HAURAKI
DISTRICT COUNCIL

Section 5i

Liability and investment policy

Liability and investment policy

Liability Management Policy

Principle and Purpose

The Council is governed by the following relevant legislation:

- Local Government Act, 2002
- Local Government (Financial Reporting and Prudence) Regulations, 2014, in particular Schedule 4.

The Local Government Act, 2002 (LGA) 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.

Objectives of the Policy

This policy addresses a number of key objectives, along with those required purely for legislative compliance.

The following objectives have been identified.

Prudence

Section 101(1) requires the Council to be prudent in managing its debt. The Council can achieve this by ensuring long-term financial stability. This is measured by financial ratios.

Prudence can also be achieved by making certain that strong control systems are in place. This should ensure that decisions are made by 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 the Council to take advantage of the tools available within the legislation. This clearly needs to be consistent with other key objectives, e.g. financial prudence.

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

Risk

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.

Borrowing exposes the Council to three principal risks:

- Liquidity and Funding Risk – Liquidity risk is where the Council does not have the ability to access committed funding at a future time as required. Funding risk centres on the ability to re-finance or raise new debt at acceptable pricing and maturity terms.
- Interest Rate Risk –The risk that the Council will be exposed to changes in market conditions, particularly wholesale interest rates, prevailing at any time. It is important to consider this on a forward looking basis when issuing new debt and refinancing existing debt on an ongoing basis. It may impact on the maturity profile of issued debt and the process of re-financing.
- Credit Risk – The risk that a party to a transaction, such as a counterparty or a financial intermediary/institution, may not settle or provide committed funding as and when required. This risk is applicable where the Council is both a borrower and an investor, with the more significant risk arising when the Council is an investor.

Liquidity and Funding Risk Management

The 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. A key factor in funding risk management is to spread and control the risk to reduce the concentration of risk at any one time.

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

Minimise Total Cost of Borrowing

Protecting and minimising the total cost of borrowing over the medium to longer term is a key objective within the Liability 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.

An approach to minimising the total cost of borrowing is internal borrowing. This enables the Council to bypass paying the fees and margins between external borrowing and investing interest rates. Internal borrowing also minimises credit risk because the Council is investing funds internally rather than with a third party.

Policies

Interest Rate Exposure (Sec 104(a) LGA)

Interest rate exposure arises from movements in wholesale interest rates over time and the refinancing/raising of new debt that may result in an adverse interest market.

If interest rates are decreasing it may be desirable to have a higher percentage of the Council's debt held at a floating interest rate to benefit from 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 forecast 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, i.e. forecasting future interest rates, should be regarded as highly speculative from the Council's perspective.

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

Where core debt is at a low level, such as 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 underlying floating rate 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 a hedging nature (e.g. Hammersmith Council in London in the late 1980s).

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. Firstly, 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.

Liability Management Policy 1 (a): Fixed/Floating Interest Rates

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

Debt/borrowings

Exposure to interest rate risk is managed and mitigated through the risk control limits below. Council's forecast gross external debt should be within the following fixed/floating interest rate risk control limits. Forecast gross external debt is the amount of total external debt for a given period. This allows for pre-hedging in advance of projected physical drawdown of new debt. When approved forecasts are changed (signed off by the Chief Executive or equivalent), the amount of interest rate fixing in place may have to be adjusted to ensure compliance with the Policy minimum and maximum limits.

Debt Interest Rate Policy Parameters (calculated on rolling monthly basis)		
Debt Period Ending	**Minimum Fixed**	**Maximum Fixed**
Current	40%	90%
Year 1	40%	90%
Year 2	35%	85%
Year 3	30%	80%
Year 4	25%	75%
Year 5	20%	70%
Year 6	0%	65%
Year 7	0%	60%
Year 8	0%	50%
Year 9	0%	50%
Year 10	0%	50%
Year 11 plus	0%	25%

- A fixed rate maturity profile that is outside the above limits, but self corrects within 90 days is not in breach of this Policy. However, maintaining a maturity profile beyond 90 days requires specific approval by the Audit and Risk Committee or Council.
- "Fixed Rate" is defined as all known interest rate obligations on forecast gross external debt, including where hedging instruments have fixed movements in the applicable reset rate.
- "Floating Rate" is defined as any interest rate obligation subject to movements in the applicable reset rate.
- Fixed interest rate percentages are calculated based on the average amount of fixed interest rate obligations relative to the average forecast gross external debt amounts for the given period (as defined in the table above).
- Interest rate instrument and fixed rate debt maturities are limited by the maximum LGFA bond maturity. Longer maturities are approved by Council.

