

REGIONAL **CITIES** VICTORIA

The logo graphic consists of a silhouette of a city skyline with a sun rising behind it, and a winding road leading from the city towards the viewer. The text 'REGIONAL' is in a standard font, while 'CITIES' is in a larger, bold font, and 'VICTORIA' is in a standard font. The entire logo is centered between two horizontal lines.

Local government financing and treasury shared service

Preliminary Feasibility and Pre-Planning Report

19th August 2014

Confidential

Dedicated municipal funding agencies operate in a number of countries. They provide access to low cost debt through the aggregation, management and distribution of local government borrowing requirements. This report details the structure for initiating such an agency for the needs of the Regional Cities Councils specifically and Victorian local governments in general. Submitted under the Department of Treasury and Finance 'Unsolicited proposal guideline' February 2014.

Table of Contents

Executive Summary	- 3 -
Introduction.....	- 6 -
Market analysis	- 8 -
<i>Internal analysis</i>	- 8 -
Historical	- 8 -
Future forecast.....	- 9 -
<i>External analysis</i>	- 9 -
International local government funding agencies	- 9 -
Rating agency assessment criteria.....	- 10 -
<i>Cost of funds</i>	- 11 -
Shared service funding model and structure	- 12 -
<i>Goals</i>	- 12 -
<i>Objectives</i>	- 12 -
<i>Background</i>	- 13 -
<i>Ownership structure</i>	- 13 -
<i>Management structure</i>	- 13 -
<i>Credit rating support structures</i>	- 14 -
Business Profile	- 14 -
Support and Ownership	- 14 -
Strategy.....	- 15 -
Low credit risk	- 15 -
Funding and Liquidity Risk.....	- 15 -
Market Risk	- 15 -
Guarantee Structure	- 16 -
Capitalisation	- 16 -
<i>Cost of funding</i>	- 17 -
Shared financial risk management resources.....	- 18 -
<i>Case studies</i>	- 18 -
Findings – Market Analysis	- 18 -
Findings – Service Design	- 18 -
<i>Financial risk management resources</i>	- 19 -
Interest Rate Risk Management	- 19 -
Debt Management	- 19 -
Cash and Liquidity Management	- 20 -
Financial Governance and Advisory Services	- 20 -
Funds Management.....	- 21 -
Transactional banking services	- 21 -
Initiation of VLGTA	- 22 -
<i>COSTS</i>	- 22 -
Summary.....	- 23 -
References	- 24 -

Disclaimer

This report contains commercially sensitive information. It may not be copied or distributed without Exem Australia Pty Ltd (Exem) express permission. In part, this report was generated from information provided by 3rd parties. Exem cannot guarantee the accuracy of that information. Neither Exem, nor its servants, consultants, agents or staff shall be responsible in any way whatsoever to any person in respect of this report, including errors or omission therein, however caused.

Author

Matthew O'Farrell 19th August 2014

Executive Summary

The report provides an overview for a new aggregated debt funding model for Victorian Local Government (LG). The key deliverable of the model is that it allows the Regional Cities Victoria (RCV) members to access *direct* financing from wholesale investment markets for their funding needs. Currently financing is accessed *indirectly* through financial institutions (i.e. banks). A feature of *indirect* funding is that it has significant cost premiums built into it to cover both credit risk and profit margins for banks.

The model provides the mechanism for local government to access the highest possible credit rating and then use this to raise funds in wholesale markets. Critically it achieves this without any form of explicit guarantee from the state government. The model detailed is expected to facilitate RCV access to finance priced at similar levels to that achieved by state and federal governments. By way of comparison, the cost of these funds is lower than what the big banks in Australia can currently fund themselves in the market. This is expected to reduce interest costs on debt by approximately 2.5% p.a. before administration and issuing costs. At current members debt levels this is equivalent to a saving of \$4.3 million p.a.

The model borrows heavily from local government funding structures used in other countries. These structures have been extensively tested and proven with long term success. Its goal is to ensure that local governments are not exposed to the risk of high cost finance by obtaining investment grade long term credit ratings.

The model establishes a central funding body to the benefit of RCV members. In turn this body can then offer its services to the whole Victorian Local Government sector. It provides superior pricing to what councils can achieve individually and enables councils to access longer dated borrowings. When funding infrastructure, access to long-term debt is important from an intergenerational cost sharing perspective. For the purposes of this report, this central funding body is called the *Victorian Local Government Treasury Agency* (VLGTA). The rationale for this name is detailed later in the report.

The Regional Cities Victoria: *Financing for Growth* report (September 2012) forecast that regional cities will need to invest over \$680m by 2021 in growth-related infrastructure. This investment is to support expected population growth from 742,300 in 2012 to 950,300 by 2031. Of this requirement, developer contributions are forecast to contribute \$170m, leaving a shortfall in financing new infrastructure of \$510m. Debt is expected to make an important contribution in funding this shortfall.

