PRICEWATERHOUSECOOPERS

Kent County Council

Review of Treasury management procedures

December 15th 2008

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1. Introduction

As governed by the terms of our engagement letter dated 12 November 2008, we have performed a review of Kent County Council's (KCC's) compliance with defined treasury management policies, the adequacy of those policies, and of the general health of the Council's treasury management framework as of October 2008, following the collapse of a number of Icelandic Banks which held deposits from KCC.

During early October 2008, at the time of the collapse of the Icelandic Banks, KCC had £50.m deposited with the Icelandic institutions.

By way of context, at the 15th of October 2008, KCC had £472m on deposit with 34 counterparties including 3 Icelandic Banks. At the most recent formal Balance Sheet date of 31st March 2008, the Pension Fund had £2.2bn in assets and KCC £3.0bn. In comparison with that total asset base of the two entities, ie £5.2bn, the £472m is 7.7% and the £50m is 0.96%.

Kent County Council's investment strategy

Kent County Council has a combined revenue and capital budget of over £2.5 billion. The Council also administers the Kent County Council Pension Fund of £2.2 billion. KCC receives income from many sources but the largest income streams are government revenue support grants, council tax income received by the District Councils and non-domestic rates; these sums are often received in advance of the days on which expenditure is incurred and it is this money which is put on deposit. Nearly all of the funds deposited represent working capital - money held for short periods before payments are made to staff or suppliers. Due to the size of the total budget these sums can at times be very large. By forecasting its cash flow needs throughout the year, KCC is able to take longer-term positions on some of its deposits.

As a deliberate investment decision of the pension fund, with equity markets struggling across the globe, the pension fund holds cash rather than allocating cash to external investment managers for investment in equities.
Through a number of statutes and professional codes, the government sets the high-level guidelines for how cash can be invested. This guidance includes the Local Government Act 2003 (and its Investment Guidance), the Statutory Instrument 3146 2003, the CIPFA Prudential Code for Capital Finance in Local Authorities and the CIPFA Code of Practice for Treasury Management in the Public Services. KCC has a risk-averse strategy of using only cash deposits, for periods from a few days to five years, with highly rated counterparties. Although the high-level treasury strategy allows for deposits in equities or property, no such investments have been made. KCC policy is to use a diverse range of counterparties, all of which should be highly rated by the rating agencies. The income received on these deposits is used directly to reduce the net expenditure of the Council and reduce council taxes. Historically, the process has managed billions of pounds of deposits and £2.6 billion alone in the last 12 months.

Kent County Council's treasury operations

Kent County Council's treasury function is undertaken within the Investment and Treasury Team of circa. 5 people. The Treasury accountant has been in post 6 years and reports to the Group Accountant (Investments & Treasury) who is line managed by the Head of Financial Service. The treasury team is responsible for the management of credit risk as well as the daily cash management which includes looking after the investment and funding needs of the Council. Over the last 2 years, KCC has made more than 400 individual investments in money markets and almost 200 deposits of less than £1m in call accounts. The current operations at KCC comprise a manual process and require the use of an Access database, various Excel workbooks and a paper deal diary, with most authorisations and review on paper.

In any organisation, the investment process normally includes decisions around the type of investment to be held (e.g. certificates of deposit, cash, equities), suitable counterparties, return on investment and the best period for the investment. This investment process is inherently risky and requires specialist skills, particularly if the volume is significant.

In that context KCC contracted with Butlers for the provision of "Treasury Consultancy Services" in 2006. In terms of the signed contract with Butlers dated 17th May 2006, the services to be supplied to KCC by Butlers include, but are not restricted to, the following:

- In respect of Treasury Management Policy and Strategy *"Butlers will assist with the annual treasury management strategy report and stewardship statement together with any changes in the Treasury Policy document."*
- In respect of Investment Policy and the Period of Investment *"In conjunction with our interest rate forecasts we will provide advice on the period of investment."*
- In respect of counterparties *"Where funds are invested externally, advice will incorporate an initial assessment and constant review of the credit rating of counterparties selected by the Council. Monthly summaries of credit ratings will be supplied. Advice will also be provided immediately of any changes to these ratings."*
- In respect of Investment Strategy *"Regular strategy review meetings will be held each year."*