Instrument use

- Interest rate options must not be sold outright. However, 1:1 collar option structures are allowable, whereby the sold option is matched precisely by amount and maturity to the simultaneously purchased option. During the term of the option, only the sold side of the collar can be closed out (i.e. repurchased) otherwise, both sides must be closed simultaneously. The sold option leg of the collar structure must not have a strike rate "in-the-money".
- Purchased borrower swaptions mature within 18 months.
- Interest rate options with a maturity date beyond 12 months that have a strike rate (exercise rate) higher than 2.00% above the appropriate swap rate cannot be counted as part of the fixed rate cover percentage calculation.
- The forward start period on swap/collar strategies is to be no more than 36 months, unless the forward start swap/collar starts on the expiry date of an existing swap/collar and has a notional amount which is no more than that of the existing swap/collar.

Approved financial instruments are as follows:

Category	Instrument
Cash management and borrowing	• Bank overdraft • Committed cash advance and bank accepted bill facilities (short term and long term loan facilities) • Committed standby facilities (where offered) from the LGFA • Uncommitted money market facilities • Retail and wholesale bond ○ Fixed Rate Note (MTN) ○ Floating Rate Note (FRN) • Commercial paper (CP)/ Promissory notes • Finance leases • Forward starting committed debt, and blending & extending debt with the LGFA
Interest rate risk management	Forward rate agreements (FRAs) on: • Bank bills Interest rate swaps including: • Forward start swaps (start date <36 months) • Swap extensions and shortenings Interest rate options on: • Bank bills (purchased caps and one for one collars) • Interest rate swaptions (purchased swaptions and one for one collars only)

Any other financial instrument must be specifically approved by the Council on a case-by-case basis and only be applied to the one singular transaction being approved.

Liability Management Policy 1 (b): Maturity Profile

The funding risk management control limits are outlined below:

- External debt and committed debt facilities together with available liquid short-term investments must be maintained at an amount exceeding 110% of existing total external debt. Liquid treasury investments have a term of no more than three months.
- The Chief Executive has the discretionary authority to re-finance existing debt on acceptable terms and conditions. Such action is to be reported to the Council's Audit and Risk Committee.
- The Council has the ability to pre-fund up to 18 months forecast debt requirements including re-financings. Debt re-financings that have been pre-funded, will remain included within the funding maturity profile until their maturity date.
- The maturity profile of the total committed funding, in respect to all loans and committed facilities, is to be controlled by the following:

PERIOD	MINIMUM %	MAXIMUM %
0 to 3 years	15%	60%
3 to 7 years	25%	85%
7 years plus	0%	60%

- A funding maturity profile that is outside the above limits, but self corrects within 90-days is not in breach of this policy. However, maintaining a maturity profile beyond 90-days requires specific Audit and Risk Committee or Council approval.
- To minimise concentration risk the LGFA require that no more than the greater of NZD 100 million or 33% of a Council's borrowings from the LGFA will mature in any 12-month period.

- Alternative funding mechanisms such as leasing should be evaluated with financial analysis in conjunction with traditional on-balance sheet funding. The evaluation should take into consideration ownership, redemption value and effective cost of funds.

Liability Management Policy 1 (c): Hedging

The 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 (it is expressly prohibited to enter into speculative contracts)

(ii) the transaction will reduce risk to the Council, by adjusting an undesirable maturity profile or a fixed versus floating interest rate position

(iii) the cost of the transaction is exceeded by the reduction in risk.

