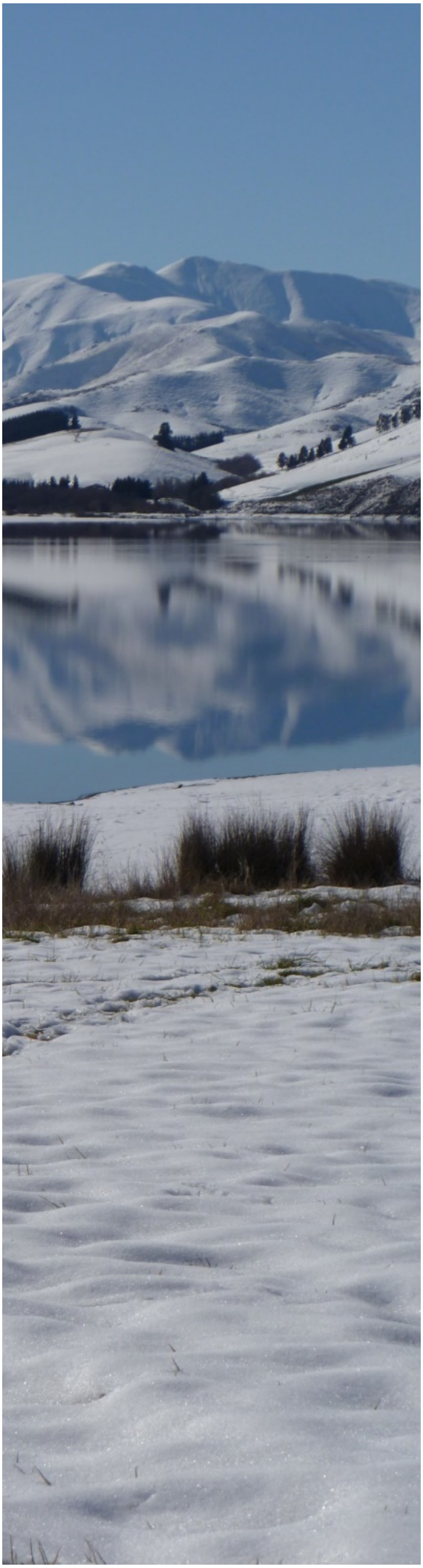

Mackenzie District Council

Liability Management Policy

STATUS:	Draft
VERSION:	20210423
POLICY OWNER:	GM Corporate Services
POLICY APPROVER / S:	Chief Executive Officer, Mackenzie District Council
DATE:	2021-04-23

"Fostering Our Community"

LIABILITY MANAGEMENT POLICY

Purpose	Mackenzie District Council (Council) must have a Liability Management Policy as required by section 102 (2) of the Local Government Act. This policy outlines how the Council will manage its borrowings and other liabilities.
Key Points	The objectives of the Liability Management Policy are to provide guidance: • To minimise the cost of borrowing (including interest, contracted services, staff, time and administration) • To minimise the exposure to the risks associated with borrowing • To maintain strong financial ratios • To consider long term indebtedness as a means of creating intergenerational equity • To maintain the integrity of Council's Long Term Plan (LTP)
Date of Issue	Previous version ADOPTED April, 2020
File Retention	Mackenzie District Council Laserfiche – Organisational Policies section
Review	Every two years at the anniversary date

RELATED DOCUMENTS / WEBSITES

Related Council policies and documents include:

- Financial Strategy
- Investment Policy
- Property Sales and Acquisition Policy
- Risk Appetite Statement
- Risk Policy

Relevant legislation and other resources include (but are not limited to):

- Local Government Act 2002 and the Local Government Act Amendment Act 2014

1. Definitions

Bank Bill: A "bill of exchange" security document issued by a corporate borrower, but guaranteed by a bank, who then in turn sells the security into the bank/investor market to re-liquefy itself with cash. Normally for terms of 30, 60, 90 or 180 days.

