TREASURY MANAGEMENT POLICY

The Local Government Act 2002 requires Council to establish liability management (Sec 102(4)(b)) and investment (102(4)(c)) policies. While the Act is specific in terms of having separate liability management and investment policies they should be viewed as integral parts of a Council Treasury Policy.

Treasury management is the management of Council's liquidity to ensure that:

- **resources are available to meet obligations at a reasonable cost**
- **Council receives an adequate return on its surplus funds**
- **overall cost of debt is minimised**
- **exposure to financial risk is minimised**

The required content of the Liability Management Policy includes:

Interest rate exposure policy	**Sec 104(a)**
Liquidity policy	**Sec 104(b)**
Credit exposure policy	**Sec 104(c)**
Debt repayment policy	**Sec 104(d)**
Specific borrowing limits policy	**Sec 104(e)**
Giving of security policy	**Sec 104(f)**

The combination of these elements provides a policy framework that should enable prudent liability management.

The Treasury Management Policy includes:

1. **A Liability Management Policy; and**
2. **An Investment Management Policy**

LIABILITY MANAGEMENT POLICY

2.1 PRINCIPLES & PURPOSES

The Local Government Act 2002 contains a number of sections, which impact on the Liability Management Policy. The key sections are noted below.

101(1) PRINCIPLES OF FINANCIAL MANAGEMENT – A local authority must manage its revenues, expenses, assets, liabilities, investments, and general financial dealings prudently and in a manner that promotes the current and future interests of the community.

104 CONTENTS OF LIABILITY MANAGEMENT POLICY – This section details what is required in the Liability Management Policy.

PART 6 SUBPART 4 BORROWING AND SECURITY – There are a number of sections within this Part of the Act which cover the following:

- **Prohibition on borrowing in foreign currency**
- **Constraints on receiver**
- **Rates as security**
- **Register of charges maintained by local authority**
- **Protected transactions**
- **The Crown not liable for debts**

The policy also addresses a number of key objectives, other than those required purely for legislative compliance.

The following objectives have been identified

Prudence

Section 101(1) requires Council to be prudent in managing its debt.

Council can achieve this by ensuring long-term financial stability. This is measured by financial ratios.

Prudence can also be achieved by making certain 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 liability management policy should have sufficient flexibility to permit Council to take advantage of the new regime. This clearly needs to be consistent with other key objectives, e.g. financial prudence.

An inflexible policy may deny Council the opportunity to reduce risk, cost or both.

Risk

Borrowing exposes the Council to two principal risks:

> *Interest Rate Risk* – Interest rate risk is the risk that Council will be exposed to changes in market conditions, particularly interest rates, prevailing at any time. It is important to consider this when issuing debt. It will impact on the maturity profile of issued debt and the process of re-financing.
> *Credit Risk* – This is the risk that a party to a transaction, such as counter-party or a financial intermediary, may not settle a transaction. This risk is minimal where Council is the borrower, as opposed to being a lender or investor.

These risks should be minimised. However it is necessary to recognise there are trade-offs between the reduction of risk and the cost associated with this.

Liquidity Management

Council must ensure that it is able to meet its obligations as they fall due. These include ongoing operational expenditures and the repayment of maturing debt obligations, which are not being re-financed.

This should be achieved through short term and long-term liquidity management.

Minimise Total Cost of Borrowing

Minimising the total cost of borrowing is a key objective within the borrowing management policy.

The total cost of borrowing not only includes the interest expense but also advisory fees, transaction costs, internal administrative costs and the commitment of staff resource.

The total of these costs needs to be minimised, rather than focusing on one of the individual items to the exclusion of the others.

The total cost needs to be minimised in the long term.

A key method of minimising the total cost of borrowing is internal borrowing. This enables Council to bypass paying the margin between borrowing and investing interest rates. Internal borrowing also minimises credit risk because Council is investing funds internally rather than with a third party.

