Guidelines

OPERATING GUIDELINES TO THE TREASURY MANAGEMENT POLICY

Investment Policy & Liability Management Policy

TEAM:	Finance
RESPONSIBILITY:	Finance Manager
APPROVED:	17 February 2021
REVIEW:	Every 3 years, or as required
RELATED DOCUMENTS:	Treasury Management Policy 2021

Guideline Objective

This Guideline details the procedures in respect of all treasury activity to be undertaken by Ashburton District Council under its Treasury Management Policy. The formalisation of such procedures will enable treasury risks within Council to be prudently managed.

Part I - Operations:

This section details the day-to-day administration of investments and borrowing of Council, including the controls and procedures used to ensure a clear audit trail of treasury activity and the accountability to Council.

Appendices

Appendix A – Authorised interest rate risk management instruments.

Appendix B – Financial market investment instruments.

Part I – Operations

This section details procedures and controls to be used by Treasury in order to provide a clear audit trail as to movements in the investments and borrowings undertaken by Council.

2.1 Duties and responsibilities

Duties and responsibilities under this policy are:

Full Council

- Approve the Treasury Management Policy including any amendments proposed by the Finance & Business Support committee
- Approve any hedging outside the parameters of the Treasury Management Policy
- Approve use of any risk management products not authorised by Treasury Management Policy
- Monitor Treasury performance through receipt of appropriate reporting.
- Approve overall borrowing limits on an annual basis through the Long-Term Plan/ Annual Plan process.

Finance & Business Support committee

- Review the Treasury Management Policy every three years or on an "as required' basis and submit any recommended changes to Council for approval.
- Monitor and review the ongoing Treasury performance of Council and compliance with the Treasury Management Policy parameters through receipt of regular reporting.
- Approve any new borrowing facilities recommended by the Finance Manager within overall borrowing limits approved by Council.

Chief Executive/Group Manager: Business Support

- In the absence of the Finance Manager, undertake all his/her duties as detailed in the Treasury Management Policy or delegate the duties as appropriate.

Finance Manager

- Make decisions in respect to treasury management within the parameters of this policy.
- Report to the Finance & Business Support committee on overall treasury activity on a regular basis.
- Manage the bank lender and capital market relationships, providing financial information to lenders and negotiate new/amended borrowing facilities or methods for approval by the Finance and Business Support committee within Council approved limits.
- Execute treasury transactions in the absence of the accountant.

Financial Accountant

- Execute treasury transactions
- Assist the Finance Manager in the preparation of reports to the Finance and Business Support committee
- Check external confirmations against internal records.

2.2 Controls and procedures

Daily Operations

Before investment decisions can be made, the Finance Manager should be aware of Council's immediate and short term cash flow requirements, taking account of:

- regular identifiable payments, e.g. PAYE and other taxes, loan repayments, payroll expenditure, regional council levies

- regular identifiable revenue, e.g. rates, subsidies, interest receipts, annual fees and charges, and debtor and creditor cashflows

Some significant payments will not be identifiable until a few days prior to payment and therefore the Finance Manager needs to leave sufficient liquidity in Council's investment policy to allow for these. Working capital is to be a ratio of 2:1 against current liabilities. Close liaison with other Council departments is essential for stringent cash flow management.

Account must be taken on a regular basis of both working capital and investment funds to allow investment decisions to be made. Working capital funds need to be assessed more frequently than investment funds to allow Council to meet its financial commitments. Loan funds and sinking funds are of a more controlled nature, and management of these funds therefore also requires less frequent attention than the working capital fund.

When making investments documentation must have the signature of the Finance Manager and any one of the Accountant, Accounts Officer, or Group Manager – Business Support. For investments made by direct debit, coding from the bank statement must be performed by either the Accounts Officer or Accounts Clerk in order to ensure that the person responsible for the initiation of the transaction is not involved in recording it.

To assist with daily operations the Finance Manager should have a good working relationship with Council's bank representative and also with Council's financial advisor. This will enable the Finance Manager to better evaluate investment opportunities.

Portfolio management

The Finance Manager needs to be aware of investment maturities in each portfolio for three reasons:

- To be aware of interest payment dates
- To ensure investments are actioned on maturity
- To determine whether maturing investments are required to meet cash outflows or are available for reinvestment

Each investment should be separately itemised along with the following details:

- Type of security and issuer
- Interest rate
- Commencement date
- Maturity date
- Type and amount of funds invested, e.g. Working capital or long-term funds
- Supporting documentation to evidence the transaction.

