
Investment Process Review

June 2003

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Introduction

In 2002, Corporate Services Department requested that the Office of the City Auditor (OCA) conduct a review of the City's investment processes. The OCA's 2003 Annual Work Plan included project time for the Investment Process Review. This review focused primarily on compliance and governance issues and was designed to provide assurance that the investment processes and methodologies employed are consistent with a reasonable system of internal controls.

Background

In 2001, the City's Investment Management function was significantly changed, a new investment management structure was implemented, and changes were made to City Investment Policy C212B. This policy is intended to ensure that funds are put to their best use through appropriate investments.

The City averages approximately \$250 million in short-term and \$1.6 billion in long-term investments. The City's Investment Management Section internally manages approximately \$800 million of the investment portfolio, which includes the Sinking, General, Transportation and Ed Tel Defeasance Funds. External investment managers manage the balance, which includes Reserve, Ed Tel Endowment, and Pension Funds (refer to Tables A and B for details). These investments are made on behalf of the citizens of Edmonton or for designated beneficiaries of pension or trust funds.

Corporate Services Department, Treasury Operations Investment Management Section is responsible for administering the investment portfolio in accordance with City Policy C212B, the Municipal Government Act of Alberta, and other established regulations and mandates. An investment committee appointed by the City Manager has the responsibility for ensuring prudent investment of the City's funds. The committee is responsible for reviewing the appointment and termination of investment managers, recommending changes to the investment policy and monitoring investment results and policy compliance. City Council, as the governing fiduciary body, is to periodically receive reports and recommendations from the City Manager and approve the investment policy and any amendments to it.

The City of Edmonton Investment Portfolio is structured as per the following tables:

Table A: Investments Managed Externally (in millions)

Fund	Market Value – Dec 31, 2001	Market Value – Dec 31, 2002
Reserve Fund	\$326	\$336
Ed Tel Endowment Fund	\$588	\$561
Pension Fund	\$115	\$107
Total	\$1,029	\$1,004

Table B: Investments Managed by City Staff (in millions)

Fund	Market Value – Dec 31, 2001	Market Value – Dec 31, 2002
Sinking Fund	\$512	\$555
General Fund*	\$133	\$111
Transportation Fund	\$120	\$102
Ed Tel Defeasance	\$30	\$16
Total	\$795	\$784

**Note: The General Fund reaches a peak each July of approx. \$375 million.*

Funds Defined

External Investment Managers manage the following funds:

- The **Reserve Fund** provides an investment vehicle for funds with a longer time horizon and a risk tolerance level that permits owning equities.
- The **Ed Tel Endowment Fund** was created in 1995 and holds the financial assets generated by the sale of Edmonton Telephones to the Telus Corporation. The purpose of the fund is to provide an income source and a financial legacy for the City.
- The **Pension Fund** consists of the Firefighters Supplemental Fund and the Fire Chiefs and Deputy Fire Chiefs Supplemental Fund.

The **City Investment Management Section** manages the following funds:

- The **Sinking Fund** has existed since the incorporation of the City of Edmonton and was established to fulfill the requirements of various public debenture issues (borrowings) requiring funds to be regularly set aside for the eventual redemption of these debenture issues.
- The **General Fund** (a working capital fund) represents the excess or shortfall in the daily operating funding requirements of the City. The purpose of this fund is to ensure that sufficient cash and liquid assets are available to cover the City's short-term obligations.
- The **Transportation Fund** (a working capital fund) was established in 2000 as a result of the fuel tax grants from the Province. The agreement with the Province restricts the use of those funds.

- The *Ed Tel Defeasance Fund* was created in 1999 as a result of Telus Corporation's decision to pay the old Ed Tel debt by using a portfolio of bonds. The final payment from the fund will occur in November 2004.

Audit Objective

To ensure that the investment activities in 2002 complied with the governing legislation and the City's Investment Policy C212B and that they were conducted in an efficient manner and properly monitored.

Audit Scope

The scope of this review included:

- Ensuring that the investment activities during 2002 were in compliance with governing documents: Investment Policy C212B, the Municipal Government Act of Alberta, and specific mandates.
- Determining whether investment operations were conducted in an efficient manner and properly monitored.
- Evaluating the effectiveness of the governance roles outlined in the Investment Committee terms of reference.