This particular VLGTA model has two targeted outcomes. First, to provide low cost external funding to minimise upward pressure on growth in rates. Second, to create a shared service that provides members with a dedicated resource for financial risk management advice on markets, products,

systems, reporting and governance. Under the suggested model, the RCV in conjunction with the state government would auspice the creation of the VLGTA to service their needs. Its medium term goal would be to also facilitate access to these benefits for all other Victorian local governments. Increasing the scale of the service would provide the RCV with many benefits. These include the dilution of rating agency and administration costs. It provides improved critical mass to support internal resources, providing sophisticated financial risk management and advice shared services. Greater debt issuance volumes also increase liquidity of the bond market offering which in turn improves/lowers the costs of funds.

Introduction

Background

In 2012, RCV commissioned a report tackling the issue of how to fund much needed infrastructure development in regional cities. This is directly linked to the *Regional Cities Victoria Growth Framework* to support investment into infrastructure and services to prepare for a population forecast to reach one million people over the next 20 years. The resulting report, *Financing for Growth*:

1. reinforced the overwhelming need for growth related infrastructure
2. reinforced the highly positive economic benefits to both the regions and the state from population growth and its concomitant economic activity
3. recommended the establishment of a government backed loan facility.

Point 3 above ran into significant opposition from state government. As an alternative it encouraged RCV to investigate methods of aggregating and issuing debt instruments, and improving its treasury management functions. In this context Exem Australia Pty Ltd approached Department of Transport, Planning and Infrastructure and the RCV with a plan for a new funding model.

The report is a preliminary feasibility and pre-planning study that investigates the creation of a shared service to fulfil the funding requirements of RCV specifically; and Victorian Local Government in general. It also provides detail of how the RCV may access a wide range of additional value-added financial risk management benefits that can result from the creation of a debt aggregation entity.

Current market practice and benefits of a funding shared service

Most shires access finance either via the local branches of major banks or by utilising individually established relationships with financiers. Each shire typically manages its financing requirements separately, thus they are highly fragmented. These parcels are not attractive to professional investors. Therefore the only mechanism to service this demand is via banks. This is known as *indirect* financing. Although certain LGs in Victoria may be of investment grade credit rating quality, small non-wholesale parcels will attract retail pricing, especially when the funding request is filtered through a bank's branch network.

Typically for smaller amounts (under \$5 million), financial institutions have pricing policies for lending based on the *product type* rather than primarily on the credit risk of the applicant. Margins for these borrowings are typically charged at *retail* prices. Financial institutions currently price much of local government funding requirements by *product*. This effectively ignores their high creditworthy status. It also reflects that banks find it more expensive to borrow funds than either the state or federal governments.

LGs in Victoria are related entities, bound by both institutions and legislation. In private enterprise, funding requirements for related entities (typically large intra-national or multinational organisations) are routinely pooled to achieve the greatest scale of economy. This provides access to wholesale investment markets and the maximum leverage when negotiating the best possible financing terms at the lowest possible margin cost. The goal of the VLGTA is to provide similar outcomes by managing the aggregation, administration and distribution of funding for LG.

While the focus of the feasibility study is on servicing local government funding requirements, it also discusses additional value-added benefits that in-house *treasury risk management functions* typically provide to larger organisations. These operate as a central resource supplying expertise for advice on interest rate risk, debt management, cash and liquidity management, funds management, best practice management reporting as well as financial markets and governance advice. Like its corporate focused peers, such a shared service would be a significant value adding resource to support RCV members' operations.

Market analysis

The following section contains high level information on internal and external market forces impacting on the aggregation of RCV funding. It highlights where similar initiatives have been rolled out in other countries. It finishes with comment on ratings agencies and the cost of funds achieved by other municipal debt aggregation vehicles internationally.

Internal analysis

Historical

Analysis of the RVC group's annual reports shows aggregated debt has had an average increase of approximately 5% p.a. since 2009. This is roughly in keeping with *adjusted total revenue* growth of 5.5% p.a. over the same period.

The *total rates and charges* figure indicates that the RCV, in aggregate, could increase borrowings to as much as \$470 million before it would be in breach of the VAGO maximum debt management ratio of 60%. However maximum debt servicing costs must stay below 5% of *total adjusted revenue* to remain in the VAGO green band for prudential debt management. At an annual interest rate of 4% this implies a maximum debt ceiling for the group of \$400 million on current revenues.