To assist this process, each investment should be numbered. A control account should be used, setting out the types of security and also the types of funds. This will provide a basis for a monthly reconciliation to the ledger and simplify the categorisation of investments held. Upon sale or maturity of each investment, details of the course of action taken should be noted, and where full or partial reinvestment is made, all details should be recorded on the maturing investment. A clear

audit trail should be maintained, setting out in chronological order the various investments (by fund type) showing investment reference, amount and security type.

Matching maturities to cash flow requirements is an important part of portfolio management and the Finance Manager must be able to obtain funds when required. Working capital investments would typically be placed on deposit from call to 90 days. In managing the portfolio the Finance Manager will need to continually monitor changes in market conditions. Timely reaction to changes in the market is an essential part of effective funds management.

Informed Decision Making: Two of the key factors in making sound investment decisions are having adequate information with respect to: the financial market; and the funding requirements and objectives of Council. It is important for staff involved in fund management to continually monitor financial markets. This can be done in a number of ways, including:

- Daily contact with financial institutions;
- Reviewing various publications ranging from the business section in the local paper, a metropolitan paper and the National Business Review, etc.
- Monitoring political statements and events in parliament,
- Reviewing Council reports and daily contact with senior staff
- Maintaining a close working relationship with Council's financial advisors.

2.3 Accountability Reporting (This section is restated from the Treasury Management Policy)

To ensure that the Treasury Management Policy is being adhered to, the Group Manager Business Support must keep abreast of significant changes in the market which could lead to an alteration in policy, strategy or the nature of investments or liabilities held. The Group Manager Business Support is responsible to Council to ensure the policies are adhered to and should report to either Council or the Chairman of the responsible Standing Committee on a regular basis providing relevant details of the portfolio excluding property.

For financial market investments, the Finance Manager will submit a monthly summary report (as contained in Council's financial variance report) to Council or the responsible Standing Committee outlining:

- term of investments
- interest rates
- movements in portfolio
- any other appropriate measures contained in this policy.

For property investments, the Property Manager and District Forester will submit an annual property investment report to either Council or the responsible Standing Committee detailing:

- investments held (Commercial and Non-commercial)
- the rate of return received by investments (Commercial and Non-commercial)
- confirming adequate insurances are held where appropriate
- movements in portfolio
- maintenance of assets has been carried out as per the relevant asset plan
- revaluations have been carried out where applicable.

For the debt portfolio, the Finance Manager shall present a monthly report to Council or the responsible Standing Committee which contains the following:

- Total debt facility utilisation, including any debt sourced from a bank, the capital markets and the LGFA
- Interest rate maturity profile against percentage hedging limits
- New hedging transactions completed – interest rate risk management
- Weighted average cost of funds
- Funding profile against the policy limits
- Liquidity profile against the policy limits
- Exception reporting as required
- Summary of any unresolved exception reports
- Statement of policy compliance

Appendix A

Authorised interest rate risk management instruments

1. Forward rate agreement

An agreement between Council and a counterparty (usually a bank) protecting Council against a future adverse interest rate movement. Council and the counterparty agree to a notional future principal amount, the future interest rate, the date and the benchmark rate, which is listed on BKBM contained in the Reuters system.

Objective

To provide Council with certainty as to its interest rate cost on an agreed principal amount for an agreed period. A forward rate agreement (FRA) typically applies to a 3 month period, starting at some point within the next 12 months.

2. Interest rate swap

An interest rate swap is an agreement between the Council and a counterparty (usually a bank) protecting Council against a future interest rate movement. Council pays a fixed interest rate and receives a floating interest rate. The parties agree to a notional principal amount, the future interest rate, the settlement dates and the benchmark floating rate, which is listed on BKBM contained on the Reuters system.

Objective

To provide Council with certainty as to its interest rate cost on an agreed principal for an agreed period. Floating rate sets are typically every 1 or 3 months over the life of the swap.

3. Forward start interest rate swap

Objective

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

4. Options on a swap – "swaption"

Objective

To provide Council 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 swaption is an option on a swap and typically requires a premium to be paid.

5. 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. Council and the counterparty agree to a notional future principal amount, the future interest rate, the benchmark dates and the benchmark floating rate which is listed on BKBM contained on the Reuters system.

