STROUD DISTRICT COUNCIL

Internal Audit Report

Title:	**Treasury Management Arrangements - Special Review**
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EXECUTIVE SUMMARY

A review was carried out by Internal Audit in October and November 2008 of the Authority's treasury management arrangements, this being initiated by the Council's Chief Executive and Head of Finance as a consequence of the Council's deposits placed with Icelandic banks.

Our review focused on two areas: an investigation into deposits with Glitnir, and a more general review of treasury management control and risk management processes. Specific objectives for the audit were set by the Chief Executive and by the Head of Finance, and were as follows:

1. To investigate the circumstances regarding deposits made with Glitnir in 2008, to identify any control breakdown, and to make recommendations for improvement.

2. To review and make recommendations in respect of:

- Processes and procedures in place for treasury management
- Risk identification and management
- Member notification of risks
- Role of Scrutiny in monitoring the performance of treasury management functions.

The review was undertaken by examining documentary evidence and by discussion with relevant members of staff.

A number of key control issues have been identified in this report. Some are of a general operational nature, and some have been raised as a result of the 2008 loans to Glitnir. These issues are listed below; remedial recommendations are listed in Appendix 1.

As regards the deposits with Glitnir:

- The two deposits made early in 2008 of £2m and £1m were both placed for 364 days. Whilst these complied with SDC's own internal restrictions, the length of the deposits were not in line with Sector's guidelines which recommended a maximum period of three months for deposits with Glitnir. In view of this it is important that the Authority's investment counterparty criteria are reviewed as soon as possible, seeking advice from Sector, and taking this on board if appropriate.

- The deposit with Glitnir agreed in February 2008 exceeded the Authority's own forward dealing time limits.

As regards operational and procedural issues:

- The updating of the Treasury Management Procedures Manual needs to be completed as a matter of priority.

- Consideration needs to be given to re-evaluating the risk arising from treasury management activities, and to whether this now merits inclusion in the corporate Risk Register.

- Management arrangements for treasury management staff should be reviewed, including the adequacy of experience, expertise, and qualifications of staff, supervision arrangements, and roles and lines of communication and responsibility.

Finally, it is important to set the issues affecting Stroud into the context of a global financial crisis, which affected many British organisations with deposits in Icelandic banks. It should also be emphasised that the decision taken by the Authority in March 2008 to withdraw from investments with Icelandic institutions was particularly prescient, and meant that the Council did not suffer further financial uncertainty.

INTRODUCTION

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2. Our review focused on two areas: an investigation into deposits with Glitnir, and a more general review of treasury management control and risk management processes. Specific objectives for the audit were set by the Chief Executive and by the Head of Finance, and were as follows:

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   - Member notification of risks
   - Role of Scrutiny in monitoring the performance of treasury management functions.

SYSTEM BACKGROUND

3. Like all local authorities, Stroud District Council (SDC) engages in treasury management activities. These involve placing deposits with, and borrowing from, a range of financial institutions. These vary greatly in length, ranging from one day to several years, dependent upon whether the money is for day-to-day cash flow purposes, or allocated for longer term projects or funding of services.

4. As at the time of audit SDC had the following longer-term deposits with financial institutions:

   - Specified investments (up to 364 days in length) £7.3m
   - Non-specified investments (over 364 days) £10m

   In addition some £8.4m was deposited for shorter-term cash-flow purposes. Monies deposited for the longer term will eventually be utilised for capital or revenue purposes.

5. In 2001 Cipfa produced a new Code of Practice for Treasury Management in the Public Sector. This replaced the previous Code which had been published in 1996. The new Code included revised

Treasury Management Practices (TMPs) which authorities were recommended to adopt.

6. Under the terms of the Local Government Act 2003 the Government replaced its previous control framework over local government treasury management, and replaced it with a more flexible system based upon the “prudential” regime introduced by Cipfa’s new Code of Practice. Under this new system the Government stated that it still wished to encourage local authorities to invest prudently, but without burdening them with the detailed prescriptive regulations characteristic of the previous regime. The general policy objective specified by the Government is that local authorities should invest prudently any surplus funds held giving priority to security and liquidity. Authorities should, however, seek the highest rate of return consistent with the proper levels of security and liquidity.

7. SDC employs Sector as a treasury management consultant. Services provided by Sector include:

    - Attending strategy meetings at SDC offices
    - Giving interest rate forecasts
    - Providing economic and political updates and bulletins
    - Giving access to advice via Sector’s website
    - Providing advice on treasury management strategies, reports, policies and procedures.

