



Plymouth City Council Governance Review

2019/20

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The contents of this report relate only to the matters which have come to our attention, which we believe need to be reported to you as part of our audit process. It is not a comprehensive record of all the relevant matters, which may be subject to change, and in particular we cannot be held responsible to you for reporting all of the risks which may affect the Council or any weaknesses in your internal controls. This report has been prepared solely for your benefit and should not be quoted in whole or in part without our prior written consent. We do not accept any responsibility for any loss occasioned to any third party acting, or refraining from acting on the basis of the content of this report, as this report was not prepared for, nor intended for, any other purpose.

Introduction and Background

This report considers the Council's governance arrangements in relation to two transactions that were undertaken:

- reducing the pension deficit via the special purpose company transaction (October 2019)
- interest rate swap with Santander Bank (April 2020).

These transactions were undertaken and considered during a period when the Council had seen its funds significantly reduce over a number of years. The Council has had to consider unusual innovative solutions to make further savings to deliver a balanced budget and a general fund balance of £10m. The Council has delivered £90m in savings since 2014. These decisions and the rationale behind these decisions were made within this context.

Reducing the pension deficit

In October 2019 Plymouth City Council (the Council) invested circa £73m in the special purpose company to undertake a restructuring of the Council's pension fund deficit. Prior to this investment in April 2019 the former Section 151 officer sought assurance from us which we could not give in terms of our role as statutory auditor. We did however raise a significant number of issues in respect of this transaction which we asked for responses to during 2019. Our concerns were not, in our view sufficiently addressed, and the transaction took place in October 2019 regardless.

We reported our concerns to the Council's Audit and Governance Committee on four occasions, two of which were ahead of the transaction being undertaken:

- 22 July 2019
- 23 September 2019
- 9 December 2019; and
- April 2020.

Interest rate swap

In April 2020, the Council initiated an interest rate swap with Santander bank. We were not made aware of this transaction until we received the draft accounts in August 2020. This transaction has raised considerable wider public interest in the sector. The aim of the interest rate swap was to reduce the Council's exposure to changes in the interest rate and to reduce the net cost of borrowing. It is considered good practice to raise proposed material transactions of an unusual nature with external auditors.

Aim of this review

The Local Audit and Accountability Act 2014 requires that we must 'be satisfied...that the authority has made proper arrangements for securing economy, efficiency and effectiveness in its use of resources'. Based on the guidance provided within AGN 03 we are required to reach our statutory conclusion based upon the following evaluation criterion:

In all significant respects, the audited body had proper arrangements to ensure it took properly informed decisions and deployed resources to achieve planned and sustainable outcomes for taxpayers and local people.

We consider that these two transactions; reducing the pension deficit and interest rate swaps are a significant risk to our VfM conclusion and that the matter is of interest to the Council and the wider public.

Scope

This review considered the governance arrangements that were in place for these transactions and included:

- Who made the decisions and the rationale for each decision
- If these decisions were made in line with the Council's Constitution, policies and its statutory powers and whether or not these arrangements provide the appropriate checks and balances to ensure decisions made by members are informed and supportable
- If the decisions were based on reliable and timely information and if this information was acted upon
- Whether the Council took and acted upon, appropriate professional advice
- If those charged with governance and other scrutiny functions were aware of what was planned and updated as and when decisions were made
- Where audit recommendations have previously been provided (pension deficit transaction) the arrangements to ensure that these recommendations are addressed and actioned.

This review has not considered the legality of the these transactions.

Approach

Our approach included reviewing a range of documentation and interviews with a number of officers and elected members. We would like to thank all those who contributed and supported us in completing this review.

Executive summary

Reducing the pension deficit

Our findings do not aim to suggest that innovative and unusual transaction should not be undertaken but that the governance arrangements should be strengthened in these situations. We consider that, whilst some aspects of the governance process did operate appropriately, in overall terms the governance arrangements did not adequately support informed decision making with respect of the special purpose company transaction to reduce the pension deficit.

The special purpose company transaction was a key decision made by the Leader, although it was a published decision, all discussions prior to the decision were conducted within informal elected member meetings and internal officer meetings. Whilst in line with the Council's delegated decision making procedures the arrangements did not enable the transaction to be considered in an open and transparent way. Neither was the decision considered by Scrutiny.

An options appraisal was not developed and although a business case was produced it was not up to date. The business case did not clearly bring together and consolidate all the advice and possible options available to the Council. The approach taken was to provide the third party reports separately to the Leader, within which the options considered varied. The business case failed to fully consider all the possible options and advice and excluded one option that was suggested by the Council's advisors. As a result the Leader was not provided with documentation which clearly evaluated and accepted or rejected all options and key issues.

In addition the Council did not have an agreed approach for the approval of the business case for an unusual transaction such as this, which required additional capital expenditure and proposed significant revenue savings.

The risks posed by the special purpose company transaction were considered but were documented in a range of different documents including third party advice. The risks were not consolidated within one document and provided to the Leader to support his decision.

Our concerns were raised with the Section 151 Officer and the Audit and Governance Committee on four occasions, including two before the transaction was completed. However, the majority of our concerns were not actioned and the Committee did not effectively discharge its duties and ensure that the recommendations raised were actioned in a timely manner.

The Council should minimise the potential for conflicts of interest to occur and should enhance existing arrangements by improving existing policies and guidance to ensure elected members and officers identify all potential conflicts and do not limit the potential conflicts to financial and personal interests.

Interest rate swap

The decision to engage in an interest rate swap was made by the Section 151 Officer. In our view as this was not an everyday transaction but an innovative and unusual matter and as such should not have been managed solely as part of everyday treasury management. In order to enable appropriate scrutiny and public debate the decision should have been made by elected members. The decision could have been taken by Cabinet and reported to the City Council.

