

3.1 PRINCIPLE & PURPOSE

The investment policy required by legislation is one aimed at formalising existing approaches and ensuring a fresh view is taken in light of the other changes/requirements included within the Act.

There are two main sections of the Local Government Act 2002 that impact on the Investment Policy:

Section 102(4)(c) INVESTMENT POLICY – This section requires every local authority to adopt an investment policy using the special consultative procedure.

Section 105 CONTENT OF INVESTMENT POLICY – This section details what is required in an Investment Policy.

Section 105(a) requires Council to include its objectives in terms of which financial and equity investments are to be managed.

Investment

Prudence

Section 101(1) requires Council to be prudent in managing its investments. Council as a responsible corporate citizen and custodian of public funds recognises that it should manage investments in a prudent manner. This will require a risk adverse approach with care to ensure unnecessary risks are avoided.

As for the liability management policy, prudence can be achieved by ensuring that strong control systems are in place. This should ensure that decisions are made by those persons with appropriate skills, at the correct level of responsibility and that policies are complied with.

Flexibility

Where possible the Investment Policy should have sufficient flexibility to permit Council to take advantage of all the tools and opportunities available. This clearly needs to be consistent with other key objectives, eg financial prudence.

Minimisation of Risk and Maximisation of Returns

These two objectives are effectively opposing forces. It is well documented that investments with low risk enjoy low returns and conversely those investments with high risk carry high returns. Council should seek to maximise returns from a given risk acceptance position, i.e. it is important to establish what degree of risk Council is prepared to accept and then seek to maximise returns.

Prudence requires a degree of conservatism in investments, meaning that the Council should be more risk averse than the average investor. Therefore, it should predominantly invest in low risk, low return investments.

Liquidity

It is emphasised in the Liability management policy that liquidity management is essential. A key element of this is the timing/matching of investment maturities to expected outflows, eg operating expenditures, project payments and debt retirement.

Given the uncertainty that inevitably surrounds forecasting it is prudent that Council provide some coverage factor for unexpected transactions. This could take the form of a percentage of funds being on call.

When making investment decisions it is important to consider the length of time the investment will be placed for and the liquidity of the investment.

3.2 POLICIES

The policy provides a framework within which decisions can be made rather than providing a prescriptive set of criteria that is currently employed for surplus funds management.

3.2.1 General Policy – Sec 105(a)

IP 1

Council as a responsible corporate citizen and custodian of public funds recognises that it should manage investments in a prudent manner. This will require a risk adverse approach and care to ensure unnecessary risks are avoided.

Council aims to maximise its returns in the long term while ensuring risks remain within Council's accepted range.

3.2.2 Disposition of Revenue and Proceeds

Council's most significant investment was its shareholding in Power New Zealand. When the shares were sold the sale proceeds were placed into an Investment Fund.

Council identified a number of key strategic assets, including the Power New Zealand share holding, forestry holdings and leasehold sections held at Waihi Beach. The net proceeds from the sale of these assets was/will be placed into an Investment Fund. (Net proceeds are defined as gross sale proceeds less costs of sale, any accrued debt arising from previous holding costs not previously funded and any rehabilitation costs.)

The Council has determined that in the interests of fairness and equity the Investment Fund benefits should be ascribed to the benefit of all ratepayers. 25% of the fund income will be allocated to funding of projects. 75% will be used to reduce the District General Rate.

Proceeds from the investment of surplus funds are credited to the District general rate pool. Separate reserve funds are allocated interest at the estimated average rate of return achieved for the financial year.

Asset sale proceeds are generally credited to the fund or activity that provided the funding for the original purchase. Asset sale proceeds could also be credited to funds notified in the resolution approving sale if required or appropriate.

Disposition of Revenue and Proceeds Policy

IP 2

Returns from investments, after the deduction of expenses, will be applied according to the following:

- 25% of the income from the Investment Fund will be used to assist with the completion of community projects. The Council will allocate the funding on a project-by-project basis.

- 75% of the income from the Investment Fund will be used to reduce the District General rate requirement.
- Interest will be credited to separate reserve funds on the basis of the estimated average yield on surplus funds for the financial year less the margin for recovery of overheads.
- In accordance with any resolution of the Council.
- To the Council's general operating revenues.

