Waimate 2020

Waimate District Council
Financial Policy 402

Liability Management Policy

Version 2.2
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Financial Policy 402 - Liability Management Policy

1. PURPOSE

To guide Council in the making of borrowing decisions.

2. SCOPE

This policy covers all borrowings by Council, except where for hire purchase, credit, or the period of indebtedness in less than 91 days, 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, being $6,000,000.

3. RESPONSIBILITY

This policy will apply to:

Corporate Services Manager

- in preparing reports to recommend borrowings for Council, the monitoring of borrowing arrangements, and monthly reporting on borrowing.

Financial Accountant

- in monitoring needs month to month and ensuring alignment with cashflow projections.

Council

- in approving recommendations with regard to borrowing.

4. GLOSSARY OF TERMS

BKBM

The Forward Rate Agreement (FRA) settlement rate as determined at 10.45 am each business day on Reuters page BKBM.

Bond Options

Council when purchasing a bond option, has the right but not the obligation to buy or sell a specified Government stock maturity on an agreed date and time, and at an agreed rate.

Forward Exchange Contract

Council when entering into a Forward Exchange Contract agrees a rate today at which one currency is sold or bought against another for delivery on a specified future date.

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 benchmark dates and the benchmark rate (usually BKBM).

Interest Rate Collar Strategy

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

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 rate (usually BKBM).

Interest Rate Swap

An Interest Rate Swap is an agreement between Council and a counterparty (usually a bank) whereby Council pays (or receives) a fixed interest rate and receives (or pays) a floating interest rate. The parties to the contract agree notional principal, start date of the contract, duration of the contract, fixed interest rate and the benchmark rates (usually BKBM).

Liquidity Ratio

This ratio measures the ability of Council to generate cash from assets in order to meet its obligations. Council's liquidity or acid test ratio consists of the sum of cash, marketable securities, short term notes and receivables, supplemented by any unused bank overdraft facility that Council may have with its principle bankers, that is able to be called upon instantly, divided by current liabilities.

Swaption

The purchase of a swaption gives Council the right but not the obligation to enter into an interest rate swap, at a future date, at a specific interest rate.

5. DESCRIPTION/METHOD

5.1. General Matters

Council will from time to time, exercise its flexible and diversified borrowing powers within the terms of this policy, as provided for by the Local Government Act 2002.

Council will observe the Principles of Good Financial Management as set out in the Local Government Act 2002 (Part 6, Subpart 3) in any borrowing decisions.

Council raises borrowing for the following primary purposes:

- General debt to fund Council's balance sheet, and from time to time liquidity requirements.
- To fund assets with intergenerational qualities.
- To fund economic development initiatives where Council reserve credits are adequate to support the initiative, but the required sums not available in the form of cash.

Council may borrow through a variety of market mechanisms, considered to be approved borrowing instruments. These primarily comprise:

Bank Overdraft

from Council's principal banker.

Term Loans

Corporate Services Manager must undertake a tender process with not less than three banking institutions before the raising of any significant new facility.

Stock/Debentures

Corporate Services Manager must undertake a cost/benefit analysis in regard to the fixed cost of the production of a Trust Deed, expected to be not less than $10,000, as compared to any potential saving in interest cost by the use of this method.

Internal Loans

to Council activities from Treasury. From time to time internal borrowing is provided through activity surpluses. Interest is charged at market rates and paid on a quarterly basis.

Further detail of requirements in relation to these approved borrowing instruments may be found in Appendix 1.

In evaluating any new or renewal borrowings (in relation to source, term, size and pricing) the Corporate Services Manager takes into account the following:

- The size and the economic life of the project.
- The impact of the new debt on the borrowing limits.
- Relevant margins under each borrowing source.
- Council's overall debt maturity profile, to ensure concentration of debt is avoided at reissue/rollover time.
- Prevailing interest rates relative to term for both stock issuance and bank borrowing and management's view of future interest rate movements.
- Available term from bank and stock issuance.

- Legal documentation and financial covenants.

5.2. Foreign Exchange

Council has foreign exchange exposure through the occasional purchase of foreign exchange denominated plant, equipment and services.

Where possible, all supplier invoices are raised in New Zealand Dollars. Where this is not possible, all significant commitments for foreign exchange are hedged using foreign exchange contracts, once expenditure is approved. Smaller payments are converted at the spot exchange rate on the date of payment. Both spot and forward foreign exchange contracts are used by Council.

Council does not borrow or enter into incidental arrangements within or outside New Zealand in currency other than NZ currency.

5.3. Interest Rate Exposure/Risk Management

(as approved by Strategies and Policies Committee, 4 June 2002)

Interest Rate Risk Management (for Borrowings)

Council's borrowing gives rise to direct exposure to interest rate movements. Generally, given the long term nature of Council's assets, projects and intergenerational factors, and Council's preference to avoid an adverse impact on rates, there is a general tendency to have a high percentage of long term fixed rate, or hedged borrowing.

The following table provides guidelines for achieving a floating rate mix, together with the appropriate discretionary authority:

Term of Exposure	Maximum Floating Rate Exposure	Revised Floating Rate Exposure allowable upon written advice from Council's Treasury borrowing advisor (at Council's loan providing Bank)
0-1 year	55%	75%
1-3 years	10%	30%
3-5 years	N.A	20%
5-7 years	N.A.	10%
7 years +	N.A.	N.A.

NOTE:-

Percentages in excess of Treasury borrowing advisor authority require approval of Council. The table includes debt maturing in the current year, i.e. debt maturing in the current year is considered floating rate debt.

The Treasury borrowing advisor sets interest rate risk management strategy by monitoring the interest rate markets on a regular basis and after taking appropriate advice, evaluating the outlook for short term rates in comparison to the rates payable on its fixed rate borrowing.

Management implements interest rate risk management strategy through the use of the following:

- Adjusting the average maturity of its borrowings, thereby managing interest rate risk within the confines of liquidity management.
- Interest rate risk management products (refer note below) to convert fixed rate borrowing into floating rate, floating rate borrowing into fixed or hedged borrowing, and to manage maturity mismatches between its borrowings and investments.
- The following interest rate risk management instruments (refer Section 4 for definitions) may be used for interest rate risk management activity, after seeking formal prior approval of Treasury borrowing advisor:

- Forward rate agreements
- Interest rate swaps
- Purchase of interest rate options products including caps, bond options and swaptions
- Interest