Local authority investments: Government, CIPFA, FSA and Audit Commission Response to the Committee's Seventh Report of Session 2008–09

First Special Report of Session 2008–09

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Communities and Local Government Committee

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First Special Report

1. On 12 May 2009, the Committee published its Seventh Report of Session 2008-09, *Local Authority Investments* [HC 164]. The Committee invited the Government, the Chartered Institute of Public Finance and Accountancy (CIPFA), the Financial Services Authority (FSA) and the Audit Commission to submit responses to the report in the form of memoranda. All the memoranda were received by 21 September 2009.

2. All four responses are published as Appendices to this Report.
Appendix 1: Government response

This memorandum, prepared by the Department for Communities and Local Government (CLG) and agreed with the HM Treasury, sets out the Government’s response to the Committee’s report.

The Government was grateful for the opportunity to participate in the Committee’s inquiry and now welcomes the thorough analysis and constructive recommendations in the Committee’s report. During the financial events of the last year, important lessons have been learnt by all with an interest in local government treasury management. The report highlights and consolidates the key messages and provides a resource to inform discussions of the subject for the foreseeable future.

The contents of this response have been discussed with the Audit Commission and the Chartered Institute of Public Finance and Accountancy (CIPFA). Both of those bodies are responding separately to the Committee, as is the Financial Services Authority. This memorandum therefore concentrates on the recommendations directed specifically to central Government. It confirms, in particular, that CLG has already begun the review of its investments guidance proposed by the Committee. In finalising the content of the revised guidance, CLG will take full account of the views of local government practitioners (see paragraph 9 below).

The responses below appear under the headings used in the Conclusions and recommendations section of the report (pages 66 to 70). The relevant recommendation of the report with its paragraph number is quoted in bold italics in each case.

Local authorities’ investments and reserves

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

The Government is in full agreement. It would be a mistake to return to anything like the restrictive regime of “approved investments” which predated the present guidance-based arrangements. Ineffective even a decade ago, such an inflexible system could prove disastrous in today’s more volatile investment circumstances. The CLG and CIPFA guidance codes by contrast encourage authorities to take responsibility for investment decisions and to react rapidly to market developments.

Both guidance codes should continue to emphasise the priority to be accorded to security and liquidity over yield. As the Committee has recognised, however, it would be unrealistic
to urge authorities to ignore yield completely. The report (paragraph 168) acknowledges that the CLG guidance in this respect strikes the right balance. But in reviewing the guidance (see paragraph 9 below), CLG will consider whether that message should be expressed even more clearly.

**Local authorities’ financial teams**

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

The Government fully supports the sharing of information and expertise and knows that many authorities already engage in such initiatives. Both CIPFA and the LGA actively promote these exchanges of knowledge, through, for example, conferences, advisory services and networking websites. CLG will discuss with CIPFA and the LGA the scope for further developing such mechanisms specifically in relation to treasury management and investment practice. CIPFA’s proposed *Treasury Management Forum* will be relevant here; it is intended to be a national forum for the discussion of major treasury management issues and to provide a local network for the dissemination of good practice.

**Credit rating agencies**

3. **[...] We recommend that the Government revise the informal commentary on its statutory guidance, to include information about the appropriate use of credit ratings. We also recommend that the CIPFA Codes include guidance to local authorities on the nature of credit ratings, highlighting the risks of over-reliance on them. Credit ratings should not be used in isolation as a justification for the soundness of an investment and local authorities should be made aware of the fact that credit ratings should be viewed within the context of wider financial and economic information and advice.”** (Paragraph 81)

In reviewing its investments guidance, CLG is considering, in particular, how it should deal with credit ratings and to what extent this issue should be covered in the statutory guidance itself or in the informal commentary, or both. The commentary at present simply states (paragraph 23) that “it is not implied that credit ratings are the only means of assessing creditworthiness”. The Government recognises that the warning about undue reliance on credit ratings should be strengthened.

