

# Liability Management Policy

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## 1. Purpose

1.1 Sections 102(2)(b) and 104 of the Local Government Act 2002 (the Act) require local authorities to adopt a liability management policy. Sub Part 4 of Part 6 of the Act (Sections 112 to 122) sets out the statutory framework for local authority borrowing.

1.2 The statutory definition of borrowing is:

*'Borrowing'-*

*a) Means the incurring by any means of debt to raise money; and*

*b) Includes the incurring of debt-*

- (i) Under any contract or arrangement for hire purchase, deferred payment, instalment payment, sale and lease back or buy back, financial lease, loan, overdraft, or other arrangement for obtaining debt finance; or
- (ii) By the drawing, acceptance, making, endorsement, issue, or sale of bills of exchange, promissory notes and other negotiable instruments and debt securities; or
- (iii) by the use, for any purpose, of funds received or invested by the local authority for any other purpose if the local authority has resolved to repay, with or without interest, the funds used; but

c) Does not include debt incurred in connection with the hire purchase of goods, the deferred purchase of goods or services, or the giving of credit for the purchase of goods or services, if-

- (i) The period for which the indebtedness is outstanding is less than 91 days and the indebtedness is not incurred again promptly after payment; or
- (ii) The goods or services are obtained in the ordinary course of the local authority's performance of its lawful responsibilities, on terms and conditions available generally to parties of equivalent credit worthiness, for amounts not exceeding in aggregate an amount—

(A) Determined by resolution of the local authority as not being so significant as to require specific authorisation; or

(B) Recorded for the purposes of this subparagraph of this paragraph of this definition in the then current borrowing management policy of the local authority; and "borrow" has a corresponding meaning:

1.3 This policy will be reviewed by Council every three years or as required.

1.4 The policy recognises that Council has a strong preference for certainty in relation to debt repayment, is averse to risk and wishes to avoid administrative complexity.

1.5 Legal requirements and their cross references are:

Requirement	Reference
General policy	Entire policy
Interest rate exposure	3.1.4
Liquidity	3.1.7
Credit exposure	3.2
Debt repayment	3.3

## 2. Objectives

2.1 The objectives of this policy are:

- To ensure Council has appropriate working capital funds available to carry out its strategic plans as outlined in the Annual Plan and Long-term Plan
- To ensure that the costs of any expenditure can be recovered at the time that the benefits of that expenditure accrue in accordance with Council's Revenue and Financing policies. In particular, debt will normally be used to fund capital expenditure that provides future service benefits
- Ensure that Council has an ongoing ability to meet its debts in an orderly manner as and when they fall due in both the short term and long term, through appropriate liquidity and funding risk management
- Arrange appropriate funding facilities for Council ensuring they are at market related margins utilising bank debt facilities and/or capital markets including the Local Government Funding Authority (LGFA) as appropriate
- Maintain lender relationships with Council's general borrowing profile in the local debt and, if applicable, capital markets (including LGFA), so that Council is able to fund itself appropriately at all times
- Control Council's cost of borrowing through the effective management of its interest rate risks, within the interest risk management limits established by the Liability Management Policy
- Ensure compliance with any financing/borrowing covenants and ratios
- Maintain adequate internal controls to mitigate operational risks
- Produce accurate and timely reports that can be relied upon by senior management and Council for control and exposure monitoring purposes in relation to the debt raising activities of Council.

### 3. Policies

#### 3.1 General

3.1.1 The Council should only raise debt in relation to its Long-term Plan, Annual Plan, specific council resolutions or the Financial Strategy, and core objectives after having first ascertained that there are no readily available uncommitted funds as outlined below:

- Cash investments under the control of the community board or committee responsible for the particular activity (repay by funded depreciation or internal loan methods).
- Cash investments under the control of the Council (repay by funded depreciation or internal loan methods).

3.1.2 Council maintains external borrowings in order to:

- Raise specific debt associated with projects and capital expenditures;
- Fund the balance sheet as a whole, including working capital requirements; and
- Fund assets whose useful lives extend over several generations of ratepayers.

3.1.3 External loans will normally be repaid as soon as possible from funds generated by operations and depreciation rated for and not otherwise committed, in accordance with revenue and financing policies.

Borrowing provides a basis to achieve intergenerational equity by aligning long-term assets with long-term funding sources and ensure that the costs are met by those ratepayers benefiting from the investment.

