South Lanarkshire Council

Investment Risk Management Framework Assessment
December 2008

Contents

1. Executive summary

Introduction

PwC was engaged to undertake an assessment of South Lanarkshire Council's ("SLC") investment risk management framework ("the framework"). The approved scope of work is attached at Appendix A. This report provides the findings from this assessment, together with our recommendations to enhance the framework.

Investment strategies consider three key objectives in the context of the organisation's overall risk appetite:

- Security: How safe are the funds invested? Will the funds be returned when expected?
- Liquidity: How accessible are the funds?
- Yield: Will an appropriate return on investments be achieved?

Security and liquidity, rather than yield, are the key drivers of South Lanarkshire Council's investment strategy (as set out in the 2008/09 Treasury Management Strategy reported to the Finance and IT Resources Committee on 14 February 2008). There are policies in place setting out restrictions on the maximum periods for which funds may be committed and criteria for selecting organisations with whom to invest. The Council's principle strategy is to invest in fixed rate deposits. It should be highlighted that the current banking crisis and economic climate has significantly changed the risk profile of investment management and placed unprecedented pressure on all treasury functions.

Summary of findings

As can be seen from the graph opposite there are a number of areas where we consider the investment risk management framework to be in line with good practice with only minor observations noted to enhance existing practices. These are discussed in the body of the report.

There are three areas that we recommend the Council focuses on to enhance the current investment framework:

1. **Counterparty limits and exposures:** when devising the policy for counterparty risk, good practice considers risk in the context of ratings, duration, geography, investment type and industry of counterparty. Setting limits for each of the 5 areas would provide the Council with a more complete picture of the risks attached to current activity. For example, one effective means of reporting this information could be in chart form:

Diagram assessment of the investment risk management framework

In addition, the legal arrangement of forward starting investments will determine whether the relative value (i.e. the rate secured compared to the current rate) or absolute investment balance, should be included within the counterparty exposure calculation.

2. **Interest rate risk:** at present, the strategy consideration when deciding whether to borrow debt in advance of cash flow requirements, is to compare the rate available on debt relative to the budget interest rate and consider forecast interest rates. Whilst these are good indicators they do not capture all of the risks associated with advanced funding. In our experience, when considering the risks associated with advanced funding, consideration should also be given to:
   - Available headroom on counterparties when finding a 'home' for the cash in advance of the funding need;
   - Credit risk associated with having to manage these additional cash balances;
   - Interest rates available on investments for the period until the funding is needed;
   - Broker and internal administration costs of placing, monitoring and reconciling these additional cash balances; and
   - Continuity of funding sources, to assess whether the funds will be equally available now as in the future.

1. Executive summary (continued)

When costing these aspects, in the current climate, it is likely that the analysis will indicate that the advanced funding policy represents a cash drain on the Council; this is driven primarily from the low interest rates available on investments relative to the cost of funding.

In this vein, the Council should focus on the cost/benefit of using surplus cash to repay debt early. In general, being in the position of simultaneously borrowing and depositing is not considered good cash management as it generates a cash drain on the organisation. Therefore, where the risk associated with continuity of funding is remote (which we understand is the case with the PWLB), the Council should consider reassessing their strategy over the use of surplus funds. To the extent that surplus funds can be used to repay debt early, and then as debt is needed at a later date it is drawn down in the future, the Council could generate considerable cash savings against the overall cost of finance. Before adopting such a strategy, the Council should define the minimum threshold of saving required to justify the action. It is noted that between the drafting and finalisation of the report the Council has adopted this approach and an element of debt has been repaid.

As an alternative strategy, we suggest that the Council consider using forward starting interest rate swaps, which appear possible under the draft Investment Regulations expected to come into force during 2009. In this scenario, debt would be drawn down to match the timing of expenditure on the project. The Council would monitor interest rates, and where appropriate, transact forward starting swaps. With a forward starting swap, the swap commencement date should match the debt drawdown date. This enables the Council to fix the funding cost in advance of drawing the debt. Such a strategy allows the Council to secure funding costs at predetermined interest rates without the credit risk and cost of managing the physical cash. The key risks associated with this approach include:

- The project for which the borrowing is required does not start according to schedule. Where this happens, the swap would either start to operate and generate interest cash flows even although the debt has not been drawn, be renegotiated to delay its start to match the revised debt drawdown date (often at a cost), or terminated (at a cost or a gain), leaving the period between the termination date and the date that the debt is physically drawn exposed to interest rate risk;
- The opportunity cost associated with the difference between the rate available at the time of drawing down the debt and the actual interest rate secured on the swap. However, this is no different in concept than the current opportunity cost being incurred by the Council associated with the rate achieved on debt physically drawn early compared to rates available at the time the debt is actually needed.

