a perception, "exacerbated an already tight liquidity position for Kaupthing Bank hf Group as a whole".[93] Mr Ziggy Sieczko for

85 Landsbanki Freezing Order 2008 (SI 2008/2668)

86 HM Treasury press release, Kaupthing Singer & Friedlander, 8 October 2008

87 KSF's Kaupthing Edge deposit business has been transferred to ING Direct, a wholly-owned subsidiary of ING Group, which operates through its branch in the UK.

88 HC Deb, 8 October 2008, col 279

89 HM Treasury press release, Kaupthing Singer & Friedlander, 08 October 2008

90 BBC News, Iceland scowls at UK after crisis, 16 December 2008

91 *Ibid.*

92 Landsbanki Freezing Order 2008 (SI 2008/2668)

93 Ev 304

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KSFIOM Action Group, also questioned whether Kaupthing's demise had been caused by "defamatory comments from the Treasury and from the Chancellor himself".[94]

43. Press reports indicated that the Chairman of Kaupthing, Sigurdur Einarsson, also attributed the collapse of his bank to the actions undertaken by the Chancellor. Mr Einarsson said the Chancellor's transfer of deposits from the bank's subsidiary Kaupthing Singer & Friedlander had triggered a technical default on the parent bank. He also blamed the UK authorities for a run on the Icelandic banks' internet operations in this country after rival Landsbanki was frozen.[95]

44. When we asked the Chancellor what led him to tell BBC Radio that the Icelandic Government had no intention of honouring their obligations, he explained that his conversation with the Icelandic Finance Minister had led him to believe that the Icelandic legislation passed over the previous weekend had the effect of "looking after Icelandic depositors but cutting off non-Icelandic depositors, including those in the United Kingdom". The Chancellor defended the steps he had taken to "safeguard the interests of the taxpayer" pointing out that "even if I was wrong on that, which I was not, five weeks later they are still not treating non-Icelandic depositors and creditors in the same way as they are Icelandic ones".[96]

45. Further controversy arose when a transcript of a conversation between the Chancellor and his Icelandic counterpart was published in the *Financial Times.* This appeared to challenge the Chancellor's claim that Iceland had refused to compensate UK savers. The transcript was of the telephone conversation with Árni Mathiesen, the Icelandic finance minister, at the height of the crisis on 7 October 2008, referred to by Mr Darling in the BBC Radio interview. In it they discussed whether or not the Icelandic Government was in a position to compensate up to 300,000 British depositors in Icesave, the online arm of Landsbanki. In the published transcript Mr Mathiesen did not state that Iceland would not honour its obligations. Rather, he explicitly indicated that Iceland planned to use its compensation scheme to try to meet obligations to British depositors. Such a move would have committed Iceland to paying €20,887 (£16,462) to each depositor under directives agreed as part of its membership of the European Economic Area.[97]

46. In January 2009, the then Icelandic Prime Minister and the Minister of Foreign Affairs met representatives of Kaupthing Bank's Resolution Committee and Landsbanki's Resolution Committee and agreed to support any suit which they chose to bring against the UK authorities.[98] On 6 January, the Althing passed an Act authorising "financial support from the National Treasury in connection with legal proceedings in foreign courts

94 Q 1292

95 *Daily Mail,* Kaupthing chairman blames Darling for predicament as Iceland's bank troubles spiral, 09 October 2008

96 Q 116

97 *Financial Times*, Transcript challenges Darling's claim over Iceland compensation, 24 October 2008

98 Government Support for Legal Action against UK Authorities, 5 January 2009

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of law concerning onerous administrative measures applied by foreign authorities during the period 1 October to 1 December 2008".[99]

47. When we questioned the Chancellor as to his view of whether the actions of the UK Government had increased pressure on the remaining Icelandic bank, Kaupthing, he told us that "anyone looking objectively at the Icelandic banks would find it difficult to come to that conclusion". He noted that the new Icelandic Government had taken a "slightly different view" from the previous Icelandic Government. In the Chancellor's view the banking failure was triggered by the conclusion drawn by the FSA that the banks "did not meet the threshold conditions and, as you know, this is a responsibility of the FSA, it has to decide whether or not an institution can carry on trading".[100]

48. The Government's use of the Anti-Terrorism, Crime and Security Act 2001, on 8 October, to freeze the assets of Landsbanki UK has provoked concern.[101] It also caused significant problems for the Icelandic authorities. Ingimundur Fridriksson, Governor of the Central Bank of Iceland until February 2009, stated that:

> priority was given to the maintenance of smooth payment intermediation and uninterrupted banking operations, and that efforts in that regard were successful in spite of measures such as the "freezing order" imposed on Landsbanki by the British authorities under the Anti-Terrorism, Crime and Security Act—a freezing order that originally extended as well to the Icelandic Government,[102]

However, the Chancellor robustly defended the use of the powers granted under the Act:

> actually the legislation we used, although it does cover terrorism also covers the powers that we have to protect the country's general economic interest. Interestingly, when you look back at what happened when the legislation went through Parliament, there was an amendment laid in the House of Lords to try and confine these powers to be used in the case of terrorism and that amendment was voted down. I think it was contemplated at the time that those powers might be used more widely.[103]

The legislation was designed to deal with a situation where there would be an economic harm done to the country. The Chancellor said that he believed that had he not taken action to freeze the assets of Landsbanki UK, he would have been asked "How come you allowed all this money to be taken out?"[104]

49. **During the collapse of the Landsbanki bank in October 2008, the Chancellor of the Exchequer took steps to safeguard the deposits of UK investors. We note that his**

99 The Icelandic Government Information Centre, *Parliament approves financial support for legal proceedings*, 6 January 2009

100 Q 2947

101 Ev 206

102 Ingimundur Fridriksson,Central Bank of Iceland, *The banking crisis in Iceland in 2008*, 6 February 2009

103 Q 47

104 Q 2947

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comments regarding the intentions of the Icelandic authorities had a serious impact on the confidence held in the remaining solvent Icelandic bank, Kaupthing, and it has been suggested that this may have contributed to its collapse. We note that the published transcript of the Chancellor's conversation with the Icelandic Finance Minister does not confirm that the Icelandic Government had stated that it would not honour its obligations but we have seen no evidence to contradict the Chancellor's view that UK depositors and creditors were unlikely to be protected to the same extent as Icelandic ones. We also have seen no evidence that Kaupthing would have survived if the Chancellor had not expressed his views.

50. **Although the Icelandic banking system was vulnerable to the crisis that has affected the international financial system since 2007, the actions of the UK Government in making statements on the capacity and willingness of the Icelandic Government to provide assistance to non-Icelandic citizens, whether or not such statements were accurate, turned the UK Government from being a seemingly passive observer of events, to an active participant in the market. Given the volatility of the situation, and the vulnerability of Icelandic banks at the time, it appears that the Icelandic Authorities found the UK Government's approach ultimately unhelpful.**

51. **The use of the Anti-Terrorism, Crime and Security Act 2001 had considerable implications for the Icelandic authorities in maintaining a functioning financial system. We call on the Treasury to consider how appropriate the use of this legislation would be in any similar circumstances in the future. The use of this Act inevitably stigmatises those subject to it and a less blunt instrument would be more appropriate. We are concerned that no appropriate legislation is available and call on the Treasury to address this matter.**

The impact of the Icelandic banks' collapse on the Crown dependencies

52. In October 2008, with a view to identifying some of the popular anxiety about the banking crisis, we invited members of the public to suggest questions they would like to see put to the Tripartite authorities on the banking crisis. We were grateful to receive almost 5,000 individual questions. The vast majority came from people affected by the collapse of the Icelandic banks. These questions came from British citizens and expatriates, many of whom had lost their life's savings when Kaupthing Singer & Friedlander (Isle of Man) and Landsbanki Guernsey Limited were liquidated. We consider their losses in Chapter 4. Here we outline the actions of the authorities surrounding the liquidation of these banks.

Landsbanki Guernsey Limited

53. Landsbanki Guernsey Limited (LGL) was placed in administration on 7 October 2008 leaving 2,033 people unable to access their money. LGL had a number of assets, including a deposit with its Icelandic parent Landsbanki Islands hf, a deposit with Heritable Bank in the UK (a sister company of LGL), a loan book secured on UK property and a letter of

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comfort from the parent company. In addition, the parent company made public statements guaranteeing deposits with LGL.[105] Unlike the UK, Guernsey had no savers' compensation scheme at that time, and its Chief Minister, Lyndon Trott, quickly clarified that Guernsey did not propose the use of taxpayers' money to support any pay-out.[106]

Kaupthing Singer & Friedlander (Isle of Man) Limited

54. On 9 October 2008, the Isle of Man Court made a Provisional Liquidation Order in relation to Kaupthing Singer & Friedlander (Isle of Man) Limited [KSF(IOM)].[107] The liquidation of this bank was particularly controversial as it was caused, in part, by steps taken by the UK Government to transfer deposits from the KSF UK branch to ING. KSF(IOM) had previously transferred £555m of unsecured funds into KSF(UK) following consultation with the FSA. Many KSF(IOM) depositors were UK expatriates or people living in the UK who were retail depositors and for legitimate reasons found themselves banking in the Isle of Man with what had until recently been the offshore arm of the UK banking group, Singer & Friedlander. [108]

55. It is the contention of the Isle of Man Government that there were considerable shortcomings in the communication between the regulatory authorities in respect of the action which the UK was planning to take in relation to KSF(UK), a UK incorporated company authorised by the FSA to take deposits.[109] This contrasted with the prompt and reliable exchange of information that had been in place previously, up to and including the handling of Bradford & Bingley just a few days earlier.

56. The Isle of Man Government told us that KSF(IOM) was a solvent bank that had been rendered insolvent by the actions of the UK authorities, when the UK was attempting to protect its own position against Iceland. Had the existing regimes and protocols been adhered to then the situation could have been managed with significantly less impact on the Isle of Man even if it could not have been avoided altogether.[110]

57. In submitting questions to us, members of the public time and again demanded that the UK Government should accept responsibility and return the £555m lost by Isle of Man savers. When we put this issue to the Chancellor at the beginning of our inquiry, he replied that the £555m did "not belong to the UK Government". [111] In evidence to us, Lord Turner indicated that KSF(IOM) was in the same position as any other creditor[112] although in a later session Hector Sants acknowledged that this was not correct given the special powers

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105 Ev 148, para 3.7

106 *Financial Times,* Guernsey rules out state funding to help savers, Page 2, 24 October 2008

107 Statement from the Liquidator Provisionally of Kaupthing Singer & Friedlander (Isle of Man) Limited, 13 October 2008

108 Ev 302, para1.8.3

109 *Ibid.*, para1.8.2

110 Ev 304, para 1.8.30

111 Qq 131-132

112 Ev 19, Q 130

that had been taken by the Treasury in relation to any payments to be made to the Isle of Man.[113]

Compensation schemes available to depositors

58. None of the UK's Financial Services Compensation Scheme (FCFS), Iceland's protection scheme, and Guernsey's Deposit Protection scheme extended cover to depositors in Landsbanki, Guernsey. Subsequent to the crisis a scheme was established in Guernsey on 26 November 2008. It was not retrospective and did not cover the losses of savers in Landsbanki.[114]

59. However, the Administrators for Landsbanki Guernsey paid compensation equal to 30% of depositors' funds in October 2008. The Landsbanki Depositors' Action Group was concerned that depositors stood to lose 70% of their savings together with the interest accrued prior to the bank's collapse.[115] However, the Isle of Man's High Court had concluded that significant cash balances would remain in the Bank after allowing for this proposed partial payment.[116]

60. The Isle of Man Government advanced funds to depositors of KSF(IOM) under the Early Payment Schemes approved by the Tynwald in January and February 2009 providing for a total of £105m in early payments.[117]

61. At the time of going to press the Isle of Man's parliament, the Tynwald, had been asked to authorise the transfer of £180m from Government reserves to put funding in place for the proposed 'Scheme of Arrangement' for depositors with Kaupthing Singer & Friedlander Isle of Man.[118] The sum included an advance on contributions that would be required to be levied from the banking sector. Total direct provision from the Manx Government is expected to be £150m. Government funds advanced to depositors under the Early Payment Schemes would be deducted from any subsequent payments made under the Scheme of Arrangement.[119]

62. The 'Scheme of Arrangement' was designed by the Isle of Man Treasury as "a tailored alternative to conventional liquidation of the bank, which would trigger the Depositors Compensation Scheme (DCS)". The Scheme, if approved, would make guaranteed scheduled payments underpinned by Manx Government funds. It is subject to approval by

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113 HC 98-i, Q 123

114 Ev 136, para 2.5

115 *Ibid.*, para 2.4

116 Deloitte Press Release, Joint Administrators secure part-payment to depositors of Landsbanki Guernsey Limited (in Administration), 16 October 2008

117 Isle of Man Government Circular Nos. 01/09 and 04/09, The Kaupthing Singer and Friedlander (Isle Of Man) Limited Early Payment Scheme and The Kaupthing Singer and Friedlander (Isle Of Man) Limited Early Payment (No. 2) Scheme

118 Isle of Man Government Press Release, Tynwald to be asked to authorise £180 million for KSF IOM Scheme of Arrangement, 17 March 2009

119 *Ibid.*

the High Court and by the bank's creditors. The matter is due to be heard in the Isle of Man's High Court on 9 April.[120] [121]

Crown dependencies and a guarantor of last resort

63. In evidence to us, the Chancellor described the Isle of Man as "a tax haven sitting in the Irish Sea".[122] In his Pre-Budget Report statement to the House of Commons, the Chancellor argued that the recent financial turbulence had highlighted "potential problems with overseas territories and crown dependencies, such as the Isle of Man and Channel Islands". He cautioned that the offshore banks had attracted banking customers with lower taxes and these customers had avoided "contributing to the UK Exchequer". In these situations he cautioned that "the British taxpayer, cannot be expected to be the guarantor of last resort".[123] We further consider this issue in Chapter 5.

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120 Isle of Man Government Press Release, Tynwald to be asked to authorise £180 million for KSF IOM Scheme of Arrangement, 17 March 2009

121 *Ibid.*

122 Qq 131-132

123 HC Deb (2007-08), 24 November 2008, col 490

4 Charities and local authorities

The local authorities

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

Advised to invest?

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

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

67. Many local authorities employ private sector advisors, who have specialised knowledge and skills in understanding money markets. The main private-sector advisors to local authorities in the United Kingdom (Arlingclose, Butlers and Sector) have recently given evidence to the Communities and Local Government (CLG) Committee. Their evidence offered several accounts of what happened in relation to the advice given on Icelandic

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124 HC (2007-08) Deb 24 Oct 2008

125 LGA Press Release, Update on Icelandic banks and their UK licensed subsidiaries, 17 October 2008

126 Audit Commission, *Risk and return, English local authorities and Icelandic Banks, Cross-cutting National report*, March 2009, p 18

127 *Ibid.*, p 19

128 *Ibid.*, p 53

129 Q 1293

130 Chartered Institute of Public Finance and Accountancy, Codes of Practice

banks and we look forward to the CLG Committee's forthcoming report on local authority investments.[131]

Reliance on credit rating agencies

68. When we asked who was to blame for the loss of local taxpayers' money, Councillor Kemp told us that he believed that there had been "a series of failures within the system". We were told that the LGA had sought investment advice from "ministers, from Parliament, from regulators, from the credit reference agencies, a whole variety of people".[132]

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

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

Plea for assistance

71. Councillor Kemp told us that the Government had helped local authorities in the short term "by allowing us to withdraw concerns about Iceland from the equivalent of our

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131 HC 164-ii, Qq 99-100

132 Ev 174, Q 1300

133 Credit rating agencies formulate and issue credit ratings of both institutions and individual debt instruments. Investors rely on these ratings as indicators of the credit risk of investment.

134 Financial Times, Councils step up fight against agencies, FT.com, 15 October 2008

135 HC 164-ii, Q 229

136 Ev 276, para 10

137 Audit Commission, *Risk and return, English local authorities and Icelandic Banks, Cross-cutting National report*, March 2009, pp 28-29

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

72. **We acknowledge that some local authorities will feel hard done by as a consequence of the limitations of Government support for them. Local authorities are required to take their own decisions on the level of prudent, affordable capital investment. They have a duty to the taxpayer diligently to protect the money they are investing on their behalf. Some authorities have shown themselves to be better than others in this regard. Under these circumstances it would seem perverse to reward those authorities who failed to protect their investment with yet more money from the taxpayer.**

Charities

Charitable deposits

73. The collapse of Icelandic banks has also placed charitable funds in jeopardy. The Charities Aid Foundation (CAF), told us that they had been asked by the Financial Services Secretary, Lord Myners, together with the National Council for Voluntary Organisations, the Charity Finance Directors Group and the Association of Chief Executives of Voluntary Organisations to collect data about the extent of charities' exposure to Icelandic Banks. Their findings suggested that 48 charities had lost a combined total of £86.6m deposited funds.[141] The Audit Commission has estimated that charities held around £120m in Icelandic banks.[142]

74. Dr John Low, Chief Executive for the Charities Aid Foundation (CAF), told us that charities had been seriously affected by the failure of the Icelandic banks. He pointed out that it was difficult to estimate fully the extent of the problem as a number of charities had chosen not to make public their losses.