3.1.4 The interest rate exposures of Council shall be managed according to the parameters detailed in the following table and shall apply to the core debt of Council. Core debt is defined as the level of debt determined by the Executive Manager – Corporate Services (EM-CS), but shall exclude any debt that is associated with Three Waters assets which will be managed outside of the interest rate risk management parameters

Fixed Rate Hedging Percentages		
Term	Minimum Fixed Rate Amount	Maximum Fixed Rate Amount
0 - 2 Years	40%	100%
2 - 4 Years	25%	80%
4 - 8 years	0%	60%

To manage the interest rate risk associated with its debt, Council may use the following interest rate risk management instruments:

- Interest rate swaps
- Swaptions
- Interest rate options
- Interest rate collar structures but only in a ratio of 1:1
- Forward rate agreements.

Definitions of these can be found in Schedule One.

- 3.1.5 For funding risk management purposes, to ensure that all of the Council's debt is not exposed to excessive refinancing risk at any one time, where practicable no more than 40% of all debt facilities should mature within a rolling twelve-month period. Compliance with this provision is not required if total external debt is less than \$20 million. Debt that is associated with Three Waters assets shall be excluded from this requirement.
- 3.1.6 These risk controls in Sections 3.1.4 and 3.1.5 will only be activated once external core debt is forecast to exceed \$20M.
- 3.1.7 For liquidity purposes, Council shall aim to maintain liquidity of not less than 10% above projected core debt over the ensuing 12-month period. Liquidity includes committed bank facilities and liquidity assets such as cash, term deposits, Commercial Paper, Fixed Rate Bonds and Floating Rate Notes. For the purpose of the liquidity calculation core debt will include debt that is associated with Three Waters assets.

### 3.2 Counterparty Exposure

- 3.2.1 Counterparty credit risk is the risk of losses (realised or unrealised) arising from counterparty defaulting on a financial instrument where the Council is a party.
- 3.2.2 Credit exposure or credit risk will be regularly reviewed by the Executive Manager – Corporate Services at least six-monthly. Treasury related transactions will be entered into with approved counterparties.
- 3.2.3 Interest rate derivative transactions and foreign exchange contracts must be transacted with NZ registered banks that have a minimum S&P Global Ratings (S&P) (or Moody's Investors Services (Moody's) or Fitch Ratings (Fitch) equivalents) long term credit rating of A or better.

### 3.2.4 New Zealand Local Government Funding Authority (LGFA)

Despite anything earlier in this policy, the Council may borrow from the LGFA and, in conjunction with that borrowing, may enter into the following related transactions to the extent it considers it necessary or desirable:

- Contribute a portion of its borrowing back to the LGFA as an equity contribution to the LGFA;
- Provide guarantees of indebtedness of other local authorities to the LGFA and of the indebtedness to the LGFA itself;
- Commit to contributing additional equity (or subordinated debt) to the LGFA if required; and
- Secure its borrowings 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.

### 3.3 Debt Repayment

Borrowings are to be repaid from:

- Sale of assets;
- Realisation of investments;
- General funds and/or specific function revenues including rates and depreciation covered by revenue or rates; or Raising of other loans.

## 4. Internal Loans

- 4.1 General Council (including ward, community board or committee) investments may be used as a source for internal loans in relation to expenditure of a capital (or one-off) nature related to any activity that would normally be funded by external loan.
- 4.2 The interest to be applied to internal loans will be determined at the commencement of each financial year based on, and not exceeding, the interest offered on a 12-month investment by the Council's bank at 1 July. It is permitted to apply rates of interest below that or zero in specific cases, after taking into account fairness and equity.
- 4.3 The term for any internal loan shall be not more than 50 years and will be set taking into account the ability to pay off the ratepayers affected, alternative uses of the funds, and the life of the assets to be funded; all terms of internal loans will be subject to review during the course of the loan.

## 5. Borrowing Limits

- 5.1 Borrowing will be managed within the following limits

Item	Borrowing Limit / LGFA Lending Covenant
Net external debt as a percentage of total revenue*	<175%
Net external debt as a percentage of total value of assets	<10%
Net external interest as a percentage of total revenue*	<20%
Net external interest as a percentage of annual rates revenue (debt secured under debenture)	<25%
Liquidity (term debt + committed loan facilities + available cash or cash equivalent) over existing external debt	>10% above projected peak borrowing over ensuing 12-month period

For the purpose of calculating the above ratios:

- Revenue is defined as revenue from rates, government grants and subsidies, user charges, interest, dividends, financial and other revenue. It excludes government capital contributions (eg. developer contributions and vested assets).
- 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 together with any revenue received from other local authorities for services provided (and for which the other local authorities rate).

Cash/cash equivalents are defined as:

- Overnight bank cash and term deposits;
- Commercial Paper
- Fixed Rate Bonds
- Floating Rate Notes
- Net external debt is defined as total external debt less cash/cash equivalents that would be available to repay debt.