The Government’s provisional view is that the CLG guidance should not include specific recommendations of alternative methods of risk assessment. Any such prescriptive approach could (like the former discredited “approved investments” regime) create a potentially false sense of security and discourage authorities from taking full responsibility for their investment procedures. The treatment of credit ratings is an issue on which CLG
will wish in particular to seek views when consulting local government on the revised guidance (see paragraph 9 below).

**Treasury management advisers**

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

5. The Financial Services Authority (FSA) should take a more active role in the regulation of treasury management advisers [...] There is a strong case for a full investigation by the FSA of the services provided by local authority treasury management advisers. We recommend that such an investigation be carried out as soon as possible. (Paragraph 120)

6. [...] The Audit Commission, CIPFA and the FSA must all re-examine the role and reliability of treasury management advisors and their discharge of duties of care for local authorities in managing this aspect of treasury management. (Paragraph 121)

The Audit Commission, CIPFA and the FSA are responding separately to the Committee. As the limitations of credit ratings become more widely appreciated, authorities will explore supplementary means of assessing credit risk and may increasingly rely upon the treasury management firms for assistance with these often complex techniques. The Government recognises therefore that it is vital for such consultants to provide an efficient and transparent service.

**The Audit Commission**

7. [...] We recommend that the Audit Commission review its own auditing procedure and prioritisation of the areas of local authority activity it chooses to audit, in order to ensure that such complacency does not happen in future. (Paragraph 135)

Although sponsored by CLG, the Audit Commission is an independent body and will be responding separately to the Committee. In relation to investment, local authorities’ statutory duties are to have regard both to the CLG investments guidance and to the CIPFA Treasury Management Code. The Government considers that auditors should give sufficient weight in the planning and execution of the audit to reviewing compliance with those duties.

**The CIPFA Codes**

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

(Paragraph 141)

It is the CLG investments guidance which introduced the concept of an Annual Investment Strategy (AIS) and specifies what it should contain. However, other regular reports on treasury management are required by the CIPFA Treasury Management Code (TMC). CLG is reviewing its guidance and CIPFA is reviewing its Code and associated guidance notes. The two bodies are working together to ensure that their respective documents are complementary and comprehensive.

CLG will wish to consult local government before deciding on any changes to the content of the AIS. The treatment of credit ratings is discussed in more detail in paragraph 8 above.

Central Government and local authority treasury management

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

(Paragraph 145)

The Government recognises that the time is right to reconsider the CLG investments guidance. Issued in 2004, the guidance is in any case due for review. But the recent events in the investment market and the Committee’s report on them give the task added urgency and will be fully reflected in the updating exercise. CLG’s review of its guidance has already started and is being undertaken through the technical sub-group of the Capital Programmes Working Party (see paragraph 11 below). The question of what should be said about credit ratings is among the main issues under examination in the work programme (see paragraph 3 above). It is aimed to have proposals ready for full consultation with all local authorities in the autumn, with a view to introducing revised guidance with effect from 1 April 2010.

The Government is grateful for confirmation that the failures in treasury management are not attributable to deficiencies in the CLG guidance. Local authorities are required by law to have regard to the guidance, which recommends the submission of an investment strategy to elected Members. While no authorities seem to have neglected their basic legal duty, there are clearly variations in the efficiency and enthusiasm with which strategies have been devised and implemented. The revised guidance will seek to encourage uniformly higher levels of performance across local government.

10. We agree with the Government’s approach to assisting those local authorities that have funds at risk in the failed Icelandic banks […] The Government will have to
monitor closely the amount of money that local authorities eventually get back from Iceland to ensure that any actual losses do not seriously disadvantage either local council tax payers or local service uses […] (Paragraph 152)

The Government welcomes this endorsement of its general handling of the situation. It is continuing to monitor developments carefully and is keeping in close touch with local government representatives, as well as CIPFA and the Audit Commission.