The Constitution and the Treasury Management Practices should be undated to improve the governance arrangements going forward, both to enable appropriate decisions to be made in formal committee meetings, but also to ensure Scrutiny are given every opportunity to effectively challenge and debate unusual transactions. Consultation with elected members was undertaken but only through informal meetings.

In our view an adequate audit trail was not maintained of the delegated decision and a detailed formal record of the decision was not produced. The delegated decision did not record the reason for the decision, legal considerations and alternative options considered and rejected.

The Audit and Governance Committee's responsibilities include the implementation of the Treasury Management Strategy and the monitoring of policies and practices. In order to enable the Committee to discharge its duties, it should have been included in the decision making process. The Committee were not asked to endorse the transaction.

The Council did not fully consider the risks posed by this interest rate swap transaction. The risks were considered by the Council's advisors, but these were not quantified and were not documented in a Council risk register.

For both the special purpose company transaction and the interest rate swap the procurement decision and the judgements supporting these decisions were not recorded. This limits our ability to assess if adequate arrangements were undertaken.

Action Plan

We have identified 11 recommendations which are set out in the action plan on page 15.

Reducing the pension deficit

Background

The Council participates in the Local Government Pension Scheme (LGPS) administered by Devon County Council. It is funded through the contributions of all employers and employees participating in the scheme. However, the value of the pension scheme assets was not sufficient to meet the requirements of the scheme members and as a result the Council had a pension fund deficit.

In 2016 at the last revaluation the deficit attributable to the Council was over £122m and the Council had agreed to repay in three tranches over three years. It was also anticipated that deficit repayments would increase over the three year period increasing the cost to the Council.

In 2018 the Council began to consider how the pension deficit could be repaid and the charge on the revenue account reduced. The Council did not have the level of reserves available to enable it to repay the deficit and it therefore sought a mechanism to both access the funds and repay the deficit in a legal way.

The solution found and undertaken included the acquisition of a share in an investment company which was funded from borrowing. The investment special purpose company then repaid the pension deficit.

The decision was taken by Leader of the Council and in October 2019 the Council invested £72m in the special purpose company to undertake a restructuring of the Council's pension fund deficit.

The table opposite identifies the key steps that took place prior to this transaction being completed.

| Date | Key Step |
|-------------------|---|
| 2016 | Elysian associates and Minerva Solutions were appointed by the Council to find legal solutions arising from financial and tax issues to help the Council deliver its capital programme. They devised the 'special purpose company solution'. |
| 29 May 2018 | The Corporate Management Team (CMT) were presented with a proposal for dealing with the pension deficit. The options considered included investing in a vehicle that would repay the full deficit. CMT endorsed the approach and agreed to proceed to developing the full solution prior to Cabinet approval. |
| 19 & 27 June 2018 | Additional presentations to CMT. |
| September 2018 | QC advice obtained, including recommendation for the Council. |
| Oct and Nov 2018 | Actuarial advice. Barnett Waddingham for Devon County Council and Lane Clark & Peacock LLP for the Council and Miel Solutions Ltd. |
| 18 Nov 2018 | Business case prepared. |
| 25 February 2019 | As part of the budget approval process the City Council approved a debt rescheduling budget saving which included the pension deficit saving of £1.448m in 2019/20. |
| May 2019 | Internal report prepared by the Council's treasury advisors (Arlingclose). This provided a range of options including the special purpose company option and an additional option 'prepayment'. |
| June 2019 | Internal legal advice provided via email. |
| July 2019 | Presentation to Cabinet Planning Meeting by Section 151 Officer and Portfolio Lead. This was not a formal decision making meeting and minutes were not recorded. |
| Date unknow | Presentations by Section 151 Officer to Labour Group and the Conservative Group. These meetings were closed meeting and minutes were not recorded. |
| 9 And 11 Oct 2019 | Decision made by the Leader of the Council followed by Actuary's revised Rates and Adjustments Certificate requiring a primary employer contribution of 14.7% and a secondary rate payable of £72m to reflect the pension deficit sums payable. |
| 16 Oct 2019 | Decision implemented, B shared purchased and pension deficit paid. |
| 17 Nov 2020 | Miel Solutions Ltd dissolved. |

Reducing the pension deficit

Informed decision making

The Council has adopted the leader and cabinet governance model, also known as the ‘Strong Leader’ model for decision making. The Leader is elected by the City Council at its annual meeting. As such those decisions which are not required to be made by the City Council are the responsibility of the Leader and must be agreed by the Leader unless he opts to delegate to Cabinet, a committee of Cabinet or an officer.

The decision to reduce the pension deficit and opt for the special purpose company transaction was the responsibility of the Leader and a key decision as defined by the Council’s Constitution. Elected members were consulted and made aware of the special purpose company solution on a number of occasions. These included one-to-one briefings with the Portfolio Lead and the Leader, presentations to the political groups (Conservative and Labour) and to Cabinet Planning Meetings. However, none of these meetings were formal meetings and as a result the debate and discussions were not formally documented. Whilst we appreciate that the transaction was commercially sensitive, the decision and supporting debate could have been undertaken within exempt sessions.

The only opportunity for formal debate was during the City Council’s approval of its 2019/20 budget in February 2019, in which the savings anticipated from the reduction in the pension deficit were included in the planned savings. The minutes did not record if this proposed saving was discussed or the extent of the debate. However, the webcast of the meeting did indicate that some debate took place and that the opposition party members were not supportive of the proposal. In our view agreement of the budget and any savings required to achieve a balance budget does not constitute formal agreement of the special purpose company transaction by the Council. This decision was made by the Leader in October 2019.

