Audit Commitee
Tuesday 22 June 2021
Item No: 5.4

Midlothian Council

Review of Treasury Management
Year ended 31 March 2021

June 2021

EY
Building a better working world

1. Executive Summary

Background

This report has been prepared as part of our response to our annual wider scope risk assessment process. External auditors in the public sector have a wider remit under the Code of Audit Practice, than those in the private sector, including aspects of governance and financial management.

All councils operate a treasury management service to ensure that cash flow is adequately planned. Midlothian Council ("the Council") secures borrowing to ensure that cash is available to meet spending commitments within the capital plan as they fall due. The management of the treasury function also allows the investment of temporary surplus funds balancing risk, liquidity and returns.

The strategy considered and endorsed by Audit Committee and approved by Council is that of cash backing its useable reserves, ensuring adequate security of the sums invested is critical as a loss of principal would result in a loss to the General Fund balance.

In December 2020, the Council received adverse media attention due to their fixed-term deposit of funds placed on 3 April 2020 with the London Borough of Croydon Council. On 11 November 2020, Croydon Council issued a statutory section 114 (3) notice in accordance with the Local Government Finance Act 1988. Under English regulations, this notice indicates that the expenditure of the authority incurred (including expenditure it proposes to incur) in a financial year is likely to exceed the resources (including sums borrowed) available to it to meet that expenditure.

Focus of our review

The increased attention and scrutiny of treasury management, along with specific concerns expressed by members of the Audit Committee, led to our consideration of treasury management as an area of increased focus as part of our wider scope audit procedures in 2020/21. This report summarises the finding of our review, which focuses on whether the Council's Treasury Management and Investment Strategy is in line with the principles of key guidance from CIPFA and whether the Council can demonstrate that strategies have been applied in practice. We also considered quality and completeness of treasury management reporting to management, Audit Committee and Council against the requirements established in guidance.

Summary of findings

Our review identified that:

- The Council's policies and procedures reflect the requirements within CIPFA's Treasury Management Code and Prudential Code. A planned update in 2020/21 should be subject to scrutiny by the Audit Committee;
- While it is more challenging to perform robust due diligence checks on local authorities, the Council has developed a draft checklist to provide an audit trail of the decision making process and checks performed;
- Annual, mid-year and outturn reports on Treasury Management are considered by the Council and the Audit Committee and cover the key requirements of the Codes; and
- Training for elected members has been provided but we noted that areas of challenge and scrutiny by audit committee members have not been as fully minuted as they could be.

2. Introduction

Background

The Council is required to operate a balanced budget, and in general the cash raised during the year will meet cash expenditure. Part of the Council's treasury management operation is to ensure that this cash flow is adequately planned, with cash being available when it is needed. Temporary surplus funds are invested in counterparties commensurate with the Council's risk appetite, as set out in the Treasury Management and Investment Strategy.

A key element of the treasury management service is the funding of the Council's capital plans. Capital planning provides projections of the longer term borrowing needs of the Council, to ensure that the Council can meet its capital spending obligations.

The contribution the treasury management function makes to the Council is critical, as the balance of debt and investment operations ensure liquidity and the ability to meet spending commitments as they fall due, either on day-to-day revenue or for larger capital projects. As the Council cash backs its general reserves, ensuring adequate security of the sums invested is critical as a loss of principal would, in effect, result in a loss to the General Fund balance.

Relevant Codes of Practice (the Codes)

Under statutory guidance, all local authorities in the Scotland are required to have regard to CIPFA's Treasury Management Code and Prudential Code when carrying out their duties. The Treasury Management Code provides a framework to:

- manage the Council's investments and cash flows;
- manage the risks associated with banking, money market and capital market transactions; and
- pursue optimum performance in a way that is consistent with those risks.

The Prudential Code sets out a framework that is intended to ensure that the linked capital investment plans of local authorities are affordable, prudent and sustainable.

Treasury Management and the application of the Prudential Code are areas of increased focus in local government across the UK as a result of controversy in relation to a misinterpretation of the existing rules. A small number of English councils have engaged in "debt for yield" activities, borrowing to fund purchases or commercial activities solely to make an investment return.