Objective

To provide Council 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 at each 1 or 3 month date for the life of the option. A premium is payable for entering into an interest rate option.

6. Interest rate collar

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

Objective

To provide Council with certainty to its interest rate cost on an agreed principal amount for an agreed period, but at the same time to avoid the need to pay an upfront premium.

Appendix B

Financial market investment instruments

1. Introduction

This section provides a brief introduction to a number of financial market instruments. It covers such aspects as the security, liquidity, pricing, payment and delivery of these instruments.

Instrument characteristics

1.1. Expected return

Government stock is a risk free investment and as such regarded as the benchmark from which the pricing of other investments is determined. For an investment with a higher risk than government stock to be acceptable the return must be proportionately higher.

Although greater returns may be achieved by investing in higher yielding stocks, e.g. in company debentures rather than government stock, the Finance Manager must be satisfied the higher yield represents the extra margin generally required to compensate the investor for increased risk.

1.2. Duration

The duration of investments can vary from a one day term, such as call deposits, to a long term (e.g. 10 years). Ideally, the duration of the investment selected should be determined with reference to the planned expenditure of Council, i.e. investment maturities should closely match expected cash outflows. Duration is not a major concern if the investment is particularly liquid.

If we assume a case where a cash outflow will occur in one year from date of deposit and investment opportunities are considered to be significantly better for a two year term then the decision may be to:

i) Invest for one year to match cash outflow, or

ii) Invest for at least 2 years, optimising return on investment, while ensuring the investment has liquidity characteristics which will allow its sale when required.

Note that a risk of adverse interest rate movements exists and must be recognised by the Finance Manager in the context of the overall management of the portfolio.

1.3. Liquidity

Liquidity is provided where there are sufficient buyers for an investment instrument whenever there are sellers. Lack of liquidity may force the seller to discount the price below its current market value. The liquidity of an instrument is affected by characteristics such as the creditworthiness of the issuer and the volume of supply.

If Council has sufficient funds to allow a portion of the investment to be unavailable until maturity, then investments with low liquidity characteristics coupled with low default risk often represent an excellent opportunity to maximise return on investment.

Effective funds management will result in a need to liquidate investments only in unpredictable circumstances. As liquidity is important to interest rate risk management it should be considered before expected return in investment decisions.

Types of financial market investment instruments

Treasury Bills ("T. bills")

T. bills have, until recently, been used by the RBNZ to manage primary liquidity in this country. They were issued for the government, when required by the RBNZ, to reduce interest rate volatility and assist with the management of markets affected by interest rate movements. The use of T. bills has now ceased and been replaced by Reserve Bank Bills. T. bills are still available in the market place for short term investment with maturities commonly ranging from 21 days to 180 days.

The issue of T. bills is at the discretion/instruction of the Debt Management Office of Treasury. This enables the Government to borrow in the same fashion as a private company on the short-term market.

The issuer and registrar of T. bills is the RBNZ. A T. bill is government guaranteed and as such is risk free. The liquidity is good, although it was marginally reduced when replaced by the R.B. bill as the tool for primary liquidity. However T. bills can be bought and sold through any bank, broker or merchant bank. These characteristics make the T. bill a good investment for Council in terms of minimising risk.

Pricing of a T. bill is by the standard discounting formula. Payment is by direct credit to an account nominated by the seller. As a registered document the T. bill is transferred into the investor's name at the registry (RBNZ) and a 'statement' of the position held is then mailed to the investor. This statement substitutes for the certificates used for the other securities. When a T. bill is sold, the investor must arrange to have a transfer delivered to the registry on the date of settlement, instructing that the T. bill be placed into the buyer's name. Payment would simultaneously be made to the Council by that buyer.

Upon maturity of a T. bill no delivery of title is required unless a 'Certificate of Title' has been issued. The registry (RBNZ) will automatically make a payment to the registered holder of the maturing bill. In the past T. bills have traded at yields below comparable bank bill yields. However, since T. bills ceased to be used as a tool for primary liquidity their yields have risen to levels similar to bank bills.

NZ Government inflation indexed bonds

These bonds are particularly appropriate to preserve the value of capital over the long term. They are issued vary rarely and have a duration of about 20 years. Every quarter the principal sum is adjusted for movements in the CPI. Generally the index adjustments are lagged. The index adjustment will be the average percentage change of two quarters ending in the quarter two periods prior to that in which the interest payment and principal adjustment date occurs, e.g. a

February 2015 principal adjustment is based on the average movement in the CPI over the two quarters ending September 2014. These bonds are tradable, allowing the investor access to their funds before maturity.

