Financial Sustainability Program

Information Paper 15

Treasury Management

June 2008

Introduction

Most Councils have capacity to better serve communities by making greater use of debt and achieving financial savings and reductions in risk from a more holistic approach to managing their borrowings and investments. These benefits can often be achieved through some relatively simple improvements in financial governance.

In the past it has been commonly accepted practice for Councils to raise borrowings for specific purposes and at the same time set aside funds for specific future expenditures. Recent changes in legislation now support a longer-term financial planning focus by Councils and these, coupled with the earlier introduction of accrual accounting, have been catalysts for changes in recommended treasury management practices.

If a Council bases budget revenue and expenditure decisions on a funding basis (e.g. by 'balancing' a 'rates determination statement') rather than on information from its Long-term Financial Plan (LTFP) it will find it harder to realise the benefits available from following contemporary treasury management practices.

This information paper discusses the key elements of treasury management and includes, at Attachment 1, a Model Treasury Management Policy that enables Councils to embrace the recommended treasury management practices. A glossary of the accounting terms used is included at Attachment 2 and some examples that illustrate the application of the treasury management principles set out in the model policy are included in Attachment 3. The information paper has been informed by the Local Government Act, 1999 and relevant South Australian Local Government financial management reference material including the LGA Financial Sustainability Information Papers on Debt Management (No.10) and Financial Targets (No.12) and the "Investment Policy and Review of Investments" guidance paper published by the SA Local Government Financial Management Group Inc in 2002.

The information paper aims to provide support to Councils as they formulate their own policy framework for treasury management decisions. It provides a structure within which Councils can consider and record their treasury management decisions. Councils should consider the content of the paper and adapt the Model Treasury Management Policy at Attachment 1 to suit their individual circumstances. In particular some text is italicised and included in square brackets. In these areas Councils should insert specific detail relevant to their own circumstances. Once adopted, Councils should review their treasury management policies on a regular basis (say annually).

This paper should be read in conjunction with other information papers which highlight the increasing demands on Councils and the importance of efficiently managing the delivery of services, and in particular in conjunction with those papers addressing:

- Long-term Financial Plans
- Local Government Financial Indicators
- Targets for Local Government Financial Indicators
- Debt Management

Other information papers have been, or will soon be, prepared on the following topics:

- Financial Sustainability
- An Overview of Audit Mechanisms
- Audit Committees
- Scope of External Audit – Audit Specification
- Efficiency and Economy Audits
- Infrastructure and Asset Management (Policy and Planning)
- Service Delivery Framework including the Role of Shared Services
- Governance in Local Government

- Model Framework for Council Annual Business Plans
- Model Work Program for Council Audit Committees
- *Financial Governance (currently being prepared)*
- *Financial Policies Framework (currently being prepared)*
- Model Format for Long-term Financial Plans
- *Depreciation (currently being prepared)*
- *Funding Policies and Strategies (currently being prepared)*
- *Audit Committee Reporting (currently being prepared)*
- *A New Approach to State-Local Resourcing (currently being prepared)*

A number of manuals, guidelines, templates, technical definitions, codes, standards and similar documents supporting this series of information papers are also being prepared by the LGA to provide practical assistance to Councils.

For an update on which information papers have now been completed or information about other documents and activities, including briefing and training sessions, please visit our website at: www.lga.sa.gov.au/goto/fsp.

What is treasury management?

Treasury management refers to the way in which borrowings are raised and cash and investments are managed. In addition to changes in the level of borrowings and in interest rates, a Council's treasury management practices also can have a significant effect on its interest costs.

Councils have flexibility with respect to the maturity of their borrowings and, more importantly, how frequently the interest rate on an individual borrowing is re-set. This flexibility enables Councils to manage their interest rate exposures in a deliberate fashion. Regardless of the level of an individual Council's borrowings, it is desirable that each Council seeks to minimise interest costs in a risk averse manner over the medium to longer term.

This information paper provides guidance to Councils in taking an active approach to managing their interest rate exposures and risks.

What does the Act now require?

Unlike the arrangements applying in other jurisdictions, Councils in South Australia are virtually unconstrained in relation to the quantum, source, term and type of their borrowings. The legislation covering investments is non-prescriptive except for a prohibition on the acquisition of shares and an avoidance of speculative or hazardous investments e.g. investments made in currencies other than Australian dollars or low credit quality investments.

As a result SA Councils have the opportunity to adopt more cost and interest rate risk effective treasury management than Local Governments in other states.

<u>Borrowings</u>

The main legislative provisions in the Local Government Act covering borrowings are:

- Section 44 - a Council must approve all borrowings and the legislation clearly states that the power to borrow cannot be delegated (for simplicity many Councils appropriately just have all proposed borrowings for the year approved at the time the annual budget is adopted).

- Section 122 - a Council's strategic management plans must include an assessment of a Council's proposals with respect to debt levels.

- Section 134 - empowers a Council to borrow and requires a Council to consider expert advice before entering into financial arrangements for the purpose of managing, hedging or protecting against interest rate movements and other risks associated with borrowing money.