Base rate: Normally a lending bank's cost of funds/interest rate for a particular funding period. The base or "prime" rate will be changed by the bank from time to time, but not every day like market rates.

Basis Point(s): In financial markets it is normal market practice to quote interest rates to two decimal places e.g. 6.25% - one basis point is the change from 6.25% to 6.26%, one hundred basis points is the change from 6.25% to 7.25%.

Benchmark: An agreed market related yardstick that investor returns, funding costs or average exchange rate achieved are compared against for performance measurement purposes.

Bond: The security instrument that is issued by a borrower whereby they promise to repay the principal and interest on the due dates. A bond's interest rate is always fixed.

Call Option: The owner or buyer of a call option has the right, but not the obligation, to buy the underlying debt security/currency/commodity at the price stated in the option "contract.

Certificate of Deposit (CD): A debt instrument (normally short term) issued by a bank to borrow funds from other banks/investors.

Collar: Two option contracts linked together into the one transaction or contract. A borrower's collar is normally a bought "cap" above current market rates and a sold "floor" below current rates. Over the term of the collar contract, if rates go above the cap the borrower is protected and pays an interest cost no more than the cap rate. Likewise, if market rates fall below the floor, the borrower pays the floor rate and does not participate in the lower market rates. Also called a "cylinder".

Collateral: A legal term that means "security".

Commercial Paper: The debt security instrument issued by a prime (and normally credit-rated) borrower to raise short-term funds (30, 60, 90 or 180 days). Also called "one-name paper" and "promissory notes" issued by competitive public tender to investors or by private treaty to one investor.

Convertible Bonds: A debt instrument issued to investors by a borrower that has a fixed interest rate for a period and then converts (under a strict pricing formula) to shares in the issuing company.

Current Ratio: A liquidity measure to determine how quickly the Council can generate cash. Current assets are divided by current liabilities.

Debenture: A debt instrument similar to a bond whereby a borrower (normally a finance company) borrows for a longer term at a fixed rate. Also a legal instrument provided as security to a lender.

Derivative(s): A "paper" contract whose value depends on the value of some "underlying" referenced asset e.g. share market stocks, bank bills, bonds or foreign currency. Also called a "synthetic." The value of the assets will change as its market price changes; the derivative instrument will correspondingly change its value.

Exchange – Traded: A currency, debt or financial instrument that is quoted and traded on a formal exchange with standardised terms, amounts and dates.

Floor: The opposite of a "cap." An investor will buy a floor, or a series/string of call options (the right to buy) to protect against falling interest rates, but be able to invest at higher interest rates if rates move upwards. A borrower may sell a floor as part of a collar structure to generate premium to pay for the "linked" bought cap.

Funding Risk: The risk that a borrower cannot re-finance its debt at equal or better terms at some date in the future, in terms of lending margin, bank fees and funding time commitment. Funding risk may increase due to the Council's own credit worthiness, industry trends or banking market conditions.

Hedging: The action of reducing the likelihood of financial loss by entering forward and derivative contracts that neutralise the price risk on underlying financial exposures or risks. The gain or loss due to future price movements on the underlying exposure is offset by the equal and opposite loss and gain on the hedge instrument.

Inverse Yield Curve: The slope of the interest rate yield curve (90-days to years) is “inverse” when the short-term rates are higher than the long-term rates. The opposite, when short term rates are lower than long-term interest rates is a normal curve or “upward sloping.” In theory, a normal curve reflects the fact that there is more time, therefore more time for risk to occur in long term rates; hence they are higher to build in this extra risk premium.

Liability Management: The policy, strategy and process of pro-actively managing the treasury exposures arising from a portfolio of debt.

Liquidity Risk: The risk that the Council cannot obtain cash/funds from liquid resources or bank facilities to meet foreseen and unforeseen cash requirements. The management of liquidity risk involves working capital management and external bank/credit facilities.

Open Position: Where a Council has purchased or sold an asset, currency, financial security or instrument unrelated to any physical exposure, and adverse/favourable future price movements will cause direct financial loss/gain.