Liquidity (Sec 104(b) LGA)

There is a need to have a policy that ensures the Council 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 Local Government Amendment Act specifically provided for short term borrowing in section 122J. The Local Government Act, 2002 replaced the specific and prescriptive powers previously in place with a general power of competence, specifically in section 12(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.

The 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.

Liability Management Policy 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 and committed but undrawn lines of bank facilities.

Pursuant to Section 12(2) of the Local Government Act, 2002, the 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 cash flow shortfalls and will not be used as a permanent source of funds. (For the purpose of this policy "permanent sources of funds" are those funds borrowed for a term longer than 12 months).

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

Credit Risk (Sec 104(c) LGA)

In any financial transaction, there is a risk that the counterparty may be unable or unwilling to settle the transaction as agreed. This risk is reduced when the Council is the borrower as the Council would be the settler of the transaction, although there is a risk of a bank lender not providing committed funding upon demand. However where the Council has transacted a hedge contract, such as an interest rate swap, there is a need to ensure the party with which the transaction has been placed is capable of settling that transaction over the entire term.

Risks are minimised by limiting the Council's dealings to counterparties with appropriate industry standing, credit rating, financial adequacy and track record.

Liability Management Policy 3

The Council will satisfy itself, in all its borrowing and interest rate management transactions with counterparties, that:

- they have a long-term Standard & Poor's (S&P) (or equivalent Fitch or Moody's rating) credit rating of at least A or above, and/or short term rating of A-1 or above
- banks are New Zealand registered banks with the Reserve Bank of New Zealand
- the New Zealand Local Government Funding Agency Limited (LGFA) has a long-term credit rating of at least AA-.

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

The following table sets out the policy limits:

Counterparty	Minimum S&P long term/short term credit rating	Interest rate risk management instrument maximum per counterparty ($million)	Total maximum per counterparty, including investments ($million)
NZ Registered Bank	A/ A-1	10.0	20.0
LGFA	AA-/A-1	unlimited	unlimited

In determining the usage of the above gross limits, the following product weightings will be used:

- Interest Rate Risk Management (e.g. swaps, FRAs) – Transaction Notional × Maturity (years) × 3%.

To avoid undue concentration of exposures, financial instruments should be used with as wide a range of approved counterparties as possible. Maturities should be well spread. The approval process must take into account the liquidity of the instrument and prevailing market conditions the instrument is traded in and re-priced from.

Individual counterparty limits are kept in a spread sheet by Council management and updated on a day to day basis. Credit ratings should be reviewed on an ongoing basis and in the event of material credit downgrade, this should be immediately reported to the Council and assessed against exposure limits. Counterparties exceeding limits should be reported to the Council.

Debt Repayment Policy (Sec 104(d) LGA)

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

Liability Management Policy 4

Funding 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 the 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.

Specific Borrowing Limits

The amount of debt that is raised by the Council clearly has implications for the 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.

Liability Management Policy 5(a)

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

Net external debt / total revenue	≤	175%
Net external public debt per assessment	≤	$8,000
Net interest expense /total revenue	≤	10%
Net interest expense /rates revenue	≤	15%

- Total revenue is defined as cash earnings from rates, government grants and subsidies, user charges, interest, dividends, financial and other revenue and excludes non-government capital contributions (e.g. developer contributions and vested assets).
- Net external debt is defined as total external debt less liquid investments. Any council lending to a CCO or CCTO can be deducted from debt (following approval by the LGFA) but only where the CCO or CCTO is a going concern and not dependent upon council financial support.
- Liquid investments are available assets defined as being:
  - Overnight bank cash deposits
  - Wholesale/retail bank term deposits no greater than 30 days
  - Bank issued RCD's less than 181 days
- External debt funding and associated investment activity relating to pre-funding is excluded from the liquidity ratio calculation.
- LGFA borrower notes can be deducted for the LGFA liquidity calculation.
- Net interest is defined as the amount equal to all interest and financing costs less interest income for the relevant period.
- Annual rates revenue is defined as the amount equal to the total revenue from any funding mechanism authorised by the Local Government (Rating) Act, 2002.
- Borrowing limits are measured on Council only not consolidated group.
- Disaster recovery requirements are to be met through the liquidity ratio.

