5. FINANCIAL IMPACT AND RISKS OF DIRECT INVESTMENT IN PROPERTY AND INVESTMENT IN HOME GROWN RURAL AND COMMUNITY FINANCIAL INSTITUTIONS – FILE REF: 20-19-1

16x’s

Report of the Director Financial Services of 8 December 2015 and attachment.

DELEGATION: Council

TO : Finance Committee

FROM : Director Financial Services

DATE : 8 December, 2015

SUBJECT : **FINANCIAL IMPACT AND RISKS OF DIRECT INVESTMENT IN PROPERTY AND INVESTMENT IN HOME GROWN RURAL AND COMMUNITY FINANCIAL INSTITUTIONS**

FILE : 20-19-1 DS:DS (o:\council & committee meetings reports\fc reports\2015 meetings\15 december\word version of report\fc report - financial impact and risks of direct investment in property and investment in home grown rural and community financial institutions.doc)

1. INTRODUCTION

1.1. The purpose of this report is to provide the Council with a high level assessment of the impact and risks of direct property investment and investment in home grown and rural community financial institutions.

2. BACKGROUND

2.1. At the Council meeting of 27 April 2015, the Council resolved in relation to the update to the Council Policy on the Investment of Council Funds that:

A further report be prepared investigating the financial impacts and risks of Council investing its capital into direct property investment and home grown rural and community financial institutions such as MyState and Bendigo.

2.2. The Council currently owns and manages 36 properties on a commercial basis through lease arrangements.

2.3. Traditionally the Council has invested surplus funds in at-call savings accounts and term deposits of up to twelve months. Council's Investment of Funds Policy (4.01.03) allows investments with financial institutions that have a Standard & Poor's credit rating of A2/BBB or better and in products where the underlying assets are cash.

2.4. The Council currently has a diversified investment portfolio with funds invested in a number of term deposits with varying terms and across a wide range of financial institutions including some that might be considered to meet the definition of 'community financial institutions' such as Bendigo and Adelaide Bank.

2.5. At the Council meeting of 27 April 2015, amendments to the Council Policy on the Investment of Council Funds were adopted. The amended policy provided that preference be given to investment institutions that do not invest in the fossil fuel industry subject to compliance with the policy's investment guidelines and a favourable rate of interest.

3. DETAILS

3.1. The current Council Policy on the Investment of Council Funds (**Attachment A**), as amended on 27 April 2015, provides for the maximisation of Council's return on its investments, subject to the following four tier risk management system for investments (in weighted order):

- Safety and Security
- Liquidity
- Rate of Return
- Ethical in Nature

Security of ratepayer's capital is the overriding consideration in all investment decisions made by Council.

3.2. At the Council meeting of 27 April 2015, amendments to the Council Policy on the Investment of Council Funds were adopted. The amended policy provided that preference be given to investment institutions that do not invest in the fossil fuel industry subject to compliance with the policy's investment guidelines and a favourable rate of interest.

3.2.1. The Council's Policy on the Investment of Council funds is guided by a series of Investment Guidelines which include:

"(ii) Investments may be made for any period up to a maximum of one year.

(iii) Investments can only be made in products where the underlying assets are cash.

(xii) Any investment outside of the investment guidelines in the policy must be referred to the Finance Committee for prior approval".

Direct Property Investment

3.3. Direct property investment refers to the purchase of a property, either partly or wholly, by leasehold or freehold for commercial purposes or for future sale. It can include residential, commercial, industrial and retail property assets such as shopping centres or office blocks.

3.4. As a property owner the Council currently receives income directly through rents from tenants or from the sale of property.

3.5. Some of the possible advantages of property investment are considered to be:

3.5.1. Any property which can be leased can provide a long term income particularly if the lease duration is for a substantial tenure and the property was purchased at a good price.

3.5.2. Increases in revenue tend to come from having fixed annual increases on leases which provide certainty in cash flow over a period of time as well as providing a hedge against inflation.

3.5.3. Rental on commercial property in a steady rental market and managed effectively, can return attractive yields.

3.5.4. Capital growth can add to the overall investment return.

3.5.5. Property can be less volatile than some other forms of investment.

3.5.6. There may be taxation benefits associated property investment (though this is not applicable to councils).

3.6. Some of the possible disadvantages of property ownership are considered to be:

3.6.1. While owning property outright has the advantage of receiving the full yield it also means that the owner carries all the risks including financial market and business risks.

3.6.2. Moreover the owner carries the responsibility of managing the property which in a tough leasing environment can often lead to default by tenants and being unable to maintain a high level of occupancy.