3. **Management information:** The monthly Treasury Management Review meeting focuses on investment activity, with good analysis of activity by counterparty, yield and maturity, and clear reporting of the Prudential Code indicators. In our experience, there are a number of additional elements that would benefit SLC in their management and review of the investment strategy. For example:
   - Setting counterparty limits and reporting actual exposures as set out at point 1 on the previous page;
   - Trend analysis of rating movements on counterparties being utilised to promote discussion on relative security of investments;
   - Establishing a process to access fair value information on forward starting investments (should they be classified as derivatives) and swaps (should these be used in the future);
   - Costing up investment alternatives as set out in point 2 opposite;
   - Graphing the current interest rates provides good visibility of high, medium and low interest rate points across the one year timeframe. This supports Treasury when determining pros/cons of placing funds to maximise yield whilst remaining within the policy restrictions on staggered duration (that we recommend be established);
   - Graphically depicting cash flow information of investment activity by maturity, overlaid with the target maturity ladder (that we recommend be established) to assess performance against policy;
   - Graphically depicting investment activity by maturity, overlaid with actual and forecast funding flows. This highlights where mismatches arise and investments that may need to be broken early or additional funding sourced to meet gaps. In our experience, the graph is used at a high level in order to avoid replicating the visibility achieved through the forecasting process; and
   - Supplementing performance indicators to include consideration of yield. Benchmarking the actual return on investment against for example money market and LIBID rates will help to provide context to the effectiveness of the investment strategy. The choice of benchmark rate should match the target maturity profile. This KPI is also beneficial from a security risk perspective: it will highlight rates secured that consistently exceed the benchmark encouraging challenge of the continuing appropriateness of using the counterparty. Excessive rates are often a sign of a struggling organisation.

2. Detailed findings and recommendations – **Policy and objectives**

To keep pace with good practice developments, we would expect the investment risk management policy and objectives to be clearly articulated in a formally approved document, and clearly communicated to relevant parties including treasury staff and, for certain aspects, external advisors. The policies and objectives should be reviewed on a regular basis to ensure they remain appropriate.

Documentation of policies

It was noted that the Council's policy documents *Treasury Management Practices* (TMPs) have not been updated since 2003. There is clear evidence that all amendments to policies and procedures, such as the recent revisions to the counterparty policy working practices, are documented in separate formal documents provided for the approval of the Members and/or the Director of Finance. No significant gaps were identified in the policies and procedures when considering all the documents. However, as a matter of good practice we would expect all investment policies and procedures to be included in one definitive source of guidance; in the case of the Council, this is the TMPs. This would simplify the maintenance of policies and support the training activities when changes are made to policies and procedures as staff will have one comprehensive source of guidance.

Suggested action

The TMP documents should be updated to reflect the current investment practices within the Council. In addition, mechanisms should be put in place to ensure the documents are kept up to date on an ongoing basis.

Forward starting investments

Treasury staff have the authority to undertake forward starting investments under the provisions of the TMPs. It is understood that such deals are undertaken relatively infrequently (on average once per month) and are generally only undertaken a few days in advance when surplus funds are identified and there is an opportunity to place a deal with an approved counterparty e.g. the treasury staff transact a deal on Monday to invest surplus funds the following Friday at a pre-determined rate agreed on the Monday. The surplus funds are identified as available from the cash flow forecast. It is acknowledged that forward starting investments require additional approvals, and normally are only undertaken with public bodies. However, there is a lack of clarity within the policy as to when forward starting investments should be used, and at present, there is no reporting of the forward starting investments undertaken.

Forward starting investments could be considered to be a derivative contract under IFRS accounting regulations where the timeframe for placement is outside regular market conventions. Although IFRS is not currently applicable to the Council this will need to be considered as part of the convergence to IFRS.