Proxy Hedge: Where there is no forward or derivative market to hedge the price risk of a particular currency, instrument or commodity. A proxy instrument or currency is selected and used as the hedging method as a surrogate. There needs to be a high correlation of price movements between the two underlying prices to justify using a proxy hedge.

Revaluation: The re-stating of financial instruments and option/forward contracts at current market values, different from historical book or carrying values. If the contracts were sold/bought back (closed-out) with the counter party at current market rates, a realised gain or loss is made. A revaluation merely brings the contract/instrument to current market value.

Spot Rate: The current market rate for currencies, interest rates for immediate delivery/settlement, and normally two business days after the transaction is agreed.

Standard & Poor’s: A credit rating agency that measures the ability of an organisation to repay its financial obligations.

Strike Price: The rate or price that is selected and agreed as the rate at which an option is exercised.

Swap Spread: The interest rate margin (in basis points) that interest rate swap rates trade above Government bond yields.

Swaption: An option on an interest rate swap that if exercised the swap contract is written between the parties. The option is priced and premium paid similar to bank bill and bond interest rate options.

Treasury: Generic term to describe the activities of the financial function within the Council that is responsible for managing the cash resources, financial investments, debt, and interest rate risk.

Treasury Bill: A short term (<12 months) financing instrument/security issued by a Government as part of its debt funding program.

Yield: Read-interest rate, always expressed as a percentage.

2. Principles

Mackenzie District Council borrows as it considers appropriate and exercises its flexible and diversified borrowing powers as outlined within the Local Government Act 2002. The Council approves borrowing by resolution arising from the Long Term Plan (LTP) and Annual Plan process. Projected debt levels are ascertained from cash flow forecasts prepared during these planning processes.

Mackenzie District Council acknowledges that there are various financial risks such as interest rate risk, liquidity risk and credit risk arising from its borrowing. Council is a risk averse entity and does not wish to incur additional risk from its treasury activities.

The Council's finance function in relation to its treasury activities is a risk management function focused on protecting the Council's budgeted interest costs and stabilising the Council's cashflows. The Council does not normally undertake any treasury activity which is unrelated to its underlying cashflows or is purely speculative in nature unless with formal prior approval of Council.

The finance function is broadly charged with the following responsibilities:

- To manage the Council's borrowings within its strategic objectives.
- To manage the impact of market risks such as interest rate risk on the Council's borrowings by undertaking appropriate hedging activity in the financial markets.
- To minimise adverse interest rate related increases on ratepayer charges and maintain overall interest expenditure within budgeted parameters.
- To provide timely and accurate reporting of treasury activity and performance.

The Council raises debt for the following primary purposes:

- General debt to fund the Council's balance sheet, including borrowing to fund Council Controlled Organisations (CCO's) etc.
- Specific debt associated with "special one-off" projects and capital expenditure
- To fund assets with intergenerational qualities.

The Council is able to borrow through a variety of market mechanisms including:

- Commercial Paper
- Local Authority Bonds
- Medium Term Notes
- Floating Rate Notes
- From the Local Government Funding Agency ("LGFA")
- Funding from internal sources.

The Council incurs risks arising from its borrowing and associated interest rate risk activity. In evaluating any new or renewal of existing borrowings (in relation to source, term, size and pricing) Mackenzie District Council will take into account the following:

- The size and the economic life of any specific project being funded
- The impact of the new debt on overall borrowing limits.

Relevant margins under each borrowing source:

- Overall debt maturity profile
- Prevailing interest rates
- Available term from bank and stock issuance
- Legal documentation and financial covenants.

This policy document details how the Council will manage its borrowing with regard to key risks faced including:

- Interest rate exposure
- Liquidity and funding risk
- Credit exposure
- Provision of security.