- Regulations 5 and 5B of the Financial Management Regulations under the Act - require the preparation of Cash Flow Statements (including financing transactions) covering Councils' Long-term Financial Plans and Budgets.

<u>Investments</u>

The main Local Government Act provisions covering investments are:

- Section 47 - prohibits a Council from directly acquiring shares in a company.

- Section 139 - empowers a Council to invest and requires that the power of investment be exercised with the care, diligence and skill that a prudent person of business would exercise in managing the affairs of other persons. Section 139 also requires a Council to avoid investments that are speculative or hazardous in nature.

- Section 140 - requires that a Council review the performance of its investments at least annually.

The Local Government Act provisions referenced above are set out in Attachment 4.

Treasury management and financial sustainability

Councils should be committed to operating in a financially sustainable manner. They should make expenditure decisions in line with the directions set out in their Strategic Management Plans (SMPs) and the scheduled works in their Infrastructure and Asset Management Plans (I&s) while setting out their financing requirements in their Long-term Financial Plans (LTFP). Whether a borrowing needs to be raised, and if so the nature of it, is a separate decision to the expenditure one and it is made in accordance with the criteria specified in Councils' Treasury Management Policies.

Councils should not make operating or capital expenditure decisions that would generate (or increase) an ongoing operating deficit without concurrently committing to other strategies that negate this impact (e.g. by increasing other revenue or decreasing other expenses). If a Council has an operating deficit it cannot normally afford more borrowings. If nothing else changes the financing costs alone exacerbate the existing operating deficit. If a Council has a projected long-run operating deficit it does not have the capacity to undertake additional projects/services and should not embark on such a course until it has developed a strategy to address the deficit and reflected this in its LTFP.

If a Council has a projected long-term operating surplus then it may be able to afford an additional project/service without increased revenue but in such circumstances it would need to compare the proposal with the benefits and net costs of other alternatives (there are always more demands/opportunities than available resources).

Even when operating in a financially sustainable manner, it will often be necessary for a Council to borrow money. This could occur for example in a year where the Council makes a decision, in

accordance with its I&, to increase its stock of assets or to replace/update existing assets. It also may be necessary for a Council to borrow for short periods during any year when operating outlays occur ahead of revenue inflows.

Furthermore, a new borrowing may be affordable if the funds are required to help reduce a Council's operating deficit (e.g. the borrowing has resulted from the need for abnormally high levels of expenditure on maintaining/replacing assets which will lead to a reduction in future operating expenses).

LGA Financial Sustainability Information Paper No.10: *Debt Management* provides guidance to Councils in their decisions regarding raising and managing borrowings.

Financing decisions

The traditional approach to determining expenditure affordability (based for example on cash costs of a project) and associated debt financing strategies has risks. These are often 'hidden' or under-recognised.

If a Council undertakes a borrowing while at the same time holding surplus financial assets there is an opportunity cost arising from the difference between the borrowing and investment interest rates achieved on each. If interest rates then fall (or increase), after locking into a long-term fixed interest rate borrowing, there is a further effective (but un-recorded) opportunity cost (or gain).

Councils should use their surplus financial assets and undertake borrowings in accordance with their LTFPs. In general, it is likely to be more cost effective for a Council to meet current expenditure needs by first using any surplus financial assets currently available before undertaking a new borrowing.

Capital outlays

There is a 'cost of capital' (interest paid on a borrowing or investment income forgone) associated with all capital outlays. Where a Council wishes to track all costs associated with a capital project its costing information should recognise the 'cost of capital' utilised in the venture regardless of whether specific borrowings were raised for such purposes or not.

In determining the impact of a capital outlay on Council's finances in the future it is best to ignore financing arrangements – an expenditure evaluation decision must come first and is always separate from the financing decision. A simple and appropriate approach is to assess the affordability of capital projects in terms of their annual long-run impact on Council's operating result. This would involve Council estimating the annualised long-run costs (e.g. depreciation, cost of capital, operating and maintenance costs etc) and comparing this with the increase in rate or other operating revenue required to leave Council's operating result unaffected on average over time.

Financial indicators

LGA Financial Sustainability Information Papers 9: '*Local Government Financial Indicators*' and 12: '*Targets for Local Government Financial Indicators*' provide information on the financial sustainability indicators adopted by South Australian Councils for the monitoring of their financial performance and position. Councils may adopt more or less conservative targets for the Net Financial Liabilities and Interest Cover ratios than suggested in those papers depending on their financial governance capabilities, current and projected needs and financial capacity (and the soundness of their Long-term Financial Plans). These target ratios need also to be set and managed in the context of the other recommended financial targets, and in particular the Operating Surplus ratio target.

The adoption of the traditionally used 'debt servicing ratio' as a financial indicator/target (particularly when based on interest and principal repayments relative to rate revenue or to total revenue) is not recommended.