Guidance to charities

75. When we asked Dr Low what financial guidance was available to charities, he told us that the Trustee Act 2000 was the only statutory measure that governed the behaviour and

138 Q 1300; A statutory override which amended the 2003 Capital Finance regulations will come into effect on 31 March 2009 which will allow local authorities to defer recognition of any potential losses until 2010-11 - Audit Commission, *Risk and return, English local authorities and Icelandic Banks, Cross-cutting National report*, March 2009, p 19

139 Q 1300

140 Q 1301

141 Ev 475, para 1.2

142 Audit Commission, *Risk and return, English local authorities and Icelandic Banks, Cross-cutting National report*, March 2009, p 17

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duties of a charity's trustees. The Charity Commission had issued guidance on how investments should be handled but this was non-statutory. Such advice focused on "diversification, taking appropriate advice, review and so on, but there is nothing statutory beyond the Trustee Act 2000."[143]

76. The Charity Commission issued a statement on 24 November 2008 to clarify the nature of advice they provided to charities, in which they indicated that the role of the Commission was to offer general advice to trustees on their duty to control and manage a charity's finances and investments. The Commission was not able to recommend specific financial services or banks. They did not "promote, endorse or approve any banks or financial services", but rather offered "advice, guidance and support" and were able to act in the administration of a charity, only in certain circumstances involving misconduct or mismanagement".[144]

77. Dr Low told us that the Charity Commission did not have a view on offshore investments and did not provide guidance on the issue. Trustees had an obligation to obtain the best possible return for their investments and were obliged to take into account the risks associated with those investments. Dr Low's biggest concern was the lack of information available to trustees about offshore bank accounts. He said that charities had "poor information on credit rating and we have no sense, other than league tables of interest rates, about the sustainability and the risk associated with each of these regulated bank accounts".[145] It was Dr Low's view that protection available under the Financial Services Compensation Scheme was "extremely vague and uncertain". He argued that charities had "no easy way of understanding whether they would be receiving any protection or not".[146]

78. **We recommend that the Government consider the case for providing charities with further statutory guidance relating to the management of a charity's finances and investments. We further recommend that the Government take steps to clarify what protection is available to charities under the Financial Services Compensation Scheme.**

Charities as "wholesale depositors"

79. The Chancellor's statement on 8 October guaranteed that all retail depositors in Landsbanki, Heritable and Kaupthing Singer & Friedlander would receive their money in full.[147] A large number of charities were not classified as retail depositors and have therefore been faced with trying to recover their funds from the Administrators. The Charity Commission issued guidance to charities explaining that retail depositors included those charities who were body corporate which had two or more of the following characteristics:

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143 Q 1296

144 Charity Commission statement, *Charities who have invested in Icelandic banks*, 24 November 2008

145 Q 1297

146 Q 1298

147 For further details, see Chapter 4 of the FSA's Compensation Sourcebook

- a turnover of £6.5m or less;
- £3.26m or less balance sheet total;
- 50 or fewer employees;
- they were an unincorporated association with assets of £1.4m or less.

Charities who have invested in Icelandic banks, and who do not fall into the description of retail depositors, are to be classified as wholesale depositors for the purposes of the FSCS.[148]

80. Save our Savings, a group of creditors in the administration of Kaupthing Singer & Friedlander Limited (KSF) comprising some 30 charities with a combined liability in the administration of approximately £50m, suggested that the distinction between wholesale and retail depositors appeared to be "based largely upon an assumption that wholesale depositors are better placed to make informed decisions." This meant that they were therefore less in need of the FSCS's protection than the "less sophisticated" retail depositors.[149] Protection under the FSCS therefore extended to individuals and smaller companies only.[150] In the view of Save our Savings, it was difficult to see why wholesale depositors, and charities in particular, were better placed than retail depositors to anticipate and respond to the current banking crisis.[151]

Government assistance

81. Save our Savings put it to us that charities qualified for certain statutory exemptions from taxation on the basis that they provided public benefit in the form of support and services to many of the most vulnerable elements of society. They therefore relieved cost to the Exchequer and, consequently, the taxpayer by providing such services.[152]

82. Dr Low told us that the Government had provided "very little support, frankly". He had asked Lord Myners for an interest free relief scheme "but that was not forthcoming". He noted that the Government was "simply was not willing to treat charities any differently to any other wholesale investor".[153] Dr Low pointed out the apparent unfairness of the decision where the Government had chosen to "bail out high net worth individuals to the full amount" but not protected money that was held in trust for public benefit.[154]

83. **We recognise that the important work undertaken by the charitable sector often provides the most vulnerable elements of society with invaluable support. At a time when more people than ever may be faced with difficult circumstances, we believe that**

148 Charity Commission statement, *Charities who have invested in Icelandic banks*, 24 November 2008

149 Ev 205

150 *Ibid.*

151 *Ibid.*

152 Ev 205

153 Q 1299

154 *Ibid.*

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it is imperative that charities have access to the funds that were provided to them by the public. We are concerned that one of the tests a charity must pass to be protected under the FSCS definition of a retail depositor is inappropriate for those charities using fixed assets in the course of their work. We recommend that, on this occasion only, all charities should be compensated for losses incurred as a consequence of the failure of the Icelandic banks. Furthermore, to avoid such problems arising in the future, we recommend that the FSCS re-examine the criteria for the classification of charities as retail or wholesale depositors in the light of this recommendation.

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5 Protecting British citizens

Individuals who lost

84. As we have seen, on 9 October 2008 HM Treasury announced that “The Chancellor has put in place arrangements to ensure that all retail depositors in the Icelandic banks of Landsbanki (including their “Icesave” products), Heritable, and Kaupthing Singer and Friedlander (including their “Edge products”) will receive their money in full”.[155] Most of these onshore UK customers saw their accounts moved to ING direct.[156] These measures protected all individuals who held accounts onshore in the United Kingdom with the branches and subsidiaries of the Icelandic banks. These announcements did not, however, cover those individuals who had money at risk in the subsidiaries of the Icelandic banks in the Isle of Man and Guernsey.

85. Information provided by the depositors’ groups provides some evidence on the make-up of these individuals. Mr Sieczko, the London coordinator for the Kaupthing Singer & Friedlander Isle of Man Action Group, suggested that “between 55% and 60%” of KSF (IOM) depositors were British expatriates.[157] A straw poll conducted by the Landsbanki Guernsey Depositors’ Action Group, suggested that 35% of depositors were British citizens from Guernsey or Jersey. Another 49% were British expatriates living elsewhere and a further 12% were British expatriates [now] living in the UK.[158] Some 60% of those savers polled had savings between £10,000 and £100,000.[159]

The provision of assistance

86. Many of those who have lost out in the failure of the offshore subsidiaries of the Icelandic banks were British citizens, and many have requested the assistance of the UK Government in seeking the return of their deposits. We have heard several arguments both for and against the provision of assistance to these depositors by the UK Government, and we consider them in turn, before providing an overall conclusion on the appropriateness of the provision of assistance by the UK Government to those depositors.

An overarching principle

87. The UK Government has been acting on the principle that it cannot be responsible for the losses of UK citizens where they invest money in jurisdictions outside the control of the United Kingdom. The Chancellor explained that:

155 HM Treasury, Press release 103/08, Landsbanki, Heritable, and Kaupthing Singer and Friedlander, 9 October 2008,

156 *Ibid.*

157 Q 1320

158 Ev 422-423

159 Ev 423

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> My obligation as the Chancellor of the Exchequer is to people who put their money into this particular UK branch. … that legally, strictly, what we have said to people is, "You have got to look for your first £16,000 or so to the Icelandic authorities" because that is what the EEA agreement is, and they are disputing that at the moment, as I understand, and we would have stood in the place between £16,000 and £50,000 under the British Financial Services Compensation Scheme. I have gone further than that. I have said I will look after the interests of all retail depositors in a branch in London that I think we are responsible for. If you go to the next stage and say, "Look, you should take over responsibility for something that is done in the Isle of Man or Guernsey or, indeed, by extension, other countries", that is quite a significant step to take.[160]

Mr Tony Brown MHK, Chief Minister, Isle of Man, also accepted this position, telling us that "As far as the situation for the Isle of Man is concerned, we are accepting our responsibilities and endeavouring to rectify the situation".[161] When pushed on whether the UK Government should seek to provide redress to savers in the Isle of Man, Mr Brown replied "I do not think the UK Government is responsible for the financial affairs of the Isle of Man".[162]

88. **We agree that the overarching principle should be that the UK Government cannot provide cover for deposits held by British citizens in jurisdictions outside the direct control of the United Kingdom.**

The role of the UK Financial Services Authority

89. Questions have been raised with us in respect of the extent of the FSA's involvement in the transfer of funds from the Icelandic parent company, Kaupthing, to its UK subsidiary, KSF(UK). By March 2008, the Financial Services Commission (FSC)[163] of the Isle of Man had become concerned by the Icelandic situation. As such, they approached the KSF IOM) board, which in turn offered to reduce its exposure to Iceland, by replacing its deposits in Iceland, with ones in KSF(UK).[164] Before allowing this transaction, the Isle of Man FSC raised certain questions with the FSA about the UK's liquidity regime for KSF (UK), which were responded to via an exchange of letters.[165] From this exchange, the FSC felt that it had satisfied itself that, should the transfer be made:

- the exposure to the parent bank would be eliminated (save for the fact that a line of liquidity was available to draw upon from the parent if needed, which netted off in the event of insolvency);

160 Q 121

161 Q 1449

162 Q 1450

163 The Isle of Man financial services regulator

164 Ev 304

165 Ev 663

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- the 60% of total assets of KSF(IOM) that were represented by claims on Kaupthing Group in October 2008 (after netting off the liquidity exposure to Kaupthing Bank hf) were due from KSF(UK), a UK bank where all related party exposures were limited to 25% of Large Exposure Capital Base and where there was no net exposure to Kaupthing Bank hf; and,
- KSF (UK) would have liquid assets to meet all maturing liabilities out to eight days and were only permitted to have a maximum mismatch of 5% out to one month.[166]

Mr John Aspden, Chief Executive of the Isle of Man Financial Supervision Commission (FSC), told us that if those understandings had been adhered to, he "would not have thought that the London bank [KSF(UK)] would be in quite the predicament that it appears to be".[167]

90. As was discussed in Chapter 3, when KSF (UK) went into insolvency, the deposit held on behalf of KSF(IOM) became part of the assets available to the Administrator, while KSF(IOM) became one of the many creditors. When it was suggested to Mr Sants that the FSA had put pressure on KSF(IOM) to invest in KSF(UK), he flatly rejected this suggestion.[168] Lord Turner in turn noted that the decisions made by the Isle of Man FSC were based on correct information provided by the FSA:

> That was the liquidity regime that was in place, which I have to say was more onerous than our normal liquidity regime that we put in place in 2005 in response to some of our concerns earlier. We confirmed that regime was in place. Whether that provided sufficient assurance to the regulator on the Isle of Man was for them to decide. We are another, as it were, host regulator and our job under our [Memorandum of Understanding] with them is to provide them with information; it is not for us to make judgments on that information. We accurately answered their question and that regime was indeed in place with the bank.[169]

91. **The failure of Kaupthing Singer and Friedlander (UK), given the deposits held by it on behalf of Kaupthing Singer and Friedlander (IOM), was extremely detrimental to the ability of Kaupthing Singer and Friedlander (IOM) to maintain its operations. However, we can find no evidence that the FSA pressured the Isle of Man authorities to authorise or encourage the placement of such a significant deposit with Kaupthing Singer and Friedlander (UK).**

92. Both the Guernsey and Isle of Man authorities also expressed concern over the level of the FSA's communication with them during the crisis with the FSA. Mr Aspden told us that he felt "disappointed" and "severely let down" by the communication with the FSA as the Icelandic subsidiaries failed.[170] The Guernsey authorities had also been in close contact

166 Ev 304

167 Q 1454

168 Qq 2300-2301

169 Q 1

170 Q 1425

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with the FSA over the crisis period, especially around the time of the crisis around Northern Rock.[171] Mr Peter Neville, Director General of the Guernsey Financial Services Commission, had concerns that the FSA believed that "it could not and should not have passed us more information than it did in terms of the changed liquidity situation, the dependence on the parent and on the action it was planning to take".[172] The concern for Mr Neville was therefore that "there was limited information given to us … and they did not tell us they were limiting information".[173]

93. **It is of critical important that regulators in different jurisdictions can communicate effectively at times of financial crisis. We note with concern the suggestion that the paucity of information provided by the Financial Services Authority may have impeded the ability of the regulators in the Crown dependencies to safeguard their own financial systems. This is a particular concern given the close working relationship that appears to have existed between the Financial Services Authority and the Financial Services Commission of the Isle of Man in relation to previous situations such as that surrounding the failure of Bradford & Bingley just days earlier. We recommend that the Financial Services Authority review its existing powers and strategy for dealing with other jurisdictions, and reports on its efforts in this respect.**

Tax havens

94. One of the reasons cited by the Chancellor in refusing assistance to the depositors in the offshore centres affected by the failure of the Icelandic banks was the low-tax environment in these jurisdictions. Using the example of the Isle of Man, he explained that:

> I think, having looked at what has happened over the last few months, we really do need to have a long hard look at the relationship between this country and the Isle of Man, a tax haven sitting in the Irish Sea leading to perhaps people not being clear as to what the different rights and responsibilities are. We come to the situation where you have sitting there all sorts of tax advantages accruing from being in the Isle of Man and when things go wrong, people then say, "What about the British compensation scheme?" It is important that we take this opportunity, not rushing into it, not a knee-jerk reaction, to have a look at it … .[174]

However, representatives of the depositor groups affected reacted strongly to this accusation. Mr Dickens stated that "We are not tax dodging millionaires".[175] Mr Sieczko pointed out that "If you are a UK resident you will pay standard rate withholding tax and [that] will be remitted back to the Treasury, the same Treasury that is now refusing to back us and refusing to help us out at all".[176] He went on to say that "It is a diabolical accusation

171 Q 1426

172 *Ibid.*

173 Q 1426

174 Q 132

175 Q 1322

176 Q 1328

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to accuse these people of being tax dodgers or going to the Isle of Man for a tax haven".[177] Tony Brown MHK, Chief Minister, Isle of Man was also keen to defend the Isle of Man against the Chancellor's accusation:

> it is not a statement that carries any weight. If you look at the basis of how the Isle of Man is structured, the Isle of Man is a well-regulated country, it has a diverse economy. It applies international standards to the highest level and has a full system of direct and indirect taxation, including a full national insurance system. If you look at all the components of how the Isle of Man operates, it reflects very much how the United Kingdom operates, so that statement was unfortunate and does not reflect the status of the Isle of Man.[178]

95. HMRC describes the EU Savings Tax Directive (came into effect on 1 July 2005) as being designed "to counter cross border tax evasion by collecting and exchanging information about foreign resident individuals receiving savings income outside their resident state".[179] Until such a time as that exchange of information occurs between all the signatory nations, both the Isle of Man and Guernsey have decided to implement a withholding or retention tax, though the option of information exchange will be available for some customers.[180] Such taxes are levied on the savings held in these jurisdictions, and then 75% is remitted to the EU member state where the beneficial owner of the interest resides.[181] Table 2 shows the receipts to HMRC from the withholding tax element of the EU Savings Tax Directive from Guernsey and the Isle of Man.

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177 Q 1328

178 Q 1445

179 European Union Savings Directive (Countering cross-border tax evasion by individuals), HM Revenue and Customs, www.hmrc.gov.uk

180 Isle of Man Government, *Isle of Man: Guide To The European Savings Tax Directive*; Commerce and Employment, a States of Guernsey Government Department, *Guidance on the application of the agreements entered into between Guernsey and each EU Member State in support of the EU directive on the taxation of savings income*

181 Commerce and Employment, a States of Guernsey Government Department, *Guidance on the application of the agreements entered into between Guernsey and each EU Member State in support of the EU directive on the taxation of savings income*, para 24

Table 2: Amounts of withholding tax paid to HMRC					
Jurisdiction	**Period (as at January 2009)**	**Amount of withholding tax**			
		£	**€**	**$**	**Swiss Frs**
Guernsey	**UK tax year 2005-06**	2,330,160	27,547	184,145	18,646
	UK tax year 2006-07	7,164,129	880,057	463,166	53,364
	UK tax year 2007-08	7,471,670	800,818	289,958	59,220
Isle of Man	**UK tax year 2005-06**	6,393,424	—	—	—
	UK tax year 2006-07	9,765,119	—	—	—
	UK tax year 2007-08	10,699,869	—	—	—

Data source: HC Deb, 12 February 2009, cols 2146-2148W

96. It should also be noted that "HM Treasury considers the standard of the money laundering systems in the Crown Dependencies and Gibraltar to be equivalent to European Union standards, as embodied in the Third Money Laundering Directive".[182]

97. **Whatever the potential limitations of Government support for these individuals, we think it is important to note that the majority of those affected are not sophisticated, investors of high net worth who are somehow insulated from the losses they have incurred.**

98. **While the Isle of Man and Guernsey obviously have different systems of tax to that in the UK, the EU Savings Directive ensures some tax in respect of UK residents banking offshore is recouped by HMRC, via the retention tax operating on the islands. If the Chancellor feels that there has been an element of tax evasion, then HMRC should investigate and prosecute those involved. Furthermore, whilst the Chancellor appears to deprecate the use of offshore banks by British citizens, we note that the FCO carries advice on its website for those retiring abroad that "you may want to … consider the benefits of offshore banking before you retire abroad. An offshore bank account can play an important role in helping to minimise your tax liabilities".**[183]

Expatriates

99. Some of those depositors involved in the failure of KSF(IOM) and Landsbanki Guernsey complained to us that, as expatriate British citizens, they had limited access to the UK financial system. The Landsbanki Guernsey Depositors' Action Group highlighted research undertaken in November 2008 that showed that out of 58 firms, only two small building societies would accept expatriate account holders, and that "Without exception, the reason given for refusal was the Anti-Money Laundering 'Know Your Customer' guidelines which, although expatriates are not barred by law from opening or maintaining an existing UK account, have effectively prohibited them from doing so in practice".[184] Mr

182 HC Deb, 26 March 2009, col 630W

183 Ev 572

184 Ev 139

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Dickens expressed the belief that "if you have a British passport—and, of course, that includes the people in Jersey and Guernsey and the Isle of Man—you should have the right to open a bank account in the United Kingdom because the only thing that is stopping one from having an account in the UK is an address".[185] Given the lack of choice in the UK market, British expatriates had instead deposited their sterling reserves in bank accounts in either the Isle of Man or Guernsey.