Bank bills

Bank bills may be purchased at a fixed interest rate for a given term, generally ranging between 21 days and 95 days, however, terms are negotiated up to 180 days. Bank bills can be issued by any bank registered with the Reserve Bank of New Zealand ("RBNZ") when approached by a borrower. There are always two parties involved when Bank Bills are drawn down with both being named on the bill. The secondary market for bank bills is the most liquid market for short term securities in New Zealand.

Any bank, broker or merchant bank can act as the buying or selling agent for a bank bill, however, professional investors discriminate between the bills issued by the original four trading banks, and those issued by any other registered bank. Bills issued by ANZ, BNZ, Westpac and the National Bank are more liquid than those from the other registered banks. Security is provided by the issuing bank which accepts and endorses the bills. The drawer is the institution or client wishing to borrow funds from the bank. The acceptor of the bill is the issuing bank.

A bank bill is sold at a discount with the face value payable by the borrower at maturity. All money market investments are priced by determining the present value of the cash flows which are being purchased by the investor.

The face value of the bill is discounted at the market interest rate for the term remaining until maturity of the bill, i.e:

- $1,000,000 discounted at 13.75% for 90 days = $967,207.68, OR
- $967,207.68 invested at 13.75% for 90 days = $1,000,000

Delivery is usually arranged by one of two methods:

- physical delivery to the purchaser
- retention of the instrument in safe custody on behalf of the purchaser at the bank where the purchase was made.

A bank bill is a bearer document. Confirmation is by contract note detailing all conditions and terms of the bill. Physical delivery places a security risk on the investor's ability to safely retain such documents in-house but is generally not required where the bank holding the bill is the issuer. Where an agent, other than the acceptor, is holding the instrument on behalf of the investor, the investor is exposed to the risk that no such instrument is being held. Thus the purchaser must be absolutely satisfied with the integrity of the agent or, alternatively, take delivery of the instrument and ensure it is held in safe custody. Recent corporate failure has heightened the awareness of the necessity to obtain and have control over all documents.

Payment is usually made by direct credit to the seller's nominated bank account prior to 4.30 p.m. on the date of settlement. In the case where the bank from which the bank bill is purchased holds

the Council’s current account, the bank may offer to debit the Council's account for payment. Alternative arrangements can be made for payment if negotiated with the selling party at the time of the transaction.

Maturing bills are repayable on the maturity date specified on the bill. Repayment is credited to a nominated bank account. This will be done automatically by the party holding the bill. However, if the bill is being held in the Council's office it must be delivered to the issuing bank for repayment.

Registered certificate of deposit ("RCD")

RCD's are issued in a similar way to bank bills, enabling the investor to accept a fixed interest rate for a term ranging from 21 to 95 days. They are issued by a bank to raise funds in its own name and bear no reference to any borrower/drawer. Security is offered by the issuing bank which endorses the RCD. An active secondary market exists as the issuing bank will often repurchase its own RCD's ensuring that there is adequate liquidity.

Internal investing

Council may also use the investment funds to finance internal borrowings. The interest and principal would be charged to the Council activity undertaking the borrowing. Matters to be considered are:

- Market loan rates v investment pool rates
- Liquidity of investment pool, i.e. are funds available to use to finance borrowings
- The desired maturity profile for the debt and the investment
- Minimum levels of investment funds required to be held

The aim of internal investing is to provide a win-win situation for the investment pool and the borrowing activity. Internal investment must leave the investment pool in no worse a position then if external investments had taken place. As these investments are repaid via rates, they are considered a low risk investment

Deposits

Deposits are the simplest form of short term money market investment.

To achieve a competitive rate of return interest rate quotes can be obtained by telephone. The investor will then accept the best offer taking account of the rate and the security of the offering institution. The selected institution is then notified and the monies banked to its account. A certificate or note of acceptance is provided confirming the transaction following settlement.

Generally specific security is not offered however, if a specified security is offered this usually becomes the sole security for the investment. In such a case the security instrument should be delivered to the investor. An example would be where an ANZ bank bill is offered as security for a deposit to an organisation which did not itself have a satisfactory credit rating. The credit risk then becomes that of the ANZ bank, not the borrowing organisation as in the event of default by the borrower the bill would be sold to realise the investment funds.