3. Policy Objectives

The objectives of the Liability Management Policy are:
- To minimise the cost of borrowing (including interest, contracted services, staff, time and administration)
- To minimise the exposure to the risks associated with borrowing
- To maintain strong financial ratios
- To consider long term indebtedness as a means of creating intergenerational equity
- To maintain the integrity of Council's Long Term Plan (LTP)

The objectives of the Management of Liquidity and Funding Risk are:
- To ensure Council's continued ability to meet its debts in an orderly manner as and when they fall due in both the short and long term, through appropriate liquidity and funding risk management
- To arrange appropriate funding facilities for Council, ensuring they are at market related margins utilising bank debt facilities and/or capital markets as appropriate
- To maintain lender relationships and Council's general borrowing profile in the local debt and capital markets, so that Council is able to fund itself appropriately at all times

The objectives relating to Reporting are:
- To produce accurate and timely information that can be relied on by senior management and the full Council for control, exposure monitoring and performance measurement purposes in relation to treasury activity.

4. Borrowing

(Note: For these purposes 'borrowing' does not include hire purchase, deferred payment or the giving of credit for goods and services where the transaction is for less than 91 days or does not exceed $500,000. Guidelines for Borrowing Limits are in the Financial Strategy document.)

Council approves, by resolution, the external borrowing requirement (including financial leases) for each financial year during the annual planning process. A resolution of Council is not required for indebtedness in connection to hire purchase, deferred purchase or the giving of credit, the aggregate amount Council determines as not being so significant as to require specific authorisation is $50,000 or where the period of indebtedness is less than 91 days.

Council must confirm all new loans required to fund expenditure that has arisen subsequent to the Annual Plan. In approving new debt Council considers the impact on its borrowing limits as well as the size and the economic life of the asset that is being funded and consistency with Council's long term Plan.

Council's infrastructural assets generally have long economic lives and long term benefits. The use of debt is seen as an appropriate and efficient mechanism for promoting intergenerational equity between current and future ratepayers in relation to Council's assets and investments.
Council's ability to readily attract cost effective borrowing is largely driven by its ability to rate and manage its relationships with investors and financial institutions.

Council will monitor and report:

- The ratio of equity : debt
- Debt per rateable property

4.1 Borrowing Principles

The following principles are embedded within the policy:

- Borrowed funds will be used to fund capital expenditure and equity investment, except as provided for working capital purposes under Cash Management policies.
- Debt will be used as a residual source of funds after Council has considered all other available options.
- The mix of debt, reserve and revenue funding will be determined by Council.
- Debt raised will be repaid over the economic life of the asset generally restricted to a maximum of 20 years but may be extended to 30 years.
- Unless Council otherwise resolves, interest costs will be treated as part of the operational expenditure and will be funded annually from operating revenue.
- The repayment of principal on debt generally will be funded from operating revenue. Although Council may resolve to repay loans from other capital sources.
- Loans raised by Council where security is required are to be secured as a charge over rates or rate revenue.
- Debt financing is recognised as a component in Council's Revenue and Financing policies and long term plan to provide intergenerational equity which prevents costs being incurred by the current users which are for the benefit of future users.
- Council may raise specific debt associated with significant "one-off" projects and non-financial investments from time to time, including investments in CCTOs.
- Council may borrow through hire purchase, credit, and deferred payment or lease arrangements in the ordinary course of Council business.
- Loans are raised to meet cash management requirements, as internal borrowing is preferred.

4.2 Internal Borrowing

Internal loans sourced from the Council's reserve funds are allowed as a valid means of funding projects, minimising the cost of borrowing while providing a market return on investment funds. Council's internal borrowing needs are typically associated with the expansion or renewal of its assets. Hence the internal borrowing is tied to assets and the cost centres associated with those assets.

Council seeks to minimise loan administration costs by structuring loans to enable repayments to be spread over a sanctioned period based on repayments tables, without the use of sinking funds.

Internal borrowing structures where interest and repayments are sourced from operating budgets (generally funded by rates income) are acceptable under this Policy. Where appropriate, inflation factors may be built into loan repayment tables to better reflect the ability of the community to pay in the future and avoid overcharging current ratepayers. The inflation adjusted debt service cost allows room to absorb interest rate fluctuations and provide more predictable cash flow projections.