We understand that it is not unusual for decisions to be made by the Leader which are not part of a Cabinet meeting and this is in line with the Council’s constitutional procedures. However, this approach risks reducing the openness and transparency of the decision making process. The meetings cannot be attended or viewed by members of the public or public questions raised. In line with the Council’s procedures the decision was recorded in the forward plan, although it was recorded as a decision to be made by Cabinet. The decision was subject to call-in but was not called-in and the Portfolio Lead was consulted one month before the Leader decision. The decision was not an urgent decision and was recorded and published on the Council’s website.

The Leader was provided with the following supporting documentation to assist the decision making process:

- Equality impact assessment
- Business case
- Initial QC advice, including recommendations for items requiring further action
- Arlingclose advice (treasury advisors)
- James Clark & Peacock advice (actuarial advice).

The decision was recorded using the Council’s standard documentation. This included the options considered and rejected. However, it did not include the additional option proposed by Arlingclose in May 2019. This information was included within the supporting papers, although the reason why this option was rejected was not recorded.

As noted on page seven, the business case also did not include this additional option. This illustrates that although we would anticipate information and options to develop as the process progresses we would expect that the decision maker would be assisted by ensuring the business case or the covering report addressed all the options and key issues in detail.

The decision was not considered by Scrutiny. The decision was published in the Leader’s Forward Plan and was reviewed by the Scrutiny Management Board at their meeting on the 9 October. However, this was the same date as the decision was made and as a result there was limited opportunity to undertake pre-decision scrutiny.

Rec 1: The Council should further improve its governance arrangements so that the number of key decisions that are made outside of formal elected member meetings is limited, thereby enhancing openness and transparency:

- Formal guidance should be developed for decision makers setting out when discretion could be exercised and their delegated powers not used, ensuring consideration is given to identifying the most appropriate place to make a decision on an innovative and unusual transaction
- Decision makers should be provided with documents that clearly assess and accept or reject all potential and relevant options and key issues
- Processes are put in place to ensure Chairs of Scrutiny Committees are given every opportunity to effectively challenge and debate unusual transactions
- Any questions raised by external advisors, including legal advice are formally closed and addressed by the Council.

Business case

The Council had been working with Elysian Associates and Minerva Solutions since 2016 and it was during 2018 that the Section 151 Officer was approached with the possibility of the special purpose company solution to reduce the pension fund deficit. This was an unprecedented and untested solution.

By May 2018 the Council had already considered a number of options and work had begun to develop the special purpose company solution. The section 151 Officer presented to the Corporate CMT a short paper that set out 5 options. Although this paper included 5 options including doing nothing, it clearly leaned towards the special purpose company solution as the only viable option. A detailed options appraisal or business case had not been prepared at this stage. CMT endorsed the special purpose company solution approach and the Section 151 Officer was given authority to develop the special purpose company solution for later approval by Cabinet. This included obtaining legal and actuarial advice.

Reducing the pension deficit

In June 2018 another presentation was made to CMT, this time 7 options were considered: the same options as were considered in the business case. We are unclear when the business case was first prepared, but we do know that a version was circulated for comment in early December 2018 and was later shared with Cabinet in July 2019 at a Cabinet Planning Meeting.

The business case is based on the HM Treasury Green Book and follows the five case model. However, the business case does not consider every option within each case. For example the strategic case does not set out how each option will deliver the Council's strategic objectives. In addition the majority of options are not considered in detail and appear to be dismissed without being fully developed within the business case.

The advice provided by Arlingclose suggested an additional option, prepayment. The business case was not updated to consider this option. Further details are included on page six. The business case is predominately based on the preferred option to invest in the special purpose company and in our view does not give a balanced view on all the possible options.

The Council did not have a formal process for the approval of the business case. It is unclear when and by whom the business case was approved. The documentation we reviewed appeared to support that approval might be sought from Cabinet and the City Council, however, this was not the case as the business case was only made available at a Cabinet Planning Meeting. Cabinet Planning Meetings are not formal meetings, therefore are not decision making meetings, neither did CMT review and approve the business case.

We consider that the business case arrangements on this occasion were not good enough as a detailed options appraisal was not developed, the business case did not fully consider all the options and the Council did not have an agreed process for the approval of the business case which it could demonstrate had been followed.

Rec 2: The Council should further improve its processes for the production of business cases to ensure:

- A detailed options appraisal is undertaken where appropriate
- Material business cases fully appraise all the options
- An agreed and consistent approach for the approval of business cases is developed and adopted.

Special purpose company transaction levy

Throughout the development and negotiations of the special purpose company option the cost was expected to be in the region of £102m. The Leader's decision was based on borrowing in the region of £102m with £102.375m allocated in the capital programme. The decisions also gave delegated authority to the Section 151 Officer to complete the final negotiations. It was not until the final stages that the final amount of £73.375m was agreed.

The special purpose company option included two elements:

1. The repayment of the pension fund – £72m
2. The transaction level to cover the operational costs of special purpose company and third party costs, such as advisory fees - £1.375m

The business case highlighted that a transaction levy was payable and that it would be approximately 1.2% of the deficit. The Council considered that there were no direct benchmarks against which to compare due to the originality of the transaction, but did compare it to a savings based solution that one of the consultancy firms might charge, thought to be in the region of 10-30%.

As noted earlier the business case did not consider the additional costs in comparison with the other options in particular the prepayment option. The Council's financial advisors Arlingclose had highlighted this within their advice. In addition the covering report provided to the Leader, which summarised and supported the decision did not highlight the transaction levy.

Managing Risk

We considered how the Council has managed risk as part of the decision making process in order to enable it to select the best option. As this transaction was a new approach we would expect that the Council would consider and document the potential risks. The risks are identified in a number of different documents, such as the business case, Arlingclose advice and reports to CMT. However, the risks identified within these documents were not consolidated and considered by the Council and have not been included within the Finance Operational Risk Register. The repayment of the pension deficit was included in the Finance Operational Risk register (August 2020) as a mitigating action in relation to the risk that the Customer and Corporate Services Directorate may not meet its financial target.