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

The Government is pleased to offer the reassurance sought by the Committee. The Capital Programmes Working Party (CPWP) has for many years provided a forum for the discussion of local government capital finance, treasury management, accounting and all related issues. The members are: CLG; the Treasury; other Government departments interested in local authority capital spending; the Local Government Association; London Councils; CIPFA; the Audit Commission; the National Assembly for Wales; the Scottish Executive. Also, the Public Works Loan Board (PWLB) participates in discussions relevant to its functions. The CPWP normally meets at least twice a year (most recently on 15 July 2009) and is chaired by a CLG official (grade 5 or 6). A technical sub-group of the CPWP is convened as required to consider changes to capital finance legislation and codes; it is now reviewing the CLG investments guidance (see paragraph 9 above). In accordance with the Committee’s recommendation, the Government will ensure that the CPWP establishes appropriate links with both the Financial Services Authority and the Bank of England.

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

This issue has been under discussion in recent months between local government representatives and the PWLB, the Treasury and CLG. The PWLB will shortly be consulting local authorities on proposals for change.
Appendix 2: Response from the Chartered Institute of Public Finance and Accountancy (CIPFA)

Introduction

CIPFA was grateful for the opportunity to input to the Select Committee’s inquiry and welcomes the Select Committee’s report and in particular its support for the measures proposed in the recent Treasury Management Bulletin produced by the Treasury Management Panel. Robust scrutiny of treasury management within local authorities is vital in making sure that taxpayer’s money is managed effectively and safely.

CIPFA will be producing a revised Treasury Management Code in the autumn, which will incorporate specific points relating to the Select Committee’s recommendations. The proposed changes to the Code are currently the subject of consultation.

This response has been discussed with the Audit Commission and Communities and Local Government, both of which will be responding separately to the Select Committee.