Suggested action

The investment policy should clearly specify when forward starting investments are permitted. For example, only on bank holidays and only to be transacted with public bodies. The Council should take into account the burden of the additional IFRS derivative accounting and reporting effort that will be required when determining the policy.

Forward investment deals should also be incorporated within counterparty exposure reports where the legal structure of the arrangement classifies the investment as a legal obligation to deposit funds.

2. Detailed findings and recommendations – **Identification of funds to invest**

An organisation should have robust and accurate cash forecasting in place, with short, medium and long term cash requirements clearly defined in terms of duration, investment activity and purpose. Adequate stand-by facilities should be in place to meet unexpected cash requirements.

The Council has developed relatively robust cash flow forecasting with the daily cash flow position updated on a rolling 3 month basis. Overdraft facilities are in place for any unforeseen expenditure, but this is rarely used. The cash flow forecast is reported in monthly Treasury Management Review meetings.

Investment maturity profile

The current investment maturity profile is largely falling within less than 3 months, although the maximum period of investment is 364 days. This is a result of a change in working practices to adopt a more cautious approach and restrict deposits to less than 3 months with the objective of reducing security risk. In addition, the investments in public bodies are generally short term requests for funds.

The short term nature of the investment maturity profile requires regular management to reinvest and place funds. Consequently, there is a relatively higher transaction cost and monitoring cost associated with this strategy. The restricted duration offers limited additional assurance in regard to security risk but it does provide greater flexibility in accessing investments from downgraded counterparties within a relatively short period of time.

Suggested action

The Council should track the cost impact of the current short term investment strategy and compare with prior years where a more balanced maturity ladder would have been used as a means of challenging the appropriateness of the strategy.

2. Detailed findings and recommendations – **Counterparty risk**

The counterparty policy should clearly articulate the counterparty assessment criteria including duration, rating and investment type, with limits set representing the organisation's risk appetite. Monitoring arrangements reflect the risk profile of the counterparties and market conditions.

Whilst the counterparty policy within the Council has remained relatively unchanged over recent years, as a result of the recent market turmoil the Council has adopted a more cautious approach and since October 2008 has implemented changes to the working practices underpinning the counterparty policy. An approved counterparty list is in place with specified limits and the monthly Treasury Management Review meeting focuses on investment activity, with good analysis of activity by counterparty, yield and maturity.

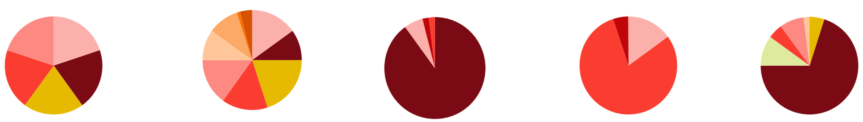
Counterparty exposures

The current reporting on counterparty exposures could be enhanced. In our experience, good practice considers risk in the context of ratings, duration, geography, investment type and industry of counterparty. Setting limits for each of the 5 areas would provide the Council with a more complete picture of the risks attached to current activity.

In addition, the legal arrangement of forward starting investments will determine whether the relative value (i.e. the rate secured compared to the current rate) or absolute investment balance, should be included within the counterparty exposure calculation.

Suggested action

Current reporting of exposures should be enhanced to capture the various dimensions of risk. For example, one effective means of reporting this information could be:



Ratings Duration Geography Investment Industry

Forward starting investments should also be incorporated within counterparty exposure reports where the legal structure of the arrangement classifies the investment as a legal obligation to deposit funds. The legal arrangement will determine whether the relative value (i.e. rate secured compared to current rate) or absolute principal should be included in the counterparty exposure calculation.

Counterparty limits

The Council considers local authorities, joint boards and passenger transport executives to have the same credit risk rating as the Debt Management Office (DMO) deposit facility. However, the maximum investment level to be placed in the DMO account is £80m whereas the maximum level of investment to be placed with local authorities, joint boards and passenger transport executives is £15m. It is acknowledged that local authorities, joint boards and passenger transport executives rarely require more than £15m, and as such, there is limited operational need for the limits to be increased beyond this.

The current investment limits with individual counterparties have remained relatively unchanged for over 5 years, with no formal assessment of the limits having been undertaken.