100. Mr Ian Pearson MP, Economic Secretary to the Treasury, stated on 6 November 2008 that:

> There is no legal bar under UK financial services regulation that would prevent a non-UK resident from opening a new bank account here. When an account is opened remotely, more onerous anti-money laundering checks are, quite properly, required because of the increased risks involved. This might well be a factor in the willingness of some UK banks to offer new accounts to non-residents. However, this would not be a burden for customers who move offshore but wish to retain existing accounts.[186]

In its response, the FSA reiterated that neither the Treasury's Money Laundering regulations, nor the FSA's handbook, prohibited expatriates opening accounts in the United Kingdom:

> The Treasury's Money Laundering Regulations require firms to know their customer. … Guidance sets out how firms should identify their customer and which aspects of their identity they should verify. There is a section in the Guidance on customers who are non-resident, not physically present in the UK, wishing to open a bank account. This section explains what firms should consider when dealing with such applications: for example, it states that a firm should apply enhanced due diligence where the customer is not met personally or where other high risk factors come into play. It does not, as noted above, suggest that firms should refrain from entering into a business relationship with a UK citizen not residing in the UK.[187]

101. **We accept that there is no specific regulation or law preventing the provision of bank accounts to expatriate British citizens, but in practice the supply appears to have been extremely limited. As such, many expatriates have been forced to deposit their money offshore, outside the protection of the Financial Services Authority, and the Financial Services Compensation Scheme, as a direct result of the way in which Financial Services Authority regulations were interpreted in the UK. We therefore recommend that the Financial Services Authority liaise with both the Building Societies Association and the British Bankers' Association, to identify why provision is so poor, and report back to us on steps to be taken to ensure better provision in the future, whether by new products, or greater access to existing products.**

185 Q 1362

186 HC Deb, 6 November 2008, col 470

187 Ev 572

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The Isle of Man subsidiary of the Derbyshire Building Society

102. A very specific complaint was raised with us by depositors holding funds in the Isle of Man subsidiary of the Derbyshire Building Society, which had then been taken over by Kaupthing's Isle of Man subsidiary in 2008. These individuals had passed from having a parental guarantee from a British Building Society, to one from an Icelandic bank. Mr Sieczko suggested that the information provided to the Derbyshire's customers was not completely transparent:

> There is a four-page document that was put out just describing that they were being taken over. There was no mention of a change of risk profile and no mention of a change of ownership and structure. It starts off by saying that Kaupthing Bank is a Northern European bank. It does not even go as far as saying it is an Icelandic bank. It does go on to say it has got offshoots in other areas of Europe, including the Nordic countries. It is very non-specific.[188]

103. The regulators, both in the Isle of Man, and in the UK, seemed relatively unconcerned about the takeover. Mr Aspden told us that, while not a regulatory requirement, the provision of the parental guarantee from Kaupthing Bank hf in Reykjavik in respect of the entire entity of KSF (IOM), not just Derbyshire had "offered an important overlay of comfort".[189] Mr Sants first reiterated that the transfers were not a matter for the FSA, pointing out that "A transfer of ownership to a company in the Isle of Man which is owned by an Icelandic company is obviously a matter for those regulators to approve those transfers".[190] However, he acknowledged that those with term deposits did not have the chance to opt out of the transfer should they have had concerns with the deal.[191]

104. **In 2008, Kaupthing Singer and Friedlander (Isle of Man) took over the Isle of Man subsidiary of the Derbyshire Building Society. While those with non-term deposits could have moved their funds if not satisfied with the new parental guarantee offered by the Icelandic parent bank (rather than their old one from a UK building society), those with long-term bonds had no chance to remove their funds without penalty. Where a parental guarantee is given, the home regulator of the parent company should be aware of that guarantee, and when it is to be transferred, should work with all the host regulators to ensure that all depositors have a chance to switch their deposits if they are not satisfied with the new deal.**

The overall case for assistance

105. We have received thousands of letters and emails from individuals and families who are suffering as a result of the collapse of Kaupthing Singer and Friedlander (Isle of Man) and Landsbanki Guernsey. **We acknowledge the severe distress shared by many individuals as a result of this banking failure.**

188 Q 1353

189 Q 1469

190 Q 2305

191 *Ibid.*

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106. **A difficult judgment though has to be made in assessing the overall case for assistance. Those involved in the failure of the offshore subsidiaries of the Icelandic banks have suffered losses to date, and many of those affected are British citizens. On the other hand, we acknowledge the clear validity of the overarching principle that the UK Government cannot cover deposits held in institutions outside its direct regulatory control. However, we believe that the UK authorities should work with the Isle of Man and Guernsey authorities to resolve these issues, especially given the complexites arising from the take over of the Derbyshire building society.**

107. **We further recommend that the UK authorities should seek to work closely with other interested parties such as the Financial Services Commission of the Isle of Man to maximise the transparency of the administration of KSF(UK) in order to facilitate the best outcome for all depositors including those with funds in KSF(IOM).**

Lessons learnt

Advice to UK citizens investing offshore

108. During our inquiry, we also discussed the advice given to consumers about depositing offshore by Independent Financial Advisors (IFAs), as some of those who deposited their savings in the Crown dependencies did so after receiving advice from an IFA. Ms Davidson, Deputy Chair, Association of Independent Financial Advisers, noted that IFAs would not necessarily know what cash holdings a client may have:

> In terms of their cash, some clients will seek advice from independent financial advisers but some will also manage their own cash. So it is not the case that every client of an independent financial adviser seeks advice on bank deposits because they are very fluid and rates are readily available in the press and also online. It is a bit of a mix. You should not make the assumption that all IFA clients seek advice on deposits.[192]

Mr Cummings, Director General, Association of Independent Financial Advisers (AIFA), explained that for clients who wanted "very low risk", offshore investment was not appropriate.[193] However, for those clients prepared for more risk, he explained that "One of [the reasons to go offshore] is in a straightforward bank account those institutions were paying slightly higher rates of interest than could be got onshore".[194] He also stated that investing offshore could assist " tax management issues".[195] Mr Cummings outlined what a good financial advisor should have explained to their client before they deposited money offshore:

192 Q 1340

193 Q 1336

194 *Ibid.*

195 *Ibid.*

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> We were absolutely aware of the notion of risk and we would have explained that to clients. We would have explained the protection that they get. We would also have explained the fact that if the client is unhappy with their independent financial advice, they are covered by the UK-based Financial Ombudsman Service, so they could have complained to the Ombudsman if they had not felt the advice was suitable. We would also have talked to them about the credit reference agency and the double or triple-A rating of the institutions. [196]

He went on to say that AIFA was ensuring that the lessons had been learnt from the present crisis, explaining that "Certainly we have issued notes to members, we have addressed these issues in our newsletters and communications with members to make sure that we are reinforcing the good practice that we see already exists".[197] **Bearing in mind the heavy coverage in the financial press of Iceland's fragility we would have expected offshore savers using independent financial advisers to have been advised of the changing risk profile of their savings. We hope to explore further the role of advice to customers in our forthcoming inquiry into consumers and the banking crisis.**

109. **We draw attention to the information available to consumers on the FSA's 'money made clear' website which details what compensation a consumer is entitled to if a UK financial services firm is unable, or likely to be unable, to pay claims against it. We recommend that the FSA publishes on this website a list of all bank and building society accounts available in the UK and regulated in part by the FSA which would be covered by the Financial Services Compensation Scheme.**

The wider issue of cross-border regulation and 'passporting'

110. As we have seen with the case of Landsbanki and Icesave, the FSA has a limited ability to regulate those firms that 'passport' into the UK financial system, as branches of EEA banks are regulated by their 'home' supervisor, which in the case of the Icelandic banks was the FME. As a result, UK savers may have thought that their savings were in an institution regulated by the FSA, and fully protected by FSCS. The consumer group Which? expressed concern at this, and made the following request:

> Host state regulators have little to no influence over the regulation of passporting firms. If home state regulators are not doing their job properly consumers are put at risk. We would like to see a change in EU legislation which shifts the responsibility for regulation of passporting firms from home to host state regulator and which also requires passporting firms to seek full membership of the host state depositor guarantee scheme. Consumers should not again be put into a position where a EEA-member state ignores its legal responsibilities to foreign depositors. We also believe that consumers should not be forced to claim from different compensation schemes but should be able to access their home state compensation scheme for all payouts.[198]

196 Q 1342

197 Q 1343

198 Ev 238

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Which? also believed that "collaboration between national regulators needs to be strengthened".[199] A similar point was made by the Financial Services Consumer Panel, who agreed that passporting arrangements made unrealistic assumptions about the nature of regulatory practice in Member States and "encouraged regulatory arbitrage". They noted the absence of a "consistent EU-wide infrastructure for the protection of consumers through access to ADR services and minimum levels of compensation."[200] In their view, the balance had turned too much in favour of companies rather than consumers, with EU initiatives concentrating on "a desire to make cross-border trade easier for firms with insufficient regard to the 'demand' side of the equation".[201] The Building Societies Association was also keen to raise its objections to the passporting arrangements as currently operated in the EU:

> The experience of the last three to four months has also placed a big question mark against 'passporting' by EEA banks into the UK—the activities and collapse of the Icelandic banks in particular left UK depositors troubled and panicky, and both the UK taxpayer, and all UK building societies and banks, severely out of pocket in paying for the depositor bailout. Wholesale depositors such as local authorities and charities, and some societies, have lost money. The whole episode has undermined financial stability.[202]

111. The FSA is already considering this issue. In its written evidence to us, it suggested that "Recent events, including the crisis in Icelandic retail bank branches, demonstrate that the EU single market rules need to be reconsidered".[203] They suggested two possible reforms. One was to restrict passporting, such as by enabling "Member States to require firms to undertake their retail operations in fully capitalised subsidiaries".[204] The other route was to encourage greater pan-European cooperation.[205] Lord Turner was adamant there was a need for change:

> We have tried to run a European single market in retail banking services as if retail banking is the same as retail or manufacturing, and that you can run a European single market without some category of European supervision of supervision or co-ordination of supervision which goes beyond what we do for retailers and manufacturers, but I do not think we can. I do not think we can run a European single market in retail banking without significant changes in the regime.[206]

112. **Our Banking Crisis inquiry, and specifically the problem of the failure of the Icelandic banks, has raised issues surrounding the cross-border regulation of financial**

199 Ev 238

200 Ev 267

201 *Ibid.*

202 Ev 275

203 Ev 459

204 *Ibid.*

205 Ev 459

206 Q 2309

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institutions. Considerable taxpayer support has been required to provide rapid compensation to onshore UK depositors in Icelandic banks that 'passported' into the UK. This area of European law requires further consideration, and we will return to this topic in our future inquiry onto the banking crisis within its international context, with specific reference to the regulation of subsidiaries and branches of cross-border financial institutions.

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Conclusions and recommendations

A crisis in Iceland

1. We think it laudable that Mr Shearer brought to the attention of the Financial Services Authority his concerns around the takeover of Singer and Friedlander by Kaupthing. While the Financial Services Authority appears to have investigated these concerns, this episode shows the paramount need for the Financial Services Authority to be open to those that may wish to contact it to register their disquiet over problems they encounter in financial markets. We also note with great concern the impotence of the FSA to tackle directly the concerns brought to its attention as a consequence of its lack of any jurisdiction, which we discuss below. (Paragraph 28)

What happened in October 2008?

2. During the collapse of the Landsbanki bank in October 2008, the Chancellor of the Exchequer took steps to safeguard the deposits of UK investors. We note that his comments regarding the intentions of the Icelandic Authorities had a serious impact on the confidence held in the remaining solvent Icelandic bank, Kaupthing and it has been suggested that this may have contributed to its collapse. We note that the published transcript of the Chancellor's conversation with the Icelandic Finance Minister does not confirm that the Icelandic government had stated that it would not honour its obligations but we have seen no evidence to contradict the Chancellor's view that UK depositors and creditors were unlikely to be protected to the same extent as Icelandic ones. We also have seen no evidence that Kaupthing would have survived if the Chancellor had not expressed his views. (Paragraph 49)

3. Although the Icelandic banking system was vulnerable to the crisis that has affected the international financial system since 2007, the actions of the UK Government in making statements on the capacity and willingness of the Icelandic Government to provide assistance to non-Icelandic citizens, whether or not such statements were accurate, turned the UK Government from being a seemingly passive observer of events, to an active participant in the market. Given the volatility of the situation, and the vulnerability of Icelandic banks at the time, it appears that the Icelandic Authorities found the UK Government's approach ultimately unhelpful. (Paragraph 50)

4. The use of the Anti-Terrorism, Crime and Security Act 2001 had considerable implications for the Icelandic authorities in maintaining a functioning financial system. We call on the Treasury to consider how appropriate the use of this legislation would be in any similar circumstances in the future. The use of this Act inevitably stigmatises those subject to it and a less blunt instrument would be more appropriate. We are concerned that no appropriate legislation is available and call on the Treasury to address this matter. (Paragraph 51)

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Charities and Local Authorities

5. We acknowledge that some local authorities will feel hard done by as a consequence of the limitations of Government support for them. Local authorities are required to take their own decisions on the level of prudent, affordable capital investment. They have a duty to the taxpayer diligently to protect the money they are investing on their behalf. Some authorities have shown themselves to be better than others in this regard. Under these circumstances it would seem perverse to reward those authorities who failed to protect their investment with yet more money from the taxpayer. (Paragraph 72)

6. We recommend that the Government consider the case for providing charities with further statutory guidance relating to the management of a charity's finances and investments. We further recommend that the Government take steps to clarify what protection is available to charities under the Financial Services Compensation Scheme. (Paragraph 78)

7. We recognise that the important work undertaken by the charitable sector often provides the most vulnerable elements of society with invaluable support. At a time when more people than ever may be faced with difficult circumstances, we believe that it is imperative that charities have access to the funds that were provided to them by the public. We are concerned that one of the tests a charity must pass to be protected under the FSCS definition of a retail depositor is inappropriate for those charities using fixed assets in the course of their work. We recommend that, on this occasion only, all charities should be compensated for losses incurred as a consequence of the failure of the Icelandic banks. Furthermore, to avoid such problems arising in the future, we recommend that the FSCS re-examine the criteria for the classification of charities as retail or wholesale depositors in the light of this recommendation. (Paragraph 83)

Protecting British citizens

8. We agree that the overarching principle should be that the UK Government cannot provide cover for deposits held by British citizens in jurisdictions outside the direct control of the United Kingdom. (Paragraph 88)

9. The failure of Kaupthing Singer and Friedlander (UK), given the deposits held by it on behalf of Kaupthing Singer and Friedlander (IOM), was extremely detrimental to the ability of Kaupthing Singer and Friedlander (IOM) to maintain its operations. However, we can find no evidence that the FSA pressured the Isle of Man authorities to authorise or encourage the placement of such a significant deposit with Kaupthing Singer and Friedlander (UK). (Paragraph 91)

10. It is of critical important that regulators in different jurisdictions can communicate effectively at times of financial crisis. We note with concern the suggestion that the paucity of information provided by the Financial Services Authority may have impeded the ability of the regulators in the Crown dependencies to safeguard their own financial systems. This is a particular concern given the close working relationship that appears to have existed between the Financial Services Authority

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and the Financial Services Commission of the Isle of Man in relation to previous situations such as that surrounding the failure of Bradford & Bingley just days earlier. We recommend that the Financial Services Authority review its existing powers and strategy for dealing with other jurisdictions, and reports on its efforts in this respect. (Paragraph 93)

11. Whatever the potential limitations of Government support for these individuals, we think it is important to note that the majority of those affected are not sophisticated, investors of high net worth who are somehow insulated from the losses they have incurred. (Paragraph 97)

12. While the Isle of Man and Guernsey obviously have different systems of tax to that in the UK, the EU savings directive ensures some tax in respect of UK residents banking offshore is recouped by HMRC, via the retention tax operating on the islands. If the Chancellor feels that there has been an element of tax evasion, then HMRC should investigate and prosecute those involved. Furthermore, whilst the Chancellor appears to deprecate the use of offshore banks by British citizens, we note that the FCO carries advice on its website for those retiring abroad that "you may want to….consider the benefits of offshore banking before you retire abroad. An offshore bank account can play an important role in helping to minimise your tax liabilities". (Paragraph 98)