## 6. Repayment of Borrowings

### 6.1 Repayment of Debt

6.1.1 Subject to Council resolution or a stated intention in the Annual Plan, it is permitted to use existing funds to repay debt, providing suitable internal arrangements are put into place to prevent any change in rates distribution among particular groups of ratepayers.

Council may also elect to use:

- Rating revenues established for that purpose;
- Proceeds from the disposition of surplus assets or investments;
- Regular instalments of principal and interest, especially with internal scheme capital works loans; and/or
- Refinancing with new debt.

Total debt levels are determined through the Long-term Plan, annual plans and asset management plans.

## 7. Authorised External Borrowing Sources

7.1 The following external borrowing sources will be utilised:

### **Bank Sourced Debt**

Council may borrow from any New Zealand registered bank with a minimum S&P (or equivalent) short term rating of A-1 and a minimum long term rating of A. There will be no limit set on the amount of funds which any of the authorised banks may lend to the Council. When borrowing, Council will go out to tender in order to obtain the best rate possible.

Where debt is sourced from New Zealand registered banks, the following borrowing facilities may be used:

- Overdraft facilities;
- Committed term loan/cash advance facilities; and
- Standby term loan/cash advance facilities

Borrowings will be secured by either a general charge over rates or over a specific asset of the Council.

### **Local Authority Bonds**

Council may authorise the issuance of local authority bonds (medium term notes), fixed rate bonds and floating rate notes.

The bonds will be secured by either a general charge over rates or over a specific asset of the Council.

This method of borrowing will be authorised by specific Council resolution in each instance.

### **Local Government Funding Agency (LGFA)**

There is no limit set on the amount of funds that are allowed to be borrowed from this agency. LGFA funding will be secured by a general charge over rates.

## **8. Benchmarking**

8.1 For performance measurement purposes, the actual borrowing performance of Council shall be compared with the following external benchmark, which is predicted off the midpoints of the risk control bands contained in the fixed rate hedging percentages table contained in Section 3 of this policy.

## **9. Treasury Responsibilities, Compliance and Controls**

### 9.1 Council

- Approves overall borrowing limits each year through the Annual Plan process
- Approves for charging assets a security over borrowing
- Approves any risk management strategy outside the delegated authorities outlined in this policy document
- Monitor treasury performance through the receipt of appropriate reporting, as per Schedule Two
- Approve new borrowing facilities from the banking sector and capital markets, including the Local Government Funding Agency (LGFA), upon recommendation from the Chief Executive (CE)
- Approve on an individual basis investment in Building Societies
- Approve Liability Management and Investment Policy
- Approve any hedging outside the parameters of this policy.

### 9.2 Chief Executive

- In the absence of the Executive Manager – Corporate Services (EM-CS), oversee the funding, interest rate risk management and financial market investment activities of Council
- Approves any amendments to the Liability Policy recommended by EM-CS, prior to submission to Council for approval
- In the absence of the EM-CS undertakes the duties as detailed in this document as appropriate, including checking external confirmations against internal records
- Approve authorised electronic signatory positions
- Signs the documents relating to the financial market activities of Council.

### 9.3 Executive Manager - Corporate Services

- Makes decisions regarding all funding and interest rate risk management activities of Council prior to implementation/execution
- Makes decisions regarding all financial market investment activities of Council prior to execution
- Refinancing of existing debt

- Manages the bank lender and capital markets relationships, providing financial information to lenders and negotiates new/amended borrowing facilities or methods for approval by Council
- Approves opening and closing of bank accounts and new banking facilities
- Approves authorised electronic signatory positions
- Provides policy advice as needed and reports to the CE and Council on overall treasury risk management issues regularly
- Conducts a review of the Liability Management and Investment Policy every three years or as required basis and submits any recommended changes to Council for approval once the CE has approved them and the necessary statutory processes have been followed
- Signs documents relating to the borrowing and financial market investment activities of Council
- Executes treasury transactions in the absence of the Finance Manager
- Checks external confirmations against internal records.

#### 9.4 Finance Manager

- In the absence of the EM-CS undertakes all his/her duties under a delegated authority authorised by the CE
- Approves authorised electronic signatory positions
- Executes treasury transactions
- Prepares regular reports to Council
- Checks external confirmations against internal records.

## 10. Internal Controls

### 10.1 Introduction

Arranging and agreeing transactions with external counterparties are required to occur in a framework of control and accuracy. It is vital to the internal control of Council that all transactions are captured, recorded, reconciled and reported in a timely fashion within a process that has necessary checks and balances, so that unintentional errors and/or fraud are identified early and clearly. Movements in financial market variables can be rapid, and exposures to such movements that are not known about due to inadequate transaction recording and reporting systems should not be allowed to occur.