Reserves

Councils should manage their finances holistically and in a strategically optimum way rather than practicing 'shoebox accounting' whereby monies earmarked for particular needs are not available for others. All unrestricted revenues and investments should be applied to meet planned expenditure outlays and extinguish borrowings where possible.

Councils may however choose to use 'reserve accounting' as a useful means of recognising and planning for future proposals. A Council may therefore establish various equity accounts ('reserves') in its balance sheet to identify an allocation for future purposes however it should not have separate bank/investment accounts for these 'reserves' unless legally required or required by an external funding body.

There are very few circumstances where a Council is legally required to quarantine funds. Typically this involves some form of trust fund e.g. developer contributions for car parks and open space reserves. Councils can and should use funds traditionally earmarked, by way of example, for Community Wastewater Management Systems, Plant Replacement, Long Service Leave and other typically cash backed balance sheet liability or equity accounts as part of their overall financing strategies. Nothing prevents Councils from using these funds to "finance" other activities and thereby achieving savings (because of the margin between borrowing and investment rates) until they are required for the original purpose. At this time a new borrowing could be raised if required.

Interest Rate Risk Exposures

A Council is exposed to risk whenever it takes out a borrowing regardless of whether it involves fixed or variable interest rates. Minimising exposure to interest rate risk requires a balance of both fixed and variable interest rate borrowings. Councils should set range limits for both fixed and variable interest rate borrowings having regard to cost effectiveness, risk management criteria and flexibility.

Locking into a long-term fixed interest rate, for example, effectively means that a Council is taking a view that variable rates over the period of the borrowing will be higher than the fixed rate negotiated. If a Council takes on a fixed interest loan and interest rates on average fall over the duration of the loan it would be worse off compared with if it had taken out a variable interest rate loan over the same period (and vice-versa). Such a Council may not intend to be punting on interest rate movements, or appreciate that it is, as the very reason it took out a fixed interest rate borrowing was for the certainty it offers. The Council will have achieved certainty but will not have obviated risk.

It is not possible for Councils to structure their overall portfolio of borrowings and investments in a way which is 'neutral' to interest rate changes i.e. Councils' interest rate risks cannot be eliminated. Councils must therefore structure their portfolio of borrowings and investments to achieve a balance between interest costs and the risk of interest rate changes. This means having a mix of interest rate exposures.

Fixed Interest Rate Borrowings

On average over time, fixed interest rate borrowings normally are slightly more expensive than variable rate ones because of the certainty they offer.

Fixed interest rate borrowings most commonly come in two forms:- 'credit foncier' and 'interest only'. Some lenders such as the Local Government Finance Authority (LGFA) also will structure fixed interest borrowings to suit the particular needs of a Council.

Credit Foncier Borrowings

In the public sector prior to the implementation of accrual accounting, credit foncier borrowings were widely considered to be the most appropriate form of borrowing on grounds of inter-generational equity. They were often used to finance the acquisition of long-lived assets. The regular repayment of principal on such borrowings was effectively treated as a surrogate for depreciation notwithstanding that the principal repayments on borrowings may not have borne any close relationship with actual depreciation if it had been measured (e.g. the life of asset may have been much longer than the borrowing period).

Under accrual accounting, principal repayments are not treated as an expense. Intergenerational equity is achieved by accurately recognising all operating expenses (including depreciation) and pricing/taxing to match them with operating revenue. Where an accrual break-even operating result is being achieved, the cost of consumption of assets is being met by ratepayers who benefit from their availability and use.

While the use of credit foncier borrowings does ensure the repayment of an individual borrowing it does not necessarily ensure a reduction in a Council's overall indebtedness. Where existing borrowings are being repaid, while at the same time new borrowings are raised, the overall value of outstanding borrowings may not vary significantly from year to year. In this case, in effect, the new borrowings would be largely offsetting regular principal repayments on the existing borrowings (although they would not have been explicitly intended for this purpose) because of the structure of the portfolio of borrowings.

Council should be mindful of the above issues in determining the extent of credit foncier borrowings in its overall portfolio of fixed interest rate borrowings.

Interest Only Borrowings

Interest only borrowings avoid regular principal repayments i.e. instead, the total principal would be repayable at maturity.

Variable Interest Rate Borrowings

A Council's treasury management strategy should aim to keep debt levels both during a year and over periods of years as low as its budget and Long-term Financial Plan allow (and its budget and Long-term Financial Plan should be based on best meeting community needs in an equitable and financially sustainable manner).

There is usually a margin between borrowing and investment rates and Councils can generate savings by structuring their portfolios of borrowings so that cash inflows that are surplus to short or medium term needs can be applied in the first instance to reduce the level of borrowings that would otherwise be necessary. This means repaying borrowings wherever, and as soon as, surplus (even short-term) cash flow allows. This is more readily and effectively achievable with variable interest rate borrowings.

Long-term Interest Only Borrowings

Councils will have periods during a year when they have significant funds available for investment and may have significant amounts that are available on an ongoing basis.

If a Council includes in its debt structure, a long-term interest only borrowing where interest rates are re-set every three or six months, a proportion of principal will be able to be repaid if any surplus funds are available at the time rates are reset.

