Nelson City Council
te kaunihera o whakatū

Liability Management Policy

Effective: June 2017

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Contact: Group Manager Corporate Services

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A1765543

Introduction

General Policy

To provide appropriate parameters in which Council will manage its borrowing activities and external liabilities to ensure compliance with the provisions of the Local Government Act 2002.

Section 102 of the Local Government Act 2002 (the "Act") requires Council to adopt a Liability Management Policy (the "Policy"). Section 104 of the Act outlines the contents of Council's policies in respect of the management of both borrowing and other liabilities, including:

- interest rate exposure; and
- liquidity; and
- credit exposure; and
- debt repayment.

The Policy is to be consistent with the Long Term Plan (LTP) and Annual Plan. The formalisation of such policies and procedures will enable treasury risks within Council to be prudently managed.

As circumstances change, the policies and procedures outlined in this Policy will be modified to ensure that treasury risks within Council continue to be well managed

Objectives:

Statutory Objectives

All external borrowing, investments and incidental financial arrangements (e.g. use of interest rate hedging financial instruments) will meet requirements of the Local Government Act 2002 and incorporate the Liability Management Policy and Investment Policy.

Council is governed by the following relevant legislation:

- Local Government Act 2002, in particular Part 6 including sections 101,102, 104 and 105.
- Local Government (Financial Reporting and Prudence) Regulations 2014, in particular Schedule 4.
- Trustee Act 1956. When acting as a trustee or investing money on behalf of others, the Trustee Act highlights that 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.
- All projected external borrowings are to be approved by Council as part of the Annual Plan or the Long Term Planning (LTP) process.
- All master legal documentation in respect to external borrowing and financial instruments will be approved by Council's legal counsel prior to the transaction being executed.
- Council will not enter into any borrowings denominated in a foreign currency.
- Council will not transact with any Council Controlled Trading Organisation (CCTO) on terms more favourable than those achievable by Council itself.

A resolution of Council is not required for hire purchase, credit or deferred purchase of goods if:

- The period of indebtedness is less than 91 days (including rollovers); or

- The goods or services are obtained in the ordinary course of operations on normal terms for amounts not exceeding in aggregate, an amount determined by resolution of Council.

General Objectives

- Minimise Council's costs and risks in the management of its external borrowings.
- Minimise Council's exposure to adverse interest rate movements.
- Monitor, evaluate and report on treasury performance.
- Borrow funds and transact risk management instruments within an environment of control and compliance under the Council approved Policy so as to protect Council's financial assets and manage costs.
- Arrange and structure external long term funding for Council at acceptable margins and cost from debt lenders. Optimise flexibility and spread of debt maturity terms within the funding risk limits established by this Policy statement.
- Monitor and report on financing/borrowing covenants and ratios under the obligations of Council's lending/security arrangements.
- Comply with financial ratios and limits stated within this Policy.
- Maintain appropriate liquidity levels and manage cash flows within Council to meet known and reasonable unforeseen funding requirements.
- Minimise exposure to credit risk by dealing with and investing in credit worthy counterparties.
- Ensure that all statutory requirements of a financial nature are adhered to.
- Ensure that financial planning will not impose an unequitable spread of costs/benefits over current and future ratepayers.
- To ensure adequate internal controls exist to protect Council's financial assets and to prevent unauthorised transactions.
- Develop and maintain relationships with financial institutions, LGFA, credit rating agencies, investors and investment counterparties.
- Any activity that is speculative in nature or where there is not a legitimate underlying business cash flow being managed is strictly prohibited.

Glossary of Terms

- A Glossary of Terms used in the financial markets is available from the Council on request (A1765543). The Glossary has been excluded from this document for the sake of brevity.

Liability Management Policy

Interest Rate Exposure

Interest rate exposure refers to the impact that changes in interest rates can have on the Council's cash flow. The Council's policy for interest rate risk management is to take a conservative, risk-averse approach by requiring a certain percentage of the Council's borrowing to be fixed rate or hedged borrowing. Both the long term nature of the Council's assets and the need for intergenerational equity mean it is important that the Council should:

- Have predictable interest costs;

- Avoid increases in annual rates caused by interest rate rises.