8. In addition to the above one of Sector’s key responsibilities is to provide the Authority with information about the creditworthiness of potential borrowers of the Council’s money. The standard schedules of institutional credit ratings which Sector provide to SDC for this purpose are based upon credit ratings produced by two companies: Fitch Ratings Ltd., and Moody’s Investors Service Ltd. These credit rating agencies are two of the three named by the Government in its advice to local authorities, the other being Standard and Poor’s. In addition to these standard schedules we understand that the Authority also obtains Standard and Poor’s analyses, and includes these in its counterparty matrix. This is described in greater detail in the “findings” section of this report, below.

FINDINGS

Review methodology

9. Our review was focused on two areas: an investigation into deposits with Glitnir, and a more general review of treasury management control and risk management processes. The review was undertaken by examining documentary evidence and by discussion with relevant members of staff.

10. Documents examined included:

- Procedures manual
- Council, Cabinet, and Committee papers
- Constitution
- Sector advice
- Government circulars
- Cipfa guidance

11. Discussions were held individually with staff, and included discussions with the following postholders:

- Head of Finance
- Accountant (Exchequer)
- Senior Accounting Technician
- Finance Officer

Treasury Management Processes and Procedures

Audit arrangements

12. Treasury management is categorised as "medium risk" in Internal Audit's Strategic Audit Plan (SAP), and audits are planned to take place on an annual basis. The risk rating and audit frequency were set by Deloitte and Touche when they constructed a SAP for Stroud in 2006. Audits have taken place each year in line with the SAP.

13. In each of the last three years 2005/2006 to 2007/2008, Audit has been able to state that "significant assurance" can be given as regards treasury management procedures. Most recommendations arising from these audits have been agreed and have been implemented, or are in the process of being implemented. However three recommendations are worthy of particular note, these relate to:

    - updating the Treasury Management Manual,
    - reviewing and approving the Treasury Management Policy,
    - reporting performance to Members.

    The first two of these are dealt with in the relevant paragraphs immediately below. The third is dealt with later in this report.

14. In view of the detailed audits undertaken each year we have not repeated similar audit checks at this review. We have, however, looked at treasury management documentation and responsibilities, and have reviewed in detail the procedures with regard to deposits with Icelandic banks, and in particular the deposit with Glitnir agreed in February 2008.

Procedures manual

15. There is a treasury management procedures manual in place. This contains operational guidance for staff. The manual is structured around the TMPs recommended by Cipfa in its Code of Practice. The Manual is entitled “Outline Treasury Management Manual”. The manual was originally produced by Finance in September 2002 on the advice of the Council’s then treasury management advisers, Butlers, who recommended that each authority needed such a document in order to comply with the new Code of Practice. The manual was based upon a framework produced by Butlers. The manual’s front page states that it was updated in September 2004. It does not appear that at any point the Manual was formally put before Members in Council, Cabinet, or Committee, although the manual itself does state that updated versions should be placed in the Members’ Lounge, and thus be available for examination.

16. The final section of the manual states that “the entire manual will be reviewed annually and updated as required”. The “review/update” section of the Manual states that the review will be conducted “in consultation with the Head of Accountancy and Audit and the Council’s treasury advisers”. There is, however, no evidence that the manual has been reviewed or updated since 2004. Whilst the practices described in the manual are largely still valid, the document is in need of updating as a number of changes have taken place since 2004, including:

- many of the post titles named have changed,
- the Finance Officer post, which deals with treasury management on a day-to-day basis on Mondays and Tuesdays, is not mentioned,
- the Council’s treasury management consultants have been changed, and
- fund management arrangements have altered.

17. Recommendations about the need to update the manual were made in the last two internal audit treasury management reports in 2007 and 2008, and were agreed by management. We understand that the Manual is now in the process of being updated by Finance. We would emphasise that this needs to be completed as a matter of priority. The Manual should thereafter be reviewed on an annual basis, and a copy placed in the Members’ Lounge for examination.

We recommend that the updating of the treasury management procedures manual is completed as a matter of priority, and that this is undertaken on an annual basis thereafter, with the updated document being placed in the Members’ Lounge for examination.

Treasury management policy

18. Both Government guidelines and Cipfa's Code of Practice stated that authorities should approve a Treasury Management Policy. At a meeting in March 2002, Cabinet adopted a Treasury Management Policy Statement, the wording of this being based upon that recommended in the Code. The Policy has not been presented to Members since 2002. In our 2005/2006 treasury management audit report we recommended that the Policy should be reviewed annually by officers, and updated as necessary, and submitted to Members for approval every five years, or earlier if changes had occurred. We were informed that Butlers had stated that re-submission to Members was only necessary when significant changes had taken place. This explanation was again given to us during the 2006/2007 audit, when it was also stated that no significant changes had taken place. We would recommend, however, that the Policy is now reviewed, and amended if necessary, and placed before Members for approval, whether or not amendments have been made.

