AGENDA ITEM 13

TRANSPORT FOR LONDON

AUDIT COMMITTEE

SUBJECT: ICELANDIC BANKING COLLAPSE: REVIEW OF AUDIT COMMISSION'S AND TREASURY SELECT COMMITTEE'S RECOMMENDATIONS

DATE: 10 JUNE 2009

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1 PURPOSE AND DECISION REQUIRED

1.1 The Audit Commission and House of Commons Treasury Select Committee published reports into the impact of the failure of the Icelandic banks. This paper reviews the recommendations of those reports, and describes how TfL meets the recommendations made. The Audit Committee is asked to note the contents of this paper.

2 BACKGROUND

2.1 TfL placed £40 million on deposit with Kaupthing, Singer & Friedlander (KSF)[I] on 9 June 2008 for maturity on 5 June 2009. On 7 October 2008, KSF was placed into administration with its retail deposits transferred to ING Bank with the support of HM Treasury. All other creditors (including TfL) are being dealt with through the administration process.

3 AUDIT COMMISSION RECOMMENDATIONS

3.1 The report titled "Risk and return; English local authorities and the Icelandic banks" was published by the Audit Commission in March 2009. The report considered the background to English local authority[II] deposits in Icelandic banks and their UK subsidiaries, and looks at treasury management in local authorities.

3.2 In summary, the key points made by the Audit Commission were:

(a) Local authorities invest large sums of public money;

(b) Deposits were widely spread;

(c) Local authorities had £954 million in Icelandic banks when they went into Administration;

(d) Some local authorities reacted to warning signals about Icelandic banks, but not all;

(e) The national treasury management framework is broadly right, but has weaknesses; and

[I] KSF was the result of a takeover of Singer & Friedlander by Kaupthing Bank hf and was a UK based subsidiary of Kaupthing Bank (regulated by the Financial Services Authority).
[II] TfL is included within the remit of the report as it is considered a local authority for the purposes of financial regulation.

(f) Local authority treasury management is of variable quality.

3.3 The Audit Commission looked at the deposits with Icelandic banks generally, rather than making a distinction between UK banks with Icelandic parents and Icelandic domiciled banks. TfL's deposit was with Kaupthing Singer and Friedlander (KSF) – a UK registered and domiciled bank. While the UK government has supported other UK financial institutions nearing insolvency (e.g. RBS, HBOS, Northern Rock, Bradford and Bingley, Dunfermline Building Society), KSF has not been given any UK government support, and is now being run by administrators – TfL remains on the creditors' committee.

3.4 The Audit Commission report made a number of recommendations for Central Government, the Chartered Institute for Public Finance and Accountancy (CIPFA), local authorities and the Audit Commission themselves. The recommendations relevant to local authorities, together with a summary of TfL's practices relevant to the recommendations are set out in the table attached as Appendix one.

3.5 The Audit Commission report included a table showing local authorities' exposure to the failed Icelandic banks. The table also showed that exposure as a proportion of "gross revenue expenditure" (GRE)[i]. TfL was included in this table with GRE shown as £723 million, and thus exposure to Icelandic banks was calculated as 5.5% of GRE.

3.6 The use of £723 million is wholly incorrect and was not checked or discussed with TfL before publication. TfL is seeking a correction from the Audit Commission for the error as it gives a very misleading position on TfL's exposure. The method of calculating GRE is not appropriate for TfL, and a more appropriate figure would be group revenue expenditure. TfL's Group Revenue Expenditure for 2007/08 was £5.3 billion, and were this figure used as a basis for comparison, TfL's exposure is 0.80 per cent.

4 TREASURY SELECT COMMITTEE REPORT

4.1 The House of Commons Treasury Select Committee published a report in April titled "Banking Crisis: The impact of the failure of the Icelandic Banks Banking Crisis". The points made in the report and the focus of recommendations were for the Government rather than local authorities generally. There are no recommendations in the report that are relevant to TfL.

4.2 While TfL was not mentioned explicitly in the report, the report did include reference to the GRE table in the Audit Commission report as described above. The Treasury Select Committee report noted that there were 30 local authorities that had exposure greater than 5 per cent GRE, which included TfL by inference. TfL is considering writing directly to the Treasury Select Committee to correct them on TfL's inclusion.