Consultation documents outline a number of key areas of potential change to the relevant Codes and as a result, key changes are likely to be made to the Council's policies and procedures in late 2021/early 2022.

In response to the recommendation of the UK Parliament's Public Accounts Committee and the substantial increase in commercial investment seen in some English authorities, CIPFA proposes to strengthen the provisions within both the existing Prudential and Treasury Management Codes. The closing date for responses to consultations was 12 April 2021 and current expectations are that the revised codes will be published towards the end of the calendar year for 2021/22 implementation.

Expected areas of change to the Codes

We expect that the revised Prudential Code will explicitly prohibit debt-for-yield investment unless incidental to the main function of borrowing, for example to support local regeneration. In addition, there are likely to be updated requirements to assess the affordability of commercial activity within local authority capital strategies and new prudential indicators on affordability - external debt charged to net service expenditure (NSE) ratio, and commercial income to net service expenditure.

Proposals in relation to Treasury Management include amendments to highlight the importance of all treasury management staff and elected members having the required skills and knowledge to be able to undertake their duties and responsibilities. This may include a comprehensive knowledge and skills schedule for both staff and elected members. There may also be guidance to recommend that decisions and strategies for more complex treasury management functions should be reviewed by a dedicated committee.

2. Areas of Focus

There is no implication that the Council has undertaken any controversial "debt for yield" activities.

The Council has not suffered any loss in respect of the deposit placed with the London Borough of Croydon Council.

Focus at Midlothian Council

In December 2020, Midlothian Council (the Council) received adverse media attention due to their fixed-term deposit of funds placed on 3 April 2020 with the London Borough of Croydon Council, which issued a statutory section 114 (3) on 11 November 2020.

Background to Section 114

Under the Local Government Finance Act 1988, which applies only to England and Wales, Section 114 (3) requires:

"The chief finance officer of a relevant authority shall make a report under this section if it appears to him that the expenditure of the authority incurred (including expenditure it proposes to incur) in a financial year is likely to exceed the resources (including sums borrowed) available to it to meet that expenditure."

When a Section 114(3) notice has been issued it means that no new expenditure is permitted for the Council, with the exception of that funding statutory services, including safeguarding vulnerable people, but that existing commitments and contracts will continue to be honoured.

Note that Section 114 does not apply to Scotland – instead the requirement to set a balanced budget is established in s108(2) of the Local Government (Scotland) Act 1973 and s93(3) of the Local Government Finance Act 1992.

The increased attention and scrutiny of treasury management and the application of the Prudential Code within local government, along with specific concerns expressed by members of the Audit Committee, has led to our consideration of treasury management as an area of increased focus as part of our wider scope audit procedures in 2020/21. We carried out an interim review to consider:

- Whether the Council's Treasury Management and Investment Strategy is in line with the principles of the Prudential and Treasury Management codes.
- Whether the Council can demonstrate that strategies have been applied in practice through the consideration of a sample of transactions in year. This will consider whether the appropriate due diligence was undertaken in advance of borrowing and investments decisions.
- The Council's process for appointing their current treasury management advisers and reviewing and considering the advice received.
- The quality and completeness of treasury management reporting to management, Audit Committee and Council.

The Council has adopted the treasury management practices outlined in the Treasury Management Code and an internal audit review provided substantial assurance that comprehensive policies and procedures are in place.

Recommendation 1: The Audit Committee should scrutinise the detailed Treasury Management Practices Statements, along with the revised Code expected later in 2021.

Compliance with the Codes

We have reviewed the Council's arrangements against the current Codes. The Treasury Management Code requires councils to have detailed treasury management practices statements which are considered best practice and should therefore only be amended to suit the Council's individual circumstances. The practices cover a number of areas including risk management, performance measurement, decision making and analysis and cash and cash flow management.

The Council has treasury management practices statements in place, which were updated and reviewed to reflect the most recent revision of the Treasury Management Code in 2017. The Council's internal auditors reviewed compliance with the Treasury Management Code and Practices in 2018. They reported that they were satisfied that the Treasury Management function had comprehensive policies and procedures in place and determined overall that the arrangements provided "substantial assurance."