The current economic climate

The recent and current catastrophe in the global economy has given rise to a number of significant challenges to Treasury Departments. With well known financial institutions such as Lehman Brothers in bankruptcy and other well known institutions nationalised (Northern Rock, Bradford & Bingley, etc.), safe investment options have diminished in recent months. Local governments have always needed to balance a fiduciary duty to protect earmarked tax and grant revenue with an opposing objective to achieve fair investment returns.

News reports as early as February 2008 suggested that well known financial institutions, for example HBOS and RBS, were looking towards alternative measures to raise further capital to strengthen their balance sheets. A number of UK banks and building societies experienced significant losses as a direct result of the sub prime crisis.

The Icelandic rescue followed similar actions in the US and the UK, whereby a number of long-standing and well-known financial institutions have been either saved by expensive government rescue packages, bought out by other financial institutions, or simply allowed to collapse, such as in the case of Lehman Brothers. This chain of events has led to widespread fear about the state of even the most blue-chip institutions in the banking and financial sectors. The Icelandic banks were no different from the UK banks in these respects and reports as early as March 2008 indicated that they were also struggling. In October 2008 the Icelandic government was forced to nationalise its third largest bank, Glitnir, in a €600m rescue, without which Glitnir would have collapsed. Before the credit crunch, Icelandic financial institutions were known for providing good returns to investors and were largely viewed by the market as safe investment options due to the nation's stable economy and its banks' foreign investments diversified loan portfolios.

The developments in the global financial sector in September and October 2008 are highly unusual and various institutions in the private and public sector were caught unprepared to deal with the after effects of the events. Credit risk, or the risk that your counterparty will default, was always considered as low because it is either unlikely to occur or not to have a significant impact on an institution. Hindsight has shown that in today's global economic climate, credit risk should now always be considered high risk and therefore requires additional focus.

In order to safeguard local governments' assets from loss on a grand scale, it is imperative that councils such as KCC maintain robust internal controls over their management of the Treasury function. The circumstances also suggest a greater need for predictive and trend information and a need to act with greater agility and speed as market conditions change. The recent events have highlighted the need to reassess the risks the Council is exposed to as well as reconsidering the way these risks are managed.

2. Scope of work performed

Following the reports by the UK media of British Councils' trapped investments and deposits in Icelandic financial institutions, we have been engaged by KCC to review the compliance of the Council's investment transactions initiated since 1 October 2006, and all investments that were entered into before then that are still outstanding, with the Treasury Manual.

We have also been asked to determine what the sequence of events was that led to the appointment of Butlers as a Treasury Consultant and understand if KCC acted on the information received from Butlers.

We have also prepared an analysis of our observations and recommendations with respect to the Council's current Treasury management framework and controls in place relevant to the framework needed going forward

3. Summary of our findings

Our work included looking at 423 deposits in money markets and 190 call deposits mainly entered into since 1 October 2006.

At the time of the collapse of the Icelandic Banks, KCC had £50.m deposited with the Icelandic institutions.

Counterparty	Amount	No of Deals
Heritable Bank	£ 18,350,000	6
Landsbanki Islands	£ 17,000,000	4
Glitnir	£ 15,000,000	3
	£ 50,350,000	

It is worth noting that many Public and Private Sector organisations were in the same situation. KCC was by no means alone. We understand that KCC is currently evaluating various options in an attempt to recover the money it had deposited in Icelandic Financial institutions.

Of this £50m, £3m had been deposited after receiving advice from Butlers that the respective counterparty be removed from the counterparty lists. A human error resulted in an email containing the information not being read and processed in time. The email was received at 3pm on 30 September suggesting that Heritable Bank be removed from the counterparty list. It was not actioned until after a deal with Heritable Bank was executed. The remaining £47m had been deposited or contracted earlier, when the respective counterparties were on the KCC counterparties list and were in accordance with the advice KCC received from Butlers.