Suggested action

The limits should be critically assessed to ensure they continue to reflect the risk appetite (i.e. the maximum levels of loss the Council would be willing to accept) and counterparty policy of the Council. Examples of methods used when establishing limits include:

– % of net assets

– % of revenue

– % free cash flow

2. Detailed findings and recommendations – **Counterparty risk (continued)**

Counterparty policy assessment criteria

The most recent amendment to counterparty working practices (December 2008) included additional criteria for the assessment of counterparties i.e. credit ratings; share price; Credit Default Swap data; research; and advice from treasury consultants. This was intended to further mitigate against security risk.

However, greater clarity is required on the implementation and applicability of the extended assessment criteria. For example, CDS data, being a tradeable instrument, is influenced by a number of factors and therefore requires experience and expertise when interpreting. In addition, share prices are only relevant to banks not building societies. It was also noted, that the criteria will not be applicable to investments in public bodies.

The current investment advisor provides high level market and economic data on a regular basis. However, this research is not specific to the Council's counterparty policy.

It should be noted that the Council is generally consistent with current good practice relevant to its scale and complexity of operations in regard to its approach to the assessment of counterparties. There are limited additional sources of assessment available to the Council.

Suggested action

The policy for the extended assessment criteria should be clarified. For example, given the complex nature of interpreting CDS data, the Council should consider the benefits of obtaining this information from the external investment advisor as opposed to the costs of skilling up the treasury team. The decision-making will still rest with the Council however the advisor should be able to provide an interpretation of the movements in CDS data. It should be noted that CDS data is rarely used as an assessment tool within treasury teams of the scale of the Council.

Similarly, the Council should consider the cost/benefit of requesting the investment advisor to provide research on specific institutions falling within the Council's counterparty list. An alternative could be to use an internet based research tool such as Factiva and devote additional staff resources to this task. The benefit of using the investment advisor option is the filtering and further analysis that the advisor should be able to provide.

Public body counterparty policy

As highlighted above, the Council considers all local authorities, joint boards and passenger transport executives to have the same credit risk rating. The policy makes no distinction between these public bodies for matters such as financial stability. It is acknowledged that central government intervention and political pressure does offer a form of protection to the Council in the event of a public body counterparty experiencing financial difficulties. However, there are no guarantees that the Council, or any other public body, would receive any preferential treatment over other creditors in such an example. Therefore the Council remains exposed to liquidity risk. This would have greater impact on the Council if the overall level of investments was lower, and hence the liquidity requirements were greater.

Suggested action

As a matter of good practice the assessment criteria for public body counterparties should include, for example:

- Internet research, perhaps to be conducted by the investment advisor;
- CPA ratings for bodies based in England & Wales;
- Audit Scotland and Audit Commission reports.

2. Detailed findings and recommendations – **Interest rate risk**

An investment risk management framework should address the strategy over interest rate profile, whether measured on gross balances, net debt proportion or duration.

The Council obtains regular information from the external advisor on the cost/benefit of rescheduling existing PWLB loans and/or repaying the loans earlier, in addition to forecast information on interest rates.

Borrowing cost/benefit analysis

The Council's policy allows the treasury team to consider borrowing in advance should this be considered to be of benefit to the Council based on forecast interest rates and the need to borrow is clearly evident. Local authorities are restricted from borrowing solely for profit gain and therefore must be able to demonstrate the borrowing requirement.

It was noted that the Council's cost/benefit analysis prior to the decision to borrow takes account of the forecast interest charge compared to budgeted e.g. £40m was borrowed in May 2008 at 4.43% in respect of the 2008/09 borrowing requirement. The budgeted interest rate for 2008/09 was 4.7%. Therefore, as forecast interest rates were expected to increase, it was seen as an advantage to borrow the full balance in May although it was known that capital programmes were scheduled throughout the year.

The Council is now forecasting slippage of £18m from the 2008/09 programme. We note that the average rate of return on investments over the 2008/09 was c.4.3%. Therefore, there has been a cash drain of 0.13% as a result of the capital slippage. With the decline in investment rates compared to the cost of borrowing the cash drain on the Council increases. It is acknowledged that the Council could not have predicted the extent of the capital slippage at the beginning of the financial year. However, we would expect the cost / benefit analysis supporting borrowing decisions to consider the complete picture of the costs and benefits.