Methodology

The OCA:

1. Established and maintained contact with the Investment Management Section of Treasury Operations throughout the project.
2. Developed a comprehensive program to review controls, record keeping, and compliance.
3. Conducted a walk-through of the processes to ensure that adequate controls are in place to minimize risks and ensure compliance to applicable policies, investment mandates, and procedures.
4. Reviewed investment committee minutes and numerous reports on investment compliance, economic updates, as well as performance and risk assessment studies.
5. Conducted compliance testing and system testing as required to determine whether the investment process is providing reliable and adequate information for accountability and decision-making purposes.

Summary of Results

The OCA developed a comprehensive audit program to assess whether the investment activities in 2002 complied with governing legislation, the City's investment policies and specific mandates, and to address areas where there are opportunities for improvement. Several observations were identified and communicated to the Administration along with recommendations based on best practices and industry standards. The status was assessed through meetings, analysis, walkthroughs, review of documentation, and compliance testing where applicable. Corporate management has accepted and established implementation dates for all action plans, and, where possible, immediate action was taken.

Overall, City Policy C212B provides investment guidelines and specific direction on the objectives and intended outcomes of the investment portfolio. Roles, responsibilities, and accountability for the management of and involvement in the investment portfolio program have been formally defined in the City of Edmonton Investment Committee Terms of Reference and Investment Management Section procedures and responsibilities.

Investment Compliance

Compliance Monitoring (Segregation of Duties)

The OCA reviewed the investment activities for 2002 to determine if they complied with the governing documents: Investment Policy C212B and the Municipal Government Act of Alberta, and specific mandates. The OCA reviewed a sample of investment activities that were completed throughout the year for compliance with policies and mandates, for asset mix; fixed income and equity position; and fixed income, equity sector, and cash sector limits. The following observations were made:

1. Input activity into the Treasury system is appropriate for type of security, issuer, amount, interest rate and maturity.
2. For the investments of surplus funds, the investments were based upon reliable cash forecasts.
3. Performance measurement criteria exist for each investment fund.
4. Compliance review is completed and reported for both externally and internally managed funds. The Investment section manages and prepares compliance reporting quarterly to Investment Committee on the internally managed funds (approximately \$800 million). Both managing the funds and reporting on compliance of the funds could compromise the information presented to Investment Committee and management.

The Investment Management Section's role with the externally managed funds is to monitor the investment activity and to build working relationships with external investment managers. This includes compliance testing and ensuring that any deviations from policy and regulations are acted upon immediately to minimize risk

exposure; evaluating adherence to stated management style and investment process restrictions; and maintaining awareness of staffing and firm changes.

The Investment Management Section has the responsibility for directly managing four funds: The General Fund, Transportation Fund, EdTel Defeasance Fund, and the Sinking Fund. Currently, the Investment Management Section both manages the four funds and reports on compliance activity. Independence and segregation of duties for staff who manage investments and those who report on compliance is necessary in order to ensure objectivity in the reporting process and that the information presented cannot be compromised (Recommendation 1).

Bid Records, Dealer Activity, and Fees

The OCA completed a sample analysis of the blue bid sheets, which are the worksheets used for investment and borrowing. In most cases, three bids were obtained except in cases where specific purchases were required and not all vendors could provide those investments.

An analysis was prepared of investment dealer distribution for 2002. One financial institution received somewhat more investment activity than the other dealers. This is mainly due to limited availability of specific investments from particular dealers. However, the observed distribution could be interpreted as the City providing preferential treatment to one Financial Institution over others. In the best interest of the organization, clear justification is required of the dealer chosen for each investment (Recommendation 2).

The OCA also reviewed contractual agreements to compare scheduled (estimated) fees and the actual fees paid. The results show that the amounts paid generally agree with those stated in the contractual agreement and in some cases exceeded estimated amounts. Since the investment management fees are based on a percentage of asset market value, the actual payments may be above or below the estimates provided in the agreement.