Please find attached a more detailed response to each of the recommendations addressed to CIPFA in the report in the table on the following pages.
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<th>Recommendation from Select Committee (including paragraph number)</th>
<th>CIPFA Response</th>
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<tr>
<td><strong>1.</strong> One of the objectives of the CIPFA Codes and Codes of Practice should be to ensure that all local authorities are aware of the level of expertise which is necessary to run a successful treasury management operation, and have all the checks and balances in place to ensure adequate monitoring, on an ongoing basis, of both the framework within which its treasury management team operates and the individual decisions which are made on a day-to-day basis. (Paragraph 49)</td>
<td>The existing code’s Treasury Management Practices (TMPs) include a section TMP5 which covers organisation, clarity and segregation of responsibilities, and dealing arrangements, TMP10 covers staff training and qualifications and TMP12 covers corporate governance. The objective of specifying these practices is to ensure that organisations have the necessary skilled staff, procedures and governance arrangements in place to operate an effective and robust treasury management system.</td>
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| **2.** We recommend that the Government, CIPFA and the LGA study ways in which local authorities, particularly smaller ones, could join together to share expertise and pool treasury management resources. The sharing of information and expertise, such as identifying banks that are in the same financial group, might have lessened the failures that occurred during the Icelandic crisis. (Paragraph 56) | CIPFA encourages the sharing of information and expertise and already runs the Treasury Management Forum, whose core objectives are:  
- to create a national Forum where the major treasury management issues of the day can be discussed and debated in an impartial and informed environment; and  
- to provide a local Network to connect participants with good practice through the dissemination of timely and authoritative information and knowledge amongst practitioners in the treasury management field.  
In addition there are various regional groups whose remits includes treasury management.  
The LGA is working with local authority treasurers and the New Local Government Network to explore the potential for joint money market institutions. |
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<td>3. We endorse the Minister’s suggestion and recommendations by CIPFA and the Audit Commission that all local authorities should have an Audit Committee with specific responsibility for the scrutiny of the treasury management function. Guidance to local authorities to that effect should be given through appropriate amendment to the CIPFA Codes. (Paragraph 68)</td>
<td>The importance of the scrutiny function is to be stressed in the revised code and it will be suggested that each authority appoints a responsible Committee, such as a finance scrutiny committee or audit committee, to take on the role of the scrutiny of treasury management.</td>
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<td>4. Members of audit committees need to take their responsibilities for that scrutiny seriously and need to ensure that they are properly trained. The CIPFA Treasury Management Code of Practice should make explicit the need for specific training in treasury management to be undertaken by those councillors with responsibility for overseeing treasury management arrangements, and the Audit Committee should be charged with ensuring that it is available and with monitoring its adequacy. (Paragraph 69)</td>
<td>The Code will stress, by expanding TMP10 the requirement for members with treasury management responsibilities to have access to appropriate training in order for them to fulfil their duties effectively.</td>
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<td>5. Whether a local authority has an Audit Committee or not, elected members should ensure that they pay proper attention to scrutiny of the Annual Investment Strategy (AIS), and of the decisions which are taken under it. We recommend that CIPFA, in reviewing its Codes, consider what further guidance is necessary to local authorities to ensure that elected members are given—and take—appropriate opportunities to scrutinise their AIS. We also recommend that CIPFA develop and include in its revised Codes more rigorous requirements for reporting to elected members on decisions taken by officials under the AIS. (Paragraph 71)</td>
<td>The importance of the scrutiny function will be stressed in the revised code. The function including examination and challenge of the Annual Investment Strategy will be the responsibility of a named Committee. The revised Code will require an additional mid year treasury management operations report in addition to the current requirement for two reports.</td>
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<td>6. […] We also recommend that the CIPFA Codes include guidance to local authorities on the nature of credit ratings, highlighting the risks of over-reliance on them. Credit ratings should not be used in isolation as a justification for the soundness of an investment and local authorities should be made aware of the fact that credit ratings should be viewed within the context of wider financial and economic information and advice. (Paragraph 81)</td>
<td>The revised Code will emphasise the requirement to consider all information available in the market place and not to simply rely on credit ratings as the sole indicator of credit worthiness.</td>
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<td>7. The involvement of treasury management advisers in local authority treasury management will only be valuable if local authorities understand the level of service they require, and if the advisers themselves are clear about the level of service they are providing. Treasury management advisers must decide, define and communicate what services they are providing clients, particularly in relation to the provision of “information” and/or “advice”. The local authority itself nevertheless remains ultimately responsible for any investment made, and CIPFA should warn local authorities about over-reliance on treasury management advisers, whose services have been shown to be variable and, in some cases, inadequate. (Paragraph 100)</td>
<td>The guidance will confirm that responsibility for treasury management cannot be delegated to third parties and that organisations should be clear about the nature and parameters of the services provided by external providers and that they meet the authority’s needs.</td>
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<td>8. We recommend that the CIPFA Codes give more detailed advice to local authorities on the services which they may expect to receive from treasury management advisers, and how to use them effectively. The guidance should make clear that such advisers may give varying types and levels of information or advice. (Paragraph 105)</td>
<td>The guidance will confirm that organisations should be clear that services provided by external providers meet their needs. CIPFA is in discussions with the FSA about the production of a Treasury Management Bulletin which will provide information to local authorities on the services provided by advisers. Once this is completed CIPFA will review whether any additional guidance is required.</td>
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<td><strong>9.</strong> […] The Audit Commission, CIPFA and the FSA must all re-examine the role and reliability of treasury management advisors and their discharge of duties of care for local authorities in managing this aspect of treasury management. (Paragraph 121)</td>
<td>CIPFA considers that the regulation of treasury management advisers should be within the remit of the FSA. The Treasury Management Bulletin with the FSA will also include the background to the regulatory framework for treasury management advisors.</td>
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<td><strong>10.</strong> We recommend that CIPFA add to the issues that need to be covered in a local authority’s annual investment strategy (AIS) the use, or not, of an external advisor; schemes of delegation and the role of the Section 151 officer; and the use of and procedures regarding credit rating agencies. The guidance need not be prescriptive about the way in which the AIS should address these issues, but it should ensure that proper attention is paid to these previously under-scrutinised areas. (Paragraph 141)</td>
<td>The AIS is required under the CLG investment guidance, which specifies its contents. There are also reporting requirements contained within the CIPFA Code. CLG and CIPFA are working together in reviewing their guidance to ensure that they are complementary and comprehensive.</td>
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<td><strong>11.</strong> We seek reassurance that regular meetings at an appropriately senior level are held between the Audit Commission, the local authority associations, CIPFA and CLG to ensure that the treasury management system is kept under review. We also recommend that these meetings include links with the financial regulatory bodies—the Financial Services Authority and the Bank of England—to ensure consistent and up-to-date information is passed onto these bodies. (Paragraph 156)</td>
<td>The Audit Commission, CLG and the FSA are members of CIPFA’s Treasury Management Panel. CIPFA, CLG and the Audit Commission are represented on the Capital Programmes Working Party (CPWP), which is a forum for the discussion of capital finance, treasury management, accounting and related issues. Also represented on the group are HM Treasury, other Government departments, the Local Government Association, London Councils, the Welsh Assembly Government and the Scottish Government. The Public Works Loans Board also participates in discussions relevant to its functions. The CPWP meets at least twice a year and is chaired by a CLG official. CPWP has a Technical Sub Group which meets to consider changes to capital finance legislation and codes.</td>
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Appendix 3: response from the Financial Service Authority (FSA)