The Code also states that the body responsible for scrutiny, such as an audit committee, will have responsibility for the scrutiny of treasury management policies and practices. However, while the practice statements were made available to elected members, they were not formally considered or scrutinised at committee level. We consider that the next revision of the practice statements, expected to be in late 2021 or early 2022, should be subject to review and consideration by the Council's Audit Committee.

The Council outlines its consideration of its borrowing and investment strategies within the annual Treasury Management and Investment Strategy. We consider the reporting requirements of the Code below.

The Prudential Code requires councils to demonstrate that capital investment proposals are affordable, prudent and sustainable. The Council has a substantial investment programme in place to respond to a quickly growing population. As a result, Exhibit 1 notes that the Council's borrowing requirement is expected to rise by £117 million in 2022/23.

Exhibit 1: The Council has committed to significant external borrowing over the next five years to fund its capital investment ambitions

Source: Midlothian Council Treasury Management and Investment Strategy 2021/22

The Council has historically managed to achieve one of the lowest weighted average borrowing rates when compared to other Scottish local authorities. The loans fund rate for the Council in 2020/21 is estimated to be 3.1%, against the 2019/20 weighted average across the sector of 3.7%.

The borrowing strategy sets out the prioritised borrowing methods the Council could use, as well as setting limits on certain types of borrowing and the debt maturity structure. The Council currently forecasts that the vast majority of borrowing will be secured via the Public Works Loans Board (PWLB). This is in line with the Council's strategy to secure long-term borrowing to fund capital investment, to take advantage of historically low long-term interest rates.

The Council participates in CIPFA's special interest group, the Treasury Management forum. The forum collates treasury management performance indicators for all Scottish local authorities. The indicators for 2019/20 highlight that the Council had the second lowest weighted average borrowing and investment (loans fund) rate across all Scottish mainland authorities in 2019/20. The Council estimated that the savings achieved by using the actual interest rate against the sector average in Scotland equated to around £2.2 million in 2019/20.

We found that the Council has adopted each of the prudential indicators, and has responded to our 2018/19 recommendation to provide additional treasury management training to support elected members to perform their scrutiny role. Link Asset Services and the Council's Treasury Management team provided a training session in November 2019, and more recent training was again provided by Link Asset Services in February 2021.

Due diligence arrangements

As part of our consideration of treasury management arrangements, we selected a sample of investment transactions secured during 2020/21 to assess whether the Council can demonstrate that strategies have been applied in practice. In assessing the transactions, we had regard to the relevant Treasury Management Practice Statements (refer to Exhibit 2).

Exhibit 2: Extracts from the Treasury Management Code

TM Practice 3 (TMP3): Decision Making and Analysis

This organisation will maintain full records of its treasury management decisions, and of the processes and practices applied in reaching those decisions, both for the purposes of learning from the past, and for demonstrating that reasonable steps were taken to ensure that all issues relevant to those decisions were taken into account at the time. The issues to be addressed and processes and practices to be pursued in reaching decisions are detailed in the schedule to this document.

TM Practice 4 (TMP4): Approved Instruments, Methods and Techniques

This organisation will undertake its treasury management activities by employing only those instruments, methods and techniques detailed in the schedule to this document, and within the limits and parameters defined in TMP1 Risk management.

Source: CIPFA Treasury Management Code, and adopted within Midlothian Council's Treasury Management Practices

We selected a sample of deposits to review, which included money market funds, and short-term deposits with other local authorities and a high street bank.

We had no findings as a result of our testing of deposits with money market funds/banks. However, common due diligence checks including credit reference and counterparty limits are rarely relevant for deposits with other local authorities.

Recommendation 2: The Council has developed a draft investment checklist to provide further evidence of due diligence checks performed. This should be completed to strengthen the audit trail in support of TMP 3.

The Council has established a draft investment checklist to ensure that a written record of due diligence consideration is maintained in future, in line with TMP 3. We note that while the checklists are complete and indicate the checks that had been performed for the deposits tested, the Council would acknowledge that the work to capture the information in the checklists format was completed retrospectively for the deposits placed in 2020.