Settlement Confirmation

The OCA observed investment activity processes and found the investment functions to be performed diligently by the Officers. The Investment Officer's role is to position the City's Bank Account and to invest excess cash, and sell or borrow to cover shortfalls. In addition, this position is responsible for maintaining a list of Issuers as per Investment Policy C212B; record investments, sales and borrowings; release maturing investments and borrowings; prepare wire transfers and settlements and provide the first of two levels of approval.

Overall, the process is well organized and investments are based upon reliable cash forecasts. The one control that should be enhanced in the overall approval process is the review of investment settlement confirmation instructions that are being sent to the custodian. This information should be retained for a longer period than the current

three-month retention period and be referenced to the pertinent blue ticket. Although the approval of this data is archived in the SAP system, this data is not easily retrieved for verification by independent review (Recommendation 3).

Controls, Record Keeping, Efficiency

The OCA prepared a comprehensive audit program to determine whether investment operations had effective controls and activities were conducted in an efficient manner and properly monitored.

Treasury System

The OCA reviewed and tested SAP Treasury System access user profiles “Treasury Officer” and “Treasury Administrator.” All areas of accessibility were unique to the different profiles except in such areas as cash forecasting, which was acceptable. The OCA conducted a variety of tests and was satisfied that adequate controls are in place.

The OCA checked to see if the treasury system (in both the Testing and QA systems¹) could accept transactions in excess of approved limits. In some cases, the system accepted transactions without any warning that the limits were being exceeded and incorrectly added the outstanding balance. That problem did not occur in the production system. However, a problem was observed in production regarding maturity and par value requirement fields that could contribute to inadvertently exceeding the approved investment limits. The treasury officers contacted Information Systems staff for immediate correction to this problem (Recommendation 4).

Conflict of Interest

The Investment Management Section requires its employees to comply with the code of ethics and conduct established by the City of Edmonton in addition to the Association of Investment Management and Research (AIMR) code of conduct. The Investment Management Section indicates their compliance to the conduct code at the end of each year by completing Conflict of Interest declaration forms. The section should require all new employees (including co-op students) to read applicable codes and sign the form in advance to ensure that he/she is aware of conflict of interest procedures and that any potential conflicts are resolved prior to employment.

The OCA reviewed conflict of interest declaration forms for two of the seven Investment committee members; those members are the two internal managers appointed to the Investment Committee. The other five members had not completed conflict of interest forms. The OCA recommends that conflict of interest declaration forms be extended to

¹ “Testing” and “QA” are testing and evaluation environments. The actual system in use by Investment Management is referred to as “Production.”

all Investment Committee members as well as all employees involved with daily investment activity (Recommendation 5).

Debt Objective – Borrowing and Investing

Projects approved under the Capital Priorities Plan often require bridge financing. The City typically borrows required funds from the Alberta Municipal Finance Corporation (AMFC) to meet these needs. The cash flow should be timed so that monies are received in time to meet payment obligations, but not so far in advance that they are invested at a lower rate of interest so that the City experiences a net loss through debt repayments.

In the November 2002 borrowing and investing activity, \$23 million was borrowed from AMFC at approximately 5.8% and reinvested at approximately 2.8%. If this pattern persisted over a full year, this difference or loss could amount to \$690K or \$56K per month. A more integrated and congruent approach to borrowing and investing of funds is necessary in accounting for AMFC borrowings and the turn around investing of those funds (Recommendation 6).

Governance Evaluation

The CICA Criteria of Control Board (CoCo) has issued guidelines intended to be useful to all kinds of organizations. CoCo provides guidance for a board of directors or committee to fulfil its responsibility for “control.” Control includes the governance processes that need to be followed to ensure that controllable risks are properly managed. The CoCo framework consists of such criteria as purpose, commitment, capability, monitoring and learning. Effective governance is made up of four major components: leadership, stewardship, responsibility, and accountability. The OCA used the CoCo framework in evaluating the governance structure of the investment portfolio.

The OCA analyzed numerous documents during the governance evaluation process: Investment Committee Terms of Reference which outlines roles and responsibilities; Investment Committee minutes; presentations and studies; compliance reports; quarterly and annual reports; codes of ethics; conflict of interest guidelines; management selection process; and related policies.