13. We accept that there is no specific regulation or law preventing the provision of bank accounts to expatriate British citizens, but in practice the supply appears to have been extremely limited. As such, many expatriates have been forced to deposit their money offshore, outside the protection of the Financial Services Authority, and the Financial Services Compensation Scheme, as a direct result of the way in which Financial Services Authority regulations were interpreted in the UK. We therefore recommend that the Financial Services Authority liaise with both the Building Societies Association and the British Bankers' Association, to identify why provision is so poor, and report back to us on steps to be taken to ensure better provision in the future, whether by new products, or greater access to existing products. (Paragraph 101)

14. In 2008, Kaupthing Singer and Friedlander (Isle of Man) took over the Isle of Man subsidiary of the Derbyshire Building Society. While those with non-term deposits could have moved their funds if not satisfied with the new parental guarantee offered by the Icelandic parent bank (rather than their old one from a UK building society), those with long-term bonds had no chance to remove their funds without penalty. Where a parental guarantee is given, the home regulator of the parent company should be aware of that guarantee, and when it is to be transferred, should work with all the host regulators to ensure that all depositors have a chance to switch their deposits if they are not satisfied with the new deal. (Paragraph 104)

15. We acknowledge the severe distress shared by many individuals as a result of this banking failure. (Paragraph 105)

16. A difficult judgment though has to be made in assessing the overall case for assistance. Those involved in the failure of the offshore subsidiaries of the Icelandic

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banks have suffered losses to date, and many of those affected are British citizens. On the other hand, we acknowledge the clear validity of the overarching principle that the UK Government cannot cover deposits held in institutions outside its direct regulatory control. However, we believe that the UK authorities should work with the Isle of Man and Guernsey authorities to resolve these issues, especially given the complexities arising from the take over of the Derbyshire building society. (Paragraph 106)

17. We further recommend that the UK authorities should seek to work closely with other interested parties such as the Financial Services Commission of the Isle of Man to maximise the transparency of the administration of KSF(UK) in order to facilitate the best outcome for all depositors including those with funds in KSF(IOM) (Paragraph 107)

18. Bearing in mind the heavy coverage in the financial press of Iceland's fragility we would have expected offshore savers using independent financial advisers to have been advised of the changing risk profile of their savings. We hope to explore further the role of advice to customers in our forthcoming inquiry into consumers and the banking crisis. (Paragraph 108)

19. We draw attention to the information available to consumers on the FSA's 'money made clear' website which details what compensation a consumer is entitled to if a UK financial services firm is unable, or likely to be unable, to pay claims against it. We recommend that the FSA publishes on this website a list of all bank and building society accounts available in the UK and regulated in part by the FSA which would be covered by the Financial Services Compensation Scheme. (Paragraph 109)

20. Our Banking Crisis inquiry, and specifically the problem of the failure of the Icelandic banks, has raised issues surrounding the cross-border regulation of financial institutions. Considerable taxpayer support has been required to provide rapid compensation to onshore UK depositors in Icelandic banks that 'passported' into the UK. This area of European law requires further consideration, and we will return to this topic in our future inquiry onto the banking crisis within its international context, with specific reference to the regulation of subsidiaries and branches of cross-border financial institutions. (Paragraph 112)

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Formal minutes

Tuesday 31 March 2009

Members present:

John McFall, in the Chair

Nick Ainger
Mr Graham Brady
Mr Colin Breed
Mr Michael Fallon
Ms Sally Keeble
John Mann
Mr George Mudie
John Thurso
Mr Mark Todd
Sir Peter Viggers

Banking Crisis: The impact of the failure of the Icelandic banks

Draft Report (*Banking Crisis: The impact of the failure of the Icelandic banks*), proposed by the Chairman, brought up and read.

Ordered, That the Chairman's draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 112 read and agreed to.

Summary agreed to.

Resolved, That the Report, be the Fifth Report of the Committee to the House.

Ordered, That the Chairman make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

[Adjourned till Tuesday 21 April at 9.30 am.

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Reports from the Treasury Committee during the current Parliament

Session 2007–08

First Report	Administration and expenditure of the Chancellor's departments, 2007–08	HC 35
Second Report	Pre-Budget Report 2008	HC 27
Third Report	Work of the Committee, 2007-08	HC 173
Fourth Report	Appointment of Paul Tucker as Deputy Governor of the Bank of England for Financial Stability	HC 34

Session 2007–08

First Report	The 2007 Comprehensive Spending Review	HC 55
Second Report	The 2007 Pre-Budget Report	HC 54
Third Report	The Work of the Committee in 2007	HC 230
Fourth Report	Climate change and the Stern Review: the implications for Treasury policy	HC 231
Fifth Report	The run on the Rock	HC 56
Sixth Report	Financial Stability and Transparency	HC 371
Seventh Report	Administration and expenditure of the Chancellor's departments, 2006–07	HC 57
Eighth Report	Re-appointment of Dr Andrew Sentance to the Monetary Policy Committee	HC 454
Ninth Report	The 2008 Budget	HC 430
Tenth Report	Re-appointment of Mervyn King as the Governor of the Bank of England	HC 524
Eleventh Report	Counting the population	HC 183

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Twelfth Report	Inherited Estates	HC 496
Thirteenth Report	Budget Measures and Low Income Households	HC 326
Fourteenth Report	Appointment of Lord Turner of Ecchinswell as Chairman of the Financial Services Authority	HC 916
Fifteenth Report	Appointment of Charlie Bean as Deputy Governor of the Bank of England	HC 917
Sixteenth Report	Appointment of Spencer Dale to the Monetary Policy Committee of the Bank of England	HC 1009
Seventeenth Report	Banking Reform	HC 1008

Session 2006–07

First Report	Financial inclusion: the roles of the Government and the FSA, and financial capability	HC 53
Second Report	The 2006 Pre-Budget Report	HC 115
Third Report	Work of the Committee in 2005–06	HC 191
Fourth Report	Are you covered? Travel insurance and its regulation	HC 50
Fifth Report	The 2007 Budget	HC 389
Sixth Report	The 2007 Comprehensive Spending Review: prospects and processes	HC 279
Seventh Report	The Monetary Policy of the Bank of England: re-appointment hearing for Ms Kate Barker and Mr Charlie Bean	HC 569
Eighth Report	Progress on the efficiency programme in the Chancellor's department	HC 483
Ninth Report	Appointment of the Chair of the Statistics Board	HC 934
Tenth Report	Private equity	HC 567
Eleventh Report	Unclaimed assets within the financial system	HC 533
Twelfth Report	The Monetary Policy Committee of the Bank of England: ten years on	HC 299
Thirteenth Report	Financial inclusion follow-up: saving for all and shorter term saving products	HC 504

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Fourteenth Report	Globalisation: prospects and policy responses	HC 90

Session 2005–06

First Report	The Monetary Policy Committee of the Bank of England: appointment hearings	HC 525
Second Report	The 2005 Pre-Budget Report	HC 739
Third Report	The Monetary Policy Committee of the Bank of England: appointment hearing for Sir John Gieve	HC 861
Fourth Report	The 2006 Budget	HC 994
Fifth Report	The design of a National Pension Savings Scheme and the role of financial services regulation	HC 1074
Sixth Report	The administration of tax credits	HC 811
Seventh Report	European financial services regulation	HC 778
Eighth Report	Bank of England Monetary Policy Committee: appointment hearing for Professor David Blanchflower	HC 1121
Ninth Report	Globalisation: the role of the IMF	HC 875
Tenth Report	Independence for statistics	HC 1111
Eleventh Report	The Monetary Policy Committee of the Bank of England: appointment hearings for Professor Tim Besley and Dr Andrew Sentance	HC 1595
Twelfth Report	Financial inclusion: credit, savings, advice and insurance	HC 848
Thirteenth Report	"Banking the unbanked": banking services, the Post Office Card Account, and financial inclusion	HC 1717

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Agenda Item 6

AUDIT COMMITTEE

Risk Management
22 April 2009

Report of Head of Financial Services

PURPOSE OF REPORT **To introduce the proposed Code of Practice for Managing Risk and Opportunity 'A Sense of Proportion', and to seek approval for it to be formally adopted in place of the current Risk Management Policy and Strategy.**
This report is public.

Recommendations

1. **That the Committee notes the reasons for reviewing the Council's risk management procedures and the major changes and improvements proposed, and gives approval for the Code to be formally adopted in place of the current Risk Management Policy and Strategy.**

2. **That the Financial Regulations within the Council's Constitution be amended as set out in the report.**

Introduction

The Council's first Risk Management Policy and Strategy were adopted on 16 December 2003. Since that date, the Strategy has been reviewed and updated three times; namely, July 2005, June 2007 and May 2008. However, these amendments to the Strategy were fairly minor and so, following a recent Internal Audit Report on Risk Management (08/0742); it became apparent that a much more substantial review was necessary. It is therefore proposed to replace the previous Policy, Strategy and Guidance documents with the consolidated Code of Practice for Managing Risk and Opportunity – '*A Sense of Proportion*' (**Appendix A).**

By keeping the separate component elements within the Code of Practice, future updates should prove manageable, i.e. formal approval will be required by Audit Committee for amendments to Section A, the Strategy and Policy, whereas Officers will have authority to review and update Section B, Guidance.

Background

The objectives for the recent Internal Audit Report on Risk Management (08/0742) were;

- To provide assurance as to the effectiveness of Services' current risk management arrangements, particularly focussing on risk associated with business objectives.
- To assist with the development of current risk management arrangements, particularly focussing on integration with the Performance Management Framework.
- Where possible, help the Council improve on its Use of Resources Assessment.

The most significant Agreed Action that came out of the Audit was to develop this proposed Code of Practice for Managing Risk and Opportunity – 'A Sense of Proportion'. This would replace the previous Policy and Strategy and explain the Authority's reviewed approach to risk management, and the framework that will operate to ensure that risks are effectively managed. The Aims and Objectives are outlined in full on page 5 of the Code of Practice, however, they were summarised in the Audit Report as being;

- Fully integrating risk management into the culture of the Council, and its strategic planning process.

- Ensuring that mechanisms for identifying, evaluating, controlling, reviewing, reporting and communicating risks are in place.

- Communicating and co-ordinating risk management activity across the Council.

- Achieving compliance with good corporate governance practice, in terms of providing assurance that risk is well managed.

- The encouragement of innovation and improvement through decision making, this being based on an awareness of risk and opportunity.

Alterations

The new Code of Practice incorporates many simple alterations to the phraseology and lay out of the previous Policy, Strategy and Guidance. There are, however, also numerous changes and improvements. Namely;

- On behalf of Corporate Management Team, the Risk and Insurance Manager will maintain a Strategic Risk Register. This will be reported to Members, in particular Cabinet, in order for it to inform proposals regarding the Budget and Policy Framework, as it is essential that key strategic risks are addressed when setting corporate priorities. This is so that the chosen priorities and non-priorities represent, as best they can, the best way forward to meet the needs and wants of the district, as well as key legal obligations.

- The current 'Corporate Risk Register' will no longer exist, as such. Instead, Service Heads will be responsible for recording their own significant business risks on their Service's Business Plans. (The format of service business plans has recently been updated, to reflect this change as well as others.) Monitoring and reporting of these risks will be on an exception basis, via quarterly performance monitoring systems (PRT reports, PMG etc).

- The 'Scope' (page 8) is more detailed than previously. The five main areas of risk; Business, Project/ Programme, Partnership, Business Continuity Management and

Health & Safety are discussed, and detailed guidance given as to how they should be effectively managed.

- Chapter 8, 'Alignment of Risk Management and Business Planning Frameworks' is a new chapter. It explains the similarities between performance management and risk management, and highlights the benefits from integrating the two processes.

- In addition to the roles and responsibilities that were in the previous strategy, this Code of Practice provides a structure for reporting risks (Table 3, page 23.) Whilst this provides similar information to the earlier 'Roles and Responsibilities' (Table 2, page 12), it introduces numerous specific areas of management for which specific risk reporting is required, taking account of the actions being taken to manage such risks.

Council Constitution

The Council's Constitution sets out how the Council operates, how decisions are made and the procedures involved in ensuring these are efficient, transparent and accountable to local people. Part 5 of the Constitution relates to Financial Regulations. If Audit Committee agrees to adopt the Code of Practice for Managing Risk and Opportunity – 'A Sense of Proportion', then the Financial Regulations and Procedures would need to be updated for various minor wording changes, as set out in the relevant extracts below:

- Financial Regulations (C), page 10, should read;

C2 The Audit Committee is responsible for approving the authority's Code of Practice for Managing Risk and Opportunity (Section A; policy and strategy), and for reviewing the effectiveness of risk management. Cabinet is responsible for ensuring that proper insurance exists where advised appropriate.

C3 The Corporate Director (Finance and Performance) is responsible for promoting the authority's risk management arrangements throughout the authority, to ensure effectiveness in supporting high standards of corporate governance. The Section 151 Officer is responsible for advising the Cabinet on proper insurance cover where appropriate, and for providing guidance on risk management (Section B of the Risk Management Code of Practice).

- Financial Procedures (C), page 33, should read:

3.03 The key controls for risk management are:

a) Procedures are in place to identify, assess, prevent or contain risks, and these procedures are operating effectively throughout the authority.

b) A monitoring process is in place to review regularly the effectiveness of risk management strategies and the operation of these controls. The risk management process should be conducted on a continuing basis.

c) Managers know that they are responsible for managing relevant risks and are provided with relevant guidance on risk management initiatives.

d) Provision is made for losses that might result from the risks that remain.

e) Procedures are in place to investigate claims within required timescales.

f) Non-acceptable levels of risk are determined and insured against where appropriate.

g) The authority has identified business continuity plans for implementation in the event of disaster that results in significant loss or damage to its resources.

Responsibilities of the Corporate Direct (Finance & Performance):

3.05 To ensure that the Risk Management Code of Practice is effective in supporting high standards of corporate governance.

Responsibilities of the s151 Officer:

3.08 To advise on the development and implementation of the Risk Management Code of Practice, and to provide guidance as appropriate.

Conclusion

The recent Internal Audit report stated that a reasonable level of assurance was provided in relation to the effectiveness of the Authority's risk management arrangements. The headline message was that adoption of a new Code of Practice for Managing Opportunity and Risk would serve to enhance this. Therefore, in approving the Code of Practice, the Committee will be endorsing the Council's dedication to efficient risk management procedures.

CONCLUSION OF IMPACT ASSESSMENT
(including Diversity, Human Rights, Community Safety, Sustainability and Rural Proofing)
None directly arising from this report.

FINANCIAL IMPLICATIONS

No implications arising directly from this report.

DEPUTY SECTION 151 OFFICER'S COMMENTS

The Deputy Section 151 Officer has been consulted and has no further comments.

LEGAL IMPLICATIONS

There are no legal implications directly arising from this report.

MONITORING OFFICER'S COMMENTS

The Monitoring Officer has been consulted and confirms that Article 15 of the Constitution provides for this Committee to agree amendments to the Financial Regulations within the Constitution.

BACKGROUND PAPERS Risk Management Policy and Strategy Council Constitution	**Contact Officer:** Lynne Armistead **Telephone: 01524 582141** **E-mail:** larmistead@lancaster.gov.uk **Ref:**

LANCASTER CITY COUNCIL

Promoting City, Coast & Countryside

Lancaster City Council

Risk Management

A Sense of Proportion

CODE OF PRACTICE FOR MANAGING RISK AND OPPORTUNITY

Version Control

Reference:	'A Sense of Proportion' – Code of Practice for Managing Risk and Opportunity
Version:	0.03
Date:	07/04//2009
Status:	Release 1
Issue History:	First release as Code of Practice 'A Sense of Proportion' Replaces previous Risk Management Strategy version 3.0
Author:	Lynne Armistead – Risk & Insurance Manager

Document History

Document Title	Version	Reference/ Date	Comments
Risk Management Strategy	3.00	25/6/08	The previous version of the Strategy was accepted by Audit Committee.
'A Sense of Proportion' – Code of Practice for Managing Risk and Opportunity.	0.01	12/1/09	First draft of Code of Practice to completely replace the previous Risk Management Strategy, version 3.00. To be considered by RM Steering Group on 6 March 09.
'A Sense of Proportion' – Code of Practice for Managing Risk and Opportunity.	0.02	19/3/09	Second draft of Code of Practice. Reviewed following comments of RM Steering Group. The Table of Contents have been re-organised so that there are two separate sections; namely, 'Strategy' and 'Guidance'. This will be considered by PMG on 27 March 09 and then Audit Committee on 22 April 2009.
'A Sense of Proportion' – Code of Practice for Managing Risk and Opportunity.	0.03	7/4/09	Roles and Responsibilities (PMG supporting individuals) reviewed by Management Team on 3 April 2009, together with minor amendments by s151 Officer.

Table of contents

Section A – Risk Management Policy and Strategy

Section B – Risk Management Guidance

1. Foreword

1.01 Welcome to the Council's Code of Practice for Managing Risk and Opportunity. This Code of Practice aims to improve the effectiveness of risk management across the Council. Effective risk management allows us to:

- Have increased confidence in achieving our priorities and outcomes
- Constrain threats to acceptable levels
- Take informed decisions about exploiting opportunities
- Ensure that we get the right balance between rewards and risks
- Improve partnership working arrangements and corporate governance

1.02 Ultimately, effective risk management will help to ensure that the Council maximises its opportunities and minimises the impacts of the risks it faces, thereby improving its ability to deliver priorities and improve outcomes for residents.