How Interest Rate Risk Is Managed: The Rules

The Council's external core gross debt should be within the following fixed/floating interest rate risk control limits:

Master Fixed / Floating Risk Control Limits	
Minimum Fixed Rate	Maximum Fixed Rate
55%	90%

"Fixed Rate" is defined as an interest rate re-pricing date beyond 12 months forward on a continuous rolling basis.

"Floating Rate" is defined as an interest rate re-pricing within 12 months.

The percentages are calculated on the rolling 12 month projected gross debt level calculated by management and signed off by the Council Chief Executive. Gross debt is the amount of total external debt. This allows for pre-hedging in advance of projected physical drawdown of new debt. When approved forecasts are changed, the amount of fixed rate protection in place may have to be adjusted to ensure compliance with the policy minimums and maximums.

The fixed rate amount should be within the following maturity bands:

Fixed Rate Maturity Profile Limit		
Period	**Minimum %**	**Maximum %**
1 to 3 years	15	60
3 to 5 years	15	60
5 years plus	15	60

Floating rate debt may be spread over any maturity out to 12 months. Bank advances may be for a maximum term of 12 months.

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 Council.

Risk Management Instruments

The following instruments may be used for interest rate risk management activity.

Category	Instrument
Interest rate risk management	Forward rate agreements ("FRAs") on: • Bank bills • Government Bonds

Category	Instrument
	Interest rate swaps including: • Forward start swaps/collars (start date <24 months, unless linked to existing maturing swaps/collars) • Swap extensions and shortenings Interest rate options on: • Bank bills (purchased caps and one for one collars) • Government bonds • Interest rate swaptions (purchased swaptions and one for one collars only)

- One for one 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';
- Interest rate options must not be sold outright;
- Purchased borrower swaptions mature within 12 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;
- Forward start period on swaps and collars to be no more than 24 months from deal date except where 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;
- Any fixed rate hedge with a maturity beyond 15 years must be approved by Council. The exception to this will be if Council raises LGFA funding as fixed rate or as a swapped floating rate and this maturity is beyond 15 years.

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.

Liquidity and Funding Risk Management

Liquidity risk management refers to the practice of making sure funds are available when needed, without incurring penalties for breaking investments before time. The Council does not hold its reserves in cash and must anticipate and plan for drawings against reserves.

The Council's objective for funding risk management is to minimise the risk of large concentrations of debt being reissued at a time of adverse movements in borrowing margins beyond the Council's control.

Council's ability to readily attract cost effective borrowing is largely driven by its ability to rate, maintain a strong financial standing and manage its relationships with its investors, LGFA, financial institutions/brokers and maintain a long-term credit rating of at least AA.

Policy

The Council's policy for liquidity and funding risk management is:

- Ensure that the Council's committed debt facilities and term loans mature over a wide time period;
- External term debt plus committed debt facilities, plus available cash and cash equivalents must be maintained at an amount of at least 110% over existing external debt;
- Diversify borrowing over a range of bank and debt capital market lenders ensuring that bank borrowings are only sought from approved strongly rated New Zealand registered banks
- Matching expenditure closely to its revenue streams and managing cash flow timing differences
- Maintaining its financial investments in cash/cash equivalent investments
- Council has the ability to pre-fund up to 12 months of the forecast debt requirements including re-financings. Re-financings that have been pre-funded, will remain included within the funding maturity profile until their maturity date.

Rules

The Council's rules for managing liquidity and funding risk are that the maturity profile of the total committed funding in respect to all external term debt and committed debt facilities is to be controlled by the following system:

Period	Minimum %	Maximum %
1 to 3 years	15	60
3 to 5 years	15	60
5 years plus	10	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 approval by Council.
- To minimise concentration risk the LGFA requires 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.

Credit Exposure

The Council does impose a minimum long term credit rating on its bank lenders of A or better and short term rating of A-1 or better, as determined by Standard and Poor's or equivalent international credit rating agency (Fitch or Moody's). Hedging facilities are only with banks that have a long term A or better credit rating.