In respect of the deposits tested with local authorities, we found evidence that checks performed included review of the most recently available financial statements and Treasury Management Strategies of proposed counterparties. In the case of the Council's deposit with the London Borough of Croydon, the Council's treasury management team sought further information from Link Asset Services to allow it to assess a number of potential counterparties that were active in the market at the time. Link provided information and assurance in relation to Croydon Council's Revolving Investment Fund and the purposes of borrowing through the inter authority market, which the Treasury Management team took into account as part of the overall due diligence work undertaken.

As a result of the decision making process and additional information provided over a period of 3 working days the Council elected to place a deposit with Croydon Council. We note that the yield offered increased over the decision making period. The final yield offered on 19 March 2020 of 1.85% (compared to 1.48% on Tuesday 17 March 2020) was a consequence of the inter-LA lending market improving, which was linked to the movement in the equivalent 2.5-3 year PWLB rates over this period.

We note above that there are no credit reference checks available in relation the majority of local authorities. We further note that the ability to complete due diligence procedures on local authorities is further impacted by the timeliness of publicly available financial information. For example, the NAO has recently reported that the delays in auditors delivering opinions in time for accounts publication deadlines in England fell from 57% in 2018-19 to 45% in 2019-20.

In addition, we understand through our discussion with council officers that typically deposit decisions are required to be made quickly or offered deposits may be withdrawn.

Nonetheless, the treasury management team has developed an updated draft investment checklist (Appendix B). The purpose of the checklist is to further strengthen the documentation of the due diligence checks carried out and to use information sourced to flag potential counterparties who are engaged with "debt for yield" activities or are otherwise considered to be higher risk in the local government context. The draft checklist would provide additional evidence of compliance with TMP 3.

We have reviewed the draft checklist and provided comments to management. These include reference to the importance of the auditors judgements and recommendations in relation to value for money within the NAO's Code of Audit Practice for English local authorities. This would include reporting of significant weaknesses in arrangements as part of the Annual Audit Letter that are not reflected within the audit opinion.

Appointment of Treasury Management advisors

Like many other councils in Scotland, the Council uses Link Asset Services as treasury management advisors. During the review of treasury management arrangements in 2018, the Council's internal auditors noted that following the expiry of the advisory contract in 2015, the service was not competitively tendered. A 'Non-Competitive Action form' was completed retrospectively in response to the internal audit report. During discussions with the finance team, we note that there are only two advisors within the Scottish market and the contract remains at a relatively low value.

Recommendation 3: The Council should amend the draft checklist to clarify that the accountability for decision making continues to rest with Council officers.

We note that the contract with Link includes the provision of information on counterparty creditworthiness. The services provided do not include the provision of specific advice on the financial standing of individual local authorities or a determination as to the appropriateness or otherwise of placing a deposit with specified local authority. However, the Treasury Team advise that Link Asset Services provide as much detail as available to clients on all aspects of the clients Treasury activities. As very few local authorities have credit ratings, and there is a time lag in the provision of key financial information, it is unlikely that specific advice on the financial standing of specific local authorities could be provided by Treasury advisors as part of a contractual requirement. In our view, the draft checklist (section 3 item 6) should be adjusted so that it is clear that while additional information obtained from Treasury advisors can contribute to the decision making basis, accountability for choosing counterparties remains with the Section 95 Officer.

We noted that council officers and Link advisors have regular discussions on aspects of the Councils treasury management activities, including possible options for borrowing and deposits and advice on specific trades. While, given the nature of these discussions, there is no detailed record maintained, we recognise that the introduction of a checklist would enhance the audit trail of the decision-making process.

Treasury Management Reporting

The Treasury Management Code stipulates a number of key documents that the Council should receive and scrutinise, including an annual report on the strategy and plan to be pursued in the coming year; a mid-year review; and an annual report on the performance of the treasury management function.

The Council annual Treasury Management and Investment Strategy is considered in line with budget arrangements. We note in particular that the presentation of the Council's Treasury Management and Investment Strategy at the same time as the capital investment plan allows elected members to consider the impact of decisions on borrowing plans. The Borrowing Strategy sets out the prioritised borrowing methods the Council could use, as well as setting limits on types of borrowing and the debt maturity structure.