In general Council, in arranging future internal borrowing under this Policy, will seek to build repayment flexibility into the loan structures. The Council will manage the risks associated with interest rate movement through the use of flexibly structured repayment loan tables.

Council can internally borrow from reserve and investment funds in the first instance to meet future capital expenditure requirements, unless there is a compelling reason for establishing external debt.

4.3 Special funds and reserve funds

Liquid assets are not required to be held against all special funds and reserve funds. Council may internally borrow or utilise these funds where possible.

5. Interest Rate Exposure

Interest is incurred on any bank funding facility, issuance of local authority stock and other borrowing arrangements. This policy recognises that the longer the term of borrowing, the greater the sensitivity to interest rate movements. Longer term borrowings may be of benefit if the market interest rates rise, but equally may not allow Council to take advantage of periods of low interest rates.

Interest rate risks may be managed by the use of derivative instruments, and by issuing fixed rate bonds or sourcing fixed rate bonds from the Local Government Funding Agency (LGFA).

The table below outlines the minimum and maximum hedged or fixed rate exposure requirements within various time buckets. The actual hedging percentages in place, within these bands, will be determined, and reviewed on a regular basis.

Fixed Rate Hedging Percentages

	Minimum Fixed Rate	Maximum Fixed Rate
Less than 2 years	50%	100%
2 years to 5 years	25%	80%
5 years to 10 years	0%	60%

Fixed rate hedging in excess of 10 years is permissible provided that it is carried out in conjunction with, or aligns with, an underlying debt instrument.

When managing the interest rate risk of the Council the hedging percentages above relate to total core debt. Core debt cannot exceed borrowing projections as per the Annual Plan or Long Term Plan with the actual quantum used for policy parameters to be reviewed annually.

The hedging parameters are cumulative. For example if total debt was $25 million, $5 million of hedging entered into for a period of five years would increase the hedging profile for all time buckets up to five years, by 20%.

Fixed rate debt is defined as any debt that has an interest rate reset beyond 3 months. The hedging parameters are dependent on the Reserve Bank of New Zealand continuing to implement monetary policy through adjustments to the Official Cash Rate (OCR).

The Council decides the interest rate risk management strategy by monitoring the interest rate markets on a regular basis, evaluating the outlook for short term rates in comparison to the rates payable on fixed rate borrowing.

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

- Forward rate agreements
- Interest rate swaps
- Swaptions
- Interest rate collar type option strategies in a ratio not exceeding 1:1.

Selling interest rate options for the primary purpose of generating premium income is not permitted because of its speculative nature.

The use of Interest rate risk management instruments must have the formal prior approval of the General Manager Corporate Services.

6. Benchmarking

The Council shall evaluate the performance of the interest rate management policy itself (i.e. the success and continued appropriateness of the risk control limits stipulated in the Liability Management Policy document) and their implementation at an operational level. This is achieved by measuring actual results (i.e. weighted average funding cost) against a market benchmark provided by an external source.

The benchmark standard shall consist of the following:

- 20% Average 90 day bank bill rate for the reporting month;
- 10% Average 1 year swap rate for the reporting month;
- 10% Average 1 year swap rate for the reporting month, 1 year ago;
- 10% Average 3 year swap rate for the reporting month;
- 10% Average 3 year swap rate for the reporting month, 3 years ago;
- 10% Average 5 year swap rate for the reporting month;
- 10% Average 5 year swap rate for the reporting month, 5 years ago.
- 10% Average 7 year swap rate for the reporting month;
- 10% Average 7 year swap rate for the reporting month, 7 years ago.

The above percentages are predicated off the midpoints of the risk control bands contained in the 'Fixed Rate Hedging Percentages' table in Section 5.

The Council's cost of funds for benchmarking purposes is exclusive of margin. For reporting of interest rate comparisons, rates rather than dollar values should be used. Benchmarking is not required if total external borrowings are less than $10 million.

