National Audit Office

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL

HC 546
SESSION 2008–2009

16 OCTOBER 2009

Government cash management

Summary

1 The aim of good cash management is to have the right amount of cash available at the right time, and to do this cost effectively. Making this cash available and storing any surplus cash has both risk and cost implications for the taxpayer. In light of the government's tighter fiscal position, good cash flow management is becoming even more important.

2 Central government departments and their sponsored bodies play a critical role in minimising the risks and costs associated with cash management. In 2008-09, the 14 departments[1] covered by this report were responsible for spending and distributing over £400 billion in the provision of public services, social welfare, and public goods and assets.

3 Departments keep money at the Exchequer[2] until they are ready to make payments. These payments represent a significant proportion of the United Kingdom's banking transactions, with state benefits alone accounting for over 16 per cent of the 6.8 billion banking transactions made in 2007[3]. While delaying payments can help to keep money within the Exchequer and minimise borrowing, the government also has a responsibility to pay its suppliers on time. In the past its target was to pay suppliers within 30 days of receiving a valid invoice. The recent announcement of measures to support business means government should be paying suppliers within 10 days, and that cash will leave the Exchequer earlier.

4 To deliver its objectives the government uses a wide range of other organisations. Hence devolved administrations, local authorities and health trusts as well as private, voluntary and community bodies also receive central government funding. Excluding Local Authorities, the majority of government funding is held at the Exchequer. It is government policy to maximise the amount of money at the Exchequer, as it helps to directly offset government borrowing or generate interest if loaned out, although holding some cash in commercial accounts is always likely to be required.

1 These include the large central government spending departments. A complete list can be seen in Appendix One.
2 We refer in this report to the Exchequer as the set of bodies that manage government funds. They comprise the Treasury, the Debt Management Office, and the Office of HM Paymaster General, which is now part of the Government Banking Service (see Appendix Four).
3 UK Payment Statistics 2008 and UK Payment Markets 2008, published by APACS and the Payments Council.

5 A recent National Audit Office report found that only half of departmental finance teams rated themselves as strong at cash management and 34 per cent of departments did not provide any cash flow information to their Boards[4].

6 Against this background, we have identified three key factors in managing government cash efficiently and effectively:

- Keeping as much money at the Exchequer as possible. This cash minimises the amount of government borrowing on any given day, reducing interest costs and improving the fiscal balance. By keeping cash centrally, the government also knows how much cash it is holding, and where it is. This allows it to better manage the associated risks of holding cash, and take better decisions about the public finances as a whole, particularly regarding cash shortfalls and surpluses.
- Accurately predicting cash flows in and out of the Exchequer. Improved precision allows the Debt Management Office to minimise the number of last minute transactions on a given day, as it is generally more expensive to carry out or to reverse a lending or borrowing transaction late in the day.
- Minimising the costs of tendering for and using banking services.

7 Our examination focuses on:

- whether cash management processes make the right amount of money available at the right time in a cost-effective way (Part One); and
- whether the costs of banking are minimised and risks associated with cash are being managed appropriately (Part Two).

Key findings

8 On cash flow management:

- **Central government departments and their sponsored bodies hold more money in commercial bank accounts than is necessary.** As at 31 March 2008, the Treasury estimated that public bodies are holding £4 billion in commercial accounts. This is partly because organisations use commercial banks when they could keep their money at the Exchequer, and partly because bodies draw down money from their sponsor departments before it is needed. Although this represents less than four days of central government spending, our sample of 16 sponsored bodies held on average 50 per cent higher cash balances throughout 2008-09 compared to 31 March 2009. While it is not possible to extrapolate from this small sample, it suggests that on average more than £4 billion was being held in commercial accounts throughout the year. By minimising these balances, there is an opportunity to reduce government borrowing, manage the risks of holding cash more effectively, and have better information about when to borrow or invest.

4 C&AG's report: *Managing financial resources to deliver public services*, HC 123, Session 2007-08.

- **We estimate that £275 million a day was held outside the Exchequer in 2008-09 by the 16 sponsored bodies in our survey**. If this cash had been in Exchequer accounts, it potentially could have saved £9.1 million in interest on government debt throughout the year, compared to the £7.1 million in interest on their commercial bank balances. However, in some cases changing banking provider would require a cultural change, including some independent bodies overcoming their resistance to banking with a government institution.

- **Departments have generally become more accurate in forecasting their cash flow with their aggregated monthly net expenditure varying from forecast by an average of £1 billion, or three per cent of average monthly expenditure**. Some departments recognise that they do not do enough to collect information from business units, budget holders and sponsored bodies to enable them to forecast their cash flow accurately. Instead they rely on profiling budgets equally across the year, adjusted for past trends. Departments that have improved the communication and interaction between their forecasting and payment functions and their sponsored bodies are better able to manage their expenditure and provide more accurate forecast information to the Treasury.