The OCA reviewed presentations from various external managers that are made at Investment Committee meetings throughout the year. The OCA observed and noted that EPCOR representatives present overviews on the financial performance, governance, and risk management of the organization at Investment Committee meetings on a regular basis. Investment Committee meetings are held monthly and quarterly updates are presented in March, May, August and November of each year. Investment Committee members appear to have sufficient opportunity to be heard and have their views discussed and to participate as equals at meetings. Based on the OCA’s review of minutes and meeting observations, the records of proceedings present a fair representation of Investment Committee members’ participation and approach to the agenda items.

The OCA observed that the CFO for the City of Edmonton performs a dual function as the General Manager of Corporate Services (responsible for the Investment Management Section) and as the Chairperson of the Investment Committee. This could be perceived as a conflict of interest. However, the OCA noted that there are compensating controls in place to address such perceptions. For example, 5 of the 7 members are external members, Council approved Investment Policy C212B, and Council approved the Investment Committee Terms of Reference that outlines roles and responsibilities of the members. Each of these serve as compensating controls.

The Investment Management Section presents quarterly compliance reports to Investment Committee. However, the Investment Management Section also manages approximately \$800 million of the funds. As previously discussed, this creates a segregation of duties issue for the information presented to Investment Committee (see Recommendation 1).

Reporting to City Council

Internal reporting on market evaluation is completed quarterly for Investment Committee and City Manager. As per policy C212B a report is presented to Council by the City Manager annually. However, given the ongoing changes in the market and impact on City revenues, frequency of communication to Council should be increased (Recommendation 7).

Timeliness of reporting

Review of Quarterly reports to Investment Committee indicated that reports were prepared and presented on March 27, 2002 for December 31st, 2001 investment status; on May 24th for March 31st; on August 24th for June 30th; and on December 6th for September 30th investment status. Investment performance for the first quarter was presented to the Investment Committee on June 28, 2002. It normally takes up to six weeks to receive financial information from the performance measurement consultant. During that time the Investment Section is able to calculate the information necessary for optimum decision-making. The Investment Section feels that nothing would be gained from receiving this information earlier.

Strategic Risk Management

Rapid changes in interest rates, investment yield curves structure, exchange rates and commodity prices have made the financial environment riskier today than it was in the recent past. Therefore, boards of directors, shareholders, and management need to ensure that corporate risk management activities are strategically assessed, prioritized, controlled, and reported adequately. At this time, the City does not have a comprehensive long-term risk management strategy in place to deal with investment uncertainty in the market. However, management has indicated that they are currently working on a risk management minimization study to deal with dividend sustainability on a specific investment and fund (Recommendation 8).

Conclusion

The OCA believes that implementation of the above opportunities will significantly enhance the internal control processes of the Investment Management Section and the Investment Committee.

The OCA would like to acknowledge the cooperation we received from the Investment Management Section and all individuals contacted during this review.

Summary of Recommendations and Action Plans

Recommendation	Action Plans
<p>1. Compliance Monitoring (Segregation of Duties)</p> <p>That those completing and reporting on investment compliance are independent of those managing the funds or handling day to day investing activity.</p>	<p>Accepted Planned implementation date: April 2004</p> <p>Response: <i>The current process for the internally managed funds consists of a monthly review by the Director, Treasury Management, Finance, Branch Manager, the Chief Financial Officer, and a quarterly review by the Investment Committee and the City Manager.</i></p> <p><i>Management agrees that the process could be improved by independent preparation of the compliance reporting if a resource with the required skill set is available without significant cost.</i></p> <p><i>Management believes that a practical alternative to independent report preparation would be an annual review of investment compliance by the Office of the City Auditor.</i></p>
<p>2. Bid records, Dealer Activity and Fees</p> <p>That in the best interest of the organization, clear justification be required of the dealer chosen for each investment .</p>	<p>Accepted Planned implementation date: Currently in place</p> <p>Response: <i>Pricing and product availability are the fundamental determinants of the selection of dealers when completing investment transactions. Management will ensure that the current system of documenting competing bids and justification when competing bids are unavailable is continued.</i></p>