3.6.3. Property investment is less liquid than other forms of investment.

3.6.4. Property values can decrease.

3.6.5. Property investment typically requires large amounts of capital which can lead to difficulty, without the availability of other funds to invest in alternate investment types, of obtaining sufficient investment diversification.

3.6.6. There are high entry and exit transaction costs such as stamp duty and agent fees.

Property investment and local government

3.7. It is generally recognised that local government needs to develop alternative revenue streams and such streams may include investment in property or entering into commercial partnerships.

3.8. A number of councils in Australasia have direct property investment policies and own commercial properties for lease.

3.9. The following councils have property investment portfolios which are run on a commercial basis:

3.9.1. Port Stephens Council's property investment is part of their investment portfolio with the revenue created used to alleviate the call on rates revenue and to provide capital growth. The Port Stephens Council commercial property portfolio includes shops, office suites and property that is suitable for professional rooms, cafes or restaurants. Commercial properties available for lease are advertised on the Port Stephens Council website.

The Port Stephens Council Financial Statements for 2013/14 value the investment property portfolio at $19.9M with an income through lease payments of $2.4M.

3.9.2. The City of Melbourne's investment portfolio includes cash investments, property holdings, car parks and shares in subsidiary and associated companies. The investment properties are 29% of the total investment portfolio.

The City of Melbourne Annual Plan for 2015/16 shows the investment properties valued at $84.5M with a net income of $3.8M, a return of 4.47%.

3.9.3. Auckland Council has a commercial property portfolio which is managed by a Council-controlled organisation (CCO) called Auckland Council Property Ltd (ACPL). ACPL is governed by a boards of directors or trustees and operated at arms length to the Council. The portfolio includes land, commercial buildings and water space licences. The ACPL is also involved in investing in housing developments.

The Auckland Council Annual Report for 2014/15 values the commercial property at NZ$105M, land at NZ$310M with rental income at NZ$19M and expenses at NZ$4.3M.

3.10. Whilst the *LGA 1993* allows the Council to invest in commercial property it is not considered to be a "core" function of local government and can raise a number of issues including real or perceived conflict of interest between the regulatory and ownership roles of local government, the capacity and competence of local government to undertake such enterprises and the exposure of ratepayers to any ensuing financial risk.

3.11. Investments in property by councils to influence the development of certain enterprises may lead to a distortion in the local property market if not managed effectively and could impact on the commercial interests of businesses and property developers and managers.

3.12. To address these issues some jurisdictions in Australasia have established subsidiary corporate structures to manage assets and services efficiently using commercial disciplines and specialist expertise. This allows the councils to focus on their core functions whilst having alternative revenue streams. Queensland, South Australia and New Zealand take this approach to managing commercial activities of Councils.

3.13. Some councils in New Zealand have council-controlled organisations (CCOs) to manage assets and services efficiently. The CCOs are governed by boards of directors or trustees and operate at arms length to the council. However the CCOs are accountable to the council which sets targets for the CCOs and monitors performance through a Council Committee.

Why invest in property

3.14. Perhaps the first question for Council in considering property investment would be for it to consider its motivation and purpose. So would Council's motivation be for example:

3.14.1. To broaden its investment portfolio beyond cash investments, with the aim to increase diversification, reduce risk and improve returns?

3.14.2. Or, would the motivation be for Council to acquire strategic or important or well positioned properties within the city, with the aim of influencing the market in some form to achieve outcomes on those properties that might not otherwise occur if just left to market forces. Such 'influencing' could take a variety of forms including Council being a developer in its own right, conducting expression of interest processes to achieve certain outcomes, or selling properties with conditions attached. This approach would need to be managed carefully, given the potential issues identified at 3.10 and 3.11.

Conclusion

3.15. A move into property investment, either for commercial return, or for wider strategic considerations for the city, would represent a major policy decision for Council.

3.16. This report identifies some higher level issues for Council to consider. If Council was of a mind to enter into property investment, it is recommended that professional advice be sought around potential risks, benefits, and governance arrangements, to enable Council to be better informed.

Investment in home grown and rural and community financial institutions

3.17. The Council currently has a diversified investment portfolio with funds invested in a number of term deposits with varying terms and across a wide range of financial institutions including some that might be considered to meet the definition of 'community financial institutions' such as Bendigo and Adelaide Bank.

3.18. At the Council meeting of 27 April 2015, amendments to the Council Policy on the Investment of Council Funds were adopted. The amended policy provided that preference be given to investment institutions that do not invest in the fossil fuel industry subject to compliance with the policy's investment guidelines and a favourable rate of interest.