An even more flexible product is the LGFA Cash Advance Debenture (other financial institutions offer similar products). Such a borrowing facility will typically have a long-term maturity date, the interest rate will vary from time to time (e.g. when there is a movement in official short term interest rates) and the amount of principal outstanding at any time would not be repayable until maturity. The outstanding balance on the facility may vary significantly during a year and between years with the timing and extent of cash inflows and outflows. Council may repay or redraw funds up to the maximum value of the borrowing facility at any time. It effectively enables Council to earn an implicit rate of interest on its surplus funds equal to the borrowing rate (typically more than 1% higher than rates earned on investing surplus funds) and draw additional funds whenever required.

The savings that are able to be generated from utilising variable interest rate borrowings in this way are likely over time to far more than offset interest rate risks from having a large proportion of Councils' debt portfolios at variable interest rates.

Proportion of Fixed Interest Rate and Variable Interest Rate Borrowings

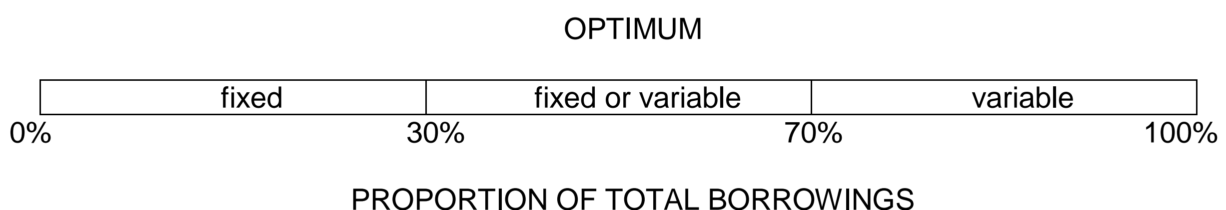
Councils may choose, from time to time, to vary the proportions of their gross debt taken up by fixed or variable interest rate borrowings. In so doing they should have a clear understanding of the likely impact on net interest costs and their exposure to interest rate risks. For example a Council may prefer to increase its proportion of variable interest rate borrowings because this should, on average over the longer term, reduce its overall net interest costs and the Council is comfortable (having regard to its financial capacity and position) with the additional cost volatility from interest rate movements that this will bring.

If a Council has variable interest rate borrowings, a rise in interest rates will have a negative budget impact (and vice versa). However when compared with total operating costs, the impact normally will be small.

If a Council aims to achieve, say, a 50:50 split on average between the value of fixed and variable interest rate borrowings, it is inevitable that there will be specific short periods of time where the weighting will be heavily in favour of either fixed or variable rate borrowings (e.g. particularly where a large receipt is received earlier than expected or a large payment is delayed). In some instances this will be unavoidable (and even to Council's financial advantage).

Councils should therefore establish a target range within which the proportions of their fixed and variable rate borrowings will lie and good cash flow planning and good treasury management will minimise the duration of periods where the weighting of borrowings is outside of this target range.

A policy of having at least 30% of borrowings with a fixed interest rate and at least 30% with a variable interest rate can be represented diagrammatically as follows:



Investments

As there usually is a margin between borrowing and investment rates, Councils should seek to avoid holding investments (and particularly considerable investments over extended periods of time) if they have outstanding borrowings. They should instead apply the funds to retire debt. Councils' abilities to achieve this will depend on the nature of both their borrowings and investments.

Interest rates offered on medium/longer term investments are often slightly higher than for short-term investments but the difference is not usually significant enough to offset the difference between borrowing and investment rates. For this reason it is important that a Council ensures that funds are only invested for a period not exceeding a point in time where they could otherwise be applied to cost-effectively either defer the need to raise a new borrowing or reduce the level of its variable interest rate borrowing facility. Unless there is considerable understanding and certainty about the timing and value of future cash inflows and outflows, the most practical and cost-effective strategy is likely to be to invest any funds at call.

Reporting

Councils may choose to report on their treasury management performance more frequently than annually e.g. biannually or quarterly in line with budget reviews. More frequent reporting than this is unlikely to prove worthwhile.

The report on a Council's treasury management performance could be submitted through its Audit Committee, Finance Committee or another committee with relevant terms of reference.

What are the issues for Councils?

Councils should clearly articulate a policy to govern and guide their borrowing and investment activities. This policy would form an integral part of a suite of their adopted financial management policies.

Acknowledgements

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Attachment 1: Model Treasury Management Policy

[Council Name]

POLICY NAME:	**Treasury Management**
APPROVED BY:	*[Council]*
DATE:	*[Date]*
SUBSEQUENT AMENDMENTS	
DATE:	*[Date]*
AUTHORISATION:	*[Authorisation]*
SECTIONS AMENDED:	*[Reference to aspects amended]*
REVIEW DATE:	*[Date of next review]*
DOCUMENT OWNER:	*[Position responsible for maintenance of the document]*

1. INTRODUCTION

This policy provides clear direction to management, staff and Council in relation to the treasury function. It underpins Council's decision-making regarding the financing of its operations as documented in its annual budget and long-term financial plan and associated projected and actual cash flow receipts and outlays.