- **Inaccurate forecasting can lead to losses for the taxpayer**. Depending on market conditions, the government may suffer a loss from poor forecasting decisions, as the market rates change over time, and because of a cost known as the 'bid offer spread'. This bid offer spread is the difference between the interest rate for a lender and a borrower, and the Debt Management Office estimates that this generally varies between 0.1 and 0.15 per cent[5]. In 2008-09 the government as a whole over-or under-forecast its cash requirements by an average of £63 million a day, or four per cent of net spending, which may have increased costs by £95,000 for the year. There are other important effects of poor cash flow forecasting of which the costs are less easily quantifiable, but are likely to be significant. Poor forecasting can lead to sustained increased borrowing, as the Debt Management Office needs to hold higher cash balances to cover unexpected late cash flows. With accurate long-term forecasts the Debt Management Office can make better use of opportunities in the market to even out future cash flows by borrowing and lending money at the best rates. It would also reduce the risk of making high value, last minute transactions at poor rates.

- **Central government departments generally produced less accurate forecasts in the final month of the financial year**. Over the last four years, March was the only month in which the variance against forecast was always greater than three per cent. March is also the month in which government spending is generally at its highest.

5 This is an annual rate, and so the true cost of the bid offer spread on a given day is equal to the bid offer spread divided by 365.

- **The Treasury incentivises central government departments to improve the accuracy of forecasting their cash flows in and out of the Exchequer, but not to maximise the amount of money they hold in these accounts, which is of greater benefit to the taxpayer**. The Treasury publishes guidance that requires public bodies to keep as much money as possible at the Exchequer, but the incentive mechanisms, which use transparent performance reporting and peer pressure, concentrate attention on forecasting. Any cash savings arising as a result of either higher balances at the Exchequer or improved forecasting fall to the government as a whole, not to individual departments or their sponsored bodies.

- **In our sample of sponsored bodies, only the Boards of Trading Funds[6] receive reports on their organisations' cash balances and interest earnings on a regular basis**. Staff felt that senior management engagement helped focus the attention of the entire organisation on good cash management.

9 On prompt payment:

- **There is an inconsistent understanding of, and variable performance against, the government's target to pay suppliers within 10 days**. In March 2009, 90 per cent of invoices in the organisations we surveyed were paid within 10 days. Electronic procurement and invoicing of goods and services were generally seen by these organisations as an effective way to improve the speed of payment.

10 On banking services:

- **It is not mandatory for public bodies other than central government departments to use Government Banking Service accounts and hold money at the Exchequer, although the Treasury's guidance states that balances in commercial accounts should be minimised**. Each public sector body that uses commercial banking services as well as, or instead of, the Government Banking Service account, competitively procures its own, which incurs additional time and costs, and leads to large variations in the transaction fees paid and interest rates earned. In 2008-09 public bodies paid £7.5 million in fees for their Government Banking Service account and banking services such as BACS[7], CHAPS[8] and Payable Order[9] transactions. In the same year, the organisations in our survey paid just over £2 million in fees and transaction charges to commercial banks. When procuring specialised banking services, such as for secure cash transit and foreign exchange, public bodies are not working together enough.

6 Trading funds are public sector organisations that have been set up as a means of financing the revenue-generating operations of a government department.
7 Bankers Automated Clearing Service (BACS) is a not-for-profit industry body which allows funds to be transferred electronically between banks. In general, a BACS payment initiated on day one of a payment cycle will arrive in the recipient's bank account two days later, on day three.
8 Clearing House Automated Payment System (CHAPS) is a same-day, inter-bank electronic credit transfer service between banks in the United Kingdom.
9 The cheque service used by the Office of HM Paymaster General.

- **Use of BACS is generally more economic and efficient**. It is cheaper than other electronic payment methods such as CHAPS, and both cheaper and more secure than using cheques. Poor planning, in conjunction with the Treasury's incentive mechanism around accurate forecasting, means that some organisations feel obliged to make some urgent payments by CHAPS, which take less than one day to clear as opposed to BACS payments which take up to three days. Some organisations also make many of their payments by cheque, partly because some payees prefer them, and partly to avoid the administrative burden of entering payees' details into the electronic payments systems.
- **Credit risk was a concern to over a third of our sample of sponsored bodies**. Many departments keep money in more than one of the United Kingdom regulated clearing banks, and there is no government-wide dependency on any one bank. Although public bodies are aware of, and monitor, credit risk, investigations of financial exposure by the 14 departments we surveyed found that 11 of their bodies had a total of £96 million invested in Icelandic accounts.

Conclusion on value for money

11 Central government as a whole is not managing its cash in a way that maximises value for money, largely because it could hold more cash in the Exchequer. Money that leaves the Exchequer needs to be raised by the government at a cost that is close to the Bank of England bank rate, which ranged from five per cent to 0.5 per cent in 2008-09. In some cases this money is held in commercial bank accounts, earning interest, before it is used to make payments. However, for the bodies in our sample the average interest rate earned was 0.7 per cent below the bank rate. Using this rate, the £4 billion held in commercial bank accounts at 31 March 2008 would have cost the government £28 million in higher interest payments over the year. Although the current unusually low interest rates would reduce the potential savings, most of our sample of sponsored bodies held on average 50 per cent higher cash balances throughout 2008-09 compared to 31 March 2009. While it is not possible to extrapolate from this small sample, it suggests the £4 billion is an underestimate. There are also broader benefits from using the central expertise of the Debt Management Office to manage cash balances and the associated risk.