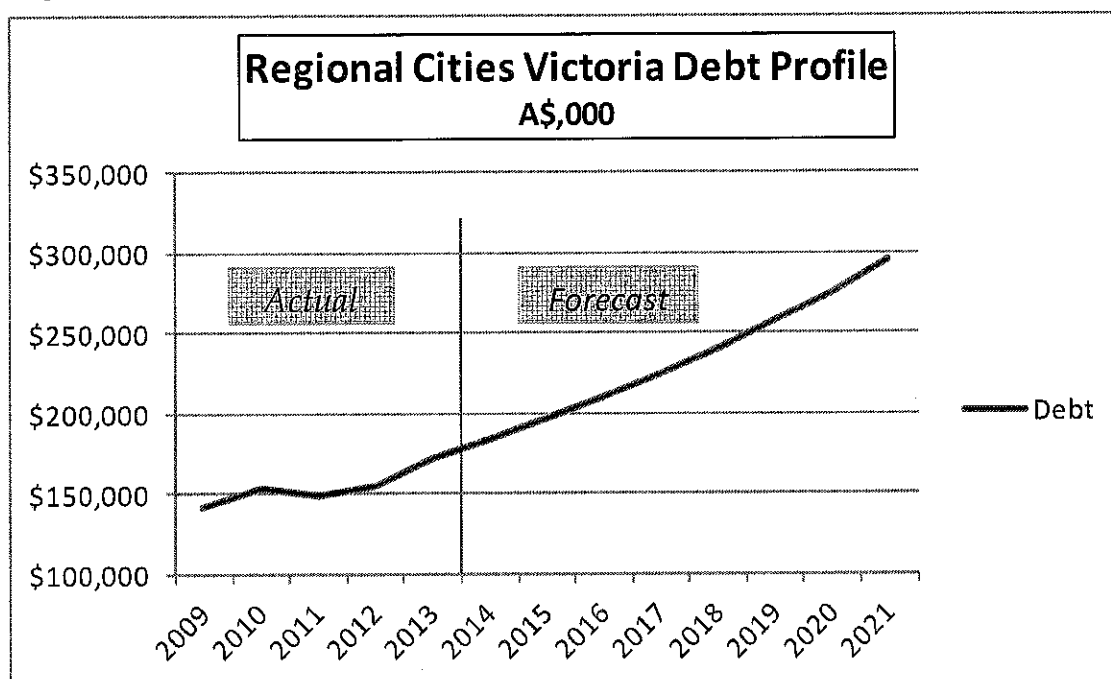
Table 1.0

Totals \$,000's

	2008/09	2009/10	2010/11	2011/12	2012/13
Adjusted Total Revenue	843,000	876,381	949,212	1,039,972	1,045,033
Total Rates & Charges	612,444	647,637	693,868	737,080	782,581
Adjusted Total Expenses	820,597	872,591	955,628	1,064,388	1,039,615
Net	22,403	3,790	(6,416)	(24,416)	5,418
Liabilities					
Debt	141,901	152,657	149,243	154,869	171,303
Leases	-	-	-	-	-
Total	141,901	152,657	149,243	154,869	171,303
Cash	265,599	276,750	295,775	318,605	325,842
Net Cash / Debt Position	123,698	124,093	146,532	163,736	154,539
Interest expense	6,787	9,142	9,817	9,988	10,643
Average interest cost	4.78%	5.99%	6.58%	6.45%	6.21%

Future forecast

To fund the forecast growth infrastructure requirements detailed in the *RCV Growth Framework*, the rate of growth in debt is anticipated to increase at 7% p.a. for the next 10 years. This indicates that by 2021, RCV as a group will collectively have \$300 million in debt. At current borrowing rates, interest costs on these debt levels will cost rate payers approximately \$18.5 million p.a.

Diagram 1.1**External analysis****International local government funding agencies**

Globally, there are a number of relevant examples of different structures municipalities have used to aggregate debt. Each of the ones listed has been created to act as a shared service to access wholesale investment markets for LG funding needs. These include funding vehicles in Scandinavia, such as KommuneKredit in Denmark and Kommuninvest in Sweden. Finland and Norway also have similar vehicles. In Japan, the *Japan Finance Organization for Municipalities* is the major funding vehicle for the local and regional government sector. In New Zealand the Local Government Funding Authority (LGFA) is the main provider of finance to municipalities.

A number of these agencies are relevant to this feasibility as they function without higher government guarantees to support their credit ratings. These are agencies in Denmark, Sweden, Japan and New Zealand. The New Zealand model is particularly pertinent. It has been developed post the global financial crisis and the legal and financial systems it operates under are virtually identical to those in

Australia. Analysis shows that all of these agencies have achieved the same credit ratings on their bonds as that of the sovereign government. For VLGTA this strongly indicates it can achieve a *AAA/Stable/A-1+* (Standard & Poors - S&P) rating for its bonds. This is the highest possible long and short term investment grade credit rating. It would facilitate easy access to issue bonds into both domestic and international capital markets.

The New Zealand Local Government Funding Authority (LGFA) was established by nine council members in 2011. As the significant cost savings it provided participating municipalities became visible, it quickly grew to become the major funding vehicle for municipalities. As at November 2013, 41 of the 78 New Zealand local governments were using its services. It loans to these members totalled A\$2.2 billion at this time. The LGFA now plays an important part in providing liquidity and diversity to New Zealand's capital markets.