We recommend that the Treasury Management Policy is reviewed, and amended if necessary, and placed before Members for approval, whether or not amendments have been made.

Code of Practice

19. At the meeting in March 2002, Cabinet also adopted the key recommendations of Cipfa's Code of Practice.

Treasury management strategy

20. In January each year the Council approves a treasury management strategy for the Authority for the forthcoming financial year. This is in line with Government guidelines and Cipfa's Code of Practice.

21. The Strategy includes guidelines about which institutions the Authority may place deposits with and for how long. Further details about this are given later in this report.

Treasury Management Practices (TMPs)

22. At its meeting in March 2002 Cabinet also adopted the TMP main principles as derived from Cipfa's Code of Practice.

Responsibilities for treasury management

23. The Council's Constitution states that the Cabinet member for Business Support and Finance has responsibility for "overseeing treasury management".

24. The Council's Financial Regulations state that: "The Treasurer shall arrange the borrowing and investments of the authority in such a

manner as to comply with the CIPFA Code of Practice on Treasury Management and the Council's treasury management policy statement and strategy. The Treasurer shall report twice yearly on treasury management activities to Cabinet".

25. More details about responsibilities are given in the Treasury Management Manual, as shown below, although it needs to be borne in mind that post titles have changed since the current version of the Manual was produced in 2004.

- Council delegates responsibility for the implementation and monitoring of treasury management policies and procedures to Cabinet
- Execution and administration of treasury management decisions are delegated to the Head of Accountancy and Audit
- The Head of Accountancy and Audit has delegated powers through the Treasury Management Policy Statement
- The Head of Accountancy and Audit may delegate treasury powers to members of staff.

26. The Manual specifies the duties of responsibilities of each of the posts then involved in the treasury management process. The posts named are as follows:

- Head of Accountancy and Audit
- Unit Accountant (Technical)
- Accountant (Technical)
- Senior Accounting Technician
- Unit Accountant (Housing)

27. The duties assigned to the above officers, as stated in the Manual, include:

- Ensuring that the Treasury Management manual is regularly reviewed
- Monitoring adherence to approved policy by the Treasury Management team
- Ensuring that all staff are properly trained to carry out the required duties
- Ensuring that day-to-day activities adhere to agreed policies and practices
- Ensuring compliance with policies, limitations and directions
- Adherence to agreed policies and practices on a day-to-day basis

28. The Authority's statutory financial officer, under the terms of Section 151 of the Local Government Act 1972, was/is as follows:

- To 2003: Director of Corporate Services
- 2003 to 2006: Head of Accountancy and Audit
- 2006 to 2008: Treasurer
- 2008 to date : Head of Finance

29. It is essential that roles and lines of communication and responsibility of all staff involved in the treasury management process at whatever level are clearly defined. These should be included in the updated Procedures Manual, and staff fully briefed on their roles and responsibilities.

We recommend that the roles and lines of communication and responsibility of all staff involved in the treasury management process at whatever level are clearly defined, and that these are included in the updated Procedures Manual, and that all staff are fully briefed on them.

30. When defining roles and responsibilities, as mentioned above, the opportunity should be taken to review the adequacy of supervision arrangements for treasury management staff.

We recommend that the adequacy of supervision arrangements for treasury management staff is reviewed.

31. Until April 2007 the Authority had used an external manager, Investec, to deposit funds on a longer-term basis on behalf of the Council. As at 31st March 2007, the value of the Investec portfolio was £10.9m. The October 2007 Annual Report on Treasury Management Activity to Cabinet stated that performance on these had been poor in 2006/2007. From April 2007 as deposits managed by Investec matured, they were gradually transferred from external management to internal management by SDC treasury management staff, with Sector providing advice. It should be pointed out, however, that prior to this the experience of these SDC staff had primarily been with regard to dealing with funds for short-term cash flow management purposes. We would now recommend that as part of the current general review of the Accountancy team's structure and staffing, the adequacy of the experience, training and qualifications of treasury management officers should be reviewed. It is important that such reviews are undertaken on a regular basis thereafter in order to ensure that knowledge and expertise is kept up to date. The aim should be to ensure that the Authority's officers have a sound, up-to-date awareness of treasury management issues, which can be used to supplement, and if necessary challenge from an informed viewpoint, advice offered by Sector.

We would recommend that as part of the general review of the Accountancy team's structure and staffing, the adequacy of the experience, training and qualifications of treasury management officers should be reviewed, and that thereafter

such reviews are undertaken on a regular basis in order to ensure that knowledge and expertise is kept up to date.

