Use of debt: common questions and answers

Q & A

Q Why does a council need debt?

A Using debt, is an effective way to provide services and infrastructure without the need for dramatic rises in council rates and to effectively spread the repayment of the cost of the assets over the ratepayers who will benefit from the assets.

Q How long will it take to pay off the debt?

A This is entirely at the discretion of a council, subject to the nature of the borrowing. Council should have a treasury management policy and this policy should guide the council, along with its long-term financial plan to determine a suitable borrowing term.

Q If we consider using interest only debt, what happens if interest rates rise dramatically over the life of the loan?

A Councils have the option of taking out variable or fixed interest rate interest only loans. Fixed interest rate interest only loans will not be impacted by changing interest rates. In considering variable interest rate interest only loans it should be noted that councils rates are generally tied to inflation. If interest rates have risen dramatically over a 10 or 15-year term it is likely that future inflation expectations has also risen dramatically over the same time period meaning that:

- Councils rate income would have also increased over the time period; and
- The debt in real dollar terms will be a lot lower due to the high inflationary environment during the loan term.

Q How will the debt repayment strategy affect the overall financial position of council in the (a) short term or (b) long term?

A Debt repayment strategies can dramatically effect a council's ability to provide other services and infrastructure for their community. If a council has an aggressive debt repayment strategy it means the cashflow requirements of the repayments will be higher.

Q Is the proposed debt to be used to meet ongoing financial running costs of council or to provide additional infrastructure?

A Debt can be used to finance the day to day operations of the council eg to meet short-term cashflow needs. The LGFA have a product called the Convertible Cash Advance Debenture (CCAD) which is used by most councils as a come and go facility, meaning it's utilised on a frequent basis with rate and other income being used to reduce the councils debt position (and therefore interest charge) when possible.

Q Why do we need debt if we have a long-term financial plan and an infrastructure and asset replacement plan?

A All councils should have a long-term financial plan and an asset management plan and the commitments within these plans should drive required rate income and potential borrowing needs. Despite the existence of these plans councils may need to consider debt to accommodate growth (eg capital works) or accommodate peaks in asset renewal.

Q What happens to our repayments if interest rates rise?

A It depends on the type of borrowing the council has engaged in. If the borrowing is a fixed rate borrowing then rising interest rates will not affect your repayments or the amount of interest you are charged. However, if the council is borrowing on a floating rate basis then the interest rate will increase in line with market pricing.

Q What happens to our repayments if interest rates fall?

A Once again it depends on the type of borrowing the council has engaged in. If the borrowing is a fixed rate borrowing then falling interest rates will not affect your repayments or the amount of interest you are charged. However, if the council is borrowing on a floating rate basis then the interest rate will fall in line with market pricing.

Q Does a council need a net financial liabilities ratio trigger?

A The LGA recommend a net financial liabilities ratio is between zero and 100% of total operating income, but possibly higher in some circumstances. Some South Australian councils have borrowed relatively high levels of debt to finance Community Waste Water Management Systems (CWMS) however these councils also collect a charge that should cover the ongoing expenses and also service the debt associated with the scheme.

If a council has borrowed to finance a number of income earning assets (such as CWMS) and when combined with other borrowings associated with other infrastructure renewal, its net debt to income ratios could be higher than 100%.

The long-term underlying operating result of a council gives a better indication of the viability of the council than its level of borrowings. If a council was operating with a significant operating deficit over several years and its strategic management and long-term financial plans did not provide clear proposals for this to be turned around then it would be inevitable that the council would face major financial shocks in the future. The council effectively would be in the same position as an individual or family living beyond their means.

(LGA Financial Sustainability Information Paper No. 9 provides more information about financial indicators and targets.)

Q Should a council borrow on a fixed or floating basis?

A Each council should have a treasury management policy which will provide guidance to the council and to council officers. Generally, the treasury management policy will set targets for the ratio between fixed and variable interest rate loans and this will guide the council in assessing the basis on which a specific borrowing will be made.

(LGA Financial Sustainability Information Paper No. 15 includes an example of a treasury management policy.)

Q As a council member I have been elected to be a custodian of our community. Shouldn't it be my responsibility to ensure the council has little or no debt?

A Your council should have a long-term financial plan that incorporates estimates of all ongoing expenditure including asset renewal to maintain preferred service levels. It is common for long term financial plans to utilise debt to accommodate growth (eg capital works) or accommodate peaks in asset renewal. So as a custodian if you do not consider using debt you will need to 'save' to accommodate large asset renewal projects and it is likely that your rate income will have to increase or spending on services will need to be reduced as a result.