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BUDGET FOR INTEREST EARNINGS

The Finance and Administration Committee recommends the adoption of the recommendations contained in the following report, February 23, 2004, from the Commissioner of Finance:

1. RECOMMENDATIONS

It is recommended that:

1. This report be received for information.

2. PURPOSE

The purpose of this report is to provide information on the methodology for calculating and budgeting for interest earnings.

3. BACKGROUND

At its meeting of February 19, 2004, Council requested that staff prepare a report on interest earnings and how forecasted earnings are reflected in the Region's operating budget.

In 2003, the Region earned approximately $27.3 million in interest income by investing reserves and surplus funds. This equates to a net annual rate of return of 3.34% on investments which totalled, on average, $818 million.

While the Region earns interest on its reserves, it does not earn (or forecast) interest income on property tax receipts forwarded to it by Local Municipalities, since these are paid in arrears. This delay in receiving tax money actually results in a need for working capital to fund the day-to-day operations of the corporation. As part of the 2003 Regional Budget, a monthly cash flow was forecast that showed net cash requirements ranging from approximately $97.5 million in March to a surplus of approximately $4.5 million in July with an average shortfall of $39 million during the year. Working capital requirements are funded first through the Working Capital Reserve, which currently has a non-interest bearing balance of $33 million, and then any further shortfalls are borrowed from reserves at a rate equivalent to the prevailing rate of return of the portfolio. In 2003 the budgeted cost of financing working capital deficiencies not funded by the Working Capital Reserve was $199,000.

Investment of reserves and surplus funds is governed by an Investment Policy that was approved by Council in October 2002. The Investment Policy's primary objectives are:

1. Adherence to statutory requirements;
2. Preservation of capital;
3. Maintenance of liquidity; and
4. Earning a competitive rate of return.

Investments are managed by the Policy, Risk & Treasury Branch of the Finance Department using the strategy highlighted in the *Annual Investment Report* prepared for Council.

4. ANALYSIS AND OPTIONS

The precise budgeting of interest to be earned in a year for reserves is difficult. Certain contributions that are made to reserves (e.g. development charges), the timing of large capital expenditures and market interest rates are all influenced by many external factors and are difficult to project with a high degree of accuracy.

4.1 Interest Earned on Investments

Of the approximately $27.3 million in interest income earned by the Region on its investment portfolio in 2003 approximately $26.4 million was earned for the reserves and the balance of $0.9 million was earned by working capital. Table 1 summarizes the source of interest income for 2003 and provides a comparison of actual to budgeted interest income.

Table 1
2003 Interest Income
Actual versus Budget

Income Source	**Actual Interest Income ($000's)**	**Budgeted Interest Income ($000's)**	**Variance ($000's)**
Reserves			
Development Charges	14,458	10,279	4,179
Water and Waste Water	3,255	2,266	989
General and Other Capital	6,193	3,947	2,246
Non-Capital Reserves	2,498	2,118	380
Total Reserves	26,404	18,610	7,794
Working Capital	900	(199)	1,099
Total Interest Income	27,304	18,411	8,893

The variance between actual interest earned in 2003 compared to budget is attributable to several factors, including:

	Impact ($000's)
1. Actual interest returns of 3.34% were higher than the rate of 2.7% used in the budget forecast;	4,344
2. Reserve revenues were higher and expenditures lower than projected resulting in higher reserve balances overall;	3,750
3. Impact of timing differences compared to forecast of certain receipts and payments.	799
Total Difference	8,893

4.2 Investment Results versus Benchmark

The average rate of return earned on the portfolio is benchmarked against the rate of return earned by the LAS-One Fund, a professionally managed fund sponsored by AMO and MFOA for Ontario municipalities. The LAS-One Fund invests in the same securities as the Region's authorized to invest through its Investment Policy and Ontario Regulation 438/97. The Region is investment returns are reported to Council each year through the *Annual Investment Report* and have consistently exceeded its benchmark over the years as indicated in Table 2.

Table 2
Comparison of Region's Portfolio Returns
Versus LAS One Fund Returns

Year	Region's ROR (%)	LAS One Fund Returns (%)	Difference	
			%	$ millions
1999	4.93	4.75	.18	1.0
2000	5.63	5.45	.18	1.3
2001	4.58	4.27	.31	2.1
2002	2.76	2.39	.37	2.6
2003	3.34	2.82	.52	4.3

Although these excess returns do not directly impact the annual tax levy, any increase in investment returns contribute to reserves and over the longer term and decrease the need for taxes and other revenue sources.

5. FINANCIAL IMPLICATIONS

In 2003 the Region earned $27.3 million in interest income that was mainly contributed to reserves. Interest income complements other reserve contributions providing an important source of funding for future capital requirements.

6. LOCAL MUNICIPAL IMPACT

There is no direct impact on the finances of area municipalities.

7. CONCLUSION

Interest forecasts are prepared annually for reserves and working capital requirements but do not have a material impact on the Region's operating budget. Notwithstanding, interest earnings are monitored and investment results are reported annually to Council.

The Senior Management Group has reviewed this report.