12 Some organisations are ready to move over to the Exchequer as their banking provider almost immediately. Others, especially those that have complicated banking arrangements or want to maintain their independence from government, would incur considerable one-off costs or require a significant cultural change. These factors would apply to any change of banking provider, and the costs may include changing internal processes to align with those of the new provider, adjusting computer software, and ensuring all customers know and use the new bank account details.

Recommendations

13 The following recommendations for departments, their sponsored public sector bodies and the centre of government identify improvements in government cash management that can be achieved primarily by changing working methods, sharing information, or adjusting organisation structures, without the need to incur significant implementation costs.

14 The highest priority recommendations that would deliver the greatest benefits, both financially and non-financially, are recommendations 1) and 6), on banking with the Government Banking Service and refocusing the Treasury's incentive mechanisms.

Recommendations for departments and public sector bodies.

Central government departments and their sponsored bodies hold more money in commercial bank accounts than they need

1 Departments and their sponsored bodies should have their main account with the Government Banking Service, so that unspent money is kept at the Exchequer. This is one of the most important elements of good cash management in government, as it not only reduces government borrowing, but minimises risks and allows the government to plan and manage its cash flow more cost-effectively. Organisations should only have commercial bank accounts where they have agreed with the Treasury that the Government Banking Service cannot satisfy a particular business need.

2 Departments need to improve their links with sponsored bodies and collect more accurate information on when they use their cash. Based on the data, they should amend payment cycles to sponsored bodies with commercial bank accounts so that the bodies receive money when they need it, and not before. This amendment may be for more frequent payments, or making the monthly payments closer to the date when significant liabilities, such as payroll, need to be met.

Monthly net expenditure for the 14 departments in our survey varies from forecast by an average of £1 billion

3 Public bodies need to gather information from business units to forecast individual monthly expenditure. To do this effectively they need to structure themselves to facilitate continuous dialogue between those staff responsible for forecasting cash requirements, and those making payments. They also need to emphasise to budget holders responsible for approving large payments and claiming receipts in their own organisation, as well as any sponsored bodies, the importance of accurate forecasting and communicating any changes to forecasts as soon as possible to the cash managers.

Few Boards routinely receive information about their organisation's cash position

4 With the tighter fiscal position, Boards should have greater oversight of information on cash flow so they better understand the pattern of spend as well as total spend, and can address any potential risks. Central finance teams should develop more informative reports, which ought to include movements in the main current bank accounts and comments on variances. Where there is an operational need to have commercial accounts, Boards should ensure that cash balances are invested in interest earning accounts, while having due regard for credit risk. They should also receive reports on the proportion of their cash which earns interest, the rates earned, and a credit assessment of the institution with which their funds are held.

Organisations are using less cost-effective methods of payment, such as cheques and CHAPS, because of poor planning

5 Organisations should manage their payments in a way that allows them to use the most cost-effective methods, and develop strategies for limiting the use of expensive paper-handling.

Appendix Three sets out some more detailed principles of good cash management.

Recommendations for the centre of government.

The current incentives for cash management focus on accurate forecasting, but this does not address money that is unnecessarily kept outside the Exchequer

6 The Treasury needs to extend its incentives to encourage public bodies to keep more money in accounts at the Exchequer, for example, by making bodies' performance in this regard more transparent. It could also, together with the Government Banking Service, take a more active approach to achieving compliance with its guidance on minimising commercial balances. Any of these steps would need to be taken in a way that minimises unintended behaviours, and would also incur some limited additional staff cost. However, new mechanisms are critical in shifting the focus away from just accurate forecasting. The most cost-effective system would be for all public bodies to bank with the Exchequer and manage their cash in accordance with the guidance without the need for incentives.

Good practice in forecasting cash flow and managing payments exists, but is not systematically adopted across government

7 The Treasury is already working with departments to improve their performance, but should focus more on those departments with the greatest scope to improve, based on current performance and the context in which they operate. In light of the tighter fiscal position, it should work with all departments to help them identify how they can improve their forecasting accuracy, particularly at the end of the financial year, without compromising the policy of minimising cash balances held in commercial accounts.

By undertaking their own tendering processes for commercial banking and cash transit services, public bodies are unlikely to all be getting the best value for government as a whole

8 Where there is a value for money case for using a commercial provider for standard banking services, public bodies should seek approval from the Treasury. When procuring specialised banking services, organisations should first check whether the new Government Banking Service is able to provide them. If not, they should work with the Government Banking Service during the specification and tendering process, as it can coordinate knowledge sharing across the wider public sector.