Updating of approved counterparties and counterparty limits

We found that the Council generally considered the information received from Butlers in a timely manner, although we noted several emails received from Butlers with warnings about specific banks, for which the Council's approved counterparties and limits were not updated for some time. We understand from management that counterparty lists are reviewed as part of regular meetings with Butlers and notes of the matters discussed are produced. We understand from the notes we have seen and from discussions with the KCC personnel involved, that these meetings did not identify any of the counterparties that should not have been on the counterparty list.

We have noted that a small number of deposits in Building Societies were made after Butlers suggested that these counterparties be removed from the list. We understand there is currently £12m still outstanding with these Building Societies. (Cheshire and Derbyshire). The Cheshire Building Society is expected to complete a merger with Nationwide on 15th December 2008. The Derbyshire Building Society has already completed a merger with Nationwide.

KCC held a regular meeting with Butlers on 29 September 2008 where the agenda included credit ratings as an item. An individual at KCC received an e-mail on 30 September at 3pm to inform him of the downgrade of Heritable Bank. A £3m deposit in Heritable Bank, made on 1 October 2008, may have been avoided if they had been removed from the counterparty list as suggested by Butlers on 30 September 2008.

We recommend that counterparty information is sent to a number of people in the treasury function to ensure timely updating and review of counterparty lists. We would also recommend that a regular review of the counterparty list occurs internally as the responsibility for maintaining the counterparty listing remains with management. We further recommend that the review of the counterparty lists in the regular update meetings with Butlers be more fully documented in the notes with the lists attached to the notes with evidence of Butlers' review and agreement.

Adherence to authorised counterparty limits

We identified one investment where the counterparty limit as per the counterparty list was breached by £5m for a period of 4 days while KCC was expecting the maturity of a deposit. We understand from Management that the decision to breach the limit in this isolated case was discussed and approved although there is no written evidence or documentation of that approval.

We recommend that counterparty limits are adhered to at all times and where decisions are made to breach limits for a period, authorisation of this is filed.

Review of treasury transactions

A finding from our review relates to a lack of evidence of senior Treasury team members' review of transactions but it should be noted that the operation and documentation of this control would not have directly prevented the money being deposited with the Icelandic Banks. The Council's Treasury Management Manual requires senior authorisation for the requests for payment release of all investment transactions with maturity periods in excess of six months. For approximately half of these investments, we found that if this review took place, it was not documented and evidenced. We understand from management that an informal review occurs for all investments over 365 days before investments are placed.

The Manual also requires for the review and sign-off of the daily transaction reports onto which all investments are to be logged. We noted that there is consistently no evidence of this review of these reports throughout 2006, 2007 and 2008.

Although this review would not have directly prevented any of the shortcomings noted, it may have resulted in additional discussion around some of the deposits. We recommend that the policies and procedures regarding review and evidence of sign-off are updated to reflect the current needs, and implemented.

Internal audit review of treasury function

The Internal Audit report issued in September 2006 included several recommendations to improve the Council's Treasury management process. A follow up review was performed by Internal Audit in 2008 to determine whether the Council had implemented the recommendations raised in 2006.

We noted that the Internal Audit's follow up report has not yet been finalised. A number of the recommendations made in 2006 are still not implemented by management and management comments on the 2008 points are still outstanding.

We recommend that all of the recommendations of the original Internal Audit review are implemented. Consideration should be given to including the Treasury function on the Internal Audit Plan at regular intervals.

Maintenance of documentation

Generally, we found improvements in the maintenance of investment documentation and evidence of review of investment documentation since 2006, particularly with respect to money market deposits. We found some cases where insufficient information exists to support deposits, counterparty lists and evidence of review.

We recommend that all supporting information is maintained for deposits made.

Appointment of Butlers

In 2006, KCC in coordination with other district councils decided to procure for a framework contract for Investment and Debt management advice. The tender process was done through the Official Journal of the European Union although strictly speaking it needn't have been owing to the relatively low cost.