The Investment Strategy notes the Council's investment priorities as the security of capital and liquidity of its investments, and sets a limit on longer term, fixed rate investments. The Counterparty List details the approved banks and other financial institutions with which the Council can undertake short-term investments.

Proposed Prudential Indicators, as recommended in CIPFA's Prudential Code, are also considered within the report. As a result, we were satisfied that the reporting undertaken throughout 2019/20 and 2020/21 met the requirements of the Code.

Recommendation 4: The Council should ensure that the scrutiny and challenge applied to treasury management activities are minuted to reflect the substance of the matters raised.

As regular attendees at the Audit Committee, we have noted regular discussion and challenge during consideration of the Treasury Management annual and mid-year reports. Specific actions have been undertaken in response to challenge including, for example, the development of training sessions for members of the committee. However, the minutes of meetings did not fully reflect the full substance of the scrutiny applied, including the topics of matters raised by committee members.

Appendices

A – Action Plan

B – Local Government Counterparty Decision draft checklist

A. Action Plan

We have graded these findings according to our consideration of their priority.

Classification of recommendations		
Grade 1: Key risks and / or significant deficiencies which are critical to the achievement of strategic objectives. Consequently management needs to address and seek resolution urgently.	**Grade 2:** Risks or potential weaknesses which impact on individual objectives, or impact the operation of a single process, and so require prompt but not immediate action by management.	**Grade 3:** Less significant issues and / or areas for improvement which we consider merit attention but do not require to be prioritised by management.

No.	Findings and / or risk	Recommendation	Management response / Implementation timeframe
1	The Treasury Management Code states that the body responsible for scrutiny, such as an audit committee, will have responsibility for the scrutiny of treasury management policies and practices. However, while the practice statements were made available to elected members at the time of the last refresh, they were not formally considered or scrutinised at committee level.	The Audit Committee should scrutinise the detailed Treasury Management Practice, statements along with the revised Code expected later in 2021. *Grade 3*	In common with most other Council's the detailed practice statements were made available to elected members for scrutiny by providing them in the members library. The next revision of the Practice Statements will however be included as part of the Audit Committee agenda papers when the revisions arising from the review of the prudential code are made. **Responsible Officer:** Chief Officer Corporate Solutions (S95 Officer) **Implementation date:** February 2022 (subject to timing of revisions to prudential code being published)
2	The Council should further strengthen the audit trail in support of compliance with Treasury Management Practice 3 by maintaining, as part of the draft checklist a comprehensive audit trail of checks completed on local authority investment options. We note that the Council has developed a comprehensive investment checklist to evidence due diligence checks on local authorities and that this is now in use.	The Council should further strengthen the audit trail to ensure that evidence of due diligence checks is maintained in accordance with TMP 3. *Grade 2*	The draft investment checklist provides a documented trail of the due diligence checks carried out in respect of potential local authority counterparties and records the time critical decisions made. The recommendation further strengths the audit trail on these checks and is agreed. **Responsible Officer:** Chief Officer Corporate Solutions (S95 Officer) **Implementation date:** Already Implemented and will be updated to reflect this report.

Classification of recommendations			
Grade 1: Key risks and / or significant deficiencies which are critical to the achievement of strategic objectives. Consequently management needs to address and seek resolution urgently.		**Grade 2:** Risks or potential weaknesses which impact on individual objectives, or impact the operation of a single process, and so require prompt but not immediate action by management.	**Grade 3:** Less significant issues and / or areas for improvement which we consider merit attention but do not require to be prioritised by management.
No.	**Findings and / or risk**	**Recommendation**	**Management response / Implementation timeframe**
3	We note the wording of the draft checklist could give rise to the potential for a lack of clarity in respect of the status of information and advice in relation to counterparty creditworthiness in respect of the inter authority lending market.	**The Council should amend the draft checklist to clarify that the accountability for decision making continues to rest with Council officers.** *Grade 2*	Agreed. The checklist will also provide a means of capturing advice and information in respect of specific trades/counterparties. **Responsible Officer:** Chief Officer Corporate Solutions (S95 Officer) **Implementation date:** Already Implemented and change has been made to checklist.
4	As regular attendees at the Audit Committee, we have noted regular discussion and challenge during consideration of the Treasury Management annual and mid-year reports	The Council should ensure that the scrutiny and challenge applied to treasury management activities are minuted to reflect the substance of the matters raised.	Agreed. Democratic Services will ensure that the minutes of Audit Committee meetings, commencing with the meeting on 22 June 2021, reflect the substance of the scrutiny applied in respect of Treasury Management reports including, the matters raised by committee members. The review and approval of the minutes of meetings at the following meeting also provides the opportunity for committee members to ensure the minutes reflect the substance of the scrutiny applied. **Responsible Officer:** Chief Officer Corporate Solutions (S95 Officer) **Implementation date:** Minutes of the meeting held on 22 June 2021 which will be presented to Audit committee in September 2021 for approval.