2.2 POLICIES

2.2.1 Interest Rate Exposure - Sec 104(a)

Interest rate exposure arises from movements in interest rates over time and the refinancing that may result in an adverse interest market.

If interest rates are decreasing it may be desirable to have a high percentage of the Council's debt held at a floating interest rate to take advantage of the falling interest rate. Conversely in a period of increasing interest rates it would be better to hold fixed rate debt.

However, it is difficult to form a view of long-term interest rates given the numerous domestic and international influences on our economy.

The only way in which optimal interest rate mixes can be determined is by having the benefit of an accurate projection of future interest rates and movements.

Domestic and international fund managers, and corporate treasury departments are often incorrect in their predictions of future trends in interest rates. Such behaviour from Council's perspective, i.e. forecasting future interest rates, should be regarded as highly speculative.

Exposure to interest rate risk can be reduced by placing debt at a mixture of floating and fixed interest rates. In addition it is appropriate to have a mix of maturity dates so refinancing risk is minimised.

Where core debt is at a low level, say less than $4 million, it may be difficult to efficiently have a flat maturity profile and/or a mixture of fixed and floating interest rates to ensure interest rate risk is minimised. It may be possible to minimise interest rate risk but potentially suffer from increased transaction and administration costs because of smaller individual debt parcels.

If current interest rates are substantially lower than that currently being paid by the Council, it may be appropriate to re-finance. Other cost factors, such as the transaction costs of re-financing, must also be considered. If the re-financing involves a substantial portion of the Council's overall debt, special consideration must be given to how it can be made compatible with the Council's overall desired maturity profile.

Using hedging instruments, which include forward rate agreements, interest rate swaps, and interest rate options, can reduce interest rate risk. These should only be used for the purpose of hedging interest rate risk against specific borrowings.

The use of hedging instruments is viewed by some as somewhat risky. There have been a number of instances where financial instruments have been used and significant negative results have resulted. It should be noted that these instances are where the instruments were used in a speculative rather than hedging nature. (E.g. Hammersmith Council in London in the late 80s).

However, the use of hedges to offset risk may be to the Council's advantage. It would be appropriate if the scale of the transaction were such that there is a significant exposure to a prevailing set of interest rates. By entering offsetting interest rate contracts or the use of other sophisticated tools, the dangers associated with any large position can be minimised.

In deciding whether to use a hedge, two factors should be considered. First, the Council must be confident that the proposed transaction is a genuine hedge, i.e. that it does in fact reduce total risk. Secondly, the cost of the hedge must be justified by the reduction in risk that is achieved.

If there is absolute certainty of the answers to these two questions, then a hedge is appropriate. It is likely that independent expertise would be sought in planning such a transaction.

Interest Rate Exposure Policies - Sec 104(a)

LMP 1 (a) (Fixed/Floating Interest Rates)

Council should maintain a mix of fixed and floating interest rates either directly via individual debt securities or via alternative debt instruments, e.g. Interest Rate Swaps.

Council should endeavour to maintain a flat maturity profile. Where possible no more than 50%, or $2 million, whichever is the higher, of external debt should be subject to refinancing in any one year.

LMP 1 (b) (Maturity Profile)

Where possible Council should endeavour to maintain a flat maturity profile with no more than 34%, or $3 million whichever is higher, of external debt subject to refinancing in any one year.

LMP 1 (c) (Hedging)

Council will only enter into a hedging transaction where it can be clearly demonstrated that

- *i) the transaction is to be used to reduce risk associated with an existing position (i.e. it is expressly prohibited to enter into speculative contracts);*
- *i) the transaction will reduce risk to Council, by adjusting an undesirable maturity profile or a fixed vs. floating interest rate position;*
- *i) the cost of the transaction is exceeded by the reduction in risk.*

2.2.2 Liquidity Policy - Sec 104(b)

There is a need to have a policy that ensures Councils has sufficient funds available to meet its immediate cash outflow obligations as they fall due and are payable.

The key factors influencing this policy are prudence, flexibility, minimising total costs and having short term borrowing capacity.