Net asset sale proceeds will be credited to the fund/activity, which originally provided the funding for the assets original purchase, or to any other fund per Council resolution.

3.2.3 Management and Reporting – Sec 105(d)

Delegated authority to approve investments should rest with the General Manager. However, for practical reasons, the power to negotiate such investment needs to be extended.

Operational Procedures will, where possible, ensure that:

- There is clear segregation of duties between the person negotiating treasury arrangements and those authorising treasury arrangements.
- Transactions are made only with approved counterparties.
- Transactions comply with legislative requirements.
- Monthly reconciliation of all cash holdings, surplus funds and investments are completed. These are to be independently reviewed by the Corporate Services Manager.
- That there is close control over daily, weekly and monthly and longer term cashflow projections so that Council's working capital requirements are met.

A quarterly report should be made to Council (for the three month period 30 September, 31 December, 31 March and 30 June each financial year).

Included within this report should be details on:

- Investments on hand at the end of the quarter, including the names of counterparties, sums invested with each, terms of each investment, and interest rates being earned;
- The average earnings rate on investments made during the quarter;

- A commentary on movements in interest rates during the quarter and the effect of these on anticipated returns for the financial year. This could include a comparison to interest rates earned over the previous six months.

Management and Reporting Policies- Sec 105(d)

IP 3a

The General Manager shall have delegated authority to negotiate and authorise any investment transaction within the approved policy and to be authorised to delegate that authority.

IP 3b

A quarterly report will be made to Council (for the three month period 30 September, 31 December, 31 March and 30 June each financial year).

Included within this report should be details on:

- Investments on hand at the end of the quarter, including the names of counterparties, sums invested with each, terms of each investment, and interest rates being earned;
- The average earnings rate on investments made during the quarter.

3.2.4 Acquisition of New Investments and Credit Risk – Sec 105(c) and 105(e)

Credit risk, also called default risk, is the risk that a counterparty will not be able to meet interest or principal payments when due.

While this was not so critical in the liability management policy it has greater significance in the investment policy.

The credit risk of issuers can be established via International Credit Agencies such as Moody's and Standard and Poor's. When viewing the ratings supplied by the agencies it is relevant to consider the instruments or debt type being rated.

There are different debt types depending on the security or ranking offered.

Credit risk can be reduced by limiting investments to highly rated organisations and diversifying the type and maturity of investments. The Council may, from time to time, wish to promote the development and expansion of commercial organisations through the advance of funds. It should be recognised that, while there may be sound reasons to justify the advances, this may involve a departure from normal investment policy. The following provision is to cover this eventuality.

Acquisition of New Investments and Credit Risk Policy – Sec 105(c) and 105(e)

IP 4(a)

Credit risk will be minimised by investing only in high quality investments.

For the purposes of this policy, this means that investments will only be acquired that have Standard & Poor's ratings for short term investments of A1 or higher and for long term investments of AA-. Equivalent Moody's ratings may apply.

IP 4(b)

The Council may, in its discretion, acquire investments that depart from IP 4(a) where it considers that the departure would advance its broader social or other policy objectives.

A Council resolution is required to authorise an investment under this provision, and that resolution shall note that it departs from the Council's ordinary policy on credit risk and the reasons justifying that departure.

3.2.5 Return on Investment Sec 105(e)

The Council should, within the parameters of other policies, seek to maximise the returns on its investments. The returns must, however, reflect the risk involved.

Government stock is regarded as a risk-free investment and as such is the benchmark from which the pricing of other investments is determined. A higher risk should only be accepted if the expected return is also higher. Although greater returns may be achieved by investing in securities issued by corporate, such as company debentures, the Treasury Manager must always

remember that the higher yield represents the extra margin that is generally required to compensate the investor for increased risk.

Returns Policy - Sec 105(e)

IP 5

The expected return on all funds invested should reflect the risk involved, according to the following guidelines:

- If a potential investment carries greater risk than is consistent with the Council's credit risk policy then an investment will not be made, irrespective of the expected returns.
- Where there are two investments of equivalent risk within the Council's risk constraints, the investment with the higher expected return shall be selected.
- If there are two investments of different risks, but both are within the Council's risk constraints, an assessment will be made of the trade-off between the risks and expected returns of the two options. The investment that is considered to be the most attractive for the Council, having regard to prudence, the risks and the expected returns, will be selected.