1.03 This Code of Practice explains Lancaster City Council's approach to risk management, and the framework that will operate to ensure that risks are effectively managed.

2. Introduction

2.01 Risk management is both a statutory requirement and an indispensable element of good management. As such, its implementation is crucial to the Council and essential to its ability to discharge its various functions as a partner within the Local Strategic Partnership, a deliverer of public services, a custodian of public funds and a significant employer.

2.02 This current version of the Council's Risk Management Code of Practice builds on previous versions of the Strategy and has been revised:

- In accordance with the statement that regular reviews would be undertaken
- To further embed good practice in relation to risk management across the Council
- In line with recognised best practice and auditors' expectations

2.03 This Risk Management Code of Practice provides a comprehensive framework and process designed to support members and officers in ensuring that the Council is able to discharge its risk management responsibilities fully. The Code of Practice outlines the objectives and benefits of managing risk, describes the responsibilities for risk management, and provides an overview of the process that we will implement to manage risk successfully.

2.04 Risk Management in Lancaster City Council is about improving the ability to deliver strategic objectives by managing threats, enhancing opportunities and creating an environment that adds value to ongoing operational activities.

2.05 Risk Management is a key part of corporate governance, which is essentially the way an organisation manages its business, determines strategy and objectives, and goes about achieving these objectives. Risk Management will help identify and deal with the key risks facing the Council in the pursuit of its goals. It is a key part of good management and not simply a compliance exercise.

2.06 The benefits of successful risk management include:

- **Improved service delivery**
  Enhanced corporate policies, fewer disasters and surprises, added value across service areas, more targets achieved, improved internal controls, consistent management of risk and opportunities resulting in improved service delivery.

A SENSE OF PROPORTION

- **Improved financial performance**
  Higher percentage of objectives achieved, lower level of fraud, increased capacity through reduction in the number of decisions that need reviewing or revising, decreased number and impact of critical risks, better income generation and fewer alterations and losses.

- **Improved human resources management**
  Potentially reduced staff turnover and absenteeism.

- **Improved corporate governance and compliance systems**
  Fewer regulatory visits, fewer legal challenges, and an improved corporate governance statement that is better substantiated and evidenced.

- **Improved insurance management**
  Reduced insurance premiums together with reduced number and level of claims. Reduction in uninsured losses.

2.07 Further advice and assistance on risk management is available from the Risk and Insurance Manager, Financial Services, Lancaster City Council, tel. 01524 582141.

3. Aim and Objectives

3.01 **AIM**

The aim of this Code of Practice is to improve the ability to deliver strategic priorities by managing threats, enhancing opportunities and creating an environment that adds value to ongoing operational activities.

3.02 **OBJECTIVES**

The objectives of this Code of Practice are to:

- Fully integrate risk management into the culture of the Council and into the Council's strategic planning processes.
- Ensure that the framework for identifying, evaluating, controlling, reviewing, reporting and communicating risks across the Council is implemented and understood by all relevant staff.
- Communicate to stakeholders the Council's approach to risk management.
- Improve co-ordination of risk management activity across the Council.
- Ensure that Members, Management Team and external regulators are provided with the necessary assurance that the Council is mitigating the risks of not achieving its objectives, and thus complying with good corporate governance practice.
- Ensure consistency throughout the Council in the management of risk.
- Encourage innovation and improvement through decision-making that is based on a sound awareness of opportunities and risks.

3.03 These objectives will be achieved by:

- Employing a corporate approach to pro-active risk management in accordance with shared best practice;
- Ensuring that officers and elected members have clear accountability for the ownership, control and cost of risk, and the tools to manage them effectively;

A SENSE OF PROPORTION

- Adopting a systematic approach to risk management as an integral element of:
  - Strategic planning
  - Business planning
  - Financial planning
  - Performance management
  - Policy making/ review
  - Decision making
  - Project/ programme management
  - Partnerships' governance
  - Operational activities (including Business Continuity Planning)

- Providing effective training and guidance in risk management practices to enable staff to take responsibility for risk within their own working environment;
- Ensuring that reports to support strategic policy decisions and other member decision related documents include a risk assessment that evaluates both threats and opportunities;
- Ensuring that all project initiation documents include a risk assessment that evaluates both threats and opportunities;
- Ensuring that the risk management process specifically identifies risks in relation to partnerships and provides for assurances to be obtained about the management of those risks.

4. Definitions

4.01 This section provides brief definitions of the terms used within this Strategy and the definitions that Lancaster City Council is working to.

4.02 **RISK**

Lancaster City Council's definition of risk is:

"Risk is the probability of an event occurring and its consequences."

4.03 A brief explanation of the key words used in this definition is given below:

- **Probability** - the likelihood of an event occurring,
- **Event** - the occurrence of a particular set of circumstances,
- **Consequences** – outcomes arising from the event. There may be more than one consequence from the same event, and consequences can be both positive and negative.

4.04 **RISK MANAGEMENT**

There are many slightly different definitions of risk management that cover essentially the same points. Lancaster City Council's approach to risk management is based upon best practise and is defined as:

"The process, by which Lancaster City Council manages threats, enhances opportunities and creates an environment that adds value to all its activities."

4.05 The focus of good risk management is the identification and treatment of such risks. It aids the understanding of the potential upside and downside of all the factors that can affect the organisation's ability to deliver its objectives. It increases the probability of success, and reduces both the probability of failure and the uncertainty that the organisation will achieve its overall objectives.

4.06 Risk management should support improved decision making through a good understanding of the risks associated with decisions and their likely impact.

4.07 Risk management should be a continuous and developing process that runs throughout the organisation's strategy and the implementation of the strategy, methodically addressing all risks surrounding the organisation's activities; past, present and future.

5. Scope

5.01 Risk Management is something that everyone within the Council undertakes almost daily, in varying degrees. Although it is difficult to draw clear boundaries around risk management areas because of the cross-cutting nature of risk, risk management within Lancaster City Council falls into five main areas:

- **Business risks**: i.e. risks identified that could prevent the Council achieving its priorities and associated objectives – either top level or operational level.
- **Project/ programme risks**: both physical and strategy related. This area is closely aligned to and may overlap with business risk.
- **Partnership risks**: These too are closely aligned to and may overlap with business risk.
- **Business continuity management**
- **Health & Safety risks**

5.02 The risk management process outlined within this Code of Practice applies primarily to the business, project, and partnership risk management areas but can, where appropriate, be used for any area. All risk areas identified above include high-level/ long-term risks (strategic risks) through to low-level/ day-to-day risks (operational risks).

5.03 All Services are responsible for managing their own risks; however, responsibility for developing and providing support/ advice in the five areas of risk management tends to fall within specific service areas. (See Table 1).

5.04 **Table 1 – Risk Areas**

Risk Area	Service Area
Business Risks	Finance (Risk & Insurance Manager)
Project/ Programme Risks	Planning (Programmes Section)
Partnership Risks	Finance and Corporate Strategy (under development)
Business Continuity Management	Health & Strategic Housing (Civil Contingencies Officer)
Health & Safety Risks	Health & Strategic Housing (Safety Officer function)

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BUSINESS RISKS

5.05 The risk management process outlined within this Code of Practice should be used to identify and manage all risks that threaten the Council's ability to deliver its priorities. This should cover both strategic and operational activities. The term 'business' risks relates to any risks that might prevent objectives being achieved at all levels, including:

- Strategic priorities identified in the Corporate Plan and Sustainable Community Strategy.
- Service priorities identified in Services' Business Plans.
- Priorities set out in individual 'team' plans.
- Individual objectives identified in EDPAs (Employee Development and Performance Appraisals).

PROJECT/ PROGRAMME RISKS

5.06 The Lancaster City Council Approach to Managing Projects (LAMP) was approved by Performance Management Group in 2006. Training was then subsequently rolled out to all relevant staff and they were issued with the LAMP Handbook. This handbook provides a corporate project management standard, based on PRINCE2, and includes basic working practices (including risk management) for all stages in a project.

5.07 The LAMP Handbook is for individuals and groups who have any form of involvement with projects, whether as Project Executive, End-Users, Project Managers, Team Members, Suppliers, Stakeholders or other interested parties. It aims to standardise the basic process for project management and achieve a consistency of approach and best practice across all Council services. It also aims to provide new Project Managers with an understanding of the main components required to successfully manage a project throughout the project lifecycle. An ongoing initiative of awareness and training is in place in order to support this method.

5.08 This Code of Practice can be used to enhance the principles risk management introduced in the LAMP Handbook, although it is not intended to supersede it.

5.09 As a separate issue, the Programmes section of Planning Services has developed detailed risk management procedures at both project and programme level. Their systems are being constantly reviewed in order to comply with the requirements of external funders and, where appropriate, to reflect this Code of Practice.

PARTNERSHIP RISKS

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5.10 Lancaster City Council's Code of Practice for Working in Partnerships was issued in January 2009. It sets out procedures for managing risks, both within the partnership, and risks to the Council as a result of the partnership arrangements.

5.11 Risk assessments of partnerships are defined as a thorough exploration or analysis of the potential threats faced by the partnership. Risk is not measured purely in financial terms, as consideration must be given to legal and statutory requirements. The impact on the partnership's reputation and service continuity are also important elements of risk analysis.

5.12 As part of the risk management process, each partnership is required to set their own risk tolerances. This is the level of risk that the partnership regards as 'acceptable'. Risks that are within the tolerance boundaries are deemed to be acceptable risks, where little or no action is required to reduce their score. For completeness, however, all key risks should be considered to ensure that the Partnership Board remain aware of them and how they were assessed (i.e. how the score was determined). Regular reviews will ensure that this scoring is revisited to confirm that the risk remains acceptable or to show that the likelihood and/or impact has increased to an extent that further mitigating actions need to be planned.

BUSINESS CONTINUITY MANAGEMENT

5.13 Business continuity management and risk management have clear inter-dependencies and are closely aligned. However, business continuity management is concerned with events that typically have a very low probability of occurring but would have a catastrophic impact on the Council's ability to deliver services, and business continuity planning is based around time-critical activities. Consequently, any risk identified through the risk assessment process as being likely to have a catastrophic impact upon the Council's ability to deliver its services will probably be mitigated through the Council's Business Continuity Management Process. The Council's Civil Contingencies Officer within Health & Strategic Housing, holds responsibility for managing the external impacts of risks of this nature.

5.14 The Council's approach to business continuity management is outlined in the Business Continuity Policy. In summary, a Council-wide business impact analysis has been undertaken and Business Continuity Plans are now in place for each Service.

5.15 The Council's approach to business continuity management has been to ensure that a generic response is in place to deal with the likely impact of an incident, regardless of the cause of the incident. This means that the Council is able to produce one generic plan rather than a series of plans to deal with different scenarios. However, the impacts arising from one particular scenario – pandemic flu – were sufficiently different to warrant a specific plan, and therefore the Council put in place a Flu Pandemic Plan.

5.16 The next version of Business Continuity Plans will further develop the previous generic approach and look in more detail at specific risks that threaten delivery of individual services.

HEALTH & SAFETY RISKS

5.16 The Council has in place long-established and effective processes for the management of Health and Safety risks. The established processes already in place in these risk areas should be followed; they are not superseded by this Code of Practice.

6. Roles and Responsibilities

6.01 Everyone in the Council is involved in risk management and should be aware of their responsibilities in identifying and managing risk. In order to ensure successful implementation of the Code of Practice, responsibilities for risk management are detailed in Table 2.

6.02 **Table 2 – Roles and Responsibilities**

Role	Responsibilities
Cabinet	• Through Performance Review Team (PRT) activity reports, to analyse and review high level strategic risks relating to portfolio holders' individual areas of responsibility and for the Leader to review the Council's overall Risk Management position. • To demonstrate and promote a risk management culture through Cabinet's activities and decision making. • To develop/ propose priorities based on a robust risk analysis in accordance with the Budget and Policy Framework timetable including receiving the full Strategic Risk Register annually, as well as risk analysis on individual budget proposals.
Audit Committee	The Audit Committee's Terms of Reference include 'To monitor the effective development and operation of risk management and corporate governance in the Council', per minutes of Council 18 April 2007. This will entail: • To agree the strategy, policy and processes for risk management and to review their effectiveness as a contribution towards providing assurance on the Council's standards of Corporate Governance. • To monitor and review the effective management of risk by officers. • To receive reports on the effectiveness of the Risk Management Strategy and to review assurances that

	corporate business risks are being actively managed. • To report to full Council annually on the Committee's work and performance during the year, including the results of its consideration of Risk Management arrangements. • To appoint the Chairman of the Audit Committee as the Council's Member Champion for Risk Management.
Overview and Scrutiny	• To consider risk management issues in the development of policy and analysis of possible options.
Budget and Performance Panel	• Through Performance Review Team (PRT) reports and Corporate Financial Monitoring, to consider risk management issues in reviewing and scrutinising performance.
The Chief Executive	• To ensure that risk is managed effectively through the development and implementation of an all encompassing corporate strategy. • To ensure that elected Members are appropriately advised on risk management matters.
Corporate Director (Finance and Performance)	• To act as the Council's Officer Risk Management Champion with responsibility for liaising between Corporate Management Team and the Risk Management Steering Group. • To ensure the Code of Practice for Managing Opportunity and Risk, 'A sense of proportion', is effective in supporting high standards of corporate governance. • To ensure the Strategic Risk Register is reported to Cabinet for consideration as part of the Budget and Policy Framework.
Corporate Management Team	• To maintain a Strategic Risk Register. • To liaise with Service Heads during their 1:2:1s in order to monitor their Services' Business Risks.
Performance Management Group	• To provide support in promoting and co-ordinating risk management activity across Service Areas. • To receive quarterly exception reports on strategic and other high impact risks and on risk treatment action progress (via

	Corporate Financial Monitoring), and to report these to Cabinet, as appropriate.
The Head of Financial Services	• To Chair the Risk Management Steering Group. • To advise on the development and implementation of the Code of Practice for Managing Opportunity and Risk, 'A Sense of Proportion', both through the Risk Management Steering Group and in the wider corporate context, and to provide supporting guidance. • To ensure that an effective system of internal audit is carried out for the authority. • To report financial risks to Cabinet / Council when setting the budget. • To oversee the monitoring and control of the risk management reserve.
Risk Management Steering Group	To provide support for and contribute to the following: • The development, implementation and review of the Code of Practice for Managing Opportunity and Risk. • Co-ordination of loss control activities and, in the process, identification of trends and priorities. • The use of the risk management reserve to support funding necessary for projects, activities and initiatives. • The evaluation of new approaches on risk management and the extent to which they would be helpful to the authority and its services. • The development of loss prevention practices as a normal part of management. • The provision of staff training in risk management. • The provision of information sharing and mutual support links with other groups at regional and national level. • The promotion of good risk management practice throughout the authority by co-operation and liaison with managers,

	other employees and relevant external agencies. • To report to Performance Management Group on an exception basis, should the need arise.
Risk and Insurance Manager	• To consult regularly with service managers concerning risk issues, providing advice as appropriate. • To assist in the promotion of good risk management practice throughout the authority, through co-operation and liaison with managers, other employees and relevant external agencies. • To undertake, where necessary, incident investigations. • To support the provision of staff training in, and raise the level of, risk management throughout the authority. • To act as lead support officer for the Risk Management Steering Group. • To ensure that appropriate insurance cover is in place and that a register of claims is maintained. • To prepare reports, on an exception basis, to Performance Management Group and the Audit Committee on behalf of the Risk Management Steering Group/ Head of Financial Services. • To produce the Strategic Risk Register for Cabinet as part of the Budget and Policy Framework. • To liaise with the Projects and Performance Officer in monitoring and recording project/ programme risks. • To liaise with the Civil Contingencies Officer in order to identify low likelihood/ high impact risks.
Heads of Service	• To identify and evaluate risks and opportunities facing their service areas and to take appropriate management action. • To ensure that all risks (strategic, business, partnerships, project and operational) are appropriately considered and recorded when developing Service Business Plans. • To ensure that risk is managed effectively in each service

	area within the agreed corporate strategy, and that risk treatment actions are implemented. • To highlight significant ongoing or emerging risks (including strategic, business, partnership, project and operational), on an exception basis, through quarterly Performance Review Team reports, and in 1:2:1s with their Directors. • To ensure that the control environment relating to systems operated within service areas are secure and that agreed actions resulting from Internal Audit reviews are implemented. • To report emerging or altered Strategic risks to the Risk and Insurance Manager as and when they arise. • To ensure effective communication within their service area of the Code of Practice for Managing Opportunity and Risk.
Internal Audit	• To develop and deliver a risk based audit plan designed to provide assurance to management and the Audit Committee on the effectiveness of risk management arrangements within the Council. • Based on the above, to provide an annual opinion and assurance statement on the effectiveness of the Council's risk management, internal control and corporate governance arrangements. • To promote and support the development of the Council's risk management arrangements.
Report writers	• To ensure that all committee reports contain an options analysis and risk assessment. Where appropriate, this must be in table format.
Project Managers	• To report all risks and their management throughout the lifetime of the project, to their Project Board and to the Project and Performance Officer (and to their Service Head).
Project and	• To monitor all project risks as they appear on Risk Logs and

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Performance Officer	liaise with the Risk and Insurance Manager to ensure that significant risks are reported and included within the Key Business Risk Register.
Civil Contingencies Officer	• To liaise with the Risk and Insurance Manager in order to identify low likelihood/ high impact risks, and to ensure that Business Continuity Plans are developed in order to mitigate against service disruption.
All staff	• To manage risk effectively in their job and report opportunities/ risks to their Service managers. • To undertake their job within risk management guidelines.

