

BORROWING STRATEGY

**RESPONSIBLE
DIRECTORATE:** Corporate Services

OBJECTIVE: *To establish a borrowing framework and provide guidance on the circumstances under which borrowing may be sought and the matters to be observed when borrowing is contemplated.*

STATEMENT:

1 Objectives:

- To specify when borrowing may be obtained and the types of financial accommodations allowed.
- To ensure that the financial position of the City is not compromised by the extent of borrowing obtained.
- To stipulate the matters to be observed before seeking new loans.
- To limit borrowing risks and preserve the City's capacity to discharge its functions into the future.

2 Legislative Requirements

The Local Government Act 1995 provides as follow:

- A local government is empowered to borrow money, obtain credit and arrange for other forms of financial accommodation, to enable it to perform its functions – Sec 6.20 (1)
- The power to borrow cannot be delegated - Sec 5.43 (f)
- The annual budget is to incorporate any proposed borrowing by the local government- Sec 6.2 (4) (d)
- Security for any borrowing can only be given over the general funds of the local government- Sec 6.21 (2)
- An absolute majority decision and one month public notice are required for any proposed borrowing that has not been included in the annual budget- Sec 6.20 (2)
- An absolute majority decision and one month public notice are required to change the purpose for which any money, or part thereof, was borrowed- Sec 6.20 (3), unless the change of purpose has been disclosed in the annual budget. Sec 6.20 (4)
- Borrowing by a Regional Local Government may be secured by security over the general funds of a participating local government, that is a party to the activity for which the money is to be borrowed- Sec 6.21 (1)(c) and (1a)

In addition, the Financial Management Regulations require any material variation between actual interest and principal repayment and what is included in budget estimates to be reported to Council in the Monthly Financial Report

3 Authorised Borrowing Purposes

Borrowing funds, obtaining credit and arranging financial accommodation for the City can only be considered for the following purposes:

- for capital expenditure on infrastructure assets with expected useful life of **ten years** or more
- for income producing assets expected to generate cash flow surplus within **five years** of operation
- for approved major land transactions or major trading undertakings
- to re-finance existing loans, where an economic benefit is evident
- to cover operational credit card and temporary overdraft facilities
- to acquire operational assets with a minimum useful life of **five years** and a combined cost of **\$500,000** or more

4 Prohibited Borrowing

Borrowing is prohibited if intended to fund the following:

- investment in securities, either in the Money Market or the Share Market
- any form of speculative investment where the safety of its principal or return is questionable
- to provide finance or extend credit to any third party
- to provide or support a financial guarantee given to any party

5 Approved Forms of Borrowing

Borrowing may come in many forms, including structured finance with or without underlying derivative instruments. However, to ensure clarity and provide certainty of exposure the approved forms of borrowing for the City are:

- fixed amount fixed interest fixed term loan with Interest only or principal and interest repayments
- short term, fixed or floating interest only loans to cover progress payments under a construction contract, until the work is complete
- short term overdraft credit facility
- corporate credit card facility
- finance leases

6 Borrowing Considerations

The matters that must be considered before borrowing is proposed are:

- the viability of different finance options, including those other than by borrowing
- market condition and expected movement in interest rates together with the likely draw down time on the proposed borrowing
- the proposed borrowing period

- the limitations described in point 7 next
- the strategic priority of the project and other competing demand for fund

7 Borrowing Limitations

These limitations are described in terms of financial ratios that should be considered to restrict borrowing when any one of these ratios is likely to be breached.

The ratios are to be calculated at the reporting date immediately prior to seeking a firm quote, including the proposed borrowing and its repayment

- **Total Liability to Economically Realisable Assets - Maximum 40%**

This ratio measures the City's ability to satisfy its liability from realisable assets.

Total Liability must include contingent liability under overdraft and credit card facilities and more importantly, to include contingent liability for guarantees given to any Regional Local Government to which the City is a participant.

Economically Realisable Assets include Current Assets, non-current receivables plus the market value of Freehold Vacant land after deducting the estimated cost of realisation. Realisation costs may be taken to be 3% of the capital value of the land.

- **Debt Service To Core Operating Revenue- Maximum 5%**

This ratio measures the extent of core operating revenue that is directed toward servicing the City's debt repayment obligation.

A large sum directed toward servicing debt will diminish the City's ability to fund and perform its regular functions

Core Operating Revenue is the annual revenue from rates, fees and charges and recurrent operating grants, not including interest on investments.

- **Operating Surplus Before Interest and Infrastructure Depreciation To Debt Repayment – Minimum 1.0**

This ratio measures the ability of operating surplus -as calculated- to cover debt repayment obligation.

Operating Surplus is the accounting surplus after taking into account all necessary provisions as estimated at the end of the financial year during which the borrowing is proposed

- **Borrowing Term**

The borrowing term is to be limited to a maximum of 50% of the useful life of the asset for which the borrowing is intended.

8 Risk Management Consideration

The risks associated with borrowings are:

- **Capacity to Repay:** This risk is mitigated by the imposition of the borrowing limitations described in point 7 above and strict observance of those limitations.
- **Liquidity Risk:** is inability to meet debt payment obligations any time they fall due.

The relatively stable rate revenue and collection pattern together with the daily cash management process applied at the City are sufficient to eliminate or minimise any possible liquidity risk.

- **Interest Rate Risk:** This arises from exposure to higher interest rate at the time of borrowing. Also from variation in floating interest rates when used.

As a matter of principle, the City would always use fixed interest borrowing for certainty of purpose.

A time gap always exists between the budget adoption and the actual draw down on approved borrowing for a variety of reasons, during which the City is exposed to interest rate risk that may cause adverse variance between actual and budget estimates.

The City is authorised, where considered appropriate, to use interest rate hedging arrangements in the form of Forward Rate or Option Contracts.

Forward Rate Contracts are used when interest rates are moving upward. They are designed to benefit the borrower from prevailing interest rates before they go up and fix the borrowing rate at the future date expected for the draw down.

Option Contracts are similar to Forward Rate Contracts and are used when the future direction of interest rates is uncertain, giving the borrower the right to exercise the option and use the contracted rate or to opt out and use market rates in case they turn out to be better at the time of the borrowing.

Forward Rate and Option contracts are in a way an insurance measure against adverse movement in interest rates. They naturally come at a price, which will be part of the reportable variation to Council if used.

Amendments:

Related Documentation: Division 5 Sub-Division 3 of the Local Government Act 1995

Issued: April 2010