3.2.6 Liquidity and Duration - Sec 105(b) and 105(e)

The liquidity and duration of investments are important considerations in respect of an overall investment portfolio. The failure to match the availability of funds to expected cash outflows, or to provide for unexpected outflows, can carry considerable costs in the form of short-term bridging finance.

The ability to liquidate an investment is determined by the existence of potential buyers. A lack of liquidity may force the seller to discount the price below its current market value. Liquidity is affected by the characteristics such as the creditworthiness of the issuer and the volume of supply.

The duration of investments can vary from a one-day term, such as call deposits, to a long term, such as 10 years. When investments are less liquid, the maturity or duration of the investment assumes higher significance. Duration of the investment is not of major significance if the investment is particularly liquid.

Investments should be principally focused on duration, i.e. investment maturities should closely match expected cash outflows.

Often investments have been made on the basis of best return without identifying what ultimate maturity date is required. To invest with a significant degree of certainty requires comprehensive forecasting systems and procedures.

Liquidity and Duration Policy - Sec 105(b) and 105(e)

IP 6

Council's portfolio shall be arranged to provide sufficient funds for planned cash outflows and to otherwise allow the payment of obligations as they fall due.

Individual investments shall be chosen with regard to:

- The period of time for which the funds are surplus to requirements;
- The maturity of the investment;
- The ability to liquidate the investment before its maturity;
- The extent to which the portfolio already provides funds as required; and
- Market conditions.

3.2.7 Portfolio Diversification - Sec 105(b)

An important method of reducing the exposure of the Council to any single bad investment is to spread the amount invested across a number of investments and counter-parties. This reduces the danger of extreme losses but also reduces the possibility of large returns.

Past examples of financial collapse of major companies clearly illustrates the inherent dangers in a high exposure to any one form of investment or single issuer.

However sometimes the cost of diversification may exceed the benefits of diversification by the increased administrative costs and the non-marketability of small parcels that may result.

Investments may be classified into broad risk types - Risk Free, Near Risk Free, and Low Risk Investments. There are others that can be classified as

Medium to High Risk investments but these are excluded under this policy (IP 4(a)).

Portfolio Diversification Policy - Sec 105(b)

IP 7

Classes of Investments:

The following will be classes of investments for the purposes of this investment policy:

- Risk-free and near risk-free investments: securities issued or guaranteed by the New Zealand government, local authority stock secured by rates.
- Low-risk investments: the debt of issuers with ratings equivalent to a Standard and Poor's rating of "AA-" or better for long term debt or A1 or better for short term debt.

Investment by class:

Limits on investment in any of the above classes of investments shall be as follows:

- Near risk-free to risk-free investments: in any one class, up to 100% of the total assets available for investment whether short or long term.
- Low-risk investments: up to 100% of the total if debt purchased is short term, i.e. less than one year, or no more than 60% of the total assets available for investment if the debt is long term, i.e. greater than one year.
- Medium to high-risk investments: nil exposure, subject to specific Council resolution.

Individual investments:

Limits on any one investment shall be as follows:

- Risk-free investments: up to 100% of the total assets available for investment.
- Near risk-free investments: up to 100% of the total assets available for investment.
- Low-risk investments: no more than 25% of the total assets available for investment.

- Medium to high-risk investments: nil exposure, subject to the Council's direction.

3.2.8 Settlement Risk - Sec 105(e)

One way to mitigate investment settlement risk is the adoption of costly, time-consuming verification procedures for the transfer of funds and securities. In general however, it is better to concentrate on the soundness of the other parties to the transaction. The critical factors that reduce settlement risk are similar to those stated in the borrowing management policy in relation to credit risk:

- Appropriate industry standing;
- Financial adequacy; and
- Track record.

Settlement Risk Policy - Sec 105(e)

IP 8

The Council will satisfy itself, in all its investment transactions, that counterparties:

- Are financially adequate;
- Have an appropriate industry standing; and
- Have an appropriate track record;

in sufficient degree to give the Council reasonable certainty that obligations under contracts will be performed.