Council is committed to adopting and maintaining a Long-term Financial Plan and operating in a financially sustainable manner.

2. POLICY OBJECTIVES

This Treasury Management Policy establishes a decision framework to ensure that:

- funds are available as required to support approved outlays;
- interest rate and other risks (e.g. liquidity and investment credit risks) are acknowledged and responsibly managed;
- the net interest costs associated with borrowing and investing are reasonably likely to be minimised on average over the longer term.

3. POLICY STATEMENTS

3.1 Treasury Management Strategy

Council's operating and capital expenditure decisions are made on the basis of:

- identified community need and benefit relative to other expenditure options;
- cost effectiveness of the proposed means of service delivery; and,

- affordability of proposals having regard to Council's long-term financial sustainability (including consideration of the cost of capital and the impact of the proposal on Council's Net Financial Liabilities and Interest Cover ratios[1]).

Council manages its finances holistically in accordance with its overall financial sustainability strategies and targets. This means Council will:

- maintain target ranges for both its Net Financial Liabilities and Interest Cover ratios;
- not retain and quarantine money for particular future purposes unless required by legislation or agreement with other parties;
- borrow funds in accordance with the requirements set out in its Long-term Financial Plan;
- apply any funds that are not immediately required to meet approved expenditure (including funds that are required to be expended for specific purposes but are not required to be kept in separate bank accounts) to reduce its level of borrowings or to defer and/or reduce the level of new borrowings that would otherwise be required.

3.2 Interest Rate Risk Exposures

Council has set range limits for both fixed and variable interest rate borrowings in order to minimise net interest costs on average over the longer term and at the same time manage interest rate movement risks within acceptable limits.

3.2.1 Fixed Interest Rate Borrowings

To ensure an adequate mix of interest rate exposures, Council will restructure its portfolio of borrowings, as old borrowings mature and new ones are raised, to progressively achieve and thereafter maintain on average in any year, not less than *[x% - Council to determine percentage but may wish to consider a value of the order of 30%]* of its gross debt in the form of fixed interest rate borrowings.

> *Decision Required:*
>
> *Council will need to determine the minimum proportion of its gross debt that it wishes to hold, at any time, in the form of fixed interest rate borrowings. In determining this minimum proportion, Council will need to take account of, and achieve its preferred balance between:*
> - *interest costs;*
> - *the risk of interest rate changes;*
> - *flexibility.*

In order to spread its exposure to interest rate movements, Council will aim to have a variety of maturity dates on its fixed interest rate borrowings over the available maturity spectrum.

In circumstances where Council needs to raise new fixed interest rate borrowings it will consider using medium to long-term borrowings (3 years or more duration) that:

- have a fixed interest rate;
- require interest payments only; and
- allow the full amount of principal to be repaid (or rolled over) at maturity.

[1] The LGA's Financial Sustainability Information Papers 9 and 12 provide further information on these (and other) financial sustainability indicators and associated targets.

Council also will ensure that no more than *[x% - Council to determine percentage but may wish to consider a value of the order of 25%]* of its fixed interest rate borrowings mature in any year.

Decision Required: *Council will need to determine the <u>maximum</u> proportion of its fixed interest rate borrowings that it wishes to have maturing in any year in order to spread its exposure to interest rate movements.*

3.2.2 Variable Interest Rate Borrowings

Council will restructure its portfolio of borrowings, as old borrowings mature and new ones are raised, to progressively achieve, and then maintain, not less than *[x% - Council to determine percentage but may wish to consider a value of the order of 30%]* of its gross debt on average in any year in the form of variable interest rate borrowings.

Decision Required: *Council will need to determine the <u>minimum</u> proportion of its gross debt that it wishes to hold, at any time, in the form of variable interest rate borrowings. In determining this minimum proportion, Council will need to take account of, and achieve its preferred balance between:* • *interest costs;* • *the risk of interest rate changes;* • *flexibility.*

Council will establish, and make extensive use of, a *[long-term variable interest rate borrowing facility / LGFA's Cash Advance Debenture facility]* that requires interest payments only and that enables any amount of principal to be repaid or redrawn at call. The redraw facility will provide Council with access to liquidity when needed.

3.3 Investments

Council funds that are not immediately required for operational needs and cannot be applied to either reduce existing borrowings or avoid the raising of new borrowings will be invested. The balance of funds held in any operating bank account that does not provide investment returns at least consistent with 'at call' market rates shall be kept at a level that is no greater than is required to meet immediate working capital requirements.

Council funds available for investment will be lodged 'at call' or, having regard to differences in interest rates for fixed term investments of varying maturity dates, may be invested for a fixed term. In the case of fixed term investments the term should not exceed a point in time where the funds otherwise could be applied to cost-effectively either defer the need to raise a new borrowing or reduce the level of Council's variable interest rate borrowing facility.