Ten risks were scored and included within the business case, however, these risks only addressed the risks posed by the special purpose company solution and did not cover all the possible options.

In addition a risk register was not included within the supporting documentation provided to the Leader to assist the decision making process and the Council's standard documentation for recording delegated Executive decisions does not include key risks or a risk register.

The finance risk management arrangements should be improved by the Council consolidating the risks identified by its various advisors, assessing and evaluating the risks and mitigations, and ensuring the decision maker is appraised of these risks.

Rec 3: The Council should improve its financial risk management arrangements to ensure that all key risks are identified, appraised and clearly reported to the decision maker.

Reducing the pension deficit

Audit and Governance Committee

The role of an audit committee is to support a council in fulfilling its governance and oversight responsibilities. In relation to external audit, an audit committee should determine if matters in a report require action and ensure that appropriate action is taken.

We have considered the role of Audit and Governance Committee in regards to the recommendations that have been presented to the Committee by Grant Thornton. We identified the special purpose company transaction as an area of focus within our 2019/20 audit plan and reported our concerns to the Committee on four occasions, two of which were ahead of the transaction being undertaken:

- July 2019
- September 2019
- December 2019; and
- 7 April 2020.

The recommendations were agreed at the Audit and Governance Committee meetings, but the Committee did not effectively discharge its duties and did not ensure that the recommendations raised were actioned in a timely manner. In our experience this is often achieved through a recommendation tracking system which is reviewed at committee meetings. The Audit and Governance Committee has a tracking system for actions required by the Committee but not for recommendations that require action by officers.

We also considered the role and function of the Audit and Governance Committee as set out within the Council's Constitution. They are high level functions and do not cover in any detail the responsibilities and requirements of an audit committee.

Discussions with officers and elected members also identified concerns regarding the workload of the Audit and Governance Committee, understanding of role of an audit committee and the need of training. The Audit and Governance Committee would benefit from a review and update of its roles and responsibilities, supported by training for elected members and an updated terms of reference which should be reviewed and updated annually by the Audit and Governance Committee.

Rec 4: The Council should ensure the Audit Committee is effective by ensuring members understand their roles and responsibilities. This should include:

- Reviewing and updating members' role and responsibilities, ensuring these are reviewed annually by the committee
- Introducing a mechanism to ensure all recommendations by External Audit and Internal Audit are actioned
- Regular training for all members.

Managing conflicts of interest

A conflict of interest is a set of circumstances that creates a risk that an individual's (elected member or officer) ability to apply judgement or act in one role is, or could be, impaired or influenced by another interest. Conflicts can exist, regardless of whether the individual actually benefits. The perception of competing interests, impaired judgement or undue influence can also be a conflict of interest.

As part of this review we identified two potential conflicts of interest that were known to the Council:

- The chair of the Audit and Governance Committee who was also a member of the Local Government Pension Scheme Partnership Committee. This interest was not recorded in the Councillor's register of interests
- Existing officer working relationships with Elysian and the Directors of Minerva prior to working with them at Plymouth City Council. This interest was documented but the action/mitigation required as a result was not recorded.

The Council has adopted a code of conduct for Councillors which is documented within its Constitution. This requires Councillors to declare any pecuniary interests and also any personal interests, both during committee meetings and as part of the annual declaration process. Annual declarations were completed for 2019/20.

However, a risk of a potential conflict can arise from a wide range of issues, not just pecuniary and personal interest and the decision about whether a councillor has an interest in any item of business at any point in time is a matter that they are required to consider personally. This increases the responsibility upon each individual councillor and the existing guidance focuses the Council to consider only personal and pecuniary interests. In our view the Council would benefit from providing more detailed guidance and training to ensure potential conflicts are recognised across a wide range of circumstance. This will ensure appropriate measures are put in place to manage the potential risks. The approach taken should be to declare potential interests as they become known not just when a conflict arises.

The Officer code of conduct requires officers to make any conflicts of interest financial or non-financial interest known to an appropriate Head of Service or Strategic Director. No detail is provided as to what might constitute a non-financial interest or how these interests should be managed. These interests have historically been maintained by individual departments, although we understand that a centralised system has been introduced as part of the core HR systems.

Reducing the pension deficit

Managing conflicts of interest continued

The Council does not have sufficiently detailed guidance which would support the Council's codes of conduct.

Whilst there is no evidence that any individual has acted improperly or that a conflict of interest raised has occurred and detrimentally affected a decision, our recommendation below aims to improve arrangements to ensure potential conflicts are effectively managed and mitigated.

Recommendation 5: The Council should minimise the potential for conflicts of interest to occur and should:

- Enhance the existing conflicts of interest policies, guidance and codes of conduct to ensure a wider range of potential conflicts are identified and managed appropriately
- Ensure the existing training for officers and elected members addresses the revised guidance and includes identifying and managing conflicts of interest.

Procurement procedures

Minerva had been working with the Council for some time prior to the pension deficit reduction transaction and an existing relationship was already established. The independent QC advice suggested that as there were no other potential suppliers, as far as they were aware, then the transaction was unlikely to give rise to any procurement issues.

Nevertheless, the Council still sought internal legal advice which confirmed via email that the Council's solicitor was satisfied with the arrangements. However, this advice was not documented and was not available to support the Council's position that the correct legal process was followed with regard to the engagement of Minerva.

Recommendation 6: The Council should ensure that where a decision relies upon internal legal advice, that the legal advice is formally documented, and the outcome and rationale for relying upon the advice is recorded.