Transactions with Icelandic banks

32. At the time of audit SDC had two deposits with Glitnir, an Icelandic bank, as follows:

- £2m deposited on 4th January, 2008.
  - Due for repayment on 2nd January 2009.
  - Rate of interest 5.61%.
  - Interest due at end of term: £111, 892.

- £1m deposited as a result of a "forward" deal agreed on 26th February 2008, with money actually being transferred to Glitnir on 15th April 2008.
  - Due for repayment on 14th April 2009.
  - Rate of interest 6%.
  - Interest due at end of term £59,835.

Further details about these two deposits are given below.

33. These two deposits arose as a result of repayments to SDC by Investec, the Council's former external fund manager. As mentioned above, the Authority had previously used Investec to manage funds on its behalf, but had made a decision to revert to in-house management, thus requiring repayment of funds by Investec as they matured. These monies were eventually to have been utilised by the Council for capital or revenue purposes.

34. Serious concerns have recently been raised nationally about Icelandic banks' ability to repay deposits placed by local and police authorities. These followed Icelandic banking liquidity crises and part-nationalisation by the Icelandic government. The concerns apply to Glitnir, and to other Icelandic banks.

35. Very early concerns about the viability of Icelandic banks had been raised by Moody's credit ratings agency. On January 30th 2008 Moody's warned that they were reviewing for possible downgrade the credit ratings of Landsbanki and Glitnir, stating that the majority of their income was derived from investment banking, and that possible future difficult market conditions could bring additional volatility to earnings in 2008. At the time Glitnir's long-term rating was Aa3. On 28th February 2008 Moody's downgraded Glitnir to A2 from Aa3. Glitnir's short-term credit rating of P-1 remained unchanged. Explanations of these credit ratings are given below.

36. As mentioned above, on 4th January 2008 SDC placed a deposit of £2m with Glitnir for 364 days at 5.61% for the duration of the deposit.

At that date Base Rate was 5.5%, and the London Inter Bank Bid Rate (LIBID – the rate at which banks in the City of London are willing to borrow from each other) one year rate was 5.22%.

37. January credit ratings for Glitnir as notified to SDC by Sector were as follows:

	Fitch	Moody
Long-term	A	Aa3
Short term	F1	P-1

38. Definitions of the above-mentioned ratings are as follows:

Fitch

A High credit quality. Low credit risk. Capacity for payment of financial commitments strong. May be more vulnerable to economic and other changes than higher ratings.
(nb Fitch has two higher long term credit ratings: AAA and AA.)

F1 Highest credit quality. Strongest capacity for timely payment of financial commitments.
(nb F1 is the highest of Fitch's short term credit ratings).

Moody

Aa3 Aa has excellent credit quality, but rated lower than Aaa as susceptibility to longer term risks appears somewhat greater. Margins of protection may not be as great as with Aaa institutions. Fluctuations of protective elements may be of greater amplitude.
(nb. Moody's have one higher long term credit rating: Aaa.

A2 A has good credit quality. Elements may be present that suggest a susceptibility to impairment over the long term.
(nb. Moody's have two higher long term credit ratings: Aaa and Aa).

(Each of Moody's categories, Aaa, Aa, and A, has three modifiers 1, 2, and 3, with 1 being the highest and 3 the lowest end of the letter rated category).

P-1 Superior credit quality. Very strong capacity for timely repayment of short term deposits.
(nb. P-1 is the highest of Moody's short term credit ratings).

39. At 364 days the deposit with Glitnir was at the very longest end of the short term spectrum, deposits of 365 days and above being classified

as long term, thus it would be prudent to take note of both long and short term ratings in this instance.

40. Also as mentioned above, on 26th February 2008 SDC agreed to a forward deal to deposit £1m with Glitnir bank on 15th April 2008 for 364 days. A rate of interest of 6% was agreed for the duration of the deposit. It may be noted that the Base Rate as at 26th February was 5.25%, and 5% on 15th April. The LIBID rate was 5.4% on 26th February and 5.67% on 15th April. At the time, therefore, it was considered that this would be a deal which would be beneficial to the Authority, locking in as it did to a high rate of interest for a relatively lengthy period of time.

41. Forward dealing is a named as an "approved technique" in the "Outline Treasury Management Manual" and is permitted for amounts up to £1m. The Manual allows forward dealing up to a maximum of 28 days. The deal described immediately above was struck on a date 50 days in advance of money being transferred, thus exceeding the time limit specified in the Manual. The Finance Officer who initiated the deal, the Senior Accounting Technician, the Accountant (Exchequer), and the then Head of Accountancy (now Head of Finance) all stated to Audit that at the time the deal was agreed they were not aware of the 28 day limit set out in the Manual. We would recommend that when the Manual is revised, all staff involved in the treasury management process, whether this be in an operational day-to-day role, or providing authorisation for deals, or dealing with strategic planning, should be fully briefed on the contents of the document, with an annual "refresher" taking place after the yearly review of the Manual.