Liability Management Policy 5(b)

There are no limits on internal borrowing.

Provision of Security

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 lower interest rates could be achieved.

The current approach provides for similar security by way of a debenture trust deed, giving the ability for a receiver to set a rate to repay any principal and interest owing. It now also allows councils to offer assets as security. It is likely that assets as a form of security would be viewed by the lenders as riskier than special rates; this would imply an increase in the cost of interest to the Council. It is therefore unlikely that assets would be offered as security to lenders.

The Council should not prevent itself from offering fixed assets as security if this was the most appropriate course of action to take. It needs to be recognised that the Council is prohibited from giving any form of security over certain classes of land, or over assets held under a trust or endowment.

Liability Management Policy 6

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

The Council is prepared to give security over its assets. Before giving security against any assets, the 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.

Any Council lending to a CCO or CCTO will be on a secured basis and be approved by Council.

Giving of Loan Guarantees

The provision of a guarantee on behalf of an organisation 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 it became reasonably possible to occur.

The most serious disadvantage guarantees 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.

Liability Management Policy 7

The 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.

Council may act as a financial guarantor to a Council wholly owned, council controlled organisation, once approved by Council.

The total combined amount the Council may guarantee at any one time shall not exceed 10.0% of the general rates levied in any year. The maximum amount the Council may guarantee to any one qualifying organisation shall be 5.0% of total rates levied, except that in special circumstances the limit of 5.0% may be exceeded upon Council resolution.

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

- a six-monthly unaudited financial report within three months of the first six months of the financial year
- an annual audited financial report within four months of the balance date
- a statement from the bank lending the money to the qualifying organisation each year that shows the principal outstanding at the end of that period and payment made during the year.

Internal Borrowing/Investing

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

Liability Management Policy 8(a)

Where at all possible, the Council will borrow or invest internally rather than externally.

Liability Management Policy 8(b)

The Council will charge interest on internal borrowings, charged in arrears, at a margin above the Council's average borrowing costs for the year. The basis point margin is determined by the Chief Executive.

Liability Management Policy 8(c)

The Council will pay interest on internal investments, charged in arrears, at a margin below the Council's average borrowing costs less a basis point margin determined by the Chief Executive.

On-lending to council controlled organisations and council controlled trading organisations

To better achieve its strategic and commercial objectives, Council may provide financial support in the form of debt funding directly or indirectly to CCO/CCTOs.
Guarantees of financial indebtedness to CCTOs are prohibited, but financial support may be provided by subscribing for shares as called or uncalled capital.

Any on-lending arrangement to a CCO or CCTO must be approved by Council. In recommending an arrangement for approval the GMCS considers the following:

- Credit risk profile of the borrowing entity, and the ability to repay interest and principal amount outstanding on due date.
- Impact on Council's credit standing, debt cap amount (where applied), lending covenants with the LGFA and other lenders and Council's future borrowing capacity.
- The form and quality of security arrangements provided.
- The lending rate given factors such as; CCO or CCTO credit profile, external Council borrowing rates, borrower note and liquidity buffer requirements, term etc.
- Lending arrangements to CCO or CCTO must be documented on a commercial arm's length basis. A term sheet, including matters such as borrowing costs, interest payment dates, principal payment dates, security and expiry date is agreed between the parties.
- Accounting and taxation impact of on-lending arrangement.

All on-lending arrangements must be executed under legal documentation (e.g. loan, guarantee) reviewed and approved by Council's independent legal counsel.

New Zealand Local Government Funding Agency Limited

Liability Management Policy 9

Despite anything earlier in this Policy, the Council may borrow from the New Zealand Local Government Funding Agency Limited (LGFA) and, in connection with that borrowing, may enter into the following related transactions to the extent it considers necessary or desirable:

- contribute a portion of its borrowing back to the LGFA as an equity contribution to the LGFA, e.g. borrower notes
- provide guarantees of the indebtedness of other local authorities to the LGFA and of the indebtedness of the LGFA itself
- commit to contributing additional equity (or subordinated debt) to the LGFA if required
- secure its borrowing from the LGFA and the performance of other obligations to the LGFA or its creditors with a charge over the Council's rates and rates revenue
- subscribe for shares and uncalled capital in the LGFA.