7. Funding

7.01 Through the Business Planning process, there is an opportunity for Service managers to make funding requests based on risk and opportunities. Integration of risk management in the corporate planning and budgeting process helps to ensure that scarce resources are directed to areas of highest priority in a systematic and transparent manner.

7.02 Funding requests that arise at short notice, such as for managing new/ emerging risks, can be referred to the Risk Management Steering Group for consideration of funds being provided from the Risk Management Reserve. This reserve provides the opportunity to apply for financial support and creates an incentive for loss control, without adversely affecting Service area budgets.

7.03 In addition to these funding sources, the Financial Regulations and Procedures allow for emergency requests for funding (see Financial Procedures (section A, 1.11 (f)).

8. Alignment of Risk Management and Business Planning Frameworks

SIMILARITIES BETWEEN PERFORMANCE MANAGEMENT AND RISK MANAGEMENT

8.01 Performance management and risk management systems are very similar both in what they are designed to achieve and in how they ensure this happens. This suggests that the development of two separate systems could result in duplication and inefficiency.

8.02 Performance management and risk management can be viewed as two sides of the same coin. Whereas performance management identifies and monitors what is needed to achieve our priorities, risk management focuses on the things which may happen that might prevent the Council achieving its priorities. The upside of risk management (identifying actions that will help achieve priorities) is, in effect, performance management.

8.03 The ultimate outcome that both systems support is the achievement of the Council's priorities. The interim steps in both systems include:

- For performance management, a list of actions required to achieve the priority; For risk management, a list of actions to mitigate risks that could prevent the priority being achieved
- SMARTER targets (specific, measurable, achievable, relative, timely, effective, resourced)
- Regular review of the actions and targets
- Annual review

8.04 The starting point for identifying both the actions required under the performance management framework and the mitigating actions required by the risk management framework is the same: the Council's priorities. Therefore, the resulting actions and SMARTER targets from both the performance management framework and the risk management framework should be broadly similar and, in some cases, identical, albeit arrived via different routes.

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BACKGROUND TO THE DEVELOPMENT OF TWO SEPARATE PROCESSES

8.05 Historically, performance management and risk management have developed separately, with risk management, by and large, being based within Financial Services.

8.06 Risk management forms part of the system of corporate governance. During the 1990s, there were a series of reports on corporate governance and financial reporting, culminating in the Turnbull Report in 1999. Entitled '*Internal Control: Guidance for Directors on the Combined Code',* it drew together many of the recommendations of the previous reports and was adopted by the London Stock Exchange. The report emphasises the need for the governing body to ensure that a high-level, risk-based approach to establishing a reliable system for internal control is implemented and then reviewed regularly. Although the report was written for companies listed on the Stock Exchange, its principles have been adopted by the public sector.

8.07 However, in adopting risk management techniques within the public sector, a key consideration is the way in which risk management links into performance management arrangements, and the overlap between the two areas. Risk management in many local authorities is managed within the Financial Services remit and is often closely affiliated to the Insurance function. This has potential to lead to risk management processes being developed in isolation from existing business and performance management processes.

INTEGRATION OF PROCESSES

8.08 The Council has a well-established and effective business planning cycle that includes setting priorities and helps to ensure that the Council's budget is aligned to the Council's priorities. The Council's performance management framework monitors the delivery of these priorities and ensures that they are achieved within budget. The performance management framework includes regular reporting to Cabinet, Budget and Performance Panel, and Management Team.

8.09 The Council's priorities are also the starting point within the risk management process. The first step in risk management is 'understanding the Council's priorities'; the second is 'identifying risk which might prevent the Council achieving its priorities'. It is essential that the risks identified and actions taken to mitigate them are regularly monitored and reported to the appropriate audience. A well established and effective performance management framework is already in place, and so has been expanded to integrate the risk management requirements.

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8.10 The integrated performance management and risk management process is, therefore, implemented in the following way;

- Through the normal Corporate / Service planning processes, Services identify their priorities and the actions required to achieve them.

- While identifying priorities and actions, Services also identify the risks that might prevent the priorities being achieved. In this way, opportunities and risks are considered at the same time.

- Services then compare the actions identified from their business planning processes and risk management processes to ensure that all actions required are included as appropriate (with no gaps, or duplication).

- Quarterly performance monitoring systems in place to check delivery of all planned actions.

BENEFITS ARISING FROM INTEGRATING THE TWO PROCESSES

8.11 There are many benefits to be realised by integrating the performance management and risk management frameworks. These include:

- Strengthened actions (actions are identified through two different processes, which look at the Council's priorities from two different angles – a positive and a negative view; consequently, the resulting actions are likely to be more comprehensive and robust).

- Reduced duplication;

  - Performance and risk can be monitored together using existing processes.
  - Performance and risk can be reported just the once using existing processes.

- Clear links established between performance and risk.

- Non-cashable efficiency savings.

9. Links to Corporate Governance

9.01 Governance is the system by which councils direct and control their functions and relate to their communities. In other words, it is the way in which they manage their business, determine strategy and objectives, and go about achieving those objectives. The fundamental principles are openness, integrity and accountability.

9.02 This Code of Practice for Managing Opportunity and Risk forms part of Lancaster City Council's corporate governance arrangements.

INTERNAL CONTROL

9.03 Internal controls are those elements of an organisation (including resources, systems, processes, culture, structure and tasks) which taken together, support people in achievement of objectives. Internal financial control systems form part of the wider system of internal controls.

9.04 A council's system of internal controls is part of its risk management process and has a key role to play in the management of significant risks to the fulfilment of its business objectives. For example, the Council's policy and decision-making process require all Committee Reports to include an option appraisal/ risk assessment.

HEALTH & SAFETY

9.05 The Council's Health & Safety Policy also is a key component to the Council's structure of controls contributing to the management and effective control of risk affecting staff, contractors, volunteers, service users and the general public.

INTERNAL AUDIT

9.06 The Internal Audit function is a component, and custodian, of the Council's system of controls protecting its financial and other physical assets. The Risk Management Process, in turn, serves the Internal Audit function by enabling it to identify areas of higher risk and so target its resources more effectively.

10. Monitoring, Reporting and Indicators of Success

10.01 Lancaster City Council's Strategic Risk Register will be reviewed annually by Cabinet as part of the Policy and Performance Framework.

10.02 Service Heads are responsible for monitoring their own business risks and for reporting progress against the actions identified to mitigate risks via quarterly performance monitoring systems (PRTs, PMG etc.)

10.03 The structure for such reporting of risks and their management is set out in Table 3 below.

Table 3 - Structure for Reporting Risks

Area of Management	Officer with Responsibility	Method of Reporting
Strategic Planning	Risk and Insurance Manager	- Via Strategic Risk Register to Cabinet as part of Budget & Policy Framework. - Via Strategic Risk Register to Performance Management Group (PMG) as part of Finance's Quarterly Financial Monitoring. Then from PMG to Cabinet, as appropriate.
	Service Heads	- To include Strategic Risks within Service Business Plans. - To report emerging or altered Strategic risks to the Risk and Insurance Manager as and when they arise.
Business Planning	Service Heads	- To record all business risks on Service Business Plans and report significant ongoing or emerging risks, on an exception basis, through quarterly Performance Review Team reports to PMG, and in 1:2:1s with their Directors.
Financial Planning	Head of Financial Services	- To report financial risks to Cabinet for each priority when setting budget.

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Performance Management	Service Heads	- As with Business Planning, all significant ongoing or emerging risks must be highlighted on Service Business Plans and reported, on an exception basis, through quarterly Performance Review Team reports to PMG, and in 1:2:1s with their Directors.
Policy Making/ Review	All report writers	- All committee reports relating to policy making and review must include an options analysis and risk assessment.
Decision making	All report writers	- All committee reports that require a decision making must include an options analysis and risk assessment.
Project Management	All project managers Service Heads	-To report all risks, throughout the lifetime of the project, to the Project Board (inc Service Head). -To ensure that all significant project risks are included within Service Business Plans and reported, on an exception basis, through quarterly Performance Review Team reports to PMG, and in 1:2:1s with their Directors.
Partnerships' Governance	Service Heads	-To ensure that all significant partnership risks are included within Service Business Plans and reported, on an exception basis, through quarterly Performance Review Team reports to PMG, and in 1:2:1s with their Directors.
Operational Activities	Service Heads	-To record all operational risks and report them to team leaders, as appropriate. -Significant operational risks must be included within Service Business Plans and reported, on an exception basis, through quarterly Performance Review Team reports to PMG, and in 1:2:1s with their Directors.
Business Continuity Planning	Civil Contingencies Officer Risk and Insurance	-To report all low likelihood, high impact risks to Civil Contingencies Group and arrange for Business Continuity Plans to be developed, as appropriate. -Liaise with Civil Contingencies Officer to identify low likelihood/ high impact risks and report to PMG and

	Manager Service Heads	Audit Committee, on an exception basis. -To maintain Service Business Continuity Plans and report significant risks on Service Business plans, PRTs and 1:2:1s.

10.04 The ultimate measure of effective risk management is that the Council has the resilience to deliver its services and core objectives and is able to identify, and take maximum advantage of, the occurrence of opportunities (positive risk).

10.05 Lancaster City Council will use the following indicators to monitor the success of its Risk Management processes:

- The Council achieves at least 85% of the Planned Actions set out in the annual update of the Corporate Plan (as these actions mitigate against strategic risks).

- Achieve at least level 2 rating (i.e. meets only minimum requirements – performs adequately) for the Council's Use of Resources assessment (Internal Control element, if scored separately).

11. Risk Management Process

11.01 The approach to risk management in Lancaster City Council is based on the best practice outlined in '*A Risk Management Standard* (IRM/ AIRMIC/ ALARM: 2002)'.

11.02 Lancaster City Council's Risk Management Process consists of five steps:

- Knowing the strategic and operational priorities
- Categorising risks
- Scoring risks
- Treating risks
- Monitoring, reporting and reviewing risks

11.03 Paragraphs 11.04 to 11.32 of this Code of Practice provide an overview of each of these steps. Further detailed guidance on how to carry out each step is set out within Risk Management guidance on the Council's intranet. This risk management process should be undertaken in conjunction with the normal annual business planning process.

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KNOWING THE STRATEGIC AND OPERATIONAL PRIORITIES

11.04 The starting point for risk management is a clear understanding of what the organisation is trying to achieve. Risk management is managing the threats that may hinder delivery of our priorities and maximising the opportunities that will help deliver them. Therefore, effective risk management should be clearly aligned to the business planning process.

11.05 This identification stage sets out to identify exposure to uncertainty and requires an intimate knowledge of the service, the market in which it operates, the legal, social, political and cultural environment in which it exists. It also requires the development of a sound understanding of its strategic and operational activities, including factors critical to success and the achievement of objectives.

11.06 These elements cross reference with the performance management framework, as both have risk and opportunity management incorporated in the process.

11.07 It is logical to combine these management practices as they have the same ultimate goal; the achievement of objectives. Planning, performance management and opportunity management focus on driving the actions required to maximise the probability that 'good things' occur, whilst risk management focuses on driving actions to minimise the probability that 'bad things' occur.

11.08 The similarities between risk management and performance management will be explained further in Section 8, *Alignment of Risk Management and Business Planning Frameworks.*

CATEGORISING RISKS

11.09 It is clear that only those risks and opportunities that have been identified can be managed, therefore the more comprehensive the approach to identification, the better placed the service will be to manage risk and opportunity.

Some useful examples of risk categories are:

- Political
- Economic
- Social
- Technological
- Legislative/ Regulatory
- Environmental

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- Customer/ Citizen
- Managerial/ Professional
- Financial
- Legal
- Partnership/ Contractual
- Physical

11.10 These categories of risk and opportunity provide a prompt for identifying and categorising a broad range of risks and opportunities facing the Council and draw on identification techniques such as PESTLE (Political, Economic, Social, Technical, Legal, Environmental) and SWOT (Strengths, Weaknesses, Opportunities, Threats) analyses.

11.11 Table 4 provides further information and examples of issues that may arise for each of the categories.

Table 4 – Prompt for Identifying and Categorising Risks/ Opportunities

These categories are neither prescriptive nor exhaustive but provide a prompt for identifying and categorising a broad range of risks facing the Council. Each category cannot be considered in isolation. Managers must consider the risks/ opportunities associated with each of the sub-categories and their inter-relationships, if a full assessment is to be carried out.	
Political ***Arising from the political situation*** - Change of Government Policy - Delivery of local policy and strategic priorities - Change of local policy or priorities - Unfulfilled promises to electorate - Political make-up - Stability of political situation - Election cycles - Decision-making structure - Meddling/abuse (fraud, corruption, lack of strategic focus) - Leadership issues - Reputation Management - Response to innovation/ modernisation	**Economic** ***Arising from the national, local and organisation specific economic situation*** - Treasury – Investments, Reforms - Borrowing, lending situations, investments and interest rates - Budgetary position - Poverty indicators - Demand predictions (e.g. on demand led services such as benefits, homelessness) - Competition between suppliers and the effect on service/ pricing - General/ regional economic situation - Unrecorded liabilities - Value/ cost of capital or assets - Impact of civil emergency (e.g. flood) - Council Tax levels

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Social	**Technological**
Arising from the national and local demographics and social trends - Social changes – needs expectations and attitudes - Demographic profile (age, race etc.) - Residential patterns and profile (e.g. temporal, commuter belt, state of housing stock, public/private mix) - Health statistics/ trends - Leisure and cultural provision - Crime statistics/ trends - Children at risk - Older people - Employment - Life-long learning - Regeneration - Disadvantaged groups or communities	***Arising from technological change and the organisational technological situation*** - Technological strategy - Technological change/ advance – capacity to deal with change/ advance - Current use of / reliance on technology - Current or proposed technology partners - State of architecture - Obsolescence of technology - Current performance and reliability - Security and standards e.g. back up, recovery, confidentiality - Technological demand – customer needs and expectations - Failure of key system or key technological project - Technological support for innovation - Procurement of best technology and sustainability of system
Legislative/ Regulatory ***Arising from current and potential legal changes and the organisation's regulatory information*** - New legislation – National and European Law - New regulations - Exposure to regulators – e.g. auditors/ inspectors, intervention - Responsiveness to criticism - CAA – Annual Risk Assessment, Use of Resources (UoR), Direction of Travel (DoT) - LAA – statutory duty to co-operate, targets, performance and annual report - Children's Trust - European Directive – Procurement - CCA – Emergency Preparedness, Business Continuity - Section 17 – Crime & Disorder Act 1998 - Equality – RRA, RED, DSA, EER, GRA	**Environmental** ***Arising from inherent issues concerned with the physical environment*** - Nature of environment (urban, rural, mixed) - Land use – green belt, brown field sites - Waste disposal and recycling issues - Exposure to drainage problems/ flooding/ erosion/ subsidence/ landslip - Impact of civil emergency (e.g. flood) - Traffic problems/ congestion - Planning, transportation - Pollution, emissions, noise - Climate change - Energy efficiency

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Customer/ Citizen	Professional/ Managerial
Arising from the need to meet current and changing needs or expectations of customers and citizens - Customer Care - Extent and nature of consultation with/ involvement of community (e.g. community groups, local businesses, focus groups, citizens' panels etc.) - Demographics – analysis, understanding - Relationships with community leaders, tenant groups and 'opposition' groups - Visibility of services (e.g. refuse collection, street cleaning etc.) - Service delivery – response, feedback, complaints, compliments - Reputation Management – Public and media communication - Outcomes for area – LAA (outcomes, targets etc.) - Community cohesion	***Arising from the need to be managerially and professionally competent*** -Views arising from peer reviews – e.g. IdeA, consultancy reviews, internal audit etc. - Professional/ managerial standing of key officers - Stability of officer structure/ management teams - Competency and capacity – Organisational and individual - Key staff changes and personalities - Turnover, recruitment and retention, talent management and succession planning - Change – implementation and management - Training and development - Partnership working - Management frameworks and processes – efficient, effective - Profession specific issues Mission, Vision and Values
Financial	**Legal**
Arising from the financial planning and control framework - Financial situation of authority - Level of reserves - Budgetary policy and control - Delegation of budget and financial disciplines - Monitoring and reporting systems - Control weaknesses – anti fraud & corruption - Income and revenue - Grants and external funding - Insurance – adequacy of covers, level of self-funding, deductibles, etc. - Capital - Interest rates, inflation, income tax, etc. - Efficiency, invest in priorities, disinvestments non-priority areas	***Arising from changes to legislation and/ or possible breaches of legislation*** - Legal challenges, judicial review - Adequacy of legal support - Boundaries of corporate and personal liabilities - Sufficient reserves to defend legal challenge or unrecorded liabilities - Reputation management - Partnerships – Legal liabilities, contractual liabilities

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Physical	Partnership/ Contractual
Arising from physical hazards or possible gains associated with people, land, buildings, vehicles, plant and equipment	***Arising from partnerships and contracts***
- Assets – Nature and state of asset base including record keeping - Commitment to health, safety and well being of staff, partners and the community - Risk assessments - Accident and incident record keeping - Maintenance practices - Business Continuity - Security – staff, assets, buildings, equipment, plant, machinery, vehicles - Assets – purchase, leasing, sales, rent, revenue, income, maintenance - HR Strategy – training, development, health etc.	- Key partners – from public, private and voluntary sectors - Accountability frameworks and partnership boundaries - Large scale projects involving joint ventures - Outsourced services - Relationship management - Procurement arrangements/ contract renewal policy - Performance of partnerships/ contractors - Business Continuity – Partner/ contractor arrangements - Change – Change control, exit strategies - Capacity and capability – increase to deliver priorities - Reputation management - Legal liabilities, contractual liabilities

SCORING RISKS

11.12 In order to score risks, a thorough risk assessment needs to be undertaken. That is, a detailed analysis of the potential threats faced by the Authority which may prevent achievement of its objectives. Through consideration of the sources of the risk, possible consequences, and the likelihood of those consequences occurring, it helps make decisions about the significance of risks and whether they should be accepted or treated.