Reducing the pension deficit

Follow-up of recommendations

The table sets out the Councils responses and our conclusions on the recommendations we have previously raised with the Audit and Governance Committee. Based on these findings we refer the reader to recommendation 4.

| | Recommendation | Council response | Grant Thornton conclusion |
|---|---|---|---|
| 1 | Obtain independent actuarial advice regarding the estimated pension liability amount. | There is comprehensive evidence of extensive exchange of information between Barnett Waddingham(BW), instructed by Devon County Council (DCC) as administering authority, and Lane Clark & Peacock (LCP), advising PCC and the special purpose company. The final valuation reflected the agreed position between PCC and DCC. After careful consideration, we believe that it was not necessary to obtain a third actuarial opinion. LCP, though jointly commissioned by PCC and the special purpose company were acting solely for the Council in respect of the valuation. We would welcome clarity on your concerns regarding their independence. | This recommendation was not actioned. BW were commissioned by DCC so were acting on behalf of DCC. LCP were commissioned by the special purpose company and advising both special purpose company and the Council and as such we do not considered LCP to be independent. |
| 2 | Obtain independent financial advice from financial advisers regarding the available options to the Council and consideration of all business case options including value for money. | Five options were considered in detail, informed by advice from independent financial advisors (Arlingclose), PCC's own internal specialists, the Corporate Management Team and the Cabinet. The Arlingclose recommendation was to explore making all (or the majority) of the scheduled deficit payments through a lump sum payment funded by capital and cash balances. As detailed in AH letter to PD of 10 October 2020, this was not feasible. Best Value considerations were at the heart of the decision making process. | This recommendation was not actioned. The only financial advice obtained was from Arlingclose. The options considered varied between advisors and the business case did not consider all options in detail. Although we recognise that the pre-payment option may not have been a viable option for the Council this was not appraised in detail and set out within the business case. |
| 3 | Obtain final independent legal advice as to the legality of the transaction including borrowing from PWLB to transact the payment of the pension fund liability and using a company to pass monies through. | David Lock QC was selected and instructed appropriately for the nature and size of the proposed transaction. His advice, and Grant Thornton's concerns were reviewed by the Council's Senior Commercial Lawyer, who was appropriately experienced and qualified to comment. Based on the above, further external legal advice was not deemed necessary or appropriate. | This recommendation was not addressed but we acknowledge the reasons why the Council considered it was not required. The QC advice was obtained in November 2018. The Council's Senior Commercial Lawyer reviewed this advice and our concerns in June 2019. This advice confirmed that in their view 'it is potentially lawful for a local authority to borrow capital in order to finance a one-off payment to the LGPS and thereby reduce future revenue costs....an invest to save project and thus could be an entirely lawful exercise of its powers by a local authority....a capital sum to meet a revenue expense, but the justification for that step would be the reduction of greater revenue costs in the future. Thus, as a matter of law, this is something that the Council could consider.' |

Reducing the pension deficit

| | Recommendation | Council response | Grant Thornton conclusion |
|---|--|---|--|
| 4 | Obtain independent due diligence on any companies or company structures that may be used to transact the payment – paying particular attention to any complexities and risks associated with the Financial Conduct Authority regulations | The Business Case as published (and correspondence with GT) confirms the Council’s opinion that the investment was not a financial promotion under s.21 of the FSMA 2000, and was therefore not subject to the Relevant Provisions. Although external advisors were retained to address this matter, it was not therefore deemed necessary to commission this advice. Advice was sought and obtained from the Council’s Senior Commercial Lawyer concerning the procurement process of Minerva and the structure of the special purpose company. The Chief Executive sought and obtained a statement from the (then) 151 Officer for due diligence purposes, and further asked for and received confirmation from the Monitoring Officer of its adequacy. | <p>This recommendation was not actioned.</p> <p>The failure to obtain and undertaken adequate due diligence increased the risk to which the Council was exposed. The Council’s opinion that the investment was not a financial promotion under s.21 of the FSMA 2000 was not based on independent advice.</p> <p>The Monitoring Officer has confirmed that the Council’s Senior Commercial Lawyer checked and was satisfied that the correct procurement procedures were followed the evidence to support this conclusion is outstanding.</p> <p>We have reviewed the statement from the Section 151 Officer with regards to their relationship with Minerva. We have requested evidence of how the Council considered this potential conflict of interest– outstanding.</p> |
| 5 | Obtain independent accounting advice on the special purpose company transaction | Upon review, the Council decided that its own treasury management team were able to provide assurance that the transaction complied with the borrowing process set out in the Council’s Treasury Management Strategy and the Prudential Code. Following QC advice on the legality of the capital transaction, the Council’s senior accountants set out the accounting treatment and shared with GT in October 2020. | <p>This recommendation was not actioned.</p> <p>Having executed the transaction in October 2019, the Council eventually provided an accounting paper in October 2020 to justify its proposed accounting treatment. This paper outlined the treatment as a capital transaction. Our review challenged this assumption based on our interpretation of accounting standards and the CIPFA Code. The Council has subsequently employed independent accounting advisers to review the accounting treatment of the transaction. The advisers have agreed with us that this is not a capital transaction, but rather an advanced payment. The Council continue to review the accounting treatment and is currently seeking further advice.</p> |
| 6 | Review the business case and re-present to Members | Presented and discussed with Cabinet 8 and 16 July 2019. | <p>This recommendation was partially addressed.</p> <p>The final version of the business case was provided as supporting documentation to the Leader in October 2019 to support the final decision. But as noted earlier the business case did not adequately appraise all the options.</p> |
| 7 | Ensure that detailed due diligence, business cases, financial information and decision-making papers are reviewed and discussed at Member level on an ongoing basis. | Between June 2018 and October 2019, the Section 151 Officer met with the Cabinet Member for Finance on over thirty occasions, during which the development of the proposal and advice received was discussed. | <p>This action was addressed through informal meetings with elected members. Whilst we would expect that informal planning and one-to-one meetings would take place we would expect that such an unusual transaction would be debated within formal Cabinet/elected member meetings. This would also have increased the opportunity for Scrutiny to have considered the transaction.</p> |

Interest rate swap

Background

In recent years whilst interest rates have been low, it has been the Council's approach to finance its capital programme through short term borrowing. The Council considers short term borrowing to be the cheapest form of borrowing, but this does expose it to the risk of an increase in interest rates and the risk that short term loans may not continue to be available.