1. We welcome the Committee’s report on Local Authority Investments. In this memorandum we respond to those conclusions and recommendations which are relevant to the FSA. In particular we describe the framework, set out in the Financial Services and Markets Act 2000 (FSMA), which underpins our regulation of certain services provided by FSA-regulated firms to local authorities.

2. Given the events that led the Committee to undertake this inquiry, we understand that your main concern centres on the decision by local authorities to place deposits in Icelandic banks and on the advice that local authorities received to make this decision. As we explain in this memorandum, advising on deposits is not a regulated activity and therefore we do not monitor the activities of regulated firms in this area.

3. We understand from paragraphs 119 and 120 of your report that you believe that we were seeking to be deliberately unclear in our answers to your questions and that you also believe that we were not discharging our regulatory duties under FSMA. You ask that the FSA take a more active role in the regulation of treasury management advisors and conduct an investigation into the services they provide.

4. For the reasons explained in our earlier memorandum to the Committee and the further answers that we provided, the application of FSMA regulation to the activities with which the Committee’s inquiry was concerned is limited, and not straightforward. For this reason it would not be appropriate for the FSA to carry out the investigation, recommended by the Committee, of the services provided by local authority treasury management advisers. An investigation of this kind by the FSA would be appropriate only if the FSA’s scope were extended to cover many more of the activities in question. This would be a matter for Government to decide. In those circumstances we would, of course, seek to address the concerns you raise.

5. For future reference, if the Committee would like further written or oral evidence from us before they finalise a report, we would be happy to provide it.

Regulation of Treasury Management Advisers (Paragraph 120 and 121)

6. The Financial Services Authority (FSA) should take a more active role in the regulation of treasury management advisers. The evidence which we have examined has raised concerns about potential conflicts of interest and questions as to whether there are any financial transactions between treasury management advisers and brokers that might compromise the independence of advice being given to local authorities. There is a strong case for a full investigation by the FSA of the services provided by local authority treasury management advisers. We recommend that such an investigation be carried out as soon as possible. (Paragraph 120)
7. Our examination of the role of treasury management advisers in the Icelandic debacle has raised wider questions about their influence on local authorities’ treasury management practice. First, there is confusion, and perhaps some deliberate ambiguity, about what services they offer. It is clear to us that some local authorities believed that they could place reliance on their treasury management advisers in a way that some of the treasury management advisers themselves now seek to argue was misguided. Second, there is concern about the independence of treasury management advisers that may be part of companies that will benefit from the investment decisions of the local authorities that they advise. Third, there is a lack of clarity about the extent to which local authorities can assume that treasury management advisers are properly regulated. While local authorities must ultimately take responsibility for their investment decisions, a range of regulatory and advisory bodies appear to us to have been complacent in their approach to the role of treasury management advisers. The Audit Commission, CIPFA and the FSA must all re-examine the role and reliability of treasury management advisors and their discharge of duties of care for local authorities in managing this aspect of treasury management. (Paragraph 121)

Legal position

8. The activities for which FSA authorisation is required (regulated activities) are set out in legislation - the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001. Changes to the definition of regulated activities are therefore a matter for HM Treasury and Parliament. Firms conducting regulated activities in the UK must apply to the FSA for authorisation, and we are responsible for regulating only those firms that we authorise. It is important to note that firms which we authorise commonly carry out a range of activities, only some of which we regulate; we explain below the relevance of that principle to this case.