11.13 Having identified the potential risks *(*see previous section; *Categorising Risks)* there is a need to evaluate them, avoiding subjective bias wherever possible, through making use of the best information available. This may be from past records, relevant experience, experiences of others, published literature etc.

11.14 Risks comprise of the following elements:

- **Inherent risk** is the ‘gross risk’, before controls or mitigation.
- **Residual risks** are those risks which still remain after taking into account any existing controls.

- **Target risk** is the level of risk that the Authority/Service is prepared to accept. In theory, risk assessment and risk treatment should be an ongoing process until the target risk level is achieved. Once the target has been achieved, such risks should not be ignored, but periodically reviewed to ensure that they do not move above the tolerance level.

11.15 Risks are then assessed for **likelihood** (the chance of it occurring) and **impact** (consequences if it were to happen). Both likelihood and impact are scored on a scale of low, medium or high as follows:

11.16 **Assessing likelihood**

Low

- Unlikely to occur; or
- Happens on average once every two years or more; or
- Will only occur in exceptional circumstances.

Medium

- Likely to occur within the next 5 years; or
- Happens on average every 1 to 5 years; or
- May occur in certain circumstances.

High

- Certain to occur; or
- Happens frequently (more than once every 12 months); or
- Will happen in most circumstances.

11.17 **Assessing impact**

Low

Where the consequences are not severe and any associated losses will be relatively small. As individual occurrences, they will have little or no effect on continuity of service provision. However, if action is not taken, then such risks may have a more significant cumulative effect.

Medium

These risks have a noticeable effect on the services provided. Each one will cause a degree of disruption to service provision. They are more likely to happen infrequently and are generally difficult to predict. More than one medium loss a year can have substantial consequences for service provision.

High

These risks have a catastrophic effect on the operation of the organisation/ service. This may result in significant financial loss, major service disruption and/ or significant impact on the public. They usually occur infrequently and can be extremely difficult to predict.

A SENSE OF PROPORTION

11.18 In order to assess impact consistently, there needs to be consensus on what constitutes 'not severe', 'noticeable' and 'catastrophic'. This consensus is a major component of determining what is sometimes referred to as the organisation's "risk appetite", and provides a way in which reasoned decisions can be taken as to the levels of risk deemed to be acceptable. Table 5 shows the set of criteria used by the Council to assess risk impact.

Table 5 – Criteria for Assessing Risk Impact

	Criteria		
Impact Area	**Low**	**Medium**	**High**
Strategic	• Minor delays in implementing strategy • Occasional missed / failing PI	• Noticeable delays in implementing strategy • Regularly missed / failing PI	• Major delays to / failure of strategy • Consistently missed / seriously failing PI
Financial	• Less than £100k	• £100k to £500k	• Greater than £500k
Operational	• Minor / temporary interruptions to service to the public	• Noticeable / medium term disruption to public services	• Major / long term disruption to public services
Regulatory	• Minor breach with no action	• Major regulatory breach resulting in sanction • Regular minor breaches	• Section 151 breach • High Court action
Information	• Delayed decisions • Lack of forward planning	• Decisions / community affected by poor / insufficient information	• Inappropriate / illegal decisions • Community significantly affected
People	• Small number of people affected. • Greater numbers affected but not significantly	• Significant number of people affected. • Smaller numbers seriously affected	• Majority of people affected • Significant number of people seriously affected
Reputational	• Several or regular complaints	• Large number of complaints • sustained local press coverage • one-off national press coverage	• Sustained national press coverage • Remembered for many years

11.19 Once the likelihood and impact have been assessed, the risk score can then be determined by plotting it on the matrix in Table 6, should circumstances warrant this approach. It is stressed, however, that if such matrix scoring is used, this is only a further stage in the tools for measuring risk; it is not an end in itself. The next stage of deciding how to treat recognised risks is much more important.

Table 6 – Risk Assessment Matrix

Likelihood				
	High	4	7	9
	Medium	2	5	8
	Low	1	3	6
		Low	Medium	High
	Impact			

TREATING RISKS

11.20 It is acknowledged that risk cannot be eliminated completely. Risk treatment is the process of taking economic action to minimise the likelihood of the risk event occurring and/ or reduce the severity of the impact should it occur. The agreed controls designed to mitigate the identified risk will be recorded in the appropriate risk records (either the Risk Register, Service Business Plans, PRT reports, project risk logs or within Business Continuity Plans).

11.21 There are six options or combinations of options for treating risk (**CARPET**):

<u>**C**ontingency</u>

11.22 Where a risk cannot be entirely avoided, contingency arrangements should be in place to ensure that any impact, for example to service delivery or reputation, is kept to a minimum.

A SENSE OF PROPORTION

Accept

11.23 Having identified and evaluated a risk, a decision may be made to accept risk without taking any mitigating action. This would usually be in instances where the likelihood and/ or impact are so small that implementing risk treatment actions would not be cost-effective, or where the risk relates to a course of action that is a key priority for the Council.

Reduce

11.24 Risk reduction relates to the implementation of cost-effective measures that will help minimise the likelihood of an event occurring or the impact of the risk should it occur.

Prevent

11.25 In certain circumstances, it may be possible and cost-effective to implement risk treatment actions that will prevent an event occurring in the first place. An extreme form of prevention could be ceasing to carry out an activity that involves the risk in question. For example, the temporary laying down of unsafe cemetery headstones, whilst controversial in some areas, effectively removed the potential risk of injury to members of the public.

Exploit

11.26 Opportunity is often regarded as the ‘flip-side’ to risk. Where opportunities arise, the likelihood of them being realised and their potential contribution to the Council need to be evaluated. If a case can be made that pursuing an opportunity will be cost-effective and benefit the Council’s objectives, it should normally be exploited. The failure to fully exploit realistic opportunities presents a particular type of strategic risk.

Transfer

11.27 Risk transfer involves transferring liability for the consequences of an event to another body. This can occur in a number of forms. Firstly, legal liability may be transferred to an alternative provider under contractual arrangements for service delivery. Secondly, liability may be transferred to a partner under agreed partnership terms. Finally, transferring some or all of the financial risk to external insurance companies may reduce the costs associated with a damaging event.

A SENSE OF PROPORTION

MONITORING, REPORTING AND REVIEW

11.28 The risk management process does not finish when the risk treatment actions have been identified. There must be monitoring and review of;

- The implementation of the agreed risk treatment/ mitigating actions.
- The effectiveness of the actions in controlling risks.
- How risks have changed over time and the emergence of new risks and opportunities.

11.29 Risks, even those at a strategic level, do not remain static. Progress in managing risk need to be regularly monitored, reported and reviewed, so that losses are minimised and the intended risk treatment/ mitigation is checked for success.

11.30 The frequency with which risks are reviewed will depend on a number of factors. If risks have been identified to support the management of a specific project, for example, it may be necessary to review risks very frequently, say every six months, to ensure the success of the project.

11.31 For risks associated with ongoing day-to-day operations or longer term strategies, less frequent review may be appropriate. In these circumstances, risks should be reviewed at least annually, and preferably quarterly or half-yearly.

11.32 The potential severity of a risk will also have an influence on how often it is reviewed. Risks which are assessed as having low likelihood and impact still need to be reviewed, but not as regularly as those risks which could pose a severe threat to the Council.

For further information, contact:

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AUDIT COMMITTEE

22nd April 2009

Internal Audit Monitoring

Report of Internal Audit Manager

PURPOSE OF REPORT
To advise Members of the latest monitoring position regarding the 2008/09 Internal Audit Plan.
This report is public

RECOMMENDATIONS

(1) That the current monitoring position is noted.

1.0 Introduction

1.1 The 2008/09 Internal Audit Plan was approved by the Audit Committee at its meeting on 25th June 2008 and a proposed schedule of potential assurance audits was approved on 24 September 2008. This report is based on the monitoring position up to 26 March 2009.

2.0 Report

2.1 2008/09 Planned Work

2.2 A monitoring report as at 26 March 2009 is attached as Appendix A. In summary, the position as that date was as follows:

Days originally planned (approved audit plan)	870.0
Days undertaken to 26 March 2009	870.7

2.3 The work undertaken includes sixteen jobs from the 2007/08 plan which were still in progress at 01 April 2008. Eighty-two days were spent in the current year on completing these jobs.

2.4 The final outturn position on the Audit Plan will be incorporated in the Internal Audit Manager's Annual Report and Assurance Statement, which will be submitted to the June meeting of the Committee. At the time of writing, the main points arising in terms of the plan are illustrated in the table below.

Area of work	**Resources (audit days)**			**Outputs (audit reports & opinions)**	
	Planned	**To Date**	**Variance**	**Planned**	**To Date**
Core Financial Systems	100	27	-73	8-10 reports	7 reports
Core Management Arrangements	125	126	+1	8-10 reports	5 reports
Risk Based Assurance Audits	250	276	+26	19-25 reports	14 reports
Follow-Up Reviews	45	62	+17		
Sub-Total, Assurance Work	**520**	**491**	**-29**	**35-45 reports**	**26 reports**
Advice & Support Work	105	144	+39		
Efficiency & VfM	100	0	-100		
Investigations	35	71	+36		
Audit Management	60	76	+16		
Non Audit Duties	10	89	+79		
General Contingency	40	0	-40		
Total	**870**	**871**	**+1**		

2.5 As can be seen from the table, the overall level of planned resources has been delivered, although there have been some significant variations across the areas in the plan. Changes in demand for Internal Audit work have been managed so as to ensure that an acceptable level of assurance work is delivered. Significant changes in the range of work undertaken have resulted from:

- Investigations arising in the final quarter, diverting resources from planned assurance work
- Under "Support Work", the major piece of work being undertaken by the Principal Auditor in the mapping and evaluation of the Council's significant partnerships. This has required 41 days work to date and will continue into 2009/10.
- Under "Non Audit Duties", the direct involvement of the Internal Audit Manager in the Fair Pay project in undertaking the pay modelling process. This role, which is ongoing, has required 74 days work which was not included in the original plan.
- Fair Pay has also required the most resource demanding piece of assurance work, accounting for 55 days so far. This work will also continue whilst the Fair Pay project is running.
- No work being undertaken on "Efficiency and VfM". This is mainly due to the above mentioned demands, being perceived as a lesser priority than the mainstream assurance work programme.

2.6 In terms of reports produced, the table indicates that, although the level of resources devoted to assurance work is only slightly below plan, the number of reports produced is more adrift. At the time of writing, 26 reports had been completed compared with the target of between 35 and 45. It should be noted, however that there are 19 audits currently in progress, a number of which are nearing the reporting stage. In a number of areas, ongoing audits have been stalled by the demand for investigations work. It is anticipated that a high proportion of these audits can be completed in time for the reports to be incorporated into the Audit Manager's Annual Assurance Statement in June.

3.0 Details of Consultation

3.1 Not applicable

4.0 Options and Options Analysis (including risk assessment)

4.1 The report is for information – no options are proposed.

5.0 Conclusion

5.1 Whilst the overall level of Internal Audit resources provided during the year is as planned, there have been a number of significant variations to the work areas covered by the 2008/09 Audit Plan. These have been managed to ensure that an acceptable level of assurance work has been delivered. A number of ongoing audits need to be brought to a conclusion in order to meet the target level for audit reports.

CONCLUSION OF IMPACT ASSESSMENT **(including Diversity, Human Rights, Community Safety, Sustainability and Rural Proofing)** Not applicable	
FINANCIAL IMPLICATIONS None arising from this report	
SECTION 151 OFFICER'S COMMENTS The Section 151 Officer has been consulted and has no further comments.	
LEGAL IMPLICATIONS None arising from this report	
MONITORING OFFICER'S COMMENTS The Monitoring Officer has been consulted and has no further comments.	
BACKGROUND PAPERS Internal Audit Plan 2008/09	**Contact Officer:** Derek Whiteway **Telephone:** 01524 582028 **E-mail:** dwhiteway@lancaster.gov.uk **Ref:** aud/comm/audit/090422

Appendix A

Internal Audit Annual Plan 2008/09 - Update at 26/03/09

Area of Work	2008/09 Planned Days	Work Allocations: Job No	Work Allocations: Title	Actuals to 26/03/09	Status at 26/03/09
1. ASSURANCE WORK					
Planned Days	100.0	07/0660	Housing Rents	1.7	✓
Actual Days To Date	27.1	07/0696	NNDR	0.1	✓
		07/0708	Income Management (Rents Direct Debits)	1.4	✓
		07/0709	Payroll 2007/08	10.8	✓
		07/0710	Ordering & Payments 2007/08	3.4	✓
		07/0711	Sundry Debtors 2007/08	2.8	✓
		07/0717	Income Management (Cultural Webstaff)	1.3	✓
		08/0739	Creditors 2008/09	3.9	⚠
		08/0746	Treasury Management	0.7	CFwd
		08/0752	Main Accounting	0.6	⚠
		08/0756	Debt Management	0.4	✗
CORE MANAGEMENT ARRANGEMENTS					
Planned Days	125.0	08/0742	Risk Management	36.9	✓
Actual Days To Date	126.3	08/0721	National Fraud Initiative 2008/09	24.0	⚠
		07/0697	Performance Management	3.9	✓
		07/0704	Partnership Arrangements	5.1	✓
		08/0703	Fraud & Corruption Arrangements	13.3	⚠
		08/0736	Business Continuity Planning	24.2	✓
		08/0757	Information Management	0.9	✗
		08/0761	Financial Management	4.4	⚠
		07/0701	Procurement & Contract Management	13.6	✓
RISK BASED ASSURANCE WORK PROGRAMME					
Planned Days	250.0	07/0676	Salt Ayre Sports Centre	12.6	✓
Actual Days To Date	275.8	07/0677	Cemeteries	0.1	✓
		07/0678	Insurances	0.1	✓
		07/0679	Markets	20.3	✓
		07/0682	Vehicles	3.1	✓
		07/0688	Income Tax & NI	1.3	✓
		08/0684	Civica Financials Project	4.2	✓
		08/0685	Electronic Document Management	6.7	✓
		08/0686	Sustainable Community Strategy Project	5.0	✓
		08/0714	Fair Pay Project	54.6	⚠
		08/0723	Arts Development	19.6	⚠
		08/0724	Land Charges	12.7	✓
		08/0725	Members Expenses & Civic Functions	11.3	⚠
		08/0726	Children & Young People	0.4	CFwd
		08/0727	Public Health & Safety	10.3	✓
		08/0728	Enforcement	7.7	⚠
		08/0729	Street Cleansing	13.7	✓
		08/0730	Climate Change	15.5	⚠
		08/0732	Econ Dev Marketing & Promotions	8.7	✓
		08/0733	Planning For Floods	15.0	✓
		08/0737	Leisure Development	1.6	CFwd
		08/0738	Information Security	6.1	⚠
		08/0745	Elections Management	0.2	⚠
		08/0747	Council Housing Repairs & Maintenance (Procurement)	3.6	⚠
		08/0748	Sickness Absence Management	1.9	CFwd
		08/0749	Cycling & Walking	10.3	⚠
		08/0750	Academy Interfaces	3.5	⚠
		08/0751	Parks & Open Spaces	2.3	✗
		08/0754	Modern.Gov System	6.6	⚠
		08/0755	Contaminated Land	2.4	⚠
		08/0758	Licensing & Enforcement - Caravan Sites	0.1	✗
		08/0759	Housing Standards	10.3	⚠
		08/0763	External Funding Arrangements (ERDF)	2.3	⚠
		08/0765	Income Management	1.7	⚠

Appendix A

Internal Audit Annual Plan 2008/09 - Update at 26/03/09

Area of Work	2008/09 Planned Days	Work Allocations		Actuals to 26/03/09	Status at 26/03/09
		Job No	Title		
1. ASSURANCE WORK					
FOLLOW UP REVIEWS					
Follow Up Reviews	45.0			62.2	⚠
ST - ASSURANCE WORK	**520.0**			**491.4**	
2. CONSULTANCY WORK					
Support Work (projects and other)					
Planned Days	45.0	08/0633	Risk Management Steering Group	2.2	⚠
Actual Days To Date	83.0	08/0591	Access To Services Focus Group	0.9	⚠
		08/0693	Business Recovery Team	1.0	✔
		08/0695	Asset Management Working Group	1.8	✔
		08/0700	Corporate Governance Framework Development	5.1	⚠
		08/0716	LAA Officer Group	0.5	✔
		08/0509	RIPA Monitoring	5.0	⚠
		08/0735	Partnership Mapping & Evaluation	40.8	⚠
		08/0740	Conditions of Service Procedures	2.6	⚠
		08/0741	Whistleblowing Policy Review	2.6	✔
		08/0743	Procurement Group	1.1	⚠
		08/0744	Money Laundering Policy Development	4.4	⚠
		08/0753	Williamson Park - Financial Procedures	15.0	✔
Ad-Hoc Advice	60.0			60.3	
Efficiency & VfM					
Planned Days	100.0				
Actual Days To Date	0.0				
3. OTHER					
Non Audit Duties	10.0	08/0392	Deputy s151 Duties	15.1	⚠
Actual Days To Date	88.9	08/0760	Fair Pay - Pay Modelling	73.8	⚠
4. AUDIT MANAGEMENT					
Planning, Monitoring and Committee Work	60.0			75.9	⚠
5. CONTINGENCIES					
General Contingency	40.0				
Investigations					
Planned Days	35.0		Investigations	71.2	⚠
TOTALS - PLANNED DAYS	**870.0**		**ACTUAL DAYS TO DATE**	**870.7**	

Key: ✔ Completed ⚠ In Progress ✘ Not Progressed **CFwd** Carried Forward to 2009/10 Plan

Audit Committee

Results of Internal Audit Work

22nd April 2009

Report of Internal Audit Manager

PURPOSE OF REPORT
To inform the Committee of the results of Internal Audit work for the period.
This report is public

RECOMMENDATIONS

(1) That the report is noted.