B. Local Authority Counterparty: draft checklist

PROPOSED LOCAL AUTHORITY COUNTERPARTY DECISION – TEMPLATE CHECKLIST

Appraisal Date: xx/xx/xxxx
Counterparty: XXX Council
Documents Checklist:- Statement of Accounts: *XXXX* (*Un/Audited/Un/Qualified*) Medium Term Financial Strategy/Plan: *XXXX* (*date*) Financial Monitoring: *XXXX* (*date*) Treasury Management & Investment Strategy: *XXXX* (*date*) Other: (Title) *XXXX* (*date*)

SECTION 1: Compliance with approved TMSS				
Indicator	**Criteria**	**Value**	**Meets Requirement (Yes/No)**	**Notes**
1. Permitted counterparty per TMSS	Counterparty must be local authority			
2. Max maturity period per TMSS	Tenor/maturity period must be less than or equal to 5 years	XX years		Must be less than or equal to 5 years (investments with another Local Authority)
3. Deposits greater than 1 year per TMSS	Total Existing Deposits + Proposed Deposits must be <= £70.000 million	£XX million Proposed STD £XX million Existing STD £XX Total STD		

SECTION 2: Additional Criteria				
Indicator	**Criteria**	**Value**	**Meets Requirement (Yes/No)**	**Notes**
1. Overall size and scale	Net Cost of Services (NCS) >= Midlothian Population >= Midlothian	NCS: £XXX million Population: XXX,XXX		Midlothian 2019/20:- NCS: £197 million Population: 91,000
2. Levels of investments and commercial agenda *	Does not intend to buy commercial assets outwith the borough/local authority area primarily for yield (source from budget & monitoring capital plans). Has not bought such commercial assets primarily for yield in last 2 sets of audited account statements months (statement of accounts, TM reports & outturn capital plans). Excludes purchase of assets and financing schemes applicable to service delivery, housing, and regeneration under the prudential regime*.	Statement of Accounts Treasury Management Reports MTFS Capital Plans		

** This includes capital projects in neighbouring districts or the authority's wider economic area, where these projects are for service delivery, housing or preventative action, or regeneration. See PWLB Future Lending Terms Consultation Response for further detail*

SECTION 3: Background information on potential counterparties			
Indicator	**Checks**	**Values**	**Notes**
1. Overall Borrowing Position & Extent of Exposure to Short Term Borrowing & Overall Market Movements	Ratios STB vs NCS STB vs PPE STB vs LTA S/LTB vs PPE S/LTB vs LTA		
2. Level of Uncommitted General Fund Reserve	General Fund Uncommitted Reserve >= 2% of Net Revenue Budget		
3. Latest Audited & Published Accounts	Unqualified/Qualified Auditors Annual Report review		
4. Section 114 Notice / Capitalisation Directive	Any Section 114 notices issued Any capitalisation directives granted		
5. TMIS Review			
6. Link Treasury Solutions advice on financial standing of Local Authority			
7. Other Relevant Information			

EY | Assurance | Tax | Transactions | Advisory

About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

Ernst & Young LLP

The UK firm Ernst & Young LLP is a limited liability partnership registered in England and Wales with registered number OC300001 and is a member firm of Ernst & Young Global Limited.

Ernst & Young LLP, 1 More London Place, London, SE1 2AF.

ey.com