Suggested action

In addition to the current analysis supporting borrowing proposals, the cost/benefit analysis to support proposals should also include:

- Available headroom on counterparties when finding a 'home' for the cash in advance of the funding need;
- Credit risk associated with having to manage these additional cash balances;
- Interest rates available on investments for the period until the funding is needed to identify if investment rates fail to break even with funding rates and generate a cash drain on the Council;
- Broker and internal administration costs of placing, monitoring and reconciling these additional cash balances; and
- Continuity of funding sources, to assess whether the funds will be equally available now as in the future.

As an alternative strategy, we suggest that the Council consider using forward starting interest rate swaps, which appear possible under the draft Investment Regulations expected to come into force during 2009. In this scenario, debt would be drawn down to match the timing of expenditure on the project. The Council would monitor interest rates, and where appropriate, transact forward starting swaps. With a forward starting swap, the swap commencement date should match the debt drawdown date. This enables the Council to fix the funding cost in advance of drawing the debt. Such a strategy allows the Council to secure funding costs at predetermined interest rates without the credit risk and cost of managing the physical cash. The key risks associated with this approach include:

- The project for which the borrowing is required does not start according to schedule. Where this happens, the swap would either start to operate and generate interest cash flows even although the debt has not been drawn, be renegotiated to delay its start to match the revised debt drawdown date (often at a cost), or terminated (at a cost or a gain), leaving the period between the termination date and the date that the debt is physically drawn exposed to interest rate risk;

2. Detailed findings and recommendations – **Interest rate risk**

- The opportunity cost associated with the difference between the rate available at the time of drawing down the debt and the actual interest rate secured on the swap. However, this is no different in concept than the current opportunity cost being incurred by the Council associated with the rate achieved on debt physically drawn early compared to rates available at the time the debt is actually needed.

In addition, in the current climate the Council should ensure the advice from the external advisor on the cost/benefit of rescheduling existing PWLB loans and/or repaying loans earlier is challenged sufficiently, for example the minimum threshold for annual savings to trigger change should be specified.

In the current low interest rate environment the Council should also be considering the cost/benefit of using temporary surplus funds to pay off debt rather than invest the funds as borrowing rates are higher than lending rates. The borrowing can be drawn down when it is required to meet expenditure needs. As well as potentially generating a net cash benefit it reduces the operational burden and security risk of having to find placements for funds as the headroom within the counterparty list is reducing. As the Council can secure funding with relative ease via the PWLB the risk associated with continuity of funding is remote.

It is noted that between the drafting and finalisation of this report the Council has adopted the approach suggested above, and an element of debt has been repaid.

2. Detailed findings and recommendations – **Management information**

In an organisation adopting good practice the management information will support informed decision-making providing comprehensive information tailored to the strategy of the organisation.

Management information and governance

The management reports prepared for the monthly Treasury Management Review meetings are relatively comprehensive. Although some areas for potential enhancement were identified.

Members, via the Finance and IT Committee, are normally provided with information on the investment policy and performance twice a year.

Suggested action

In the current market, it may be of benefit to provide information on a more regular basis to provide assurance to the Members, and for the Members to govern the decision-making process. A dashboard style of reporting of the Council's key metrics should be considered for ease of understanding and succinct approach.

We recommend that the monthly management reports be updated to include:

- Counterparty limits and actual exposures to reflect the 5 key risk dimensions: ratings, duration, geography, investment type and industry;
- Trend analysis of rating movements on counterparties being utilised to promote discussion on relative security of investments;
- Cost/benefit of investment alternatives, quantifying investment yields versus repayment of debt;
- Graphically displaying the current interest rates provides good visibility of high, medium and low interest rate points across the one year timeframe. This supports Treasury when determining pros/cons of placing funds to maximise yield whilst remaining within the policy restrictions on staggered duration (that we recommend be established);
- Graphically depicting cash flow information of investment activity by maturity, overlaid with the target maturity ladder (that we recommend be established) to assess performance against policy. This is often presented in bar chart format;
- Graphically depicting investment activity by maturity, overlaid with actual and forecast funding flows. This highlights where mismatches arise and investments that may need to be broken early or additional funding sourced to meet gaps. In our experience, a bar chart is used at a high level in order to avoid replicating the visibility achieved through the forecasting process;
- Providing the cash-flow information in graphical form, to allow quick identification of any surpluses or deficits from the short term liquidity buffer which will require action;
- Supplementing performance indicators to include consideration of yield. Benchmarking the actual return on investment against for example money market and LIBID rates will help to provide context to the effectiveness of the investment strategy. The choice of benchmark rate should match the target maturity profile. This KPI is also beneficial from a security risk perspective: it will highlight rates secured that consistently exceed the benchmark encouraging challenge of the continuing appropriateness of using the counterparty. Excessive rates are often a sign of a struggling organisation; and
- Highlights of any operational issues within the treasury team e.g. training requirements; pressures on the team due to increased volumes, etc.