9. Treasury management departments within local authorities do not require authorisation by the FSA. In line with the overall approach set out in paragraph 8, whether a separate organisation providing services to a local authority to assist it in its treasury management requires authorisation by the FSA depends on whether that activity is a regulated activity as defined by FSMA. In that context the following points are important:

a) A deposit by a local authority is not a regulated deposit under legislation.

b) Moreover, advising on deposits is not a regulated activity. Therefore advising a local authority to place its deposits with a particular bank is not a regulated activity.

c) Equally, carrying out deposit-broking services (for example, arranging for a client’s money to be invested in deposits with particular banks) is not a regulated activity.

d) Broadly speaking, advising on buying and selling government or private sector debt securities requires authorisation if the advice relates to specific transactions. Broader strategic or generic advice (for example ‘we recommend that you invest in sterling denominated debt securities’) are not regulated activities.
e) Broking and arranging activities in relation to these investments are also usually regulated activities.

10. Broadly, our rules do not apply to activities that are not regulated activities. However, if non-regulated activities (for example, advising on deposits) are conducted alongside regulated activities (for example, advising on investments), certain FSA rules (such as the suitability rules referred to below) apply to the nonregulated activities as well as the regulated activities.

11. As others have pointed out in their evidence to the Committee, many of the rules governing regulated activities derive from the Markets in Financial Instruments Directive (MiFID). Broadly, under this legislation, the FSA is not allowed to set more stringent rules than those in MiFID, including the rules referred to in paragraph 12 and 13.

12. If the firm gives regulated advice to any client, the suitability rules will apply: broadly, a firm must take reasonable steps to ensure that the advice it gives its client is suitable for that client.

13. Generally, local authorities are ‘professional clients’ under the rules set by MiFID. The scope of a ‘professional client’ is determined by MiFID and our rules reflect the MiFID requirements. MiFID provides a lower standard of protection for professional clients. A regulated firm is entitled to assume that a professional client has the necessary level of experience and knowledge to understand the risks involved in the transaction when assessing the suitability of advice being given. So if advice is given to professional clients, the regulated firm is entitled to assume that the client is financially able to bear any related investment risks. Professional clients do not have access to the Financial Ombudsman Service.

14. The Committee also expressed interest in what information the FSA makes available to local authorities about regulated firms and their activities. All firms regulated by the FSA are listed in our Register, which is publicly available on our website. FSMA sets out what we must include on the Register of regulated firms (for example the name of the firm, the regulated activities the firm holds itself out as able to provide, a suitable business address for the firm and the name of any approved persons carrying out controlled functions in the firm). FSMA also requires us to include other information that we deem appropriate for the public record. Under this heading we include any publicly available disciplinary history of a firm or individual and the regulatory history of a firm or individual for the benefit of consumers and market participants.

The FSA’s supervisory approach

15. For the reasons explained above, we do not regulate much of the activity carried out by the firms which provide services to local authorities. To the extent that we do regulate activities they carry out, we take a risk-based approach, taking into account the risk posed to the market and to consumers by the firm’s regulated activities.

16. Where firms form part of a wider group (for example; Sector Treasury Services Ltd is a small firm which is part of the Capita Group Plc. Butlers is the trading name of a division
of ICAP Securities Ltd), we supervise them as part of the group. The extent to which we focus specifically on individual firms within the group depends on their size and their risk profile within the group. In their own right, Sector and Butlers are significantly below the size threshold to warrant a risk assessment. However, as they are both part of wider groups, we take their business into account when we carry out our risk assessment of the wider group.