5 RECOMMENDATION

5.1 The Audit Committee is asked to NOTE the contents of this paper.

[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. The GRE figures used were auditors' estimates for 2008/09.

6 CONTACT

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APPENDIX 1

Table of Audit Committee Recommendations and TfL's practices

<table>
<tr><th>Audit Commission recommendation</th><th>TfL's position</th></tr>
<tr><td>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.</td><td>The Finance Committee and Board consider an annual Treasury Management Strategy (for Board approval) which discusses the extent to which TfL has appetite and capability to manage risk when placing funds with financial institutions. Institutions must either be incorporated in the UK or the European Economic Area (EEA), or if incorporated outside the EEA they must be authorised by the FSA to accept deposits through a branch in the UK.

The maturity of TfL's various deposits were timed to fit within an expected profile of need – based on modal short-term and medium-term forecasting.

Until October 2008, TfL had a maximum limit on the amount that could be placed with each institution based on its credit rating with Moodys rating agency. The higher the rating the higher the limit. The range was set between £200 million for AAA and £60 million for A1.

Since October 2008, TfL has made deposits only with UK government guaranteed institutions (Debt Management Office or Northern Rock). HSBC may hold short term deposits as it is TfL's clearing bank. At the Finance Committee on 2 June, deposits with Barclays, Lloyds and RBS were approved (within certain limits).

In March 2009, the Board approved the 2009/10 Treasury Management Strategy (TMS), which incorporated the following key changes from the 2008/09 strategy:
Establishment of an "Approved Investment List" of entities with whom TfL may deposit funds;
Establishment of an "Investment Group" staffed by senior TfL officers to consider the entities on the Approved Investment List;
Requirement for entities to have at least two credit ratings, and to take the lowest credit rating (where a split credit rating occurs); and
Maximum tenor for deposits based on credit rating reduced (but still remaining less</td></tr>
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Audit Commission recommendation	TfL's position
	than one year). The TMS also included a country exposure limit of £200 million (except the UK).
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.	TfL has always followed the CIPFA code of practice; annually the TMS is discussed with the Finance Committee before seeking approval from the Board. Regular updates are provided to the Finance Committee during a financial year as part of a quarterly update, and over the last year, the Finance Committee has been more actively and regularly involved in discussions of strategy. Internal Audit regularly audit Group Treasury's compliance with the TMS and internal processes.
Ensure elected members receive regular updates on the full range of risks being run.	Regular updates are provided to the Finance Committee.
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.	TfL has a dedicated team providing cash and treasury management. They deal with the daily business of managing cash deposits and supporting services. Information sources used are Reuters, Bloomberg, broker and credit rating agency reports as well as discussions with market participants, brokers and media reports. TfL's treasury team (led by a Chartered Accountant) reports to the Director of Corporate Finance (also a Chartered Accountant with extensive investment banking experience).
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.	TfL's Finance Committee is made up of people who have significant financial experience – in senior positions of responsibility within banks and organisations across a range of sectors. TfL can arrange training for any Members who wish to receive it.

Audit Commission recommendation	TfL's position
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.	TfL's borrowing profile has been agreed for the next 10 years with HM Government. TfL's business plan assumes borrowing these amounts, in full, in the years agreed. As permitted under the CIPFA Prudential Code, borrowing funds is allowed up to three years in advance of spend. TfL is committed to significant expenditure over the next few years which will substantially reduce TfL's cash balances. Early repayment of loans is not currently appropriate given the need to fund the capital investment. Strategies around these issues are discussed regularly with the Finance Committee.
Use the fullest range of information before deciding where to deposit funds.	Information sources used are Reuters, Bloomberg, broker and credit rating agency reports as well as discussions with market participants, brokers and media reports.
Be clear about the role of external advisers, and recognise that local authorities remain accountable for decisions made.	TfL does not use external advisers, except in certain discrete areas, related to change / new opportunities. Where brokers are used, their services are for execution only. The final decisions have always stayed with TfL.
Look for economies of scale by sharing resources between authorities or with pension funds, while maintaining separation of those funds.	TfL currently manages £2 billion of cash deposits and sharing resources with other authorities is unlikely to improve economies of scale given the scale of operations. The investment objectives, particularly in terms of maturity of investment, are very different from those of the TfL Pension Fund.