2. Detailed findings and recommendations – **Management information (continued)**

External investment advisors

The main service provision from the current investment advisor is credit agency rating information on the counterparties. A weekly list is provided, as well as daily updates emailed with changes in ratings and outlook. The advisor also provides general updates on the market and economy as well as information of forecast interest rates.

It is acknowledged that the investment advisor is not providing a management service i.e. the decision-making responsibilities will remain with the Council. However, the Council would benefit from the advisor providing more specific information from the market.

Suggested action

The Council should negotiate with the current advisor to agree how more specific relevant market information on counterparties and the implications of this could be provided. For example, as highlighted above the advisor may be able to provide insights into the movements in Credit Default Swap data on relevant counterparties. In addition, the Council should consider these factors as part of the specification within the external advisor tender exercise being undertaken in 2009.

It should be noted that there may be a cost implication of this extended service.

2. Detailed findings and recommendations – **Practical application**

Controls operate to ensure compliance with policy and strategy. Key controls should include authorities and limits for dealing and instrument selection, inward and outward confirmations, reconciliations, and escalation and resolution procedures.

Deal control environment

Currently deals are placed with brokers by relatively junior members of staff within the treasury team under the supervision of senior treasury staff. However, there is no evidence retained of the senior staff involvement until the payment process.

We were informed that comparative quotes for investments are obtained however no evidence is retained of the comparison exercise. It is therefore difficult for the treasury staff to provide evidence to the Director of Finance and the Members that the deals were the best available to the Council within the limits of the investment policy.

Inward confirmations are filed with the deal paperwork. We were informed that the confirmations are reviewed by senior staff, however no evidence is retained of this review.

It was also noted that although a daily reconciliation is performed between the bank records and the deal records, this is prepared and reviewed by separate junior staff members within the treasury team. Therefore although there is segregation of duties and general oversight by senior staff we would expect a senior member of staff to evidence their review of the reconciliation.

Suggested action

The current deal process should be supplemented with the following controls:

- Evidence of senior treasury staff approval of deal proposals prior to placement with the brokers should be documented;
- Inward confirmation of the deals should be requested from the counterparties by fax or email prior to settlement. The treasury manager should check the details on the confirmation to the deal paperwork prior to settling payment. Evidence of this review should be documented; and
- The daily reconciliation between the deal records and the bank records should be reviewed by a senior member of treasury staff, and evidence retained of this review.

Appendix A: Scope of work

The objective of a treasury governance and risk framework is to encompass the financial risks of an organisation and to establish robust processes to monitor, manage and report on these financial risks. We will therefore compare the investment risk management aspects of your overall risk management framework against good practice, and identify opportunities for improved governance, process efficiencies and performance management. Specifically, we will consider the following:

Policy and objectives

- Through discussions and review of documentation we will gain an understanding of the investment policy and assess the policy content in addressing the three core objectives of security, liquidity and yield. For example, clarity over identification of funds to invest, decision of where to invest, implementation of investment decision, appraisal of the investment decision etc
- Using our treasury risk management specialists, we will assess the comprehensiveness of the current investment risk management framework against our experience of good practice. Specifically, we will consider the alignment of cash investment objectives with financial objectives around investment return targets within stated instrument, interest rate and counterparty risk profiles. We will also consider the alignment between security of investment and counterparty risk management policy.
- We will gain an understanding of the current range of authorised investments, duration, geography and return profile. This information is useful when assessing the comprehensiveness of policy constraints.