Rating agency assessment criteria

When assessing the credit risk of an entity, ratings agencies (such as Standard & Poors) analyse the strengths and weaknesses of its key factors. These include the business profile, support and ownership, strategy, underlying credit risks, funding and liquidity risks, market risks, capitalisation, industry outlook and undertakes comparative analysis with its peers. These factors are covered in greater detail in discussion about the VLGTA shared services model. The suggested model is designed to mitigate risks associated with each of these factors as much as possible.

Table 1.2 below details comparative pricing and information on risk and profit margin premiums. Both the Commonwealth Government and Treasury Corporation of Victoria (TCV) are rated AAA by S&P. The S&P credit rating for all the major Australian banks is lower at AA-.

Of note in the cost of funds information for the major banks is the blend of retail and wholesale interest rates paid to investors. To protect their credit ratings by reducing risks to liquidity, major banks must diversify their sources of funds and spread their funding risks across a number of markets. This pushes their net funding costs far above that achieved by TCV.

Cost of fundsTable 1.2

as at 30 June 2014

	C/wealth Government	Treasury Corp Vic	Credit Risk Premium ⁽¹⁾	Big 4 Banks	Local ⁽³⁾ Government
90 Day	2.50	2.68	0.18	3.65	5.00
3 Year	2.66	2.85	0.16	4.05	5.36
5 Year	2.92	3.14 ⁽²⁾	0.22	4.45	5.83

(1) Credit risk premium compared to 'Risk Free' Commonwealth Treasury Bonds

(2) Pro-rata price between 3 and 10 year bond

(3) Bank quotes for funding as at 8 August 2014

Par coupon yield priced from respective Issuer's zero curve

Source: TCV, RBA, RCV members & Reuters

Commonwealth Government domestic bonds are perceived by the wholesale investment market as being essentially *risk free*. This is because of the ability of the federal government to issue currency to cover any repayments. Despite having the same credit rating, Treasury Corporation of Victoria bonds are perceived as having a slightly higher risk than Commonwealth bonds due to the states inability to issue currency. This equates to a credit risk premium of 0.22% for a five year bond.

The major banks have a much higher cost of funds. This is driven by a combination of their lower credit ratings and the need to diversify their funding from sources that are not as cost effective as wholesale markets. The average *net interest margin* for the Australian majors in 2013 was 213 basis points (2.13%). Their cost-to-income ratio for the same period is reported to be 45%. This means that to cover overheads a margin of approximately 1.0% must be added to the cost of funds to recover administrative expenses. As such for a five year bond, the *all up real cost of funds* for the majors was approximately 5.45% at as 30 June 2014. When they lend to a client, margins for capital *risk premium* and *profit margins* are added to this consolidated cost of funds base. As such the five year borrowing rate of 5.83% for local government in the table above is an entirely realistic figure for where bank finance would be priced. The pricing on these five year funds is 2.69% above that achieved by the Treasury Corporation of Victoria as at 30 June 2014.

Preliminary estimates indicate that administrative costs for VLGTA would equate to 0.6% of aggregate debt. This figure is lower than the major banks as there is no need to support a large branch network. Thus the overall expected savings in interest costs to RCV members from accessing wholesale markets would be approximately 2%. At current debt levels this would save the RCV \$3.4 million p.a. The savings for the group would rise to \$6 million p.a. by 2021 if the debt forecasts detailed in the *Financing for Growth* report were reached. VAGO reported that total debt across all 79 Victorian municipalities was \$830 million in 2013. A reduction of interest costs by 2% over this amount would save LG \$16.6 million p.a. in expenses.

Shared service funding model and structure

This section provides recommendations on business, commercial and strategic objectives for the funding entity. Further, it recommends credit rating support structures to achieve these objectives. It finishes with analysis as to what pricing RCV members would likely achieve for future debt funding in the domestic capital markets.

Goals:

1. to access the highest possible credit rating for RCV funding requirements
2. to service RCV funding requirements at the lowest possible interest costs via wholesale capital markets
3. to create a dedicated shared service resource owned and controlled by its members to manage this process
4. to structure the resource so its strategic and operational goals are fully aligned to the goals of the members
5. to provide a market return on capital invested of the cost of funds rate plus a fixed margin
6. to provide services to manage the distribution and servicing of funding programs on RCV's behalf
7. to initiate a dedicated shared service resource to provide members with support over a range of value-add treasury and financial risk management services.