As at 31 March 2019 the Council required external borrowing of £465m, 90% of its total capital finance requirement (£514m). Short term borrowing accounted for £339m (73%) of the external borrowing requirement. The Council were aware of the risk that focusing predominately on short term borrowing posed and in 2019 it began to consider the option of entering into an interest rate swap. An interest rate swap is a financial instrument where parties swap/exchange a variable interest rate for a fixed rate. The amount and duration of the swap is agreed. There is no exchange of principle, only the difference in interest rates is paid.

Treasury management decisions

The Council's Constitution sets out that the Responsible Finance officer (Section 151 Officer) is responsible for day-to-day treasury management in liaison with the Treasury Management Board. All treasury management transactions should be carried out in accordance with the Council's Treasury Management Practices. The Responsible Finance officer has authority from the City Council to make treasury management decisions.

The Treasury Management Strategy (TMS) and the Treasury Management Practices are approved by the City Council and the Audit and Governance Committee is responsible for scrutinising the TMS and practices prior to their approval by the City Council.

The table opposite summarises the key steps undertaken before and after the interest rate swap.

| Date | Key Step |
|-------------------|---|
| 11 February 2019 | The Treasury Management Board (TMB) were made aware of the possibility of an interest rate swap being undertaken. The presentation provided by the Council's treasury management advisors Arlingclose included interest rate swap. |
| 11 March 2019 | The Audit and Governance Committee agreed the Treasury Management Practices. These practices cover derivatives and interest rate swaps. |
| 11 May 2019 | Legal advice obtained. |
| 19 June 2019 | Another presentation was provided by Arlingclose to the TMB. Providing an updated position on current interest rates. |
| 20 August 2019 | The Section 151 Officer presented to the Corporate Management Team (CMT) on the Council's TMS and interest rate swaps. |
| 17 October 2019 | Arlingclose presented their detailed reports on interest rate swaps to the TMB. |
| 20 November 2019 | Internal legal advice sought that the decision could be made by the Section 151 Officer |
| 9 December 2019 | Audit Committee approved the Council's 2020/21 TMS which included the Council's policy on financial derivatives. |
| 1 April 2020 | The TMB received a further update from Arlingclose and it was reported that the Council was ready to complete the transaction on Monday 6 April. |
| 6 April 2020 | The interest rate swap was authorised by the Section 151 Officer for the value of £75m for a fixed term of 20 years. |
| 21 September 2020 | Audit and Governance Committee were asked to endorse the approach the Council is taking to reduce its exposure to future interest rate increases. The Committee were made aware of the £75m interest rate swap that occurred in April and updated that the Council has decided to take out a further £35m Interest Rate Swap to fixed borrowing rates for a period of 15 years. |

Interest rate swap

The decision making process

Treasury management differs from other areas of decision making within local government as the Section 151 officer and often officers below the Section 151 officer have the authority to make quick decisions which involve large amounts of money, often on a daily basis.

The decision to undertake an interest rate swap related to treasury management, in our view was not a decision on an everyday transaction. It was an innovative and unusual decision which as far as we are aware has not been taken by a local authority since the decision of the House of Lords in *Hazell v Hammersmith and Fulham LBC in 1992*. In addition, if successful the interest rate swap should save the Council in the region of £20m. For this reason we consider that the decision was likely to be of public interest. However, because the decision was made by the Section 151 Officer as part of the Council's treasury management arrangements the decision was not scrutinised by elected members and the decision was not published. Neither was a options appraisal or business case required.

The Council had sought internal legal advice to confirm that the decision could be taken by the Section 151 Officer and the view taken was that had it not been taken by the Section 151 Officer then the decision would not have been in keeping with the Council's own procedures. The decision was based upon the Treasury Management Board (TMB) having been consulted and being in agreement to proceed. Although the TMB is a cross party group, which can challenge and suggest, it is not a formal decision making group and does not enable transparent and open challenge debate. Detailed formal minutes of the meetings were not maintained, so it is difficult to determine the level of challenge that was provided. Action notes were recorded. We note that CMT were also consulted on two occasions.

The decision was not taken over a short timescale and as the table on the previous page illustrates the decision was considered over a 14 month period. It is for this reason and the reasons noted above that we consider that the decision could have been made by elected members in a more open and transparent manner. It did not need to be a delegated decision by the Section 151 Officer. In order to be in line with the Council's Constitution the decision would have had to be made by the City Council.

Rec 7: In order to enable innovative and unusual treasury management decisions to be formally scrutinised, debated and as appropriate made by elected members the Council should update the Constitution and Treasury Management Principles to:

- Enable treasury management decisions to be made by elected members
- Define significant delegated decisions, such as 'innovative and unusual'
- Ensure the following are made aware of unusual treasury management activity before a decision is made:
 - Chair of the Audit and Governance Committee
 - Portfolio Lead
 - Chair of the Scrutiny Committee.

Therefore, it would be for the Council to determine what transactions would meet the criteria of innovative and unusual, we would suggest that overly prescriptive criteria may restrict the Council's judgement when considering innovative transactions and maintaining an element of judgement would be beneficial.

In addition despite all the processes described above to inform relevant stakeholder, Grant Thornton your external auditors were not informed of this proposal.

Rec 8: The Council should ensure that it consults with its external auditors before any unusual treasury management transactions are completed.

Treasury Management Practices (TMP)

The Treasury Management Practices delegates responsibility for the implementation of the TMS and regular monitoring of policies and practices to the Audit and Governance Committee.