3.19. Whilst there is no definition of 'home grown' nor of 'rural and community', for the purposes of this report, the following assumptions have been made:

3.19.1. that 'home grown' refers to Tasmanian institutions such as MyState, B&E and Tascorp; and

3.19.2. 'rural and community' refers to institutions whose stated mission is to serve the rural sector (such as Rural Bank) or community (such as Bendigo and Adelaide bank) or member based institutions whose objective is to provide services and direct profits into services to members, such as credit unions and building societies, rather than the return of dividends to shareholders typical of the large institutions.

3.20. Council's current Investment policy provides for the maximisation of Council's return on its investments, subject to the following four tier risk management system for investments (in order):

- Safety and Security
- Liquidity
- Rate of Return
- Ethical in Nature

Security of ratepayer's capital is the overriding consideration in all investment decisions made by Council.

3.21. Within these guidelines, the policy further provides for maximum investment limits, using a credit rating approach. It provides for:

3.21.1. Unlimited funds may be placed with Tascorp;

3.21.2. Maximum exposure to Council's transactional banker, currently the CBA, of $12M;

3.21.3. A maximum exposure to the other Big Four banks of $7M;

3.21.4. A maximum exposure to institutions with a Standard and Poor's credit rating of A1/A- (ie: short term, long term) of $5M;

3.21.5. A maximum exposure to institutions with a Standard and Poor's credit rating of A2/BBB of $2M.

3.22. As a reminder, Standard and Poor's ratings provide the following (the long term rating being >90 days, is the most commonly used):

Rating	Definition
AAA to AAA-	Extremely strong capacity to pay
AA+ to AA-	Very strong capacity to pay
A+ to A-	Strong capacity to pay
BBB+ to BBB-	Adequate capacity to pay

Anything less than BBB- (BB, B, CCC, CC) is considered to have speculative characteristics.

Increase in Risk

3.23. Any proposal to increase, or indeed limit Council's investments to institutions deemed to be Tasmanian, or rural or community based, will increase the risk profile of the investment portfolio. Such a portfolio would for the most part, necessarily consist of smaller, regionally based institutions that do not have the scope of business to be involved in large scale lending and investment. As a result, they typically have lower credit ratings than the large and more diverse institutions.

3.24. There are approximately 150 institutions (termed authorised deposit taking institutions) in Australia. These are entities which are authorised under the Banking Act 1959, and regulated by the Australian Prudential Regulation Authority. They comprise banks, credit unions and building societies.

3.25. Standard and Poor currently has credit ratings for 38 banks, and 11 other ADIs – mostly some credit unions and building societies. The corollary to this is that many institutions do not have a credit rating – and thus would not be eligible under Council's policy which requires a minimum BBB rating.

3.26. To demonstrate the change in risk profile, the following is a table of institutions currently commonly used, and their credit rating, and institutions that might qualify under the Tasmanian/rural/community criteria.

Institution	**Maximum** per Council policy	**Rating**	**Currently used**	**Considered Tasmanian, rural or community based**
4 majors	$7M (excepting transactional banker, CBA $12M)	AA-	Yes	No
AMP	$5M	A+	Yes	No
Macquarie Bank	$5M	A	Yes	No
Bank of Queensland	$5M	A-	Yes	Yes
Bendigo and Adelaide	$5M	A-	Yes	Yes
Suncorp Metway	$5M	A+	Yes	Yes
Rural Bank (a subsidiary of Bendigo & Adelaide bank)	$5M	A-	Yes	Yes
MyState	$2M	BBB	Yes	Yes
Members Equity	$2M	BBB+	Yes	Yes
Newcastle Building Society	$2M	BBB+	No	Yes
Credit Union Australia	$2M	BBB+	No	Yes
Greater Building Society	$2M	BBB+	No	Yes
Big Sky Building Society	$2M	BBB	No	Yes

3.27. Some comments on the table overleaf:

3.27.1. The table is not an exhaustive list of all institutions used, or available to be used should policy be changed.

3.27.2. Both Bank of Queensland and Suncorp Metway would be considered to be still be available, on the grounds both of these are not fossil fuel supporting institutions.

3.27.3. Tascorp holds significant Council funds at times, and would be proposed to continue to.

3.27.4. The Tasmanian institution B&E Building Society is not included, on the basis it does not have a Standard & Poor's credit rating.

3.27.5. The change in risk profile can easily be seen. Essentially, the large AA and A rated institutions (although some A rated remain), would be replaced with a number of much smaller BBB rated institutions.

3.27.6. Depending on the quantum of funds with A rated institutions (where the maximum investment is $5M), given the current $2M limit per BBB rated institution, Council may have to deal with a greater number of institutions than present, in order to place all of its funds. This would increase the administrative cost.