17. Sterling Bank and Arlingclose Ltd are small independent firms, not part of a wider group. We do not routinely carry out risk assessments of these firms but instead we monitor the information (covering, for example, financial position, volume of business, number of complaints received) which we require firms to submit to us regularly.

Conflicts of interest

18. The FSA takes potential conflicts of interest within firms very seriously. Principle 8 of the FSA Principles for Business states ‘A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client’. The FSA Handbook develops this principle in detailed systems and controls rules which prescribe that firms must (i) identify conflicts of interest, (ii) manage those conflicts to prevent them from harming their clients interests, and (iii) in the case that conflicts can not be managed, firms must disclose them to their clients. Compliance with this Principle and our rules is monitored through our risk assessment process.

19. The FSA also regularly undertakes thematic supervisory work across a range of authorised firms in a number of areas, including conflicts of interest. The main objective of this thematic supervisory work is to promote good practice across particular industry sectors of the firms we regulate and to pinpoint and remove bad practice.

Review of Treasury Management (Paragraph 156)

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

21. There is a well-established framework for such communication: the Capital Programmes Working Party (CPWP). This is a forum for the discussion of capital finance, treasury management, accounting and all related issues. Its members are: the Department for Communities and Local Government (DCLG); HM Treasury; other Government departments interested in local government capital spending; the Local Government Association; London Councils; CIPFA; the Audit Commission; the National Assembly for Wales; the Scottish Executive. We understand that the Capital Programmes Working Party (CPWP) already fulfils the Committee’s expressed desire for regular meetings between these groups. We also understand that the DCLG is considering, with HM Treasury, how best to establish links between the CPWP and the FSA.
Regulatory scope

22. As we have explained, the extent of our jurisdiction over the activities with which the Committee is concerned is very limited. It would therefore not be appropriate for us to take a more active role in the regulation of treasury management advisers. Decisions to extend our jurisdiction to cover other activities relating to advice given to local authorities are a matter for Treasury. The Government’s recent White Paper on financial services does not propose any changes in this area. We would like to assure the Committee that we will continue to be active in our supervision of the firms where we have responsibility for their conduct of business.

23. Finally, if the Committee has specific evidence that FSA-regulated firms have not complied with the applicable regulatory standards in carrying out FSMA regulated activities for local authorities, we would invite you to send it to us so that we can look into it.
The Audit Commission welcomes the Communities and Local Government Select Committee report on Local Authority Investments.

We are pleased that the Committee was able to rely on the evidence in the Commission’s own report *Risk and Return: English Local Authorities and the Icelandic Banks*, and that the Committee’s conclusions about local authorities are very much in line with our own. The Commission notes the Committee’s endorsement of its criticism of the seven local authorities that made deposits with Icelandic Banks after the banks’ credit ratings had been downgraded.

We have been asked to respond to the Committee’s report and have the following comments on those of the Committee’s conclusions and recommendations that relate to the Commission.

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

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

The Commission agrees that local authorities could benefit from a greater understanding of the role of external treasury management advisers and *Risk and Return* included a recommendation reflecting this view. However, there may be a more immediate way of producing advice for local authorities than undertaking a study. We therefore propose to discuss with CIPFA and representatives of local authorities how best to meet the need for appropriate advice on the use of external treasury management advisers.
3. The Audit Commission took it for granted that treasury management was a well managed function, and, consequently, was not an area of concern for auditors. Even if it could not reasonably have been expected to foresee the collapse of a country’s entire banking system, the Audit Commission should have been aware of the greater risk to treasury management as a result of the prevailing financial climate and should have adjusted its practice accordingly. The Audit Commission failed to realise that treasury management was becoming an increasingly risky area and, in that respect, it must share some of the blame for the potential loss of funds in the Icelandic banks. If it had viewed treasury management within the increasingly volatile economic context, it would have put treasury management higher in its auditing procedures, and if it had done that, it is possible that less public money would now be at risk. We recommend that the Audit Commission review its own auditing procedure and prioritisation of the areas of local authority activity it chooses to audit, in order to ensure that such complacency does not happen in future. (Paragraph 135)

We agree that, with the benefit of hindsight, we could have highlighted to auditors the emerging risks to treasury management and asked them to do more work in this area or draw them to councils’ attention.