    We recommend that when the Treasury Management Manual is revised, all staff involved in the treasury management process should be fully briefed on dealing rules contained in the document, with an annual "refresher" taking place after the yearly review of the Manual.

42. Forward dealing is an accepted method of treasury management dealing in local government. An analysis by audit of a random sample of 12 other authorities' treasury management practices showed that:

    - 1 authority permitted forward dealing up to 5 years
    - 1 permitted it up to 2 years
    - 2 permitted it up to 1 year
    - 4 permitted it up to 364 days
    - 2 permitted it up to 6 months
    - 1 permitted it up to 1 week (for periods in excess of this specific permission was needed from the Chief Accountant in consultation with the Section 151 officer)
    - 1 did not permit it except with the specific approval of the Section 151 officer and Head of Financial Services.

43. Although forward dealing is permitted by the Treasury Management Manual, in practice it has never been used before in SDC, according to the Senior Accounting Technician, who has been dealing with treasury management within the Authority for several years.

44. The £1m forward deal with Glitnir was initiated by the Finance Officer who is responsible for day-to-day treasury management on Mondays and Tuesdays. The deal had been offered to her by Sterling brokers on the morning of 26th February, and, as mentioned above, appeared to be a good rate of interest guaranteed for nearly a year. The Finance Officer informed us that she sought verbal approval to the deal from the then Treasurer around mid-day on the 26th and that the Treasurer agreed verbally that the deal could go ahead provided no regulations were contravened. The money transfer was to take place on 15th April 2008, as funds would be available then from repayments by Investec. A letter confirming the deal was sent to Glitnir's London office on 26th February. The letter was signed by the Treasurer, as authorised signatory for the Authority.

45. Following a meeting of SDC officers with Sector on 5th March 2008 at the Council's offices, at which concerns about Icelandic banks were raised by the Treasurer, it was decided to contact Sterling to see if the deal could be cancelled. Sterling agreed to contact Glitnir, but it appeared that whilst cancellation might be possible, the cost of doing so would be significant, although no specific sums were given at that time. In the light of this the Treasurer decided to let the deal run. Subsequent advice from Sector indicated that cancellation costs would have been at least the amount of interest, £60k, plus any other associated costs. The total could have been in the region of £100k. The sum of £1m was subsequently sent to Glitnir on 15th April, the CHAPS transfer being signed by the Treasurer as authorising the payment.

46. We understand that this issue regarding forward dealing rules was brought to the attention of the Head of Finance and the Accountant (Exchequer) in October 2008 by the Finance Officer.

47. As stated above the forward dealing limit of 28 days as specified in the Treasury Management Manual was exceeded by this transaction. The Manual does give a senior finance officer the authority to amend the document. At the time the Manual was updated in 2004 this officer was stated to be the Head of Accountancy and Audit. We can, however, find no written evidence to show that the Treasurer, or other officer, explicitly intended to amend the 28 day forward dealing limit for this, or any other deal.

48. As at the 26th February 2008, Glitnir's credit rating was as follows:

- Fitch

    - Long term A
    - Short term F1
- Moody
    - Long term A2
    - Short term P-1

49. According to SDC's own authorised limits, as laid out in matrix form in the annual treasury management strategy, a deposit of up to £5m could be placed with a specified institution with the above ratings for a maximum period of one year. In particular SDC's authorised list would allow a deposit of up to £5m to be placed with Glitnir for a maximum of one year. Thus the deal did comply with the Council's own limits. However, Sector's credit rating analysis sheets for January and February show Glitnir as category "Green" which means that Sector recommended deposits with the bank should be placed for no more than 3 months. Had SDC followed Sector's guidance in this respect then the January 2008 deposit of £2m, and the February/April 2008 forward deal of £1m, both with Glitnir, would have been repaid in April and July respectively, by which time concerns about Icelandic banks were becoming clearer and had already caused SDC not to renew existing deposits with them.

50. As has been shown immediately above, the failure to follow Sector's guidelines has created financial uncertainty for the Authority. In fact Sector did provide SDC with advice in March 2007 on how to improve the Authority's counterparty criteria by including other factors and aligning it more closely to Sector's own. It is not evident that the SDC criteria were amended in line with this advice. We understand that this would have been the responsibility of the then Head of Accountancy, who has since left the employ of the Council. There is no documentary evidence to show why Sector's advice was not acted on.

We recommend that the Authority's counterparty criteria be reviewed as a matter of priority, seeking advice from Sector, and taking this on board as appropriate.