Objectives:

1. to address the *profit dilemma* imbedded in the business models of finance providers; banks have a strong financial incentive to maximise their margins to maximise their profits. This creates the potential for bank personnel to skew recommendations on financial products and risk advice to maximise profits rather than best service the needs of their clients.
2. to structurally ingrain best practice corporate social responsibility and sustainability practices by:
 - a. ensuring the focus is on margin minimisation and the return of excess revenue generated to Victorian communities
 - b. creating a mechanism to provide a centralised self funding resource that provides a dedicated and best practice financial risk management and governance service to LG
3. to structure the funding agency so it is directly accountable to its members; rather than just having to take them into account when making strategy, policy and management decisions.

Background

The suggested model for achieving these objectives has been provisionally called the *Victorian Local Government Treasury Agency (VLGTA)*. The term *treasury* is used because under this model the agency would provide a broad range of financial risk management services. These services are detailed in the section *shared financial risk management resources*. In this context the term more closely resembles the services and structure a treasury operation of a large organisation typically provides to operationally independent divisions.

The development of this resource is recognition of the fact that while access to these capabilities can add a great deal of value, individual shires typically only require them on an ad hoc and irregular basis. As such individual shires cannot justify the demand on resources to develop and permanently maintain them.

Ownership structure

It is recommended that the VLGTA is 100% owned by LG members. This supports the following outcomes:

- all profits are distributed to, or retained for the benefit of members
- creates the foundation for a resource to provide unbiased financial risk management advice and support services to LG
- it is similar to other rated municipal funding bodies
- simplifies the support mechanisms in event of major financial distress by minimising barriers that would prevent its bonds being purchased by either the state or the RBA
- addresses the profit dilemma by making the key stakeholders shareholders in the entity
- makes it directly accountable to its members.

Management structure

A supervisory board would be appointed to oversee the entity. Its makeup should provide for key support resources in local government expertise, market intelligence, risk management, business advice as well as the key corporate governance oversight function. Advice would need to be sought as to which was the appropriate regulatory body to supervise the VLGTA. As the entity will not be an authorised deposit-taking institution (ADI) and not a service provider in the payments systems, it is envisaged that APRA is likely not the best placed entity to provide this supervision.

The VLGTA would initially engage external expertise to assist a small management team in setting up systems and processes to instigate and manage funding programs. This would provide services and support for the VLGTA while it internally developed these core competencies. It is recognised that the Treasury Corporation of Victoria has a number of core competencies that would allow it to participate in aspects of the professional development of this resource.

This expertise would implement management and risk systems, provide structures for bond issues, manage distribution and servicing of bonds, develop risk management advice capabilities as well as supporting investor, banking and credit rating relationship management. Essentially it would provide investment banking services solely to VLGTA.

Credit rating support structures

The structure of the entity must be designed to achieve the highest possible credit rating.

The primary components are the capital structure, ownership structure, liquidity profile and mechanisms to access additional liquidity, legislative support (where necessary) and policies managing funding profiles and market risk. By focusing on these key aspects, the following model would have a substantial likelihood of achieving a AAA credit rating. These structures are broadly based on that used by the LGFA in New Zealand.

Business Profile

To operate as a centralised funding vehicle for Victorian councils. Its primary purpose is to provide cost effective funding to local government, rather than profit maximisation.

To provide best practice shared service resources in financial risk management to local government. Essentially to create an unbiased dedicated centre for providing advice in financial governance as well as treasury risk management and banking products.

Support and Ownership

Councils are the shareholders. All councils that borrow over a certain threshold will be required to become shareholders. This provides a mechanism for capitalising the VLGTA. Enshrined in the VLGTA shareholders agreement would be a requirement that the entity must pay a dividend to shareholders. Apart from earnings to pay dividends and maintain capital requirements, its key commercial characteristic will be its not-for-profit focus.

Strategy

Lower financing costs; diversify funding sources, dedicated shared resource for financial risk management services.

Low Credit Risk

Victorian councils have a good aggregate credit rating as borrowings are secured against rate income. Additionally there has never been an instance of loan default. The VLGTA would deal only with Victorian councils.

Ratings agencies will note there is geographic and sector concentration in such a loan portfolio, however this is offset by the strong institutional framework supporting the sector. Local governments are also required to undertake long term financial sustainability planning and must comply with conservative financial ratios that are monitored by the Victorian Auditor General's Office (VAGO).

Funding and Liquidity Risk

There are three main mechanisms the VLGTA could use to maintain high liquidity ratios and thus minimise funding and refinancing risks. The first of these is to issue more bonds than the entity needs for immediate financing. These funds are then placed on deposit with highly rated entities (banks) for instant access in times of reduced liquidity.

The second is establishing standby committed loan facilities. These may be drawn on in a stress event. In other territories, the controlling government typically provides access to a facility that is small, relative to the size of the total loan portfolio.

Thirdly it would be prudent to structure the bonds so they can potentially be purchased by the RBA in extreme stress events. As the RBA has no restrictions on the amount of Australian dollars it can issue, this would provide the VLGTA access to a potential bond buyer that has unlimited access to liquidity.