Counterparty/Issuer	Minimum long term/short term credit rating	Risk management instrument maximum per counterparty

NZ Registered Bank (per bank)	A+/ A-1+	15.0

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

- Interest rate risk management (eg. swaps, FRAs) – Transaction Notional X Maturity (years) X 3%
- Foreign Exchange Risk (e.g. Forward Exchange Contract) – Transaction Face Value amount x ((square root of the maturity (years)) x 15%).

Debt Repayment

The Council repays borrowings from rates, debt raising, surplus funds, proceeds from the sale of investments and fixed assets.

Debt will be repaid as it falls due in accordance with the applicable borrowing arrangement. Subject to the appropriate approval and debt limits (per Council delegations register), a loan may be rolled over or re-negotiated as and when appropriate.

Note that the proceeds from sales of fixed assets and investments may also be used for the acquisition of other fixed assets.

Borrowing Mechanisms

The Council will borrow through a variety of market mechanisms including approved financial instruments 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) Uncommitted money market facilities Retail and Wholesale Fixed Rate Bond and Floating Rate Note (FRN) Issuance Commercial paper (CP) Promissory 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.

Specific Borrowing Limits

The Council's policy for borrowing limits is to adhere to the following:

Item	Borrowing Limit
Net interest expense on external debt as a percentage of total revenue to be less than	15%

Net interest expense on external debt (secured by rates) as a percentage of rates revenue to be less than	20%
Net external debt (secured by rates) as a percentage of total revenue to be less than	150%
Liquidity (external term debt + committed debt facilities + available cash/cash equivalents) over existing external debt to be at least	110%

- 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, for example Development Contributions and vested assets;
- Net external debt is defined as total external debt less cash or cash equivalents;
- Liquidity is defined as external debt plus committed debt facilities plus available cash or cash equivalents divided by external debt. Cash/Cash equivalents are 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
- Net interest is defined as the amount equal to all interest and financing costs less interest income for the relevant period;
- Annual rates income is defined as the amount equal to the total revenue from any funding mechanism authorised by the Local Government (Rating) Act 2002 together with any revenue received from other local authorities for services provided and for which the other local authorities rate;
- Financial covenants are measured on Council only, not consolidated group.

Internal borrowing

The primary objective in funding internally is to use reserves and external borrowing effectively, by establishing a portfolio that provides funding to internal activity centres. This creates operational efficiencies, as savings are created by eliminating the margin that would be paid through Council separately investing and borrowing externally. In addition to external borrowing mechanisms all reserve accounts are used for internal borrowing purposes.

The interest cost will be set with reference to margins on external borrowing.

Actual rates of interest charged for internal borrowing will be approved as part of Long Term Plan process and charged annually in arrears at the weighted average cost of external borrowing (including credit margin and other related costs).

Guarantees

Council, from time to time, provides financial guarantees to local organisations, groups or bodies for recreational and community purposes. Council is prohibited from guaranteeing loans to Council Controlled Trading Organisations under Section 62 of the Local Government Act. In determining whether a guarantee is to be approved, the Council considers the social benefits provided to the community and the following:

- The potential for loss of capital;

- Where the Council assumes the asset in the case of default; the ongoing operating costs or completion costs of the asset;
- The nature of the organisation including its management, financial stability, cash flow forecasts and membership.

The total value of guarantees at any one time will not exceed 5% of the total annual rates, levied during that year. Total loan guarantees held at any time shall be taken into account when calculating the Council's maximum borrowing limit.

The Finance Department monitors the total value of guarantees provided, reporting annually to Council.

As a condition of the guarantee, the guarantor's annual financial statements are to be promptly given to Council after each year end and monthly reports can be requested at any time.

Security Policy

Council's external borrowings and interest-rate risk management instruments will generally be secured by a charge over rates and rates revenue offered through a Debenture Trust Deed. Under a Debenture Trust Deed, Council's borrowing is secured by a floating charge over all Council rates levied under the Rating Act. The security offered by Council ranks equally or pari passu (on equal terms in all respects, at the same rate, or proportionately) with other lenders.

From time to time, with Council and Trustee approval (the Trustee of the Debenture Trust Deed), security may be offered by providing a charge over one or more of Council's assets.