In March 2019 the Audit and Governance Committee approved the 2019/20 Treasury Management Practices and the TMS in December 2019. In March 2020 the Audit and Governance Committee was cancelled and as a result the 2020/21 Treasury Management Practices were not approved.

The Audit and Governance Committee were not formally made aware or asked to endorse the interest rate swap completed in April 2020. It was not until September 2020 that the Audit and Governance Committee were asked to endorse the Council's approach to reduce its exposure to future interest rate increases. It was at this point that the Committee were made aware of the £75m interest rate swap that had occurred in April 2020 and updated that the Council had decided to take out a further £35m Interest Rate Swap with fixed borrowing rates for a period of 15 years.

In order to enable the Audit and Governance Committee to discharge its duties it should have been formally updated and asked to review the interest rate swap transaction prior to the transaction being undertaken.

TMP3 relates to decision making and analysis. With regard to major treasury decisions the following is documented:

'As a public service organisation, there is a requirement to demonstrate openness and accountability in treasury management activities. Accordingly, the Council will create and maintain an audit trail of major treasury management decisions.'

We compared how a delegated decision for an elected member is recorded with this decision and consider that the interest rate swap was a major treasury decision and as such an audit trail should have been created of the decision.

Interest rate swap

Treasury Management Practices (TMP) continued

However, a detailed formal record of the decision was not maintained, only a confirmation of the investment/borrowing which was dated and signed by the Section 151 Officer. A document was provided that set out the rationale for the decision, however this document was not dated and in parts is worded to suggest it was written after the decision had been made. For example *'In April 2020 the Council agreed its first Interest Rate Swap of £75m which gives a fixed cost of borrowing of 0.56% for the next 20 years.'*

A range of documentation has been provided that supports the decision taken, however because this transaction has been debated within informal meetings a record and the extent of the debate was not recorded. As a minimum the Council should record the rationale for the decisions and the supporting documentation considered at the point of the decision.

Whilst we appreciate that treasury management involves frequent consideration of the risks and judgement calls we consider that these judgements should be recorded to enable an audit trail to be maintained.

Rec 9: The Council should formally record innovative and unusual treasury management decisions, as defined by the Council in recommendation 7. As a minimum this should include:

- Decision taker, and why the decision is a delegated decision
- Date of decision
- Reasons for the decision
- Risk considered/mitigated
- Alternative options considered and rejected
- Financial and legal implications
- Supporting documents/information considered to inform the decision.

Corporate Management Team

The CMT includes the Chief Executive, all the Strategic Directors and the Section 151 Officer. However, it does not routinely include the Monitoring Officer. The Monitoring officer will attend if requested or will request to attend if they consider it was beneficial.

The legal aspects of agenda items are usually addressed prior to items being discussed by CMT. However, to ensure the Monitoring Officer can affectively discharge their duties consideration should be given to whether the Monitoring Officer should attend.

Rec 10: Consider if the Monitoring Officer should attend all CMT meetings, along will all the Council's other Statutory officers.

Managing Risk

When an organisation is embarking on a new and innovative approach it is important that it understands and effectively manages the risks. Whilst the risks were considered by the Council's advisors Arlingclose, these risks were not quantified and included within the Finance Operational Risk Register or documented in any other way by the Council to demonstrate that it fully understand the underlying risks and any additional risks that might result.

The financial advisors, Arlingclose also identified that an appropriate risk management framework should be in place and that the risks should be *'explicitly designated and documented'*. The Council proposed that the risk management framework is addressed by the Council's Treasury Management Strategy. However, we do not consider that the risks are not effectively managed by Treasury Management Strategy.

The interest rate swap was not included within the Finance Operational Risk register until August 2020. The risk register did not consider the risk of undertaking the interest rate swap, but just considered it as an action/mitigation to manage the risk of the Council's expenditure exceeding resources.

As per recommendation 3: The Council should improve its financial risk management arrangements to ensure that all key risks are identified, appraised and clearly reported to the decision maker.



Selection Process for Santander Bank

A tender process was not undertaken to select Santander, as the Council were of the view that no other banks were offering a similar transaction. This decision was documented and we are unclear how this could be determined without posing the question to the market.




Recommendation 11: To ensure the Council achieves best value for all its treasury management transactions the Council should:

- Consider testing the market for unusual one off transactions
- Document procurement decisions and supporting judgements.




Action plan

| Assessment | Recommendations | | | | |
|--|--|----------------------------|---------------|------------------------------|----------------|
| <p>1</p> <p> (High)</p> | <p>The Council should further improve its governance arrangements so that the number of key decisions are made outside of formal elected member meetings is limited, thereby enhancing openness and transparency:</p> <ul style="list-style-type: none"> • Formal guidance should be developed for decision makers setting out when discretion could be exercised and their delegated powers not used, ensuring consideration is given to identifying the most appropriate place to make a decision on an innovative and unusual transactions • Decision makers should be provided with documents that clearly assess and accept or reject all potential and relevant options and key issues • Processes are put in place to ensure Chairs of Scrutiny Committees are given every opportunity to effectively challenge and debate unusual transactions • Any questions raised by external advisors, including legal advice are formally closed and addressed by the Council. <p>Management response</p> <p>Accepted</p> <p>The Council will:</p> <ol style="list-style-type: none"> Develop guidance in consultation with stakeholders for decision makers to inform discretion over decision making through delegated decisions or at Cabinet. Review and update guidance covering documentation for decision makers which addresses alternative options and reasons for rejection. Scrutiny chairs will receive and will be briefed on the content of the Council's Forward Plan for key decisions, and the description of these decisions will be reviewed to ensure that it is sufficiently detailed for their proper consideration. <table data-bbox="465 778 1146 847"> <tr> <td>Responsible Officer</td> <td>Timing</td> </tr> <tr> <td>Assistant Chief Executive</td> <td>September 2021</td> </tr> </table> | Responsible Officer | Timing | Assistant Chief Executive | September 2021 |
| Responsible Officer | Timing | | | | |
| Assistant Chief Executive | September 2021 | | | | |
| <p>2</p> <p> (High)</p> | <p>The Council should further improve its processes for the production of business cases to ensure:</p> <ul style="list-style-type: none"> • A detailed options appraisal is undertaken where appropriate • Material business cases fully appraise all the options • An agreed and consistent approach for the approval of business cases is developed and adopted. <p>Management response</p> <p>Accepted</p> <p>The Council will:</p> <ol style="list-style-type: none"> Produce a standard business case format for unusual and innovative financial transactions Set down a working procedure for the passage of such cases though the governance path. <table data-bbox="465 1177 1146 1248"> <tr> <td>Responsible Officer</td> <td>Timing</td> </tr> <tr> <td>Service Director for Finance</td> <td>September 2021</td> </tr> </table> | Responsible Officer | Timing | Service Director for Finance | September 2021 |
| Responsible Officer | Timing | | | | |
| Service Director for Finance | September 2021 | | | | |