1.0 Introduction

1.1 Part of the Audit Committee's terms of reference is:

"To receive and review the findings of both Internal and External Audit examinations and to ensure that management takes appropriate action to implement agreed recommendations and to remedy any internal accounting, organisational or operational control weaknesses identified." (Constitution part 3, section 7, § 10)

2.0 Results of Internal Audit Work to 30 March 2009

2.1 This report covers audit work and reports issued since the last report to Committee on 21st January 2009. Summary reports are issued to Members for consideration and are also posted on the Council's Intranet.

2.2 If there are any specific questions about a report, or more detailed information is required, it would be helpful if Members could contact the Internal Audit Manager on telephone number 582028 or email dwhiteway@lancaster.gov.uk prior to the meeting.

2.3 The list below gives the assurance opinion issued for areas audited since the January 2009 meeting.

Audit Title		Report Date	Assurance Level
New Audit Reports			
08/0729	Street Cleansing (Enforcement)	05/01/09	Reasonable
07/0769	Markets	10/02/09	Limited
08/0733	Planning for Floods	25/02/09	Limited
Follow up Reviews			
07/0711	Sundry Debtors	13/02/09	Reasonable
06/0642	Building Control	25/02/09	Limited
07/0678	Insurances	05/03/09	Reasonable
07/0717	Income Management (Cultural Services Webstaff Payments)	20/03/09	Limited

3.0 Matters Arising from Audit Reviews

3.1 Members' attention is drawn to the audits where a "Limited" assurance opinion has been issued; there have been no audits resulting in a "Minimal" assurance opinion. The following audits completed since the last meeting of Committee have been issued with a "Limited" assurance opinion:

07/0769 – Markets

This audit covered management of the Festival Market, Charter Market and Assembly Rooms, as the future of the Lancaster Market was under review. Eight risks were considered of which five are considered to be well managed.

The main issue preventing a 'Reasonable' level of assurance being given was in relation to the ongoing arrangements for the majority of market traders to pay their rent in cash. Whilst acknowledging that these arrangements have worked well for many years, the audit report points out that they are now contrary to Council policy and are no longer in line with new arrangements, approved by Star Chamber, to reduce the number of Securicor collections on cost efficiency grounds.

Property Services and Financial Services have been reviewing these arrangements, the latest position being that Securicor collections are to continue as before until such time as the situation can be further reviewed as part of the ICON Income Management Project currently underway.

08/0733 – Planning for Floods

This audit concentrated on the potentially significant implications arising out of the Government's review of flood management and resilience following the major flood emergencies which occurred in the summer of 2007.

The audit report concluded that, whilst arrangements are being considered to ensure that the Council is prepared for a major change in its statutory responsibilities, there are a number of areas where the Council's responsibilities and capacity to deliver is unclear at present. Specifically, these include the provision of effective local leadership and partnership working, managing the risk of surface water flooding and proactive arrangements for ensuring successful engagement with, and education of, the general public in the event of a major flood.

At this time, a 'Limited' assurance opinion was given on the basis that until new legislation in the form of the Floods and Water Bill is in place and the role of local authorities in the district has been clarified by Lancashire County Council there is limited scope for the Council's preparedness to be developed further. Implementation dates of agreed actions reflect that the position is expected to be much clearer after the summer of 2009.

06/0642 – Building Control

The follow up review acknowledges that the Building Control function is undergoing a significant period of change and challenge, with a newly appointed Building Control Manager, expected new legislation on energy efficiency in the construction industry and a reduction in income as a result of the current credit crunch.

Some progress has been made, however, and the Building Control Manager is undertaking a major review of current arrangements, which together with the implementation of agreed actions, should result in a 'Reasonable' level of insurance.

07/0717 – Income Management (Cultural Services Webstaff Payments)

At the September 2008 meeting of the Audit Committee the level of assurance had risen to 'Reasonable' based on comments made by management that significant improvements had been made to ensure compliance with the Data Protection Act and the Payment Card Industry Data Security Standards (PCIDSS).

During the follow up review undertaken during January 2009, however, a breach of PCIDSS came to light which could have had serious repercussions for both the Council and individual officers in the form of considerable financial penalties, and could have impacted on customer confidence in the Council's arrangements for debit/credit card payments.

Cultural Services have reacted positively to the implications of this breach by taking further steps to ensure full compliance with the PCIDSS requirements. There has been insufficient time to assess the effectiveness of these new arrangements, however, and so Internal Audit can only give a 'Limited' assurance opinion at this time. Plans have been made to undertake a further review in six months time, the outcomes of which will be reported to Audit Committee in due course.

4.0 Update on Previous Assurance Opinions

4.1 Appendix A provides an updated position for all those audits where the level of assurance provided has not yet reached "Reasonable", including the Income Management (Cultural Services Webstaff Payments) and Building Control audits referred to in §3.0 above.

4.2 The last meeting of the Committee resolved (Minute 28(2)) that *"…if the follow up audit to Housing Rents (debit control) and Income Tax and National Insurance 2007/08 (Expenses and Benefits) does not improve the assurance level, the relevant Officers be requested to attend the next meeting of the Audit Committee to explain why."* In both instances, the follow up audits are still to be completed. The most recent updates provided by officers suggest that the assurance level has improved for the Income Tax and National Insurance audit, but not for Housing Rents (Debit Control) – Appendix A provides an update statement on this audit. The Internal Audit Manager will provide a verbal update to the meeting on the outcome of the follow up work and arrange for the appropriate officers to attend and report as necessary.

4.3 Also at the last Audit Committee meeting Members were informed of the findings and agreed actions arising from a review of financial management arrangements at Williamson Park, which had been requested by the Williamson Park Board. This work was completed at the end of November 2008 and a formal follow up review is due to be carried out in April 2009. Cultural Services continue to provide interim operational support at the Park and management have stated that progress has been made in implementing agreed actions, particularly in respect of petty cash arrangements and the ordering, receipt and payment of works, goods and services. A number of actions are ongoing or are yet to be implemented in respect of budgetary control, income management, security and other operational arrangements and, on that basis, a 'Limited' assurance opinion remains in place.

5.0 Results of Responsive Audit Work (Advice, Support and Investigations)

5.1 Internal Audit have provided ad-hoc advice and support to all levels of management, the most significant of which relate to:

- Ongoing project assurance and related support work, notably the ongoing Fair Pay Project (Internal Audit Manager) and the development of the Storey Creative Industries Centre (Principal Auditor).

- Co-ordination and management of the National Fraud Initiative (NFI) in line with the relevant *Code of Practice* and Data Protection requirements. Following submission of personal data information to the Audit Commission by the required deadline some 4,000 data matches have been identified. All of these have now been allocated to Council officers for investigation. Progress is being monitored by the Principal Auditor, who will be responsible for reporting on the outcomes of these investigations and recommending improvements to any identified control weaknesses.

5.2 The Principal Auditor also continues to take the lead role in the ongoing work to identify the number, type and level of significance of the Council's partnerships and the development of a framework for evaluating their effectiveness and performance. Good progress has been made with the 'mapping exercise' and the pilot study of the Partnership Development and Evaluation Toolkit now completed. Following approval by the Budget and Performance Panel arrangements are currently being made to evaluate the effectiveness of eight of the Council's major partnerships during 2009/10 and for this work to be incorporated within relevant Service Business Plans.

5.3 In the last quarter of the year, Internal Audit has undertaken two investigations in accordance with the Council's Disciplinary Policy and Procedure. One has been completed with no further action being taken. The other is ongoing and will require a substantial amount of audit resources in the coming weeks.

6.0 Details of Consultation

6.1 Not applicable

7.0 Options and Options Analysis (including risk assessment)

7.1 Not applicable

CONCLUSION OF IMPACT ASSESSMENT
(including Diversity, Human Rights, Community Safety, Sustainability and Rural Proofing)

None identified

FINANCIAL IMPLICATIONS

None directly arising from this report

SECTION 151 OFFICER'S COMMENTS

The Section 151 Officer has been consulted and has no further comments.

LEGAL IMPLICATIONS

None directly arising from this report

MONITORING OFFICER'S COMMENTS

The Monitoring Officer has been consulted and has no further comments.

BACKGROUND PAPERS Internal Audit Files	**Contact Officer:** Derek Whiteway **Telephone**: 01524 582028 **E-mail:** dwhiteway@lancaster.gov.uk **Ref:** aud/audcomm/220409/ROIAW

Appendix A

LANCASTER CITY COUNCIL
Promoting City, Coast & Countryside

Internal Audit - Assurance Opinion Monitoring as at 30 March 2009

Date of Assessment	Source	Level of Assurance Provided	Comments
06/0642 - Building Control			
29-Jul-07	Internal Audit - Final Report	**N/A**	Audit report pre-dates the provision of assurance opinions
25-Feb-09	Internal Audit - Follow-Up Review	**Limited**	Building Control arrangements are currently under review and procedures may be subject to change. This review will include implementation of the agreed actions relating to the management of the building control account; introduction of procedures to support chargeable and non-chargeable work and monitoring of the partnership agreement with Lancashire County Council, at which point a 'Reasonable' level of assurance will be achieved.
06/0660 - Housing Rents (debit control)			
28-Apr-08	Internal Audit - Final Report	**Limited**	Raising the assurance level to reasonable should be achieved by the implementation of agreed actions relating to the reconciliations to the asset register; checks to verify the accuracy and validity of changes made; and reconciliation of the net debit to the general ledger. The majority of agreed actions should be implemented by 30th June '08 and a formal follow-up is due by 30th September '08.
24-Sep-08	Management - Post Audit Review	**Limited**	Progress has been delayed due to resources being focussed on ongoing work with Anite Housing and Anite (EDMS) modules and new financial monitoring responsibilities. The majority of actions are now scheduled to be implemented by 31/12/08 at which point a formal follow-up will be undertaken.
12-Dec-08	Management - Post Audit Review	**Limited**	Little progress has been made due to other/increasing work commitments and cover for officers who have left the Council and have not been replaced and long-term sickness. A new version of the Task job management system is due to be implemented early in the new year, however, after which arrangements will be made to consider implementation of the required Anite system upgrade with a view to addressing the key action of implementing new arrangements for reconciling the Housing net debit to the General Ledger
23-Mar-09	Management - Post Audit Review	**Limited**	Progress has been made to reconcile properties to the asset register and the net debit to the general ledger, although there are some information technology matters still to be resolved. The follow-up review, currently underway, will determine whether sufficient progress has been made to raise the level of assurance to 'Reasonable'.

Date of Assessment	Source	Level of Assurance Provided	Comments
07/0701 - Procurement and Contract Management 2007/08			
01-Oct-08	Internal Audit - Final Report	**Limited**	The opinion relates to the areas covered which were selected for review on the basis that they are areas where more work is required. It does not provide an opinion on corporate achievements relating to procurement. Clearly stated corporate procurement aims and objectives, corporate engagement and an effective means to monitor performance and progress are needed to raise the opinion to 'reasonable'.
24-Mar-09	Management - Post Audit Review	**Limited**	The 'Limited' assurance opinion reflects aspects of the wide agenda for procurement that still needed to be addressed at the time of the audit. Some progress has been made to implement the agreed actions, specifically the workshop involving contract managers which is informing the way forward on a number of corporate procurement aims and objectives. Outstanding actions are expected to be implemented by the summer, at which point the level of assurance should be raised to 'Reasonable'
07/0708 - Income Management (Housing Rents Direct Debit Payments)			
30-Apr-08	Internal Audit - Final Report	**Limited**	Reasonable assurance could be achieved through implementation of the Electronic Documentation Management System (EDMS) and the Anite Direct Debit Module.
23-Sep-08	Management - Post Audit Review	**Limited**	Actions relating to the EDMS implementation within Council Housing Services have been completed, although some operational procedures need to be reviewed following its implementation. The key action required to raise the assurance opinion to "reasonable" is the implementation of the Anite Direct Debit module, which is now expected to be during Summer 2009. A formal follow-up review will be undertaken at that time.
12-Dec-08	Management - Post Audit Review	**Limited**	Progress has been limited due to other work committments and operational issues around the EDMS implementation. Assurance opinion will remain at 'limited' until such time as the Anite Direct Debit Module is fully tested and implemented
20-Mar-09	Management - Post Audit Review	**Limited**	Little progress has been made due to other work commitments and a delay in the next Release of the Housing Rents system by Northgate OHMS (formerly Anite Housing). A 'Reasonable' assurance opinion will be achieved through improvements provided by the new Release and the introduction of automated direct debit payments for Housing Rents. A Post Audit Review is due at the end of April.

Date of Assessment	Source	Level of Assurance Provided	Comments
07/0709 - Payroll 2007/08			
04-Dec-08	Internal Audit - Final Report	**Limited**	Limited assurance can be placed on current payroll arrangements until significant control issues are addressed. Raising the assurance level to reasonable should be achieved through implementation of the agreed action plan though full implementation is expected to take in excess of twelve months.
26-Mar-09	Management - Post Audit Review	**Limited**	Good progress has been made to implement agreed actions, although a number of significant issues are still to be addressed, specifically a planned review of recruitment policies and procedures and the procurement of an integrated Human Resources and Payroll system. These are longer term actions (Implementation Target Date 30/09/09), implementation of which will result in a 'Reasonable' level of assurance.
07/0717 - Income Management (Cultural Services Webstaff Payments)			
15-Apr-08	Internal Audit - Final Report	**Limited**	Improvements are required to ensure that processes in place for processing card payments via the Webstaff system within Cultural Services are compliant with the Data Protection Act and the Payment Card Industry Data Security Standards. Implementation of the action plan should result in the provision of 'reasonable' assurance.
24-Sep-08	Management - Post Audit Review	**Reasonable**	Significant improvements have been made to ensure that the Service is compliant with the Data Protection Act and the Payment Card Industry Data Security Standards. The installation of a dedicated telephone line for ticket sales has been introduced thus enabling all card transactions to be processed via the Webstaff system promptly upon receipt and negating the need for a booking form (inc card details) to be completed and retained. Full card details are no longer entered into the PASS ticketing system unnecessarily, thus avoiding non compliance issues. Regular reconciliations between the Webstaff system and the general ledger have been introduced ensuring that differences between income taken and the general ledger are highlighted and investigated as necessary.
19-Mar-09	Internal Audit - Follow-Up Review	**Limited**	Despite enhanced processes to ensure compliance with the Data Protection Act and the Payment Card Industry Data Security Standards, an incident resulting in non-compliance occurred on 7th January 2009. Whilst the Service has taken positive action to enhance control further, only a 'Limited' assurance opinion can be given as insufficient time has passed to be confident that these new controls are working effectively in practice. Provided there have been no further breaches by the time of the next follow-up review a 'Reasonable' level of assurance will be achieved.

Date of Assessment	Source	Level of Assurance Provided	Comments
08/0724 - Land Charges			
05-Nov-08	Internal Audit - Final Report	**Limited**	Limited assurance can be placed on current arrangements for the provision of local land charge searches until significant control issues are addressed. Raising the assurance level to reasonable should be achieved through implementation of the agreed action plan.
23-Mar-09	Management - Post Audit Review	**Limited**	Whilst good progress has been made to strengthen risks relating to income management and reconciliation arrangements, guidance from Central Government to address the most significant risk is still awaited. Implementation of this guidance will enable the Council to demonstrate that the provision of Land Charges search fees are cost effective and identify what costs can be legitimately recovered, at which point a 'Reasonable' level of assurance will be achieved. The position will be reassessed during the follow-up review in June.