When investing funds Council will select the investment type which delivers the best value, having regard to investment returns, transaction costs and other relevant and objectively quantifiable factors.

Council management may from time to time invest surplus funds in:

- deposits with the Local Government Finance Authority; and/or
- bank interest bearing deposits.

Any other investment requires the specific approval of Council. Where Council authorises any investments of a type outside of those specified above, the amount so invested will be cumulatively limited to no more than *[x% - Council to determine percentage but may wish to consider a value of the order of 20%]* of the average level of funds expected to be available for investment by Council over the duration of the specific authorised investments.

Decision Required:

Council will need to determine the proportion of its investment funds that will be placed in various investment types. In determining this proportion Council will need to take account of:
- *investment risk;*
- *likely return;*
- *relevant legislative requirements.*

3.4 Reporting

At least once a year Council shall receive a specific report regarding treasury management performance relative to this policy document. The report shall highlight:
- for each Council borrowing and investment - the quantum of funds, its interest rate and maturity date, and changes in the quantum since the previous report; and,
- the proportion of fixed interest rate and variable interest rate borrowings at the end date of the reporting period and an estimate of the average of these proportions across this period along with key reasons for significant variances compared with the targets specified in this policy.

4. RELEVANT LEGISLATION

4.1 For Borrowings
- Local Government Act, 1999
  - Section 44
  - Section 122
  - Section 134
- Regulations 5 and 5B of the Financial Management Regulations under the Act

4.2 For Investments
- Local Government Act, 1999
  - Section 47
  - Section 139
  - Section 140

Attachment 2: Glossary of Accounting Terms Used in this Paper

Credit Foncier Borrowings are borrowings for a fixed period with regular repayments where each repayment includes components of both principal and interest, such that at the end of the period the principal will have been entirely repaid. Commercial credit foncier borrowings (including to local governments) usually have a fixed rate of interest. Mortgages taken out by householders with a variable interest rate and requiring repayments that include both principal and interest such that the principal is repaid over a specific period sometimes are also described as credit foncier borrowings.

Financial Assets include cash, investments, receivables and prepayments. Equity held in a Council business is normally regarded as a financial asset but is excluded for the purpose of calculating Local Government published financial indicators. Also, inventories and land held for resale are not regarded as financial assets.

Financial Sustainability is achieved where planned long-term service and infrastructure levels and standards are met without unplanned increases in rates or disruptive cuts to services.

Net Financial Liabilities equals total liabilities less financial assets, where financial assets for this purpose include cash, investments, receivables and prepayments, but excludes equity held in a Council business, inventories and land held for resale.

Interest Cover Ratio indicates the extent to which a Council's operating revenues are committed to interest expenses.

Net Financial Liabilities Ratio indicates the extent to which net financial liabilities of a Council could be met by its operating revenue.

Non-financial or Physical Assets means infrastructure, land, buildings, plant, equipment, furniture and fittings, library books and inventories.

Operating Deficit occurs where the value of operating revenues less operating expenses is negative and operating income is therefore not sufficient to cover all operating expenses.

Operating Expenses are operating expenses including depreciation but excluding losses on disposal of non-financial assets.

Operating Revenues are "operating revenues" as shown in the Income Statement but exclude profit on disposal of non–financial assets and grants and contributions received specifically for new/upgraded infrastructure and other assets, e.g. from a developer. For Local Government published financial indicators calculated where the denominator specified is total operating revenue, Natural Resource Management (NRM) levy revenue is excluded. For the purpose of calculating the ***Interest Cover Ratio*** investment income also is excluded from the denominator.

Operating Surplus occurs where the value of operating revenues less operating expenses is positive and operating revenue is therefore sufficient to cover all operating expenses.

Operating Surplus Ratio is the operating surplus (deficit) expressed as a percentage of general and other rates net of rate rebates and revenues from the NRM levy.

Rates Revenue is general and other rates net of the impact of rate rebates and revenue from the NRM levy.

Attachment 3: Illustrative Questions and Answers on the Application of the Model Treasury Management Policy

QUESTION 1

Most Councils currently have outstanding a lot of small value fixed interest rate borrowings (typically taken out for 5 to 15 year periods). They also hold various (often numerous) investments that are 'ear-marked' for specific purposes. What sort of structure of borrowings should such a Council aim to progressively achieve?

Answer:

Ideally the Council would, over time, move to a reduced number of fixed interest rate borrowings. These borrowings could, for example, be of similar value with maturity dates spread over a period of, say, ten years. Only one variable interest rate borrowing facility would be necessary and with a suggested maturity date of at least ten years. The amount of the facility could be set at, say, 70 per cent or more of the maximum level of the Council's estimated net financial liabilities as shown in its Long-term Financial Plan.

QUESTION 2

How should a Council go about phasing in changes in practices consistent with the model treasury management policy?