Physical assets will be charged only where:

- There is a direct relationship between the debt and the purchase or construction of the asset, which it funds, for example an operating lease, or project finance;
- Council considers a charge over physical assets to be appropriate;
- Any pledging of physical assets must comply with the terms and conditions contained within the Debenture Trust Deed.

New Zealand Local Government Funding Agency

The Council may borrow from the New Zealand Local Government Funding Agency Limited (LGFA) as a Guaranteeing Local Authority. In connection with that borrowing, the Council may enter into the following related transactions to the extent it considers necessary or desirable:

- contribute a portion of its borrowing back to LGFA subordinated debt, convertible to redeemable preference shares in LGFA if required by LGFA
- provide a guarantee of the indebtedness of LGFA;
- commit to contributing additional equity to 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.

Foreign Exchange

Council has foreign exchange exposure through the occasional purchase of foreign exchange denominated goods and services.

Generally, all significant individual amounts of NZD100,000 or greater commitments for foreign exchange are hedged using foreign exchange contracts, once expenditure is approved and the currency amount, and timing are known. Both spot and forward foreign exchange contracts can be used by Council.

By legislative restriction, Council cannot borrow or enter into incidental arrangements within or outside New Zealand in currency other than New Zealand currency.

Approved financial instruments

Foreign exchange management	Spot foreign exchange Forward exchange contracts Purchased currency options and 1:1 option collars

Emissions Trading Scheme

The objective of the ETS carbon credit policy is to minimise the financial impact of movements in the carbon credit prices on Council. The objective requires balancing Council's need for price stability with the benefit of realising market opportunities to reduce costs as they arise.

ETS is risk managed under the following risk control limits.

NZUs and NZAAUs are the only units available to participants for surrender.

Period	Minimum %	Maximum %
Committed*	80%	100%
Forecast		
0-1 years	0%	80%
1-2 years	0%	50%
2-3 years	0%	30%

*Exposures become committed Jan-Mar (quarter following emission period as Council must report emissions from previous calendar year).

Forward price transactions are limited to NZ registered banks per approved counterparties and approved legal documentation.

The actual annual ETS cost for Council should be no worse than the budgeted ETS cost for that year.

Approved financial instruments

Carbon price management	New Zealand Units (NZUs) and Assigned Amount Units (NZAAUs)

Delegated Authorities and Limits

Pursuant to Clause 32 (2), Schedule 7, of the Local Government Act 2002, Council may make delegations to officers of Council to allow for the efficient conduct of Council business. Clause 32 (3), Schedule 7 of this Act allows officers to delegate those powers to other officers.

Notwithstanding Clause 32 (1) (c), Schedule 7, the power to borrow money, or purchase or dispose of assets, other than in accordance with the Long Term Plan remains the sole responsibility of the Council. This responsibility cannot be delegated.

Treasury transactions entered into without the proper authority are difficult to cancel given the legal doctrine of "apparent authority". Also, insufficient authorities for a given bank account or facility may prevent the execution of certain transactions (or at least cause unnecessary delays).To prevent these types of situations, the following procedures must be complied with:

- All delegated authorities and signatories must be reviewed at least annually to ensure that they are still appropriate and current.
- A comprehensive letter must be sent to all bank counterparties at least annually to confirm details of all relevant current delegated authorities empowered to bind Council.

Whenever a person with delegated authority on any account or facility leaves Council, all relevant banks and other counterparties must be advised in writing in a timely manner to ensure that no unauthorised instructions are to be accepted from such persons. Delegated responsibilities and authority limits are captured within Council's delegation register.

Operational Risk

Operational risk is the risk of loss as a result of human error (or fraud), system failures and inadequate procedures and controls. Operational risk is minimised through the adoption of all requirements of this Policy and detailed within Council's Treasury Procedures Manual.

Cash Management

From time to time, Council has daily cash flow surpluses and borrowing requirements, due to the mismatch of daily receipts and payments. All cash inflows and expenses pass through bank accounts controlled by the Finance Department. Council maintains a daily cash position report, and a yearly cashflow projection is prepared during the annual planning process. These reports determine Council's borrowing requirements and surpluses for investment for the year. Detail is captured within the Treasury Procedures Manual.