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KCC appointed Butlers for Treasury consultancy services. The cost of the annual contract was not significant and therefore the contract was negotiated by Finance. The Council followed its bidding and tender procedures with respect to obtaining adequate bids, tenders and quotes. KCC attended evaluation meetings with other district councils. A paper setting out the basis of the decision was produced by Finance at the time but was not filed with the other documents retained by procurement.

Going forward, we recommend that KCC performs a risk assessment of services required and that where high risk services are involved the key evidence is retained, for the purposes of evidence and scrutiny, within the procurement function to support the selection process, irrespective of the cost of the service.

4. Recommendations to improve the current control environment

Investment strategy and KPI's

KCC's investment strategy mainly focuses on diversification and limiting investments to a selection of instruments. We have noted in the Medium Term Plan for 2008/9 that management will 'favour quality counterparties when placing funds, even if this involve yield sacrifice'. In addition we noted 'treasury management activity will provide for £9 million of interest earned, which supports the overall revenue budget.'

There is a requirement that KCC has a budget for all facets of its operations, including Treasury. Whilst the use of such budgets or targets could give rise to a situation whereby return on investment is seen as more important than risk management, there are procedures in place to mitigate against that situation arising, for example, return on investment not being considered in the performance evaluation of key personnel and the involvement of the Treasury Policy Group.,

We note the requirement to have budgets in this area.

We recommend that the Treasury Policy Group consider the overall adequacy of the safeguards in place that ensure that the balance of the focus of investments between return and risk management is appropriate.

We also noted that in line with the CIPFA Code (as per the Medium Term Plan), KCC measures the performance of their treasury activities by benchmarking interest rates received against the 7 day London Inter-Bank Bid (LIBID) rate as well as CIPFA benchmarking which benchmark 90 local authorities to each other. This type of benchmarking as a tool to measure performance is more common in a treasury function where the objective is to maximise return.

Financial performance is monitored and reported on a regular basis through budget monitoring as well as the quarterly activity report to the Treasury Policy Group. We understand that the efficiency of operations is not monitored or measured. This would normally include the monitoring of breaches, errors within the process etc.

We recommend that the Council develop a set of financial and non-financial key performance indicators that reflect the objectives of the treasury function. These KPIs should focus on the areas of identification, monitoring and management of risk.

Policies and procedures

The Treasury Management Manual currently acts as both the policy document and procedure manual for the Treasury function.

The procedure manual does not currently include the end to end process for transactions and consequently operations rely heavily on the knowledge of key employees.

We recommend that in the light of recent events the Manual is reviewed and updated as and when processes change, in line with the documentation standards applicable to all processes. We also recommend that the policy is improved to provide more detail on the end to end process and the management of credit risk.

In determining a suitable policy we recommend that KCC considers using other information for example credit default swap rates in addition to credit ratings to monitor the suitability of the counterparties. We also recommend that KCC consider how different banks within the same group should be treated during the management of credit risk.

We further recommend the use of predictive and trend information, like outlook reports, to provide any indications of potential issues with counterparties.

Automating the treasury process

As mentioned above, the current treasury process is quite manual and relies on a number of databases, spreadsheets and workbooks. A manual process and excessive use of spreadsheets increases the risk of error during operations.

We recommend that KCC considers the implementation of a treasury management system (TMS) to assist them with cash management and the daily treasury operations. A treasury system would not only make the process more efficient but will also improve the controls in the treasury area.

Process improvements

There are a number of areas in the current process where improvements can be made to improve the overall efficiency but also strengthening the current control environment. These improvements include timely follow up of counterparty confirmations, more frequent bank reconciliations and improved cashflow forecasting.

We have noted that payment details are currently held in Excel and manually entered into the banking system. There is a chance that human error or fraud could result in payments going astray. In our experience, bank systems offer a secure environment in which to store sensitive master data such as bank details. Bank details can be saved as templates with controls to prevent unauthorised amendment.