51. As mentioned earlier, a meeting was held at SDC with Sector on 5th March 2008. The Treasurer raised the issue of concerns about Icelandic banks. At the time SDC had 10 deposits totalling £13.4m with three Icelandic banks. It was decided those deposits maturing in March 2008 would not be re-deposited with Icelandic banks. Subsequently £11.4m was repaid. The outstanding £2m is due for repayment on 2nd January 2009, having being deposited on 4th January 2008. This decision was to prove prescient in view of subsequent developments regarding Icelandic banks.

52. On 2nd April 2008 Sector notified SDC by email that Icelandic banks had been placed on "negative watch", but were still in Sector's "Green" category. "Negative watch" means that movement in a rating in a downward direction is a reasonable possibility. On 3rd April Sector confirmed this in a formal notification, which also advised that

authorities should “lend only short term cash with such institutions ie. a maximum of three months”.

53. As at 15th April 2008, the date SDC’s funds were actually transferred, Fitch still rated Glitnir as A. On 13th May Sector notified SDC that Fitch had downgraded its long term rating for Glitnir from A to A- with a “negative outlook”, meaning that downgrading might be likely. On the same day Sector changed its colour category for Glitnir to “no colour”, which means that lending to the institution was not recommended.

Risk identification and management

54. The Council’s Treasury Management Policy Statement which was approved by Cabinet in March 2002, and by full Council in April 2002, emphasises the importance of the management of risk in the treasury management process. One aspect of the definition of treasury management is stated as “the effective management of the risks associated with those activities, and the pursuit of optimum performance consistent with those risks”. The Policy goes on to state: ”The Council regards the successful identification, monitoring and management of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of treasury management activities will focus on their risk implications for the organisation. The Council acknowledges that treasury management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving best value in treasury management, and to employing suitable performance measurement techniques, within the context of effective risk management”.

55. During our 2006/2007 audit we discussed the issue of risk relating to treasury management with the then Head of Accountancy. We were informed that this risk would not appear in the Authority’s corporate Risk Register, as only risks scoring a sufficiently high score according to the Council’s risk rating methodology would be included therein. Risks appearing in the Register would have high likelihood of occurrence, and high impact on the Authority if they did occur. Treasury management activities were considered to have high impact but low likelihood. There was no documentary trail which led to this conclusion, although we were given to understand at the time that it was reached by the then Head of Accountancy who had discussed finance risks with the risk consultant employed by the Authority when the Register was being drawn up.

We recommend that consideration is given to re-evaluating the risk arising from treasury management activities, and to whether this now merits inclusion in the corporate Risk Register.

56. Cipfa’s TMP1 concerns risk management. The individual risk areas specified in Cipfa’s framework document are listed below:

- Liquidity risk management
- Interest rate risk management
- Exchange rate risk management
- Inflation risk management
- Credit and counterparty risk management
- Refinancing risk management
- Legal and regulatory risk management
- Fraud, error and corruption, and contingency management
- Market risk management

Each of these is addressed in adequate detail in the Treasury Management Manual, showing how each will be put into effect. It should be pointed out, however, that the controls over forward dealing are detailed in this section of the Manual. These limit periods to a maximum of 28 days, and sums deposited to a maximum of £1m. As shown above the 28 day limit was exceeded by the £1m loan to Glitnir agreed in February 2008.

57. Counterparty risk is also addressed in the Manual. In practice these risks are mitigated by specifying, in matrix form in the annual Treasury Management Strategy document, the criteria for judging which institutions the Authority will deposit with. The matrix specifies how much may be deposited, and for how long, to institutions having a specific credit rating as allocated by Moody's, Fitch, and Standard and Poor. The Strategy document further refines this matrix by naming specific institutions and how much may be deposited with them and for what length of time. As mentioned above, Sector provided SDC with advice in March 2007 on how to improve the counterparty matrix by including other factors and aligning it more closely to Sector's own matrix.

58. The Manual also states that "In respect of every decision made Stroud District Council will above all be clear about the nature and extent of the risks to which the organisation may become exposed" and "ensure that third parties are judged satisfactory in the context of the organisation's creditworthiness policies, and that limits have not been exceeded".

59. Operational risks within Financial Services, as with all other SDC services, are addressed in annual service plans. There were no specific risks relating to treasury management included in the 2007/2008 or 2008/2009 Finance service plans.

Member notification of risks

60. Members may be notified of risks in a number of ways. These include the following, but as shown above risks associated with treasury management may not be identified:

- Individual Service Plans. As mentioned above no treasury management risks are included in Finance Service plans
- Risk Management annual report, presented to Cabinet. The latest report was considered by Cabinet on 10th July 2008. This report identified high priority risks facing the Council at the time, but no risks involving treasury management were included.
- Risk ratings in Internal Audit plans considered by Scrutiny. As shown above treasury management is categorised as "medium risk".