Market Risk

The VLGTA would accept minimal/no market risk from exposure to interest rate movements due to mismatches between its funding and lending profiles. Firstly this would be done by matching funding raised on domestic markets with that required by the borrower. However where this was not cost effective, interest rate profiles would be matched via the use of financial interest rate derivatives. This in turn creates counterparty exposure to the banks with whom VLGTA enters into these contracts. This counterpart exposure can be managed through the use of ISDA master agreements and CSAs (Credit Support Annex).

Guarantee Structure

To become a member of the agency and access its services, each local government must sign a joint and several guarantee to cover the agencies' commitments.

The guarantee would be structured in such a way that each member's ultimate exposure would be limited to its own share of any liability on which the VLGTA defaults. This is effectively the same liability position councils are in now when they individually borrow funds from banks.

This guarantee structure would be a key element underpinning the credit rating on the agency.

Capitalisation

To achieve the desired credit rating, the VLGTA would need to maintain a certain capitalisation ratio. However, with the structures recommended above in place, these are at minimal levels compared to other financial institutions.

By way of example, the New Zealand Local Government Funding Agency (LGFA) was set up in 2011. It is currently rated AA+ by Standard & Poors. This is the same as the New Zealand sovereign credit rating. It achieves this despite having a net capitalisation of only 2.4%. The capitalisation is made up of shareholder funds and subordinated convertible debt securities called *borrower notes*.

Shareholders are required to purchase shares to the value of 1% of the funds they wish to borrow. However not all LGs are shareholders. The balance of the capital is from the *borrower notes*. Borrowers are required to purchase borrower notes equivalent to 1.6% of their aggregate outstanding borrowings. These notes are automatically converted into capital if the LGFA is in imminent risk of default. The LGFA pays dividends on the shares (fixed at 2% above the cost of funds) and interest on the borrower notes.

It is expected that many aspects of the organisational and funding model of the LGFA could be directly applied to minimise risk when deciding on the most appropriate structure for a VLGTA.

Cost of funding

Correctly structured, the VLGTA should achieve a AAA credit rating. However it is likely that the cost of funds for the agency would be slightly more expensive than that of state. Analysis of credit premiums paid by other AAA rated municipal entities (without government guarantees) suggest margins would be in the vicinity of 30 to 40 points more expensive than that of the Commonwealth for a five year bond. The table below shows that the LGFA pays a credit risk premium of 0.55% on five year funds. The premium for the VLGFA should be less than this due to its expected higher credit rating. After administration costs this equates to a saving of between 2.0% and 2.1% for RCV members compared to where funding can currently be accessed from banks. This data indicates the RCV group would be able to borrow funds at an all up cost to its members of 3.55% for three years and 3.85% for five years. This is significantly lower than where the major banks can currently fund their own loan portfolios.

Table 1.3**New Zealand sovereign cost of funds compared to the New Zealand LGFA**

as at 29th June 2014

	NZ Government	Local Gov Fund Auth	Credit Risk Premium
1 Year	3.6	3.95	0.35
3 Year	3.83	4.28	0.45
5 Year	4.05	4.6	0.55

Standard & Poors credit rating. Domestic currency AA+ (stable outlook)

Source: Reuters

Shared financial risk management resources

This section details the value-added services an appropriately structured agency could provide its members. These are benefits most large organisations typically expect (and access) when setting up a centralised shared service treasury operation. As part of normal operations a dedicated funding entity will have extensive financial markets knowledge on banking products and services, as well as market intelligence and best practice financial risk management. As such it would be in an ideal position to function as a shared service resource to support its members in these areas.

Case studies

In 2011, Exem conducted case studies on five regional shires as part of a survey into LG funding mechanisms, debt profiles, financial governance systems and treasury risk management controls. The purpose was to gain understanding of their requirements and, what levels of internal resources were available to fulfil these.

Findings – Market Analysis

The top four responses that LG identified as their service needs were:

1. access: cheap funding, reporting support, market intelligence, risk management and product advice with minimal drain on limited internal resources
2. reliability: confidence in the dependability, accuracy and the quality of the services
3. expertise: service with specialised expertise in LG requirements that is able to provide individualised support
4. support: when an issue arises there is a timely and personalised system for resolution.

Findings – Service Design

Individual local governments lack the scale of economy and internal resources to access a number of professional financial services. Significant savings to LG may be achieved by accessing:

1. cheap funding for debt and leasing requirements
2. unbiased market and risk management advice
3. risk reporting templates to link the LG Act and financial risk management reporting
4. treasury risk management policies customised to LG specific needs with regular compliance updates.

Financial risk management resources

The following are examples of services that a shared central treasury operation will typically provide to a large organisation. RCV members are constantly exposed to complex financial risks.

