RE: INTEREST RATE ON LAND SOLD BY AGREEMENT FOR SALE

MUNICIPAL MANAGER'S RECOMMENDATION:

1. *THAT the recommendation of the Director Finance be adopted.*

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TO: MUNICIPAL MANAGER

FROM: DIRECTOR FINANCE

1984 July 04
File: L5-2

RE: INTEREST RATE ON LAND SOLD BY AGREEMENT FOR SALE

RECOMMENDATION

1. THAT interest be charged on the outstanding balance of agreements for sale at a rate which floats at 2 1/2% above The Royal Bank of Canada prime rate.

SUMMARY

This report recommends a change in policy on the interest rate charged on agreements for sale. Currently we charge a fixed rate of interest based on a three year mortgage rate. This policy does not adequately protect the municipality during periods of rising interest rates, and therefore this report is recommending a change in policy that would tie interest rates on our agreements for sale to the bank prime rate.

REPORT

BACKGROUND

Presently, when municipal land is sold by agreement for sale, the purchaser is required to make a down payment of 25% and pay the balance owing in three annual instalments. Interest is due and payable each year, and is calculated at a fixed rate based on The Royal Bank of Canada three year mortgage rate on the day that the proposed sale of land is advertised.

The last three years have seen a decline in prime interest rates from their record high in 1981 of 22% to more modest levels of 11% in 1983 and during the first part of 1984. During the last two months the prime interest rate has increased a full two percentage points and now stands at 13%. Present indications are that interest rates are expected to fluctuate throughout 1984/85. During the last three years, fixed rate three year mortgages have ranged from 2 1/2% below prime to a more conventional 1 1/2% to 2 1/4% above prime.

REASON FOR CHANGE

The existing interest rate policy does not adequately protect the municipality during periods of rising interest rates. A purchaser has the flexibility to finance the purchase at a fixed rate and subsequently reap the advantage of this fixed rate when interest rates rise. If rates fall after an agreement has been signed, a purchaser is protected since he has the option to prepay the balance owing on the agreement for sale at any time.

RATE DETERMINATION

Although mortgage rates are determined by supply and demand, there is an historical relationship to the chartered bank prime. Three year fixed rate mortgages generally fluctuate between 1 1/2% to 2 1/4% above prime.

Payments of principal and interest on a mortgage are normally made each month. The effect of this is improved cash flow and increased investment income because cash collected monthly can be re-invested.

Our present policy is for interest to be paid annually. This is convenient and it reduces administrative costs associated with billing and collecting on a more frequent basis. No change in the policy of collecting interest annually is currently being recommended. We should not, however, lose the re-investment opportunity which a bank or other lending institution gains from collecting monthly.

If we collected the interest on agreements for sale monthly and invested that money, we would earn approximately 1/2% more on the principal outstanding. Or, stated another way, a bank which puts out a mortgage at 1 1/2% to 2 1/4% over prime ends up earning about another 1/2% if it can re-invest the monthly interest payments, for a return of somewhere between 1 3/4% and 2 3/4% over prime. It follows, therefore, that we should charge a rate which is higher than the conventional mortgage rate. Since we do save administrative costs by collecting on an annual basis, a rate of 2 1/2% over prime appears appropriate.

Agreements for sale provide an attractive investment opportunity for the municipality. 2 1/2% over prime compares favourably with the return on an investment in three year bank term deposits, which presently yield about 1 1/2% over prime. There is a small amount of risk involved with agreements for sale and therefore the yield should be more than for term deposits. On the other hand, our rate should not be so high as to discourage property buyers from taking advantage of our agreements for sale.

Selling by way of agreement for sale can be continued so long as our reserves can be maintained at levels to meet our continuing cash needs. If in the future, however, there is a need to improve the cash flow, then a change in policy may be needed.

> It is recommended that interest be charged on the outstanding balance of agreements for sale at a rate which floats at 2 1/2% above The Royal Bank of Canada prime rate.

EXISTING AGREEMENTS

Existing agreements for sale will not be affected by this change in policy. Nor will this recommended policy apply to those lots on Harken Drive which were recently advertised for sale (Item 8, Report No. 38, 1984 May 28).

The policy will be applied to all future properties which are offered for sale.

Howard Karras
DIRECTOR FINANCE

cc: Director Administrative &
Community Services