Delegation of authority

Council delegations are held in the Delegations Manual.

Investment Policy

Principles and Purpose

The Council is governed by the following relevant legislation:

- Local Government Act, 2002.
- Local Government (Financial Reporting and Prudence) Regulations, 2014, in particular Schedule 4.
- Trustee Act, 1956.

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 and requirements included within the Local Government Act, 2002 (LGA).

The Trustee Act, 1956 highlights that when acting as a trustee or investing money on behalf of others, trustees have a duty to invest prudently and that they shall exercise care, diligence and skill that a prudent person of business would exercise in managing the affairs of others. Details of relevant sections can be found in the Trustee Act, 1956, Part II Investments.

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

- 102(4)(c): INVESTMENT POLICY – Requires every local authority to adopt an investment policy using the special consultative procedure.
- 105: CONTENT OF INVESTMENT POLICY – Details what is required in an Investment Policy.

Objectives of the Policy

Section 105 LGA requires the Council to include its objectives in terms of which financial and equity investments are to be managed. The following objectives have been identified.

Prudence

Section 101(1) LGA requires the Council to be prudent in managing its investments. The 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.

For the Investment 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 the Council to take advantage of all the tools and opportunities available. This clearly needs to be consistent with other key objectives, e.g. 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 carry low returns and conversely those investments with high risk carry high returns. The Council should seek to maximise returns from a given risk acceptance position; it is important to establish what degree of risk the 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 negotiability of investments and timing and matching of investment maturities to expected outflows, e.g. operating expenditures, project payments and debt retirement.

Given the uncertainty that inevitably surrounds forecasting, it is prudent that the Council provides some coverage factor for unexpected transactions as provided by the liquidity management policy through committed unused bank facilities and treasury investments of no more than three months.

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.

Policies

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

General Policy (Sec 105 LGA)

Investment Policy 1

The 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.

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

New Zealand Local Government Funding Agency Limited investment

Despite anything else in this Policy, the Council may invest in shares and other financial instruments of the New Zealand Local Government Funding Agency Limited (LGFA), and may borrow to fund that investment. The Council's objective in making any such investment will be to:

- obtain a return on the investment
- ensure that the LGFA has sufficient capital to remain viable, meaning that it continues as a source of debt funding for the Council.

Because of these dual objectives, the Council may invest in LGFA shares in circumstances in which the return on that investment is potentially lower than the return it could achieve with alternative investments. If required in connection with the investment, the Council may also subscribe for uncalled capital in the LGFA and be a guarantor.

Disposition of Revenue and Proceeds

Investment Fund

The Council's most significant investment was previously its shareholding in Power New Zealand. When the shares were sold the sale proceeds were placed into a notional investment fund.

The 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 or will be placed into the same 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. Twenty five percent of the fund income will be allocated to funding of projects. Seventy five percent will be used to reduce the District General Rate.

General Funds

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 by the Council approving sale if required or appropriate.

Investment Policy 2

Returns from investments, after the deduction of expenses, will be applied as follows:

- 25% of the income from the Investment Fund will be credited to the District Community Projects Assistance Fund. This 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.
- Returns will be applied in accordance with any resolution of the Council.
- Returns will be applied to the Council's general operating revenues.

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

Management and Reporting (Sec 105(d) LGA)

Delegated authority to approve investments should rest with the Chief Executive. 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 persons executing treasury arrangements, those authorising treasury arrangements, confirming, settling and accounting/reporting.
- 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 and approved by the Corporate Services Manager.
- There is close control over daily, weekly and monthly and longer-term cash flow projections so that the Council's working capital requirements are met.

Quarterly reports should be made to the Council for the three month periods ending 30 September, 31 December, 31 March and 30 June each financial year. Included within these reports should be details of the following:

- 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.

Investment Policy 3a

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

Investment Policy 3b

Quarterly reports will be made to the Council (for the three month periods ending 30 September, 31 December, 31 March and 30 June each financial year).