Identification of funds to invest

Through discussion, we will gain an understanding of:

- Cash forecasting tools and coverage. Enhanced cash flow forecasting models can improve awareness of current and future obligations, and therefore increase the level of funds available for investment.
- The liquidity management structure, specifically how cash flows through SLC, in order to appraise the completeness of the investment risk framework.
- The quality of forecast information, covering real-time actual cash flows and the robustness of information on future cash flows.
- Stand-by facilities / investment selection to meet unexpected cash outflows / borrowing needs.
- The nature of cash surpluses and the classification of surplus cash between working capital, short-term predictable cash and long-term cash. This will include the clarity of policy around proportion of cash which must be invested in liquid instruments and the definition of liquid.

Liquidity risk

As liquidity risk is not considered a key risk of SLC, we will undertake a high level assessment of the following areas:

- We will assess the extent to which liquidity risk is addressed within the investment risk framework.
- We will consider investment policy content in terms of constraints, acceptable investment instruments, target maturity ladders, information available around delays in realising investments, etc.
- We will discuss with management the practical application of the liquidity policy given the effectiveness and reliability of their cash forecasting model.

Counterparty risk

We will assess the extent to which the risk framework addresses counterparty risk. Specifically, we will consider:

- Use of credit ratings
- Monitoring procedures designed to maintain view of credit assessment
- Frequency of monitoring
- Extent of proactive credit research
- Use of credit limits: absolute limits, relative limits, counterparty limits, instrument limits, term limits, group limits, country limits etc
- Approach to setting limits and how exposure is measured
- Policy addressing rating downgrades/upgrades
- Use of third party advisers and clarity of frequency of rating monitoring
- Use of custody arrangements/collateral
- We will consider whether the investment policy reflects bank relationship concerns.
- We will benchmark the credit risk management information generated against our experience of good practice, peers and emerging trends given current market conditions
- Through discussion, we will assess the visibility and consistency of counterparty limit selection process
- We will also meet with key recipients of counterparty risk management information to assess the clarity of reporting around ratings assigned and associated risks.

Interest rate risk

We will review the investment policy for coverage of interest rate risk e.g.:

- proportion of investments which should be held in fixed rate instruments
- net debt proportion
- term of investment e.g. maximum duration versus reinvestment in shorter dated instruments
- We will consider the availability of management information to support the decision making process e.g. riding the yield curve, interest rates, trends.
- Through discussion we will gain an understanding of policy and / or legislation restrictions around the use of derivative instruments as part of the risk management strategy.

Management information

- We will consider the quality of management information in explaining investment profiles, risks, safety measures and performance measurement. For example, we will review the investment portfolio reports produced for the Council and the Finance and IT Committee and other management reporting purposes and challenge their nature, relevance and content. We will assess their usefulness at illustrating how different risk scenarios may affect the security, liquidity and yield of investments.
- We will benchmark the management information generated against out experience of good practice and emerging trends given current market conditions.
- We will assess the management information generated for clarity of message.
- We will review the investment performance measures applied within SLC and the use of benchmarks to appraise investment performance.

Practical application

- There are a number of operational issues which can affect which investment decisions can be taken. For example, investment policy, bank relationships and dealing procedures. In order to provide constructive feedback on the practical application of the Council's investment risk strategy and framework, we will gain an understanding through discussions with management of the procedures undertaken and staff roles and responsibilities. This will include:
  - Authorities and limits
  - Instrument selection
  - Dealing
  - Confirmations
  - Settlements
  - Reconciliations
  - Escalation and resolution procedures
- We will also gain an understanding of the controls and checks in place, whether manual or automated, that are designed to enforce compliance with the investment framework policy and objectives and provide feedback to management on the operational control framework in place. We will not test or validate the operation of the controls in practice.

Exclusions

The review will not include:

- Testing or validating the documented operating procedures and control processes relating to investments;
- Providing recommendations on the absolute level of buffer SLC should hold as part of their overall liquidity management process. We will however comment on the use or non-use of margins/buffers;
- Assessing the investment strategy relating to pension funds. As the pension fund is not under the remit of SLC, it is managed by Glasgow City Council, the pension fund investments and risk framework will not form part of this review;
- Assessing proposed custodian arrangements supporting possible investment in government bills;
- Investigating the sequence of events relating to investments being placed with Icelandic banks and subsequent escalation and recovery practices;
- Consideration of all other aspects of the wider risk management framework of SLC, its processes and controls; and
- Testing or validating the operation of the investment risk framework controls in practice.