The 1996 Act specifically provided for short term borrowing in section 122J. The 2002 Act replaced the specific and prescriptive powers previously in place with a general power of competence, specifically in S12(2):

For the purposes of performing its role, a local authority has—
(a)full capacity to carry on or undertake any activity or business, do any act, or enter into any transaction; and
(b)for the purposes of paragraph (a), full rights, powers, and privileges.

Council needs to have strong forecasting systems in place to ensure it minimises the need for borrowing, especially short-term borrowing, and maximises the returns available from the investment of surplus funds.

Liquidity Policy - Sec 104(b)

LMP 2

The Council will ensure that it has, at all times, sufficient funds available to meet its obligations as they fall due. Potential sources of funds include cash deposits, committed but undrawn lines of credit and short-term lending.

Pursuant to Section 12(2) of the Local Government Act 2002, Council may borrow funds on a short-term basis to provide for efficient and effective cash management. Borrowing under this policy shall be used for the purpose of meeting temporary shortfalls in liquidity and will not be used as a permanent source of funds. (For the purposes of this policy "permanent sources of funds" are those funds borrowed for a term longer than twelve months.

Council delegates responsibility for establishing short-term debt and overdraft facilities and/or the day-to-day management of any Council overdraft facility to the Chief Executive and his staff. The long-term borrowing requirements for any year are approved by the Council

2.2.3 Credit Risk Policy - Sec 104(c)

In any financial transaction, there is a risk that the counter-party may be unable or unwilling to settle the transaction as agreed. This risk is reduced when Council is the borrower as Council would be the settlor of the transaction. However where Council has hedged the transaction there is a need to ensure the party with which the transaction has been placed is capable of settling that transaction.

Risks are minimised by limiting the Council's dealings to counter-parties with appropriate industry standing, financial adequacy and track record.

Credit Risk Policy - Sec 104(c)

LMP 3

Council will satisfy itself, in all its borrowing transactions, that counter-parties:

- are financially adequate;
- have an appropriate industry standing; and
- have an appropriate track record;

to give the Council reasonable certainty that obligations under concluded contracts will be honoured.

2.2.4 Debt Repayment Policy - Sec 104(d)

This policy gives effect to the objective of minimising the Council's interest rate risk

LMP 4

Loan terms are to be set to ensure that the overall borrowing is consistent with an even spread of debt maturities.

Where repayment by the use of a sinking fund or loan repayment reserve is contemplated, sufficient funds will be provided to enable the repayment of the loan at the time contemplated.

Where Council has surplus long-term funds these may be used to repay debt if this doesn't compromise other aspects of the liability management policy.

2.2.5 Policy on Specific Borrowing Limits - Sec 104(e)

The amount of debt that is raised by Council clearly has implications on Council's overall financial position and future income streams required to fund the debt.

This is fundamentally dictated by the community's ability to pay.

Appropriate limits on total borrowing should be reflected as ratios or dollar limits in terms of income streams, interest expense and debt per assessment.

Policy on Specific Borrowing Limits - Sec 104(e)

LMP 5(a)

The Council must ensure that its borrowing satisfies the following ratios:

External Public Debt per Assessment	<=	*$2,000*
Net interest-expense *Total revenue*	<=	*10%*
Net interest-expense *Rates revenue*	<=	*15%*

LMP 5(b)

There are no limits on internal borrowing.

2.2.6 Policy on the Provision of Security - Sec 104(f)

In the past Territorial Local Authorities offered the ability to levy a special rate as security to a lender. This afforded the lender significant comfort, i.e. reduced their risk, and interest rates discounted from the retail market could be achieved.

The new regime allows for similar security by way of the ability for a receiver to set a rate to repay any debt owing. It now also allows councils to offer assets as security. It is likely that this form of security would be viewed by the lenders as more risky than special rates. This would imply an increase in the cost of interest to Council. It is unlikely that assets would be offered as security to lenders.