Recommendation	Action Plans
<p>3. Settlement Confirmation</p> <p>That the retention of investment settlement confirmation instructions be retained for a longer period of time than the current three-month period and be referenced to the pertinent blue ticket.</p>	<p>Accepted Planned implementation date: June 30, 2003</p> <p>Response: <i>Although the same data is available form querying the SAP Treasury system, management will maintain a copy of the settlement instructions for transactions completed in each calendar year for a period of 6 months after each calendar year-end.</i></p>
<p>4. Treasury System</p> <p>a) In the short term, ensure that the treasury officers continue to pay close attention to limits and balances outstanding as well as to the maturity and par value fields when performing investment activities until the System Owner and Data Administrator investigate and correct the program anomalies.</p> <p>b) That the Office of the City Auditor be invited to participate early in the update project for the Treasury Security System to provide proactive control-related feedback.</p>	<p>Accepted Planned implementation date: QA System Errors: July 31, 2003</p> <p>Response: <i>The errors encountered in the QA system will be corrected to ensure that they are not transported to the Production environment.</i></p> <p><i>The Office of the City Auditor will be invited to participate in the Treasury System Update.</i> (Timing of this project is currently uncertain)</p>

Recommendation	Action Plans
<p>5. Conflict of Interest</p> <p>That each new employee sign conflict of interest declaration forms in advance of employment and that conflict of interest declaration forms be extended to all Investment Committee members.</p>	<p>Partially Accepted Planned implementation date: June 30, 2003</p> <p>Response: <i>Management accepts the recommendation that new employees should sign the conflict of interest declaration forms in advance.</i></p> <p><i>Management does not accept the recommendation of extending the annual conflict of interest statements to the Investment Committee. Investment decision making responsibility is delegated to the Chief Financial Officer (CFO). The Investment Committee is established as an advisory Board to the CFO. The Investment Committee does not have decision-making responsibilities that could be influenced by conflicts of interest. Further the nature of the City's investments and investment manager structure do not provide opportunities to the Investment Committee to have personal gains from the information on the City's investments.</i></p>

Recommendation	Action Plans
<p data-bbox="201 264 594 300">6. Borrowing and Investing</p> <p data-bbox="201 333 764 478">That a more integrated and congruent approach to borrowing and investing be used to ensure protection of the best interests of the organization as a whole.</p>	<p data-bbox="820 256 1419 317">Accepted Planned implementation date: December 31, 2003</p> <p data-bbox="820 342 1382 485"><i>Response: Obtaining the overall lowest cost of borrowing to the organization is the main objective for borrowing decisions.</i></p> <p data-bbox="820 506 1414 758"><i>This requires consideration of the timing of cash outflows to avoid the 'negative carry' described in the observation, however the more important issue is the timing of debt issuance to take advantage of lower interest rates at certain times in an economic cycle.</i></p> <p data-bbox="820 779 1414 1171"><i>This is an area that has seen some improvement in the last year. All borrowing decisions are now made by the Investment Strategy Committee, which meets weekly. Management acknowledges that improved communication and information flow between the Investment Management Section, Corporate Accounting and the Operating departments will enable further improvement in to this function.</i></p> <p data-bbox="820 1192 1398 1289"><i>The Finance Branch will undertake a review to determine more specific needs and action required.</i></p>
<p data-bbox="201 1318 605 1354">7. Reporting to City Council</p> <p data-bbox="201 1388 786 1717">That relevant aspects of the quarterly information currently presented to Investment Committee and the City Manager be reported to City Council when it impacts the City Budget. This information could be presented through a medium currently in place, i.e., current quarterly financial performance reporting process.</p>	<p data-bbox="820 1312 1328 1373">Accepted Planned implementation date: Immediately</p> <p data-bbox="820 1394 1377 1570"><i>Response: When Investment performance impacts the City's budget, the impacts will be reported to City Council through the Finance Branch financial performance reporting.</i></p>

Recommendation	Action Plans
<p>8. Strategic Risk Management</p> <p>That ongoing work continues on the long-term investment risk management strategies to deal with the sustainability of revenues and dividend losses during times of uncertainty.</p>	<p>Accepted Planned implementation date: On-going</p> <p><i>Response: The Ed Tel Endowment Fund is the largest contributor to City revenues from the Investment Management Section. The review under way at the time of writing will address the City's budget risk from this investment fund.</i></p> <p><i>Risk management strategies related to the City's budget risk from the City's large private equity investment will be presented to City Council in late 2003.</i></p>