Answer:

If the value of a Council's borrowings exceeds the value of its investments it is likely to be better off by applying surplus funds to reduce the level of outstanding principal under its variable interest rate borrowing facility (such facilities, e.g. the LGFA's Cash Advance Debenture, typically allow part or full repayment of the outstanding principal at any time without penalty). Accordingly, many Councils may find it unnecessary to hold any investments.

If the value of a Council's investments exceeds its variable interest borrowings it should use the investment funds to pay down its variable interest borrowings to zero and retain the balance as an investment until these funds can be applied to avoid new borrowings that would otherwise be necessary. There is no value in seeking to 'cash out' outstanding fixed interest rate borrowings. This will not generate savings as any lender that agrees to do so would seek to be financially compensated and be left no worse off.

Councils that have utilised their investments and still require additional borrowings should look first to ensure that their level of variable interest rate borrowings is in line with the suggested target (between, say, 30% and 70% of total borrowings on average over a 12 month period) rather than raise additional fixed interest rate borrowings.

Where a Council's existing level of variable interest rate borrowings is already within the target range and/or proposed new borrowings are relatively large the Council should look to raise a combination of fixed and variable interest rate borrowings to ensure that the proportions of both are expected to remain within its target ranges in future. Nevertheless in so doing it may find it simpler to raise all of the new borrowing as a variable interest rate one in the first instance and then convert a proportion to a fixed interest rate by adding it to an existing fixed interest rate borrowing when it matures and needs to be rolled over. This would help the Council to avoid building up a large portfolio of small value fixed interest rate borrowings.

Councils are required to prepare Long-term Financial Plans which will show the extent of expected movements in their forecast stock of borrowings for the budget year and for each year of the Long-term Financial Plan. Councils should use this information to help plan the timing, duration, magnitude and mix of new fixed and variable interest rate borrowings (including any necessary as a result of the maturing of existing borrowings).

In addition to managing borrowing needs between years, Councils also need to optimise treasury management within a budget year. Each year they will have periods where they have high levels of net cash inflows (e.g. at times when rates or Grants Commission payments are due) and other times where they have net cash outflows. Their portfolio of borrowings should be structured to enable surplus funds received during periods of net cash inflows to be used to repay borrowings (even if for only a short periods) rather than to be invested if borrowings also exist. This can best be achieved by repaying variable interest rate borrowings during periods of net cash inflow and drawing additional such borrowings during periods of net cash outflow. As a result a Council that averages a 50:50 split between fixed and variable interest rate borrowings over a year may experience periods where there is a heavy weighting of fixed or variable interest rate borrowings in its total portfolio and periods where its portfolio of borrowings is considerably higher or lower than its budgeted end of year position.

Attachment 4: Local Government Act Provisions Relating to Treasury Management

Local Government Act 1999

Section 44 (1) – (3) provides that:

(1) A council may delegate a power or function vested or conferred under this or another Act.

(2) A delegation may be made—

- (a) to a council committee; or
- (b) to a subsidiary of the council; or
- (c) to an employee of the council; or
- (d) to the employee of the council for the time being occupying a particular office or position; or
- (e) to an authorised person.

(3) However, a council may not delegate—

- (a) power to make a by-law;
- (b) power to declare rates or a charge with the character of a rate;
- (c) power to borrow money or to obtain other forms of financial accommodation;
- (d) power to adopt or revise a strategic management plan of the council;
- (da) power to adopt or revise an annual business plan or budget of the council;
- (e) power to approve expenditure of money on works, services or operations of the council not contained in a budget adopted by the council;
- (f) power to determine annual allowances under Chapter 5;
- (g) power to approve payment or reimbursement of expenses that may be paid at the discretion of the council and for which the council has not adopted a formal policy or made specific financial provision;
- (h) power to establish a subsidiary, or to participate in the establishment of a regional subsidiary;
- (i) power to make an application or recommendation, or to report or to give a notice, to the Governor or the Minister, being an application, recommendation, report or notice for which provision is made by or under this or another Act;
- (j) power to fix, vary or revoke a fee under section 188(1)(d) to (h);
- (k) a power or function excluded from delegation by the regulations.

Section 47 provides that:

(1) A council must not—

- (a) participate in the formation of a company; or
- (b) acquire shares in a company.

(2) However, subsection (1) does not—

- (a) limit the investment of money under this Act; or

(b) limit the ability of a council to participate in the formation of, or to become a member of, a company limited by guarantee established as a national association to promote and advance the interests of an industry in which local government has an interest.