Controls

-  High – Significant effect on control system (red)
-  Medium – Effect on control system (amber)
-  Low – Best practice (green)


Action plan

| Assessment | Recommendations |
|--|--|
| <p>3</p> <p> (High)</p> | <p>The Council should improve its financial risk management arrangements to ensure that all key risks are identified, appraised and clearly reported to the decision maker.</p> <p>Management response</p> <p>Accepted. The Council will:</p> <ul style="list-style-type: none"> Adjust proformas used for Corporate Management Team, Cabinet Reports and delegated decisions to ensure that a section is added to record (a) financial risks and (b) the mitigation of same. <p>Responsible Officer Assistant Chief Executive and Service Director for Finance</p> <p>Timing September 2021</p> |
| <p>4</p> <p> (High)</p> | <p>The Council should ensure the Audit Committee is effective by ensuring members understand their roles and responsibilities. This should include:</p> <ul style="list-style-type: none"> Reviewing and updating members' role and responsibilities, ensuring these are reviewed annually by the committee Introducing a mechanism to ensure all recommendations by External Audit and Internal Audit are actioned Regular training for all members. <p>Management response</p> <p>Accepted The Council will:</p> <ol style="list-style-type: none"> Develop a training programme for the Audit and Governance Committee in consultation with the Chair. Introduce a tracking system for all audit recommendations. Invite Internal and External Audit to participate in the training programme. <p>Responsible Officer Service Director for Finance</p> <p>Timing September 2021</p> |
| <p>5</p> <p> (Medium)</p> | <p>The Council should minimise the potential for conflicts of interest to occur and should:</p> <ul style="list-style-type: none"> Enhance the existing conflicts of interest policies, guidance and codes of conduct to ensure a wider range of potential conflicts are identified and managed appropriately Ensure the existing training for officers and elected members addresses the revised guidance and includes identifying and managing conflicts of interest. <p>Management response</p> <p>Accepted The Council will:</p> <ul style="list-style-type: none"> Review and update existing conflicts of interest policies, guidance and codes of conduct in line with best practice and ensure that appropriate training is in place to support the revised approach. <p>Responsible Officer Assistant Chief Executive</p> <p>Timing October 2021 (Note: any changes to the constitution in respect of the management of interests will need to be agreed at a meeting of the Council)</p> |

Action plan

| Assessment | Recommendations |
|---|--|
| <p>6</p> <p>●</p> <p>(High)</p> | <p>The Council should ensure that where a decision relies upon internal legal advice, that the legal advice is formally documented, and the outcome and rationale for relying upon the advice is recorded.</p> <p>Management response</p> <p>Where a council decision relies on internal legal advice the legal service will continue to and assure that its advice is formally documented on the legal department's case management system. The legal service will update its work instructions for general legal advice in line with this recommendation and include the new work instructions in its quality assurance system for monitoring and review purposes. The council will ensure that the existing process for securing legal sign off is reviewed and updated in line with this recommendation.</p> <p>Responsible Officer Assistant Chief Executive</p> <p>Timing September 2021</p> |
| <p>7</p> <p>●</p> <p>(High)</p> | <p>In order to enable innovative and unusual treasury management decisions to be formally scrutinised, debated and as appropriate made by elected members the Council should update the Constitution and Treasury Management Principles to:</p> <ul style="list-style-type: none"> • Enable treasury management decisions to be made by elected members • Define significant delegated decisions, such as 'innovative and unusual' • Ensure the following are made aware of unusual treasury management activity before a decision is made: <ul style="list-style-type: none"> • Chair of the Audit and Governance Committee • Portfolio Lead • Chair of the Scrutiny Committee. <p>Management response</p> <p>Accepted but with reservations The Council will:</p> <ol style="list-style-type: none"> a. Define 'Innovative and Unusual' within the Treasury Management Strategy when next updated. b. Consult with the External Auditor on these changes. <p>The Council has reservations about part of this Action Point because:</p> <ul style="list-style-type: none"> • Treasury Operations are highly technical in nature and often requiring a rapid decision path. This is why the treasury function is delegated to the Section 151 Officer as a general principle across the sector. Accordingly the Council is concerned that insofar as this recommendation requires member decision making it is out of step with national practice within the sector. <p>Responsible Officer Service Director for Finance</p> <p>Timing October 2021</p> |

Action plan

| | Assessment | Recommendations |
|----|---|--|
| 11 |  (High) | <p>To ensure the Council achieves best value for all its treasury management transactions the Council should:</p> <ul style="list-style-type: none"> • Consider testing the market for unusual one off transactions • Document procurement decisions and supporting judgements. <p>Management response Accepted. The Council will:</p> <ul style="list-style-type: none"> • Adopt the recommendation as described. <p>Responsible Officer Service Director for Finance</p> <p>Timing August 2021</p> |