However, we do not accept the Committee’s suggestion that the Commission is culpable for the potential loss of funds deposited by local authorities in Icelandic banks. This confuses the responsibility of the Commission and its appointed auditors with that of managers and those charged with the governance in local authorities.

Audit is an expensive and finite resource and the Commission is always mindful of the need to minimise the cost of audit to bodies within its remit. Audits are conducted on an annual cycle, planned in advanced and targeted on risks, on the basis of the evidence available at the time. When the audits were being planned, the Commission took the view that the evidence showed that most councils were effective at managing their deposits. On a balance of risk and cost, it was not appropriate to ask all auditors to do specific work on treasury management beyond that required for the Use of Resources assessment. The Commission remains of the view that this was the correct judgement.

It is not the role of auditors to provide assurance to councils on the effectiveness of their systems. The Statement of Responsibilities of Auditors and of Audited Bodies (Statement of Responsibilities) is issued to all audited bodies and referred to in all audit reports. It makes these matters clear:

Auditors evaluate significant financial systems, and the associated internal financial controls, for the purpose of giving their opinion on the financial statements. Where auditors identify any weaknesses in such systems and controls, they will draw them to the attention of the audited body, but they cannot be expected to identify all weaknesses that may exist (paragraph 17);

While auditors may review audited bodies’ arrangements for securing economy, efficiency and effectiveness in the use of resources, they cannot be relied on to have identified every weakness or every opportunity for improvement (paragraph 28).
Treasury management is part of an authority’s wider system of internal control and should be included in the authority’s annual statutory review of the effectiveness of its system of internal control. The results of this review are reported in an annual governance statement, which is normally signed by both the leader and chief executive.

Although auditors are required to review whether the statement on internal control has been presented in accordance with the relevant requirements, the Statement of Responsibilities is clear that auditors are

not required to consider whether the statement on internal control covers all risks and controls, nor are auditors required to form an opinion on the effectiveness of the audited body’s corporate governance procedures or risk and control procedures (paragraph 18).

Councils, therefore, must not rely on external auditors to find out whether treasury management, or any other aspect of their management arrangements, is working effectively. That is a function of managers and those charged with governance, and is not a matter for auditors or the Commission.

The Committee recommended that we review our own auditing procedure and prioritisation of the areas of local authority activity that we choose to audit, in order to ensure that such complacency does not happen in future. The Commission can confirm that it keeps all of its processes under review, including those for identifying risks to be considered as part of the annual audit.

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

The Audit Commission is an active participant in CIPFA’s treasury management panel, which meets regularly to discuss the functioning of treasury management. Other participants include representatives of local authorities, the FSA and central government.

The Capital Programmes Working Party also provides a forum for discussion of treasury management issues.

**Next Steps**

In *Risk and Return* the Commission said it would ask auditors of all local authorities, police and fire and rescue authorities to follow up the lessons learned. Such central direction is now clearly justifiable on the balance of risk and cost, and we have developed a short mandatory work programme for auditors.

The work programme is supported by a technical briefing on treasury management commissioned from the expert advisers involved in *Risk and Return*, which has been made available to all auditors. This summarises the characteristics of good and poor treasury management, as identified during the study research.
The Commission is also contracting for more technical support and advice to auditors on treasury management. Finally, it is identifying staff from within its own audit practice to take the new specialist treasury management qualification launched this month by CIPFA and the Association of Corporate Treasurers (ACT).

For its own treasury management activity, the Commission acknowledges the criticisms made by the Committee, which reflect the Commission’s own reviews. The Commission’s treasury management is now compliant with the best practice identified during the research for Risk and Return.