Section 122 (1) provides that:

(1) A council must develop and adopt plans (which may take various forms) for the management of its area, to be called collectively the ***strategic management plans***,

which—

(a) identify the council's objectives for the area over a period of at least 4 years (the ***relevant period***), and provide a clear indication of—

(i) the extent to which the council has participated with other councils, and with State and national governments, in setting public policy objectives, and the extent to which the council's objectives are related to regional, State and national objectives; and

(ii) the extent to which the council has given consideration to regional, State and national objectives and strategies which are relevant to the economic, social, physical and environmental development and management of its area; and

(iii) the extent to which the council intends to co-ordinate with State and national governments in the planning and delivery of services in which there is a common interest; and

(ab) provide assessments that relate to the following matters (with particular reference to the relevant period):

(i) the sustainability of the council's financial performance and position; and

(ii) the extent or levels of services that will be required to be provided by the council to achieve its objectives; and

(iii) the extent to which any infrastructure will need to be maintained, replaced or developed by the council; and

(iv) anticipated changes in its area with respect to—

(A) real property development; and

(B) demographic characteristics of its community to the extent that is reasonable taking into account the availability of appropriate and accurate data; and

(v) the council's proposals with respect to debt levels; and

(vi) any anticipated or predicted changes in any factors that make a significant contribution to the costs of the council's activities or operations; and

(b) identify the principal activities that the council intends to undertake to achieve its objectives; and

(d) state the measures (financial and non-financial) that are to be used to monitor and assess the performance of the council against its objectives over the relevant period; and

(e) identify the means by which its activities are to be carried out and its objectives achieved; and

(g) address issues associated with arranging its affairs so as to separate its regulatory activities from its other activities, so far as this is reasonable to do so; and

(h) make provision for the regular review of the charters, activities and plans of any subsidiary of the council.

Section 134 provides that:

(1) A council may borrow money and obtain other forms of financial accommodation.

(2) A borrowing may take any form considered appropriate by the council, including through the use of an overdraft or finance lease.

(3) A council may enter into financial arrangements for the purpose of managing, hedging or protecting against movements in interest rates or other costs of borrowing money, including—

(a) interest rate swaps;

(b) forward interest rate agreements;

(c) interest rate options;

(d) other prescribed arrangements.

(4) However, a council must not enter into a financial arrangement under subsection (3) unless or until—

(a) the council has obtained and considered independent and impartial advice about the proposed financial arrangements and the appropriate risk-management policies, controls and systems that should be in place from a person whom the council reasonably believes to be competent to give the advice; and

(b) the council has adopted risk-management policies, controls and systems by a resolution passed by at least a two-thirds majority of the members of the council.

Section 139 provides that:

(1) A council may invest money under its control.

(2) A council must, in exercising its power of investment—

(a) exercise the care, diligence and skill that a prudent person of business would exercise in managing the affairs of other persons; and

(b) avoid investments that are speculative or hazardous in nature.

(3) Without limiting the matters that a council may take into account when exercising its power of investment, a council must, so far as may be appropriate in the circumstances, have regard to—

(a) the purposes of the investment;

(b) the desirability of diversifying council investments;

(c) the nature of and risk associated with existing council investments;

(d) the desirability of maintaining the real value of the capital and income of the investment;

(e) the risk of capital or income loss or depreciation;

(f) the potential for capital appreciation;

(g) the likely income return and the timing of income return;

(h) the length of the term of a proposed investment;

- (i) the period for which the investment is likely to be required;
- (j) the liquidity and marketability of a proposed investment during, and on the determination of, the term of the investment;
- (k) the aggregate value of the assets of the council;
- (l) the likelihood of inflation affecting the value of a proposed investment;
- (m) the costs of making a proposed investment;
- (n) the results of any review of existing council investments.

(4) Without limiting the matters that a council may take into account when exercising its power of investment, but subject to the operation of subsection (3), a council may, so far as may be appropriate in the circumstances, have regard to—

- (a) the anticipated community benefit from an investment;
- (b) the desirability of attracting additional resources into its local community.

(5) A council may obtain and consider independent and impartial advice about the investment of funds or the management of its investments from a person whom the council reasonably believes to be competent to give the advice.

Section 140 provides that:

A council must, at least once in each year, review the performance (individually and as a whole) of its investments.

Local Government (Financial Management) Regulations 1999

Regulation 5 provides that:

Pursuant to section 122(2)(b) of the Act, a long-term financial plan must include—

- (a) an estimated income statement, balance sheet, statement of changes in equity and statement of cash flows with respect to the period of the long-term financial plan presented in a manner consistent with the Model Financial Statements;
- (b) a summary of proposed operating and capital investment activities presented in a manner consistent with the note in the Model Financial Statements entitled *Uniform Presentation of Finances*;
- (c) estimates with respect to an operating surplus ratio, an asset sustainability ratio and a net financial liabilities ratio presented in a manner consistent with the note in the Model Financial Statements entitled *Financial Indicators*.

Regulation 5B provides that:

Pursuant to section 123(10)(b) of the Act, each budget of a council under the Act must—

- (a) include a budgeted income statement, balance sheet, statement of changes in equity and statement of cash flows, presented in a manner consistent with the Model Financial Statements; and
- (b) state whether projected operating income is sufficient to meet projected operating expenses for the relevant financial year; and

(c) include a summary of operating and capital investment activities presented in a manner consistent with the note in the Model Financial Statements entitled *Uniform Presentation of Finances*; and

(d) include estimates with respect to the council's operating surplus ratio, asset sustainability ratio and net financial liabilities ratio presented in a manner consistent with the note in the Model Financial Statements entitled *Financial Indicators*.