Included within these reports should be details on:

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

Acquisition of New Investments and Credit Risk (Sections 105(c) and 105(e) LGA)

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

The credit risk of issuers can be established via international credit agencies such as Moody's, Fitch, and Standard and Poor's (S&P). 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 credit 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 policy is to cover this eventuality.

Investment Policy 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 A-1 or higher and for long-term investments of A+ or higher. Equivalent Moody's and Fitch ratings may apply.

Approved financial instruments are as follows:

Category	Instrument
Investments (no greater than 12 months)	Short term bank deposits Bank certificates of deposit (RCDs) Treasury bills
Investments	LGFA borrower notes

Any other financial instrument must be specifically approved by the Council on a case-by-case basis and only be applied to the one singular transaction being approved.

All unsecured investment securities must be senior in ranking. The following types of investment instruments are expressly excluded:

- Structured debt where issuing entities are not a primary borrower/ issuer.
- Subordinated debt (other than Borrower Notes subscribed from the LGFA), junior debt, perpetual notes and debt/equity hybrid notes such as convertibles.

Investment Policy 4(b)

The Council may, in its discretion, acquire investments of up to $500,000, that depart from Investment Policy 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.

Return on Investment (Sec 105(e) LGA)

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) it must always be remembered that the higher yield represents the extra margin that is generally required to compensate the investor for increased default risk.

Investment Policy 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 compliant with counterparty credit limits.
- 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, policy compliance, the risks and the expected returns, will be selected.

Liquidity and Term (Sec 105(b) and 105(e) LGA)

The liquidity and term of investments are important considerations in relation to 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, penalty interest costs, and capital loss.

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 characteristics such as the credit-worthiness of the issuer and the volume of supply.

The term 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 term of the investment assumes higher significance.

Investments should be principally focused on credit quality of the issuer, term, liquidity and policy compliance; investment maturities should closely match expected cash outflows and liquidity management requirements.

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.

Investment Policy 6

The 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. Investment terms are for no greater than 12 months
- the ability to liquidate the investment before its maturity
- the extent to which the portfolio already provides funds as required
- the credit quality of the counterparty
- market conditions.

Portfolio Diversification (Sec 105(b) LGA)

An important method of reducing the exposure of the Council to any single adverse investment is to spread the amount invested across a number of investments and counterparties. 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. There are others that can be classified as medium to high risk investments but these are excluded under this policy (see Investment Policy 4(a)).

Investment Policy 7

When investing, the Council will seek to minimise its risk by investing only in institutions with a high degree of security or credit rating, and by limiting maximum exposure in certain cases. The Council has established the following requirements for all financial investments:

Counterparty/ Issuer	Minimum long term / short term credit rating	Investments maximum per counterparty ($million)	Total financial investment portfolio	Total maximum per counterparty, including risk management instruments ($million)
Risk Free: NZ Government	n/a	unlimited	100%	unlimited
Risk Free: LGFA	n/a	unlimited	100%	unlimited
Low Risk: NZ Registered Bank	A/ A-1	10.0	100%	20.0

In determining the usage of the above gross limits, the following weightings will be used:

- Investments (e.g. Bank Deposits) – Transaction Principal × Weighting 100%.

To avoid undue concentration of exposures, financial investments should be made with as wide a range of approved counterparties as possible. Maturities should be well spread. The approval process must take into account the liquidity of the instrument and prevailing market conditions the instrument is traded in and re-priced from.

Individual counterparty limits are kept in a spread sheet by Council management and updated on a day to day basis. Credit ratings should be reviewed on an ongoing basis and in the event of a material credit downgrade this should be immediately reported to the Council and assessed against exposure limits. Counterparties exceeding limits should be reported to the Council.

Settlement Risk (Sec 105(e) LGA)

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 Liability Management Policy in relation to credit risk:

- appropriate industry standing
- financial adequacy
- long-term S&P credit rating of at least A+ or above
- track record.

Investment Policy 8

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

- are financially adequate
- have an appropriate industry standing
- have an appropriate track record
- have an appropriate credit rating

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

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