61. The Council adopted a Risk Management Policy Statement and Strategy in 2004. This was reviewed and updated in November 2006. This document sets out the corporate objectives of risk management, and methods to achieve these. One of the methods identified is "adopting national risk management strategies where appropriate eg ….Cipfa treasury management guidelines."

62. The annual Prudential Indicators and Treasury Management Strategy Report contains much more specific references to treasury management risks. The latest of these reports was considered by the Council on 24th January 2008. This report initially shows Prudential Indicators which the Authority is required to approve. Essentially these are about affordability. The report states that these Indicators are "to contain the activity of the treasury function within certain limits, thereby managing risk". The report goes on to state that "a key requirement of the Annual Strategy Report is to explain both the risks and the management of these risks". As regards Borrowing and Debt Strategy the report states that "Uncertainty over future interest rates has increased the risks associated with the treasury activity. As a result the Council will take a cautious approach to its treasury strategy". There is no mention of possible risks regarding the ability of borrowers to repay debts to the Council, although as regards Icelandic banks this is not unreasonable given that no substantiated concerns had been widely aired at the time. The report goes on to state that priority is given to security and liquidity before yield, and that the Strategy will define:

    - Maximum periods for which funds can be committed
    - Specified Investments the Council will use, these being high security/high liquidity investments
    - The greater risk implications of Non-Specified Investments
    - Limits to the overall categories which can be held at any time.

63. As far as Specified Investments are concerned the report states that these are "low risk assets, where the possibility of loss of principal or investment income is negligible". Specified Investments are short term, being of less than 365 days duration. The Council's deposits with Glitnir fall into the Specified classification.

64. The latest Annual Report on Treasury Management Activity and Actual Prudential Indicators was considered by Cabinet on 2nd October 2008, and Council on 6th November, and related to the financial year 2007/2008. The report stated that "Investment decisions for internally and externally managed funds are concerned primarily with minimising the risk of capital loss, the key factor being the creditworthiness of the counterparties. The transactions entered into were in accordance with the counterparty constraints and limits set by the Council for the specific investment type."

Role of Scrutiny in monitoring the performance of treasury management functions

65. The Treasury Management Manual states that "The Authority will review its performance against the benchmarks shown below, primarily the 7-day rate. In order to attain the optimum return rates from brokers and direct counterparties are received before dealing, to assess the competitiveness of the rates". The Manual goes on to specify: "The performance of investment earnings will be measured against the following benchmarks:-

a. In-house investments:

- 7 day LIBID rate, uncompounded
- Average base rate

b. Cash fund manager:

- 7 day LIBID rate, compounded
- Average base rate"

66. Actual interest rates achieved compared to the above-mentioned benchmarks in respect of 2007/2008 were given in the Annual Report on Treasury Management Activity as presented to Cabinet on 2nd October 2008. Our 2006/2007 audit report recommended such use of Performance Indicators.

67. Audit review of both Scrutiny committees' papers for the last two years showed that the only involvement of Scrutiny in the treasury management process was on 23rd October 2008, when the Performance and Audit Overview and Scrutiny Committee (PAOSC) was asked to note the Annual Treasury Management Activity report which was presented to Cabinet on 2nd October 2008. Our review showed that annual treasury management activity reports had not been presented to Scrutiny in previous years.

68. We would suggest that review of the annual activity report is part of Scrutiny's monitoring role. As such we would recommend that in future this report, as a matter of course, is initially sent to Cabinet, but then to PAOSC.

We recommend that the annual Treasury Management Activity report is sent to PAOSC, after being considered by Cabinet.

69. The Prudential Indicators and Treasury Management Strategy report is presented annually to Council. Scrutiny members would have the opportunity to consider and discuss the report at Council.

CONCLUSION

70. A number of key control issues have been identified in this report. Some are of a general operational nature, and some have been raised as a result of the 2008 loans to Glitnir. These issues are listed below; remedial recommendations are listed in Appendix 1.

As regards the deposits with Glitnir:

- The two deposits made early in 2008 of £2m and £1m were both placed for 364 days. Whilst these complied with SDC's own internal restrictions, the length of the deposits were not in line with Sector's guidelines which recommended a maximum period of three months for deposits with Glitnir. In view of this it is important that the Authority's investment counterparty criteria are reviewed as soon as possible, seeking advice from Sector, and taking this on board if appropriate.

- The deposit with Glitnir agreed in February 2008 exceeded the Authority's own forward dealing time limits.