3.27.7. An exception may need to be made for transaction banking. Council's transactional banking needs are complex given the diversity of Council's operations. The Commonwealth Bank is the incumbent, having been successful in its public tender submission. If the desire to move to Tasmanian/rural/community institutions is applied to transactional banking, excepting Bendigo and Adelaide Bank and Bank of Queensland, the available providers will be the smaller institutions who most likely will not have the range of services Council requires.

Possible increase in investment returns

3.28. As noted above, moving to Tasmanian/rural/community institutions would result in a shift to smaller and lower rated entities. These institutions typically provide a higher rate of return on investments to compensate investors for the higher risks inherent in smaller, and less diverse business models.

3.29. It is difficult to be definitive, and financial markets are never static, however, typically an increase of around 10 basis points or 0.1% might be a guideline.

3.30. On a $40M investment portfolio (the most recent finance report tabled at Committee was for September reported cash and investments on hand at $42M), a 0.1% increase in returns would generate an additional $40K in interest earnings per annum.

Conclusion

3.31. To conclude, this report identifies some higher level issues for Council to consider. Much like the property investment issue discussed above, it is considered that if Council was of a mind to amend its investment policy to move its portfolio into Tasmanian/rural/community institutions, professional advice be sought around possible risks and return. This report has identified that an increase in risk would result, but professional advice would be better able to quantify that risk and determine whether an unacceptable level of risk resulted. Similarly, the issue of the extent, if any, to which investment returns may increase would benefit from considered opinion.

4. PROPOSAL

4.1. It is proposed that, in the event Council is interested in either:

- Moving into direct property investment; or
- Amending the investment policy to investments in Tasmanian/rural/community based institutions

that further professional, and more detailed advice be obtained.

5. STRATEGIC PLANNING IMPLICATIONS

5.1. The two subjects of this report touch on a number of strategic objectives in Council's strategic plan 2015-2025, namely:

3.4 Leadership in environmental performance with the efficient use of natural resources;

5.1 Good governance – financial sustainability;

5.2 Recognise and manage risk.

6. COMMERCIAL OPPORTUNITIES

6.1. The Council currently owns and manages 36 properties on a commercial basis through lease arrangements.

6.2. Property management is not considered to be a core function of local government and any expansion of the Council's property portfolio will require careful consideration to ensure that portfolio is managed competently so as to reduce exposure to financial risk.

7. FINANCIAL IMPLICATIONS

7.1. Funding Source(s)

7.1.1. Not applicable – this report recommends further analysis so there are no financial implications at present.

7.2. Impact on Current Year Operating Result

7.2.1. See 7.1.1

7.3. Impact on Future Years' Financial Result

7.3.1. See 7.1.1

7.4. Asset Related Implications

7.4.1. See 7.1.1

8. RISK MANAGEMENT IMPLICATIONS

8.1. Refer discussion at Section 3.

9. LEGAL IMPLICATIONS

9.1. There are a number of provisions in the *Local Government Act 1993 (LGA)* which govern council investments and their ability to purchase, acquire, sell and lease property

- Section 20 (5)(a) of the *LGA 1993* provides that *a council may acquire, dispose of and otherwise deal with property.*

- Section 73 of the LGA 1993 (Part 8 - Financial Management Division 1 - Funds, expenditure and investments - Sources of funds) provides that:

  A council may raise funds in any one or more of the following ways:

  (c) by selling property and assets;

  (d) by leasing or hiring out property;

  (f) by carrying out commercial activities.

- Section 75 of the *LGA 1995* Investments provides that:

  A council may invest any money –

  (a) in any manner in which a trustee is authorised by law to invest trust funds; and

  (b) in any investment the Treasurer approves.

- Section 175 of the *LGA 1993* (Part 12 – Special Powers Division 1 – Purchase, acquisition, sale and lease of property) provides that *a council may purchase or lease land for any purpose which it considers to be of benefit to the council or the community.*

- Section 21 also contains enterprise powers to form, establish, subscribe to, become a member of corporations, trusts, partnerships or other bodies.

10. DELEGATION

10.1. This matter is delegated to Council for determination.

11. CONSULTATION

11.1. In the writing of this report consultation has been undertaken with the Group Manager Executive and Economic Development and the Manager Legal and Governance.