Internal Controls

Council's systems of internal controls over treasury activity include:

- Adequate segregation of duties among the core treasury functions of deal execution, confirmation, settling and accounting/reporting. There are a small number of people involved in treasury activity. Accordingly strict segregation of duties is not always achievable. The risk from this is minimised by the following processes:
- A documented discretionary approval process for treasury activity;
- Regular management reporting;
- Regular operational risk control reviews by an independent audit function; and
- Organisational, systems, procedural and reconciliation controls to ensure:
    - All treasury activity is bona fide and properly authorised; and

- o Checks are in place to ensure Council's accounts and records are updated promptly, accurately and completely.

Legal Risk

Legal and regulatory risks relate to the unenforceability of a transaction due to an organisation not having the legal capacity or power to enter into the transaction, usually because of prohibitions contained in legislation. While legal risks are more relevant for banks, Council may be exposed to such risks. If Council is unable to enforce its rights due to deficient or inaccurate documentation, Council will seek to minimise the risk by adopting policies regarding:

- The use of standing dealing and settlement instructions (including bank accounts, authorised persons, standard deal confirmations, and contacts for disputed transactions) to be sent to counterparties;
- The matching of third party confirmations and the immediate follow-up of anomalies; and
- The use of expert advice for any non-standardised transactions.

Agreements

- Financial instruments can only be entered into with banks that have in place an executed ISDA Master Agreement with Council. All ISDA Master Agreements for financial instruments and carbon units must be signed by the Group Manager Corporate Services and the Chief Executive.
- Council's appointed legal counsel must sign off on all documentation for new loan borrowings, re-financings and investment structures.

Financial Covenants and Other Obligations

- Council must not enter into any transactions where it would cause a breach of financial covenants under existing contractual arrangements.
- Council must comply with all obligations and reporting requirements under existing funding facilities and legislative requirements.

Accounting Treatment of Financial Instruments

Council use financial arrangements ("derivatives") for the primary purpose of reducing its financial risk to fluctuations in interest rates. The purpose of this section is to articulate Council's accounting treatment of derivatives in a broad sense. Further detail of accounting treatment is contained within the appropriate operations and procedures manual.

Under New Zealand Public Benefit Entity (PBE) International Public Sector Accounting Standards (IPSAS) changes in the fair value of derivatives go through the Income Statement unless derivatives are designated in an effective hedge relationship. Council's principal objective is to actively manage the Council's interest rate risks within approved limits and chooses not to hedge account. Council accepts that the marked-to-market gains and losses on the revaluation of derivatives can create potential volatility in Council's annual accounts.

The Group Manager Corporate Services is responsible for advising the Chief Executive of any changes to relevant New Zealand Public Sector PBE Standards which may result in a change to the accounting treatment of any financial derivative product.

All treasury financial instruments must be revalued (marked-to-market) at least every six months for risk management purposes.

Treasury Performance

In order to determine the success of Council's treasury management function, the following benchmarks and performance measures have been prescribed.

- Operational performance; compliance to Policy and treasury deadlines.
- Management of debt and interest rate risk (borrowing costs); actual borrowing costs to budget rates and market benchmarks.
    - The actual borrowing cost for Council (taking into consideration costs of entering into interest rate risk management transactions) should be below the budgeted borrowing costs.
    - Actual wholesale interest costs must be benchmarked to market interest rates. The applicable market interest rate is determined by finding the mid-point policy benchmark rate. Council's policy mid-point represents an average maturity term of 5-years. The market benchmark rate will be calculated every month and represent the 5-year swap rate monthly rolling average over a 5-year period.

Those performance measures that provide a direct measure of the performance of treasury staff (operational performance and management of debt and interest rate risk) are to be reported to Council or an appropriate sub-committee of Council on a quarterly basis.

Policy Review

The Policy is to be formally reviewed on a triennial basis, and annually for internal purposes. The Council receives the report, approves Policy changes and/or rejects recommendations for Policy changes.