As regards operational and procedural issues:

- The updating of the Treasury Management Procedures Manual needs to be completed as a matter of priority.

- Consideration needs to be given to re-evaluating the risk arising from treasury management activities, and to whether this now merits inclusion in the corporate Risk Register.

- Management arrangements for treasury management staff should be reviewed, including the adequacy of experience, expertise, and qualifications of staff, supervision arrangements, and roles and lines of communication and responsibility.

71. Finally, it is important to set the issues affecting Stroud into the context of a global financial crisis, which affected many British organisations with deposits in Icelandic banks. It should also be emphasised that the decision taken by the Authority in March 2008 to withdraw from investments with Icelandic institutions was

particularly prescient, and meant that the Council did not suffer further financial uncertainty.

APPENDIX 1

SUMMARY OF RECOMMENDATIONS AND AGREED ACTION

The recommendations contained in this report are:

	Recommendation	**Management Response**	**Grade and Agreed Implementation date**
1	The Treasury Management Manual: o should be updated as a matter of priority, o should be updated thereafter on an annual basis thereafter, with the updated document being placed in the Members' Lounge for examination. o Should clearly define the roles and lines of communication and responsibility of all staff involved in the treasury management process at whatever level, and all staff are fully briefed on them. o should be given to all staff involved in the treasury management process, and they should be fully briefed on dealing rules contained in the document, with an annual "refresher" taking place after the yearly review of the Manual.	Agreed. The TM Manual was in the process of being updated prior to the events leading up to the collapse if the Icelandic Banks. It will be completed for the Council meeting in January 2009 and reviewed annually thereafter. The structure of the Accountancy Team is currently being reviewed and some of the roles and responsibilities around Treasury Management may change. The manual will be updated accordingly. In the meantime, the Treasury Management team meet regularly to discuss what course of action to take when large sums become available for investing.	**Grade A** **Currently in progress and will be completed by January 2009**
2	The Authority's counterparty criteria should be reviewed as a	Agreed, however, it should be noted that the Counterparty list and matrix	**Grade A** **Sector's approach**

	matter of priority, seeking advice from Sector, and taking this on board as appropriate.	being used at the time the Icelandic deposits were made were based on advice from the Council's previous treasury advisers, Butlers, an equally reputable company. This has been used for many years by the Council and has not presented any problems in the past. Sectors advice places further restrictions on the length of time deposits can be placed with certain institutions which will impact on the rate of return that can be achieved for longer term deposits. It is recognised, that in the current climate, Sector's advice should be followed. The counterparty list will be presented to Council in January as part of the Annual Treasury Management Strategy. It will have been thoroughly reviewed and constructed following advice from Sector and will include support ratings as well as credit ratings.	**has been adopted immediately and Treasury Management activity has been significantly restricted at the present time. The revised counterparty list will be reported to Council in January 2009**
3	As part of the general review of the Accountancy team's structure and staffing: o the adequacy of the experience, training and qualifications of treasury management officers should be reviewed, and thereafter such reviews should be undertaken on a regular basis in order to ensure that knowledge and	Agreed As mentioned above, the structure of the Accountancy Team is currently being reviewed and some of the roles and responsibilities around Treasury Management may change. Bringing the externally managed funds back in-house has changed the emphasis of what is required of the Treasury Management team. Previously, mainly shorter term investments were all	**Grade A Review is in progress. Will be completed in January 2009**

	expertise is kept up to date. o the adequacy of supervision arrangements for treasury management staff should be reviewed. o Lines of communication and responsibility for all staff involved in the treasury management process should be very clearly defined and included in the Treasury Management Manual.	the team dealt with. Managing longer term investments requires different skills and knowledge of the markets and of the instruments that are available. Training needs will be assessed and appropriate training will be provided to all staff involved in the process. Regular Treasury Management briefings now take place with all staff in the TM team to discuss the current market situation and make decisions about who to place deposits with and for how long.	
4	The Treasury Management Policy should be reviewed, and amended if necessary, and placed before Members for approval, whether or not amendments have been made.	Agreed. Will be included in the report to Council in January 2009.	**Grade B** **January 2009**
5	The annual Treasury Management Activity report should be sent to PAOSC as a matter of course after being considered by Cabinet.	Agreed. Head of Finance will discuss with Democratic Services to ensure all TM reports are considered by PAOSC as a matter of course	**Grade B** **December 2008**

Key to Grading of Recommendations
Grade A – A significant control issue, or breach of the Council's Standing Orders or Financial Regulations. Immediate implementation is required.
Grade B – Other control issue, breach of the Council's agreed policies or procedures, or suggestions for improving economy, efficiency or effectiveness. Implementation required within a timescale to be agreed with management.