12. CONCLUSION

12.1. This report responds to a resolution of Council that "*a further report be prepared investigating the financial impacts and risks of Council investing its capital into direct property investment and home grown rural and community financial institutions such as MyState and Bendigo.*"

12.2. This report has, at a high level, considered some possible risks and benefits of the above.

12.3. In both cases (direct property investment, and a move to smaller community based financial institutions) such a decision would represent a major policy revision. Accordingly, it is recommended that Council give in principle consideration to these issues, and in the event Council remains interested, further more detailed professional advice be sought regarding the risks and possible benefits.

13. RECOMMENDATION

That:

13.1. The report DS:DS (o:\council & committee meetings reports\fc reports\2015 meetings\15 december\word version of report\fc report - financial impact and risks of direct investment in property and investment in home grown rural and community financial institutions.doc) be received and noted.

13.2. The Council give initial consideration to whether it wishes to move into direct property investment, and in the event it does, external

professional advice be obtained to further investigate possible risks, benefits, and governance arrangements.

13.3. ***The Council give initial consideration as to whether it wishes to further invest in home grown rural and community financial institutions, and in the event it does, external professional advice be obtained to further investigate the risks and benefits.***

As signatory to this report, I certify that, pursuant to Section 55(1) of the Local Government Act 1993, I hold no interest, as referred to in Section 49 of the Local Government Act 1993, in matters contained in this report.

(David Spinks)
DIRECTOR FINANCIAL SERVICES

Attachment A Council Policy on the Investment of Council Funds

Attachment A

Policy Manual

Title:	Investment of Council Funds
Subject:	Finance – Cash Management
Policy Number:	4.01.03
Adopted by Council:	24/10/2011
Next Review:	November 2019
Responsible Officer:	Director Financial Services

1. Objectives: To maximise the Council's return on its investments, subject to the satisfaction of the criteria of safety and security, liquidity, and ethical nature.

2. Background: The permitted methods of investment of Council funds are defined within the Local Government Act 1993. The below policy outlines the Council processes within legislated parameters.

3. Policy:

1. CRITERIA FOR INVESTMENT

(i) *Safety and Security* – Security of the ratepayer's capital is the overriding consideration in all investment decisions.

(ii) *Liquidity* – Investments must be managed to ensure that sufficient funds are available to meet cash requirements as they fall due.

(iii) *Rate of Return* – Subject to the two preceding considerations, Council will aim to maximise its return.

(iv) *Ethical in Nature* – Subject to the preceding considerations, in making investment decisions, regard will be taken to an investment being environmentally and socially ethical. Subject to the investment guidelines, preference will be given to investment institutions that do not invest in the fossil fuel industry over those institutions that do invest in the fossil fuel industry.

2. EXPECTED RATE

The performance benchmark is the 90 day Bank Bill Swap Rate (BBSW).

3. DELEGATED AUTHORITY

The Director Financial Services is delegated authority to invest according to Section 75 of the Local Government Act 1993, from the Council through the General Manager.

4. INVESTMENT GUIDELINES

(i) Section 75 of the Local Government Act 1993, will be complied with at all times.

(ii) Investments may be made for any period up to a maximum of one year.

(iii) Investments can only be made in products where the underlying assets are cash.

(iv) There is no limit on the amount of funds that can be placed with Tascorp.

(v) Exposure to Council's transactional banker is limited to $12,000,000.

(vi) Subject to item 4(v), exposure to Australia and New Zealand Banking Group, Commonwealth Bank of Australia, National Australia Bank and Westpac Banking Corporation is limited to $7,000,000.

(vii) Subject to item 4(vi) exposure to other banking institutions with a Standard and Poors credit rating A1/A- is limited to $5,000,000.

(viii) Subject to item 4(vii) exposure to other banking institutions with a Standard and Poors credit rating A2/BBB is limited to $2,000,000.

(ix) When determining the level of exposure to a financial institution, the exposure includes all funds held with the institution, including funds not classified as investments.

HOBART CITY COUNCIL

Policy Manual

(x) Where a banking institution is a subsidiary of another the level of exposure shall be the sum of the exposure to each institution and limited as above.

(xi) For any fixed term investment, whether new or rollover, quotes must be obtained from a minimum of three institutions. Investment decisions must be documented.

(xii) Any investment outside of the investment guidelines contained within this policy must be referred to the Finance Committee for prior approval.

5. PROVISION OF INFORMATION TO ALDERMEN

(i) Details of all current investments are to be provided to any Alderman upon request.

4. Legislation, Terminology and References:

Section 75 of the Local Government Act 1993

Delegations Register

History

Council Policies are reviewed annually with amendments to a Policy listed below

Date Policy first adopted:	13/11/1995
Amendments:	
Amendment	13/6/2000
Amendment	28/7/2008
Amendment	24/10/2011
Annual Policy Review	8/9/2014
Amendment	27/4/2015