7. Liquidity and Funding Risk Management

The Council's ability to readily attract cost effective borrowing is largely driven by its ability to rate, maintain a strong balance sheet as well as its ability to manage its relationship with its banker(s) and the capital markets.

To minimise the risk of large concentrations of debt maturing or being reissued in periods where credit margins are high for reasons within or beyond the Council's control, the Council ensures material debt maturities are spread over a number of years. The Council manages this by aiming where practical to have no more than 33% of its outstanding borrowings subject to refinancing in any rolling twelve month period.

The Council's treasury operation must also ensure that there are sufficient resources or "liquidity" to provide the funds to meet its immediate obligations such as creditors and current debt maturities.

Appropriate cash flow reporting mechanisms will be maintained to monitor the Council's estimated liquidity position over the next 12 months. In any case funding facilities must be in place to give headroom of at least 110% over and above the maximum net debt requirement as estimated in the Annual Plan or Long Term Plan.

8. Credit Exposures (Treasury)

In general the Council borrows funds from a variety of registered banks, institutional investors and the LGFA. It is considered that the range and size of Council's individual borrowings together with the relative strength of these lenders offsets any institutional credit risk.

9. Provision of Security

For its general borrowing programme the Council offers security under its debenture trust deed, for which security is a charge over all rates.

In unusual circumstances, with the prior consent of the Council, security may be offered by providing a charge over one or more of the Council's assets.

10. Repayment

The Council repays borrowings from general or targeted rates, general funds or renewal loans.

10. Local Government Funding Agency (LGFA)

Despite anything earlier in this Liability Management 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:

- To contribute a portion of its borrowing back to the LGFA as an equity contribution to the LGFA;
- To provide guarantees of the indebtedness of other local authorities to the LGFA and of the indebtedness of the LGFA itself;
- To commit to contributing additional equity (or subordinated debt) to the LGFA if required;
- To subscribe for shares and uncalled capital in the LGFA; and
- To 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.

Because of the dual objective, 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 alternate investments.

If required in connection with the investment, the Council may subscribe for un-called capital in the LGFA.

11. Management and Reporting Procedure

Mackenzie District Council's Finance Committee oversees and monitors the risks arising from its treasury activities to ensure consistency with the Council's Long Term Plan and to evaluate the finance function's effectiveness in achieving its objectives. The Finance Committee is responsible for approving strategy and for monitoring compliance and performance of the Council's treasury activities.

The General Manager Corporate Services has financial management responsibility over the Council's borrowing and investments. The Council is able to appoint an independent advisor to assist in the management of the financial market exposures that the council is subjected to. The scope of the appointment and the parameters within which the advisor operates, will be determined by the General Manager Corporate Services and at all times will operate within the parameters of this policy document. The Council's borrowing and cash management activities are managed centrally through its finance function.

The Management of the Council's borrowing portfolio is carried out under delegated authority to the General Manager Corporate Services (who has delegated the day to day operation to the Council's Finance Manager and Management Accountant). Reports on the Council's borrowings are prepared on a quarterly basis for the Council.

12. Clarification and Breaches

This policy represents the formal policy and expected standards of the Mackenzie District Council. Appropriate approvals need to be obtained prior to any deviation from the policy. Elected Members and employees are reminded of their obligations under the Council's Code of Conduct to give full effect to the lawful policies, decisions and practices of the Council.

12.1 Clarification

Clarification regarding this policy can be sought from the Mackenzie District Council General Manager Corporate Services.

12.2 Breaches

The Mackenzie District Council General Manager Corporate Services is responsible for monitoring compliance with this policy. All identified breaches will be escalated to the Chief Executive Officer and the Manager People and Culture, and will be treated as misconduct which may result in disciplinary action.

12.3 Exceptions

The Mackenzie District Council General Manager Corporate Services (being the policy owner) will need to authorise any deviations from this policy.