We recommend that Treasury review the storage of bank details in an Excel format and consider using templates which restrict the amendment of details.

Monitoring and review of treasury activities

The Treasury Policy Group (TPG) is a very useful forum which meets quarterly to discuss treasury issues, potential instruments, treasury strategy, debt monitoring, and quarterly activity reports.

We recommend that the TPG meet monthly, given the volatility in the markets. We also recommend that KCC develop a monthly Treasury activity reporting pack for circulation to senior management and discussion at the TPG.

We also recommend a Management Review of treasury operational activities on a regular basis.

Skills within the treasury team

Although KCC rely upon Butlers for expert Treasury input, the treasury employees have a good knowledge regarding the operations of KCC treasury and appeared to have an understanding of the risks that KCC faced and KCC's role in managing them. However, currently, no person in the treasury department has any specialist treasury qualifications.

We recommend that the Council review the training needs of the department and consider sending staff on appropriate courses to

broaden their approach to risk management and increase their knowledge of treasury.

The use of treasury advisors

KCC is responsible for the management of the funds within the council as well as the KCC pension scheme and the Kent Police Authority. KCC uses treasury consultants to advise and provide them with information to assist them in the management of the investment portfolio. Butlers have been used in recent years as Treasury Consultants.

We recommend that in light of recent events, KCC performs a needs based assessment to consider what quantitative and qualitative information they will require to maintain the investment management internally. We also recommend that KCC performs a cost/benefit analysis to determine if it would be efficient to outsource part or all of the fund management to an external service provider.

5. Management's comments

The current global economic conditions are unprecedented and the report explains the volatile nature of a whole range of financial institutions over the last months. Speculation has been rife and in this period of uncertainty reliance was placed upon recommended best practice - that is to diversify risk across approximately 30 organisations meeting a high ratings level in terms of security.

Like most other councils, Kent County Council does not directly employ specialist treasury staff. This expertise is provided through a specialist treasury advice organisation called Butlers. This role is particularly vital when markets are in such turmoil. We are surprised and disappointed that despite meeting with senior managers on the 29th September, the advisers did not raise any concerns about the situation in Iceland and a subsequent email on 30th September notifying the council of the latest situation was sent to a junior member of staff. Nevertheless, with the exception of this last communication problem, this report shows that the Icelandic Banks were on the Council's Counterparty List when deposits were made or contracted with them and that the Counterparty List was in accordance with the external advice provided.

Kent County Council is already working closely with other councils across the country to share available knowledge. In addition, this report notes that recommended practice would include the use of specific market information which is not currently provided by Butlers. Overall, the Council is concluding that to ensure that the best information is available when decisions are taken, reliance cannot be placed externally. So, while the report suggests a consideration of additional outsourcing of the treasury function, instead a new specialist post will be created within the function to "insource" at least part of this analysis.

Looking ahead, "money in the bank" can no longer be deemed safe. The report notes that KCC already had a risk-averse strategy and did not engage in any "high risk" investments in equities and property. Had part of our deposits been exposed to these permitted areas, losses of up to 30% could reasonably have been expected over the last year.

Immediately following the situation in Iceland all new and maturing monies have been deposited in the Government's "Debt Management Office". While this is a low risk option, there is clearly an equally low rate of interest paid on deposits. Subject to Budget County Council it is likely that the Council will as a matter of strategy severely limit future deposits to a small number of highly rated institutions, with a commensurate reduction in expected interest. As a direct consequence each institution will see a higher level of our money deposited, in direct contradiction of the existing best practice recommendations. We anticipate that such a change in strategy will cost KCC up to £6-7M per year.

Another option may be for councils across the country to consider creating a “local government bank”. This option is now being actively pursued, as not only would it provide a safe option for deposits, it would equally provide much needed liquidity in the UK markets.

It is noted that there have been a small number of technical breaches identified during this review and these are to be regretted. Management action is already in place to deal with these issues.

The remaining detailed recommendations about process and procedure are welcomed, reflecting good practice.