Council should not prevent itself from offering fixed assets as security if this was the most appropriate course of action to take. Recognition needs to be made of the fact that Council is

prohibited from giving any form of security over certain classes of land, or over assets held under a trust or endowment.

Policy on the Provision of Security - Sec 104(f)

LMP 6

In general, Council will secure its borrowings against its rates revenue.

Council is prepared to give security over its assets. Before giving security against any assets, Council must be satisfied that doing so is fairly reflected in the cost of borrowing. Comparisons of the cost of borrowing between different alternative borrowing transactions must account for different requirements as to the giving of security.

2.2.7 Policy on the Giving of Loan Guarantees

The provision of a guarantee on behalf of an organization should enable the provision of goods or services at a lower cost because of a reduction in the organisation's cost of interest. This indirect benefit to the Council must be weighed against the lack of control associated with guaranteeing the obligations of another party, the increased risk to the Council that is involved and whether there are any offsetting considerations, such as the potential availability of assets to offset obligations under the guarantee.

It is appropriate to cap the limits on the total to be guaranteed, both overall and to any one organisation.

Monitoring of the guaranteed party is a first step towards limiting the Council's risk. Consideration should be given to requiring notice of any abnormal or extraordinary events that relate to a substantial change in the nature, objectives or functions of the guaranteed organisation, or that could affect the ability of the guaranteed organisation to meet its financial obligations. Notice would be required as soon as the event occurred or became reasonably possible to occur.

The most serious lapse is the absence of controls on guaranteed organisations, as opposed to purely procedural reporting requirements. There should be rules requiring organisations to maintain their ability to meet their obligations, analogous to interest coverage ratios and balance sheet ratios required of the Council by the borrowing limits policy. These rules are yet to be developed.

The remedies for the failure of a guaranteed organisation to comply with the agreement to guarantee its obligations require consideration. While the terms of a particular agreement to guarantee should specify the remedies available to the guarantor, these remedies must lie purely against the guaranteed party. They cannot, as a matter of contractual privity, affect the rights of the lender.

Giving of Loan Guarantees Policy

LMP 7

Council may act as guarantor to bank loans for an incorporated organisation which will provide, improve, or develop amenities for recreation, amusement or the instruction of the public.

The total combined amount Council may guarantee at any one time shall not exceed 5.0% of the total rates levied in any year, and;

The maximum amount Council may guarantee to any one qualifying organisation shall be 1.0% except that in special circumstances the limit of 1.0% may be exceeded, and;

Each organisation that Council has provided a loan guarantee shall provide to Council:

> *A six-monthly unaudited financial report within 3 months of the first 6 months of the financial year, and;*
> *An annual audited financial report within 4 months of the balance date, and;*

that the bank lending the money to the qualifying organisation be required to provide Council with a statement each year that shows the principal outstanding at the end of that period and payment made during the year.

2.2.8 Policy on Internal Borrowing / Investing

Where possible Council will borrow / invest funds internally, so as to minimise its total cost of borrowing while still providing a market rate of return on its investments. Council will also borrow / invest internally to minimise its credit risk. Council may include a margin on borrowings / investments to recover administration costs.

LMP 8(a)

Where at all possible Council will borrow / invest internally rather than externally.

LMP 8(b)

That Council charge interest on internal borrowings equivalent to a market base rate, such as the 90-day bank bill mid rate, or the 1 year fixed interest borrowing base rate plus a basis point margin determined by the General Manager.

LMP 8(c)

That Council pay interest on internal investments equivalent to a market base rate, such as the 90-day bank bill mid rate, or the 1 year fixed interest borrowing base rate less a basis point margin determined by the General Manager.

INVESTMENT POLICY

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.

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 averse 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 averse 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:

1. 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.
2. 75% of the income from the Investment Fund will be used to reduce the District General rate requirement.
3. 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.
4. In accordance with any resolution of the Council;
5. 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 corporates, 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, ie less than one year, or no more than 60% of the total assets available for investment if the debt is long term, ie 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 counter-parties:
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.