### 10.2 Transaction Origination

The following authorities shall apply in respect to the execution of transactions with bank dealers and brokers on behalf of Council that can commit Council to all related contractual obligations under these transactions. All such transactions are generally originated and agreed either verbally by telephone or by email. Therefore, it is important that procedures are in place to control the activity.

### 10.3 Funding from bank facilities, issuing Council debt, undertaking financial market investment transactions, including LGFA and entering into interest rate derivative transactions



- Funding from bank facilities, issuing council debt, undertaking Financial Market Investment Transactions, including LGFA and entering into Interest Rate Derivative Transactions with an approved banker broking counterparty entails the personnel of Council, who are approved to undertake these activities, verbally or by email agreeing with the bank or broker amount, term selection, rate accepted and the type of instrument being issued (in the case of borrowing), or transacted (in the case of a derivative transaction).
- Once the deal is agreed, details of the transaction shall be entered on the internal system
- Once the bank or broker confirmation of the transaction is received, the details should then be checked to ensure that the bank or broker confirmation is in accordance with the details on the Council's internal system.

Any discrepancies noted in the above procedures should immediately be communicated to the bank or broker so that the correct details of the deal can be agreed on. Where the EM-CS has transacted the deal in the first place, the deal shall be ratified and signed off by either the CE or the Finance Manager, and where the CE has transacted the deal in the first place, the deal shall be ratified and signed off by the EM-CS of Finance Manager. In this way, there is a clear division of responsibility and a self-checking system.

#### 10.4 Settlement Procedure

All transactions are to be confirmed and reconciled to external confirmations and internal documentation before settlement.

# Schedule 1

## Definitions of interest rate risk management instruments

### **Forward Rate Agreement (FRA)**

An agreement between Central Otago District Council (CODC) and a counterparty (usually a bank) protecting CODC against a future adverse interest rate movement. CODC and the counterparty agree to a notional principal amount, the future interest rate, the date and the benchmark rate, which is usually as detailed on the daily bank bill reference (BKBM) page, on the Reuters' financial market information system.

#### *Objective*

To provide CODC with certainty as to its interest rate cost on an agreed principal amount for an agreed period. An FRA typically applies to a three-month period, starting at some point within the next 12 months.

### **Interest Rate Swap (IRS)**

An interest rate swap is an agreement between CODC and a counterparty (usually a bank) to manage Council's exposure to interest rate movements. CODC pays (or receives) a fixed interest rate and receives (or pays) a floating interest rate. The parties agree to a notional principal amount, the fixed interest rate, the settlement dates and the benchmark floating rate, which is usually BKBM off the Reuters' page containing the daily rate sets for various market reference rates.

#### *Objective*

To provide CODC with certainty as to its interest rate cost on an agreed principal amount for an agreed period. Floating rate periods are typically quarterly or semi-annual.

### **Forward Start Interest Rate Swap**

#### *Objective*

To provide CODC with certainty as to its interest rate cost on an agreed principal amount for an agreed period which commences at a future point in time. All other conditions are as with an interest rate swap.

### **Option on a Swap Agreement – Swap Option**

#### *Objective*

To provide CODC with the right but not the obligation to enter into a fixed rate swap at a future point in time on an agreed principal amount for an agreed period. A swap option is an option on a swap and typically requires a premium to be paid.

### **Interest Rate Options**

The purchase of an interest rate option gives the holder (in return for the payment of a premium) the right but not the obligation to borrow (described as a cap) or invest (described as a floor) at a future date. CODC and the counterparty agree to a notional future principal amount, the future interest rate, the benchmark dates and the benchmark floating rate (usually BKBM on Reuters).

### *Objective*

To provide CODC with worst case cover on its interest rate cost on an agreed principal amount for an agreed period. As for an interest rate swap, rate sets are typically quarterly or semi-annual for the life of the option.

### **Interest Rate Collar**

The combined purchase (or sale) of a cap and the sale (or purchase) of a floor.

### *Objective*

To provide CODC with certainty as to its interest rate cost on an agreed principal amount for an agreed period, but by limiting CODC's downside participation, typically avoiding the payment of a premium.

### **Limits on Selling Options**

CODC will only sell an option if at the same time it purchases an option for a similar term with the same notional value.

The reasons for the use of any incidental arrangements will be explained within a specific resolution of Council, enabling such arrangements to be entered into.

## **Schedule 2**

### **Quarterly Reporting Requirements**

A quarterly report should contain the following:

- Total debt utilisation, including sources of debt
- Interest rate hedging profile against hedging percentage limits
- New interest rate hedging transactions completed
- Weighted average cost of funds
- Performance measurement
- A statement of policy compliance
- Details of any exception reports including remedial action taken or intended to be taken.