From 1 April 2002 regulations regarding local authorities responsible for managing their general funds were finally changed – enabling them to take advantage of a more secure investment environment.

MMFs in local government

BEFORE 1 April 2002 it was possible for the local authorities that were responsible for managing pension funds (about 100 of 440) to invest any pension fund cash in money market funds (MMFs) but the same local authority could not use such funds for its general cash. This was clearly an anomalous situation and resulted from the different regulations applying to the two types of fund. The regulations for the general fund cash were written in the early 1970s, long before MMFs came into existence.

There was pressure from a number of the larger local authorities and some MMF managers to persuade HM Treasury to agree to the regulations being changed. It is always difficult to find parliamentary time to make changes to regulations but they were finally amended and with effect from 1 April 2002 all local authorities now have the option of investing in money market funds for their cash balances.

Local government is big business. In total, it spends more than £250m every working day. This spending is spread over about 440 local authorities in England and Wales that vary enormously in size. Each authority has to work out the most effective way to conduct its day-to-day cash management business with regard to the number and size of its transactions.

In recent years, local government directors of finance have adopted a very conservative approach to investment of their short-term 'surplus' cash. This is understandable, given two major financial scandals of the late 1980s. The first concerned investments made by some local authorities seeking the attractive yields offered by the Bank of Credit and Commerce International (BCCI). In some cases, it was so seductive that a number of local authorities took the risk of investing all their 'surplus' cash with the BCCI. They were not alone and many large institutions round the world had their fingers burned when it was later shown that the BCCI was acting fraudulently.

The second event was over the use of swaps. Almost all local authorities that chose to use swaps did so as hedging instruments, but one London borough thought it could make a great deal of money using swaps and geared its investment to a large extent (estimated to be nominally £6bn). Inevitably, it went wrong and extensive losses were made. In a subsequent court case, it was ruled that local authorities did not have the legal powers to enter into swaps. All the transactions made by every local authority had to be unwound, a process that took many years.

It is important to understand that local authorities and other public authorities can only do what the law specifically allows, so the introduction of extremely secure AAA-rated money market funds is particularly attractive to them.

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Current management arrangements

There are a variety of procedures adopted by local authorities in managing their cash balances. The most common is to use money brokers for either borrowing or lending for periods up to one year. However, the trading tends to be at the shorter end of the market, with most deals being for periods of less than one month.

Many local authorities have built up relationships with banks and building societies and often make direct deals with them. It is common practice for the district councils within a county council area to have a close relationship with the county and lend and borrow from each other. In addition, a number of local authorities have funds that are not needed for periods longer than a year and here they usually employ money market investment managers to run a segregated portfolio of between £10m and £20m. If the sums available are very large, several managers can be appointed. The level of risk they find acceptable varies between local authorities, but most funds are managed conservatively.

Credit risk

Historically, local authorities have not had to pay a great deal of attention to credit ratings and have chosen their counterparties largely by size and reputation. Their acceptable counterparty lists normally include the main UK banks, some leading overseas banks and the major building societies. However, this is changing as local authorities are being inundated with a variety of inspection systems imposed by central government.

Treasury management reviews

These inspections are leading to in-depth reviews of all aspects of local authority services, including treasury management. The highly regarded accountancy body to which most local directors of finance are members is the Chartered Institute of Public Finance and Accountancy (CIPFA). This Institute has worked closely with central government for many years to minimise the difficulty of keeping regulations up to date by producing codes of practice which are mandatory for its members. There is a treasury management code that is under the control of the Institute and can quickly be updated to incorporate changes in markets, such as the introduction of money market funds, and to encourage 'best practice'.

Although the Myners report dealt with pension fund investment, its findings have relevance for wider forms of investment. The review is causing all investors to look in more detail at how their cash is being managed. Local authorities that examine this topic frequently discover that the issues of counterparty risk, management expertise, investment returns and diversification

CHOOSING A LIQUIDITY FUND

How should local authority investors evaluate the growing number of sterling liquidity funds now available?

- **Investment Experience** Ensure the manager of the fund selected has in-depth experience in this area including credit analysis and a track record of success.

- **Size of Fund/Number of Clients** Large funds are more easily able to provide liquidity, achieve a wider diversification of the underlying assets and have more flexibility as to how they are invested along the yield curve. The bigger the fund, the less impact any one investor's transactions will have in terms of liquidity and fluctuations in yields.

- **Performance** Performance is an important factor but comes behind security and liquidity with most investors priorities. Erratic performance may signify poor investment process or indicate that high cashflows are affecting the fund.

- **Service and Ease of Use** An area of differentiation is the quality of service offered by liquidity fund managers. Investment into the fund can be made directly by the local authority. In each case the service arrangements will need to fit well into the local authority's treasury management process.

MMFs, with their large pool of diverse securities and skilled credit management, offer greater flexibility in their investing deadlines compared to individual securities.

are not of the highest standard and are seeking improvements against a background of budget pressure to reduce administration costs.

Impact of introducing AAA-rated money market funds

The existing arrangements have worked well for local authorities. However, they tend to require a considerable amount of time of skilled staff and need a high degree of knowledge of the day-to-day movements in the money market for all periods up to one year.

The introduction of AAA-rated MMFs has provided a considerable number of advantages over the current arrangements and can be easily integrated into existing treasury management procedures. The main advantages are:

- access to types of investment not available outside these funds, for example, commercial paper (CP);
- scale of operation;
- increased security and diversity from the wider spread of a fund's investments;
- time saving – no need to find 'best' rates or to roll over investments;
- a very skilled portfolio manager experienced in money markets; and
- no penalty for dealing later or in small or large amounts.

AAA-rated money market funds

These funds provide investors with an extremely conservative, highly diversified and liquid portfolio. They are a highly secure and liquid vehicle used by institutional investors, including public authorities, pension funds, insurance companies and corporate treasuries.

Assets under management in US MMFs, now totaling about $2.3 trillion, far surpass the amount currently held on deposit at banks. Europe is quickly catching up, but has a long way to go.

The benefits of money market funds

The key benefits for any liquidity fund investor are security, liquidity and yield, with the emphasis on security.

MMFs, with their large pool of diverse securities and skilled credit management, offer greater flexibility in their investing deadlines compared to individual securities. They may invest the fund's assets out along the yield curve to enhance returns but continue to offer daily liquidity. In addition, a large fund with a diversified investor base that has differing cashflow requirements will provide a more stable return.

The larger funds tend to have a lower volatility in the interest rate. Investors are paid the same yield irrespective of the size of their investment or the length of time for which they are investing. The weighted average maturity of funds typically ranges from 30 to 50 days.

The process is very straightforward and is very similar to opening a bank account. A liquidity fund 'account' is opened by the officer of the local authority which is responsible for the treasury management function. Once opened, dealing can be conducted by telephone or facsimile.

Maximum security

In an environment of low returns, where security is an overriding issue, every basis point of return is important. MMFs have grown to become the cash vehicle of choice in the US and the same pattern of growth is emerging in Europe. As well as seeking to maximise returns, such funds offer a high degree of security, enhanced liquidity, flexibility and diversification.

The take-up by local authorities has so far been cautious and perhaps is a reaction to their experience in the late 1980s. However, in recent months, increased interest has been shown with many new accounts opened and it is expected that by the end of this financial year most local authorities will have a MMF account with one or more managers.