Collectively they are also of a scale that can be described as being a large organisation. Access to all, or a mix, of these services to address these risks would add value to members by assisting in management decision making, compliance, governance, reporting, advisory and cost minimisation.

Interest Rate Risk Management

Focused interest rate risk management services

These allow an organisation to:

- better understand the impact of interest rate risk
- quantify the potential outcome of these risks
- develop strategies to ensure interest rate income is maximised, or mitigate the cost of interest from borrowings.

Prudent interest rate risk management reduces an organisation's exposure to an adverse fluctuation in interest rates or helps take advantage of a favourable variation.

Debt Management

Debt management is a significant part of many organisations' operations. Treasury operations offer a comprehensive approach to debt and funding needs, ranging from advice and analysis to provision and execution.

A dedicated treasury adds value by its stand-alone independence, expertise and transparent approach. A core business strategy is offering a flexible approach designed to complement the skills of an existing team and provide resources that aren't available internally.

Typical debt advisory and debt management services include:

- developing and/or reviewing funding options and alternatives
- reviewing, benchmarking and advising on structuring and restructuring debt facilities
- arranging and refinancing bank debt
- preparing board papers and recommendations.

Cash and Liquidity Management

Cash management expertise

Expert resources for all aspects of cash management helps organisations gain greater certainty over their cash position and ability to meet short and longer-term commitments. This includes independent advice and reporting mechanisms to help ensure the most effective use of cash reserves.

Treasury services assist in the implementation or review of:

- daily cash management – collection, collation and management reporting of required information flows in order to deliver time efficient and accurate cash flow decision making
- segregation of duties – ensuring treasury operational controls, dual authorisation and bank mandates are appropriate
- surplus cash maximisation – a review of investment structures in association with cash management to enhance group investment returns or reduce interest payments
- bank account structure – assessment and review of current bank account structure
- internet banking and accounting Interfaces – review of current internet provider facilities and interfaces (automated bank reconciliation, payment referencing and bank statement uploads)
- cash concentration and float lag – review for potential idle cash and its transition to working capital
- transactional bank costing – assessment of transactional banking costs and peer provider reviews
- cash management policy – creation or review of ad hoc cash management policies (i.e. corporate credit card or petty cash policy) to ensure organisational governance.
- independent commentary – independently assess and provide feedback on solutions provided by transactional banking solution providers.

Financial Governance and Advisory Services

- pricing support of financing and investment products; execution in financing only
- risk management policy development and review
- risk management reporting templates and updates
- hedging strategy advice
- debt advisory
- compliance reporting templates and updates
- banking services updates
- operational management development and process reviews (segregation of duties, systems, levels of authority, etc)
- portfolio analysis
- executive and councillor professional development
- market and economic reports.

Funds Management

Due to its constant and deep involvement in the money markets, a treasury team has substantial quantitative and qualitative expertise in all aspects of funds management. This includes continuously reviewing emerging investment opportunities and trends as well as access to the latest market intelligence. A key attribute of a dedicated treasury to an organisation is its independence and transparency. This entity will have no vested interest in product recommendations and advice to clients is always motivated by what is purely in their best interests.

The range of highly rated investment options that comply with restrictive legislation is growing rapidly. An organisations investment program is dependent upon a number of factors, most importantly investment policy, strategic and legislative guidelines and objectives. Treasury recommendations would be able to take these into account while reviewing the full range of investment choices in the market, including direct investments.

Transactional banking services

The agency would be ideally placed to use the scale of the groups' requirements to arrange, negotiate and renegotiate with providers for service improvements. This scale would maximise access to the full pricing benefits for fees and services.

Transactional banking services that may be considered include:

- bank fees;
- electronic banking
- systems for generating and receiving cheques
- credit and purchase card arrangements
- merchant facilities
- fleet vehicle financing
- personal banking services for staff.

Initiation of VLGTA

The next step is to obtain authorisation for development of a full business plan. This would also include a strategic review of local government debt requirements, analysis on the most appropriate structure (ownership and legal) for the VLGTA and investigation of program management systems to sustain the initiative. Key to its success would be early engagement with agencies such as RDV, TCV, MAV and various ministerial departments to gain their support.

COSTS

Capital Costs

If the same capital structure as the New Zealand LGFA was adopted, member councils would provide much of the capital through the purchase of limited liability shares and the investment in the convertible bond. For the first year, this would effectively add 2.6% in costs to councils' borrowings through the VLGTA. The investment is only payable once and would remain as an asset on individual council balance sheets. This capital would also generate dividend and interest income streams for member councils.

It would be beneficial if the state government also participated in purchasing shares. This simultaneously provides additional capital and sends a positive message to the ratings agencies. As the VLGTA started producing income there would be the opportunity for this shareholding to be repurchased.

Professional Services Cost

The current level of analysis does not provide enough information to estimate these costs. However as professional services require little infrastructure, these costs are expected to be reasonably modest. They would mainly consist of wages, office rent, computer and communication expenses.

