**SNTA Brief #[\*]**

**AVOIDING FINANCIAL MANAGEMENT DISASTERS: PART TWO**

Introduction:

Avoiding financial management disasters is a basic goal of all local governments[[1]](#footnote-1) and their leaders. There are many types of financial disasters that can befall a local government: budget disasters, cash crises, fund management problems, and debt defaults are some of the most common ones. There is also an array of proven good practices that can be used to avoid these disasters. Part one of this SNTA Brief points the way to avoiding budget disasters and cash crises. Part two focuses on avoiding fund management problems and debt defaults.

Fund Management Problems:

Local governments typically keep money in several types of funds to segregate and monitor resources that are intended for different purposes. Sometimes these are separate accounts at a bank or other financial institution, for example a *debt service reserve fund* kept in an escrow account at a local bank. Other times, the funds are simply an accounting entity within the local government’s books, for example the *general fund* from which most operating expenses are paid. In some cases the money in the funds may be invested to earn interest. In all cases, the balances in the funds need to be protected from two types of problems: 1) loss of value, and 2) lack of availability when required.

Prudent cash management for all funds is a fundamental stewardship responsibility. Money that is not wisely invested can be lost if the investment itself runs into problems. Stock and bond prices can fall. Banks can fail. If a local government has money in a failed investment, that money may never be recovered and the local government has failed in its stewardship responsibility. Typically, local governments get into the problem of losing the public’s money when they chase after higher yields on their investment. In the world of investments, higher returns are always associated with higher risks.

To avoid losses, a golden rule is to make “safety first” the principal criterion for fund management decisions. This means that local governments should only put money into investments and institutions with the highest possible credit rating (AAA), for example national government financial instruments and accounts in AAA-rated banks. Yields may be unimpressive, but the chance of a loss is essentially zero. A second golden rule is to diversify where the local government places its money. Even for short-term instruments like demand deposits, CD’s, and savings accounts, local governments should use severaltop-rated institutions to their diversify assets and not leave “all the eggs in one basket”!

Local governments also need to make sure that their money is accessible when it is needed. Local government fund managers typically get into trouble by investing money needed for immediate purposes in instruments with a longer maturity and then having to pay either an explicit, known penalty for early withdrawal (as with CD’s) or an unknown market penalty for premature sale of a security. Therefore, a third golden rule of fund management is to match investment maturities to the purpose of the fund.

The maturity of any investment vehicle needs to a little shorter than the scheduled payment to be made by the fund. In the case of a general fund for making the payroll and paying other recurring operating expenses the schedule of payments is very short, so money should be kept in demand deposits, and immediately accessible savings accounts. For a fund that is to pay for construction projects over a period of one or more years, or a debt service reserve fund to cover pre-established debt payments, money can be invested in short to medium length CD’s and short maturity national government notes and bonds. For a pension fund, or a long-term sinking fund to replace a depreciating asset, it may be possible to invest in medium- to long-term securities such as AAA-rate government or corporate bonds.

Just remember the golden rules: safety first, diversify assets, and match maturities to the purpose of the fund.

Debt Defaults:

Debt defaults occur when a local government fails to make a debt service payment in full and when due. A day late, or a dollar short is not acceptable; it is a default! In the event of a default, most loan and bond agreements require that the entire remaining debt be *immediately* paid in full. Since this will create great difficulties for any local government, defaults are to be carefully avoided.

To avoid defaults, local governments first need to assure that they do not become over indebted. Before taking on any new debt, the local government must be sure that it has a reliable surplus of operating revenues over operating expenses (including any existing debt service expenses), and that the reliable surplus is larger than the amount needed to pay the annual debt service on the new debt. Beyond this most basic requirement, local governments also need to follow three golden rules of debt management:

1. Short term debt should **only** be used *if necessary* to provide liquidity when the timing of revenue collections and expenditure patterns create a temporary budgetary shortfall. Short term debt should be fully repaid by the end of the fiscal (budget) year. Short term debt should **never** be “rolled over” to disguise an operating margin deficit.
2. Long term debt should **only** be used *according to a plan* to finance capital investments, and **never** to disguise operating budget deficits.
3. Foreign exchange risk must be avoided by borrowing **only** in local currency because local governments do not normally have foreign currency revenues to cover foreign currency debts. A significant devaluation of the local currency at any time during the term of a foreign currency debt can result in the debt service increasing far beyond the repayment capacity of the local government, and this leads to default. (See SNTA Brief: The Importance of Sub-National Authorities Avoiding Foreign Exchange Risk When Borrowing Long-Term.)