Interest is payable on the amount deposited and a deposit may either be repaid or renegotiated in part or in full upon the maturity date agreed to at inception. If a deposit has been secured, by delivery of some form of security that security must be returned to the party from whom repayment is sought. Repayment will, in most cases, be made to a bank account nominated by Council.

Stocks/Bonds ("Stocks")

In New Zealand, the terms stocks and bonds are used interchangeably. For the purpose of simplicity in this report we have used the more common term 'stocks'. Stocks are issued by a wide variety of organisations, including the government, to raise long term debt at a fixed interest rate.

Typically the shortest term offered is 2 years and, while commonly the longest term is not more than 10 - 12 years, it can be as long as the issuer requires. Generally stocks are registered investments and knowledge of the registry system will enable swift and efficient transfer of ownership. Bearer stocks are rare.

Commercial Paper

Commercial Paper is a short term bearer security issued at a discount by a borrower who promises to repay the face value of the note to the bearer when the note reaches maturity. Because the only name appearing on CP belongs to the issuer, these securities are sometimes referred to as “one name Paper”.

The pricing and marketability of CP is primarily determined by the credit worthiness of the issuer, since it is the issuer who promises to directly repay the bearer of the CP upon maturity. CP is usually issued via an open market tender or dealer system where appointed dealers bid competitively for the CP. An issuer will usually advise the market of its intention to tender CP on a “same day” basis i.e. the market is usually given a few hours’ notice. A fixed amount is normally offered for tender, with successful bidders being allocated the notes according to the lowest yields bid.

CP may be issued with a term to maturity ranging from 7 to 365 days though maturities of more than one year can and have been arranged the majority of the CP issued in the New Zealand market are for terms of 30 60 or 90 days. Similar to bank bills, the market price is determined as a discount on the face value of the note using the following formula:

Market price = $FV/(1+(Y/100)*(n/365)$

Where: FV = face value

Y = yield to maturity

n = number of days to maturity

Investors price P. Notes at a margin over bank bills for a similar maturity. The basis point margin over bank bill bid rate (BBBR) will reflect an investor's assessment of the credit risk of the particular issuer and the paper's marketability or liquidity.

Debentures

Debentures are a form of debt security issued by organisations pursuant to a trust deed. Until 1986 debenture issues were quite common in both the wholesale and retail markets. Debentures are now common only in the retail investor market.

Liquidity is low for debentures. Corporate borrowers have moved from issuing debentures, as was common in the early 1980's, to the use of P. notes or stock issues. This has reduced the volume of debentures available for financial market trading and thus their liquidity. A lack of homogeneity in maturity and interest payment dates also restricts the liquidity of the debenture market.

Security on debentures must be assessed carefully as consideration must be given to the security of the issuing organisation and to the ranking of the debenture. In a very similar fashion to the way mortgages may be registered as first or second, debentures may be first ranking or second ranking.

Debentures are priced on a yield to maturity in a similar fashion to other debt securities, such as stocks and money market investments.

Interest payment dates also vary more on debentures than on the instruments previously described. Several companies chose to debentures with semi-annual interest payments however, others issuing them with quarterly interest payments and in some cases compounding interest facilities.

Registration of debentures is often kept by the issuing company; however, it is not uncommon for a registry service to be employed. Certificates are issued to the investors and must be stored securely as return of this document is required before repayment will be made on maturity. If the certificate is lost a legal indemnity must be signed acknowledging responsibility for the loss before another will be issued.

Mortgages - Council as Mortgagor

Commercial or residential mortgages may be issued at the request of the Council. While it is not advisable for the Council to invest in mortgage secured loans as a commercial investment, there may be times when social objectives will override commercial objectives. If such a mortgage investment is made the funds offered should not exceed 65% of an independent registered valuation obtained by Council. The mortgage security should in every case be a first mortgage security. Due consideration must be given to the borrower's ability to repay over the term of the loan. In making this assessment Council may require independent professional advice. Repayments of capital and interest should, in all cases, be made by regular automatic payments to Council's account on predetermined dates.

Equities/Registered Mortgages

Investment in equities (shares) and registered mortgages may be made by Council and would need direct Council approval. Should Council wish to invest directly in equities/registered mortgages it should take professional advice.