Ratings Agencies Fees

Ratings agencies typically take a staged approach with their fees structures. A preliminary estimate on initial fees of \$120,000 has been supplied by Standard & Poors. This would cover S&P undertaking:

1. high level review of the a VLGTA structure
2. credit analysis of each council
3. credit analysis of the portfolio
4. a legal and structural review to provide an indicative rating.

Upon completion of a bond issue a *rating establishment fee* quoted at approximately \$75,000 would be charged. S&P also have an *annual surveillance fee* for subsequent years. This has been quoted at 2.5 basis points p.a. (0.025%) of the average monthly outstandings.

Summary

The key recommendation to RCV in the *Financing for Growth* report (September 2012) was “to work with RDV and other state government agencies to develop a financing facility that allows RCV members to access finance equal to the amount of DCPs that the council will themselves finance unless a facility is put in place”. The structure detailed here takes that much further. Firstly, it provides the mechanism to access finance for this purpose at interest rates similar to what TCV can access in wholesale markets. Secondly, it allows members to significantly reduce their interest costs to the same level for all existing debts. Finally, it supports the creation of a sophisticated financial risk management shared service treasury resource. Critically, it achieves all of this competitive advantage without a state government guarantee.

Analysis indicates that such an agency would reduce interest costs on existing RCV debt by \$3.4 million p.a. However, the *Financing for Growth* report estimates that by the VLGTA enabling the required investment in development infrastructure, it will create 4,200 construction-related jobs and 19,720 ongoing jobs. This will accrue economic benefits to RCV councils that are estimated to exceed \$2.3 billion by 2031. These benefits cannot be realised if councils do not have access to appropriate finance to develop infrastructure.

The New Zealand LGFA was initiated in 2011 by nine councils. It now provides funding services to all New Zealand councils. Using this as a model, RCV is ideally placed to provide the same leadership function for creating a Victorian local government funding agency. Given the benefits such an initiative would provide for all local government entities, a strong case for support (in the areas of financial, advocacy and market access) from various government agencies and departments can be made. Initially, RCV members would access the benefits for themselves. At the appropriate time they may then be offered to other councils. Increasing the scale of VLGTA would bring additional benefits from diluting administrative costs and further reducing the cost of funds for RCV.

References

Ben Hunt and Chris Terry, 2011: *Financial Institutions and Markets*

City of Ballarat, 2009 to 2013: *Annual Report*

City of Greater Bendigo, 2009 to 2013: *Annual Report*

City of Greater Geelong, 2009 to 2013: *Annual Report*

City of Wodonga, 2009 to 2013: *Annual Report*

Greater Shepparton City Council, 2009 to 2013: *Annual Report*

Horsham Rural City Council, 2009 to 2013: *Annual Report*

KPMG, 2013: *Major Australian Banks: Full Year Results 2013* viewed 5 August 2013
<http://www.kpmg.com/AU/en/IssuesAndInsights/ArticlesPublications/Financial-Institutions-Performance-Survey/Major-Banks/Documents/major-australian-banks-full-year-results-2013.pdf>

Latrobe City Council, 2009 to 2013: *Annual Report*

Mildura Rural City Council, 2009 to 2013: *Annual Report*

Parliament of Victoria, 2014: *Local Government Act 1989 (number 11 of 1989) (Version 100)*

Reserve Bank of Australia, March 2014: *Developments in Banks' Funding Costs and Lending Rates. Bulletin March Quarter 2014*
<http://www.rba.gov.au/publications/bulletin/2014/mar/pdf/bu-0314-8.pdf>

Reserve Bank of Australia, June 2014 *Interest Rates and Yields - Money Market – Monthly* viewed 9 July 2014 <http://www.rba.gov.au/statistics/tables/index.html#interest-rates>

Rural City of Wangaratta, 2009 to 2013: *Annual Report*

Standard & Poors Ratings Services, 2011: *RatingsDirect – KommuneKredit*

Standard & Poors Ratings Services, 2014: *RatingsDirect – Kommuneinvest i Sverige AB*

Standard & Poors Ratings Services, 2014: *RatingsDirect – Japan Finance Organisation for Municipalities*

Standard & Poors Ratings Services, 2013: *RatingsDirect – New Zealand Local Government Funding Agency Ltd*

Thompson Reuters Eikon information service. Pricing on New Zealand Local Government Funding Agency verses New Zealand sovereign debt

Treasury Corporation of Victoria, June 2014: *Current Interest Rates* viewed 27 July 2014
http://www.tcv.vic.gov.au/page/Market_Activity/Interest_Rates/Current_Interest_Rates/

Victorian Auditor General Report 2013. *Local Government: Results of the 2012–13 Audits.*

Warrnambool City Council, 2009 to 2013: *Annual Report*