Implementing good debt management practices enables local governments to avoid defaults. Good practices start with having written policies and procedures for debt management; even if there is no current debt on the books. It is best to have the debt policies formally established by a legislative council resolution or similar measure so that they cannot be easily ignored or reversed by future administrations. The three golden rules of debt management should be the foundation stones of a local government’s written debt policy. In addition, a local government needs written policies and procedures covering several other key topics.

There needs to be a policy establishing the basis on which short and long terms debt can be authorized. While authorizing short term debt (within specified limits) may be left to the executive branch, good practice for authorization of long term debt requires approval of the legislative branch or a referendum voted by the community. This leaves liquidity management flexibility with the executive while assuring that there is broad popular support for debts that will have to be repaid over many years. Coupling these policies with one that formally makes all debts binding on subsequent administrations assures that defaults will not occur because a future administration decides to renege on the debts of its predecessor administrations. Finally, a written policy that requires the executive branch to make payment of annual debt service always the top priority for the use of funds budgeted in any year avoids defaults caused by shifting or confused budget priorities.

Essential written procedures include the requirement to do a capital investment plan and debt service capacity study before contracting any long term debt. This enables a local government to avoid defaults due to over indebtedness while providing the analytic basis for authorization of long term debt. Another important procedure is one establishing the requirement to seek the best possible terms for any debt by using competitive or other appropriate practices. This will minimize the financial strain on the annual budget and thereby the chance of default.

Written procedures should also establish safeguards designed to prevent even the accidental delay of a debt service payment that can trigger a default. Some practical examples include:

* + Establish a debt service reserve for each debt and maintain a balance in the reserve that is sufficient to cover **at least a year’s worth** of debt service payments at all times.
	+ Put the amount of the current year’s total debt service payments into an escrow account that cannot be used for any purpose other than payment of debt service due as each payment date arrives. Instruct the escrow agent to make payments according to the terms of the loan or bond.
	+ Maintain a system of alerts that enable the executive branch of the local government to assure that adequate funds are available and positioned for payment to creditors in advance of each debt service due date.

Finally, every local government needs a debt management unit to assure that there is clear responsibility for implementation of debt management policies and procedures as well as careful risk management and cash management. This unit is essential once a local government begins to contract debt, but plans for its creation should be in place even before the first debt is established. Core functions of the debt management unit include:

* + Planning of all borrowing according to written policies and procedures. It is a good practice for this function to be supported by an external independent financial advisor familiar with local debt market conditions.
	+ Following all policies and procedures for executing debt service payments on time and in full. This includes minimizing fund management risks and assuring the availability of adequate cash in all debt service accounts.
	+ Maintaining a record of all debts and any contingent liabilities created by debts of subordinate units (such as utility companies) owned by the local government. Reporting to the chief executive and legislative council on the status of all debts should be done on a regular basis but at least annually.

Conclusion:

Implementing prudent good practices for fund management and debt management enables a local government to avoid the problems of losing money in risky investments, not having cash available when it is needed, and (worst of all) defaulting on its debts. When combined with the use of sound principles for budgeting operating and capital expenditures as well as careful liquidity management (see Avoiding Financial Management Disasters: Part One), a local government can also avoid budget deficits, unfinished capital improvement projects, cost overruns, and cash crises.

For a more detailed discussion of the topics in this SNTA Brief, please see **Municipal Finances - A Handbook for Local Governments**, Edited by Catherine Farvaque-Vitovic and Mihaly Kopanyi, World Bank 2014. This publication is available from the World Bank at:

<http://siteresources.worldbank.org/EXTWBP/Resources/pubform.pdf>

1. This SNTA Briefing Note frequently refers to “local government”, but the issues and advice contained in the note are equally applicable to all types of sub-national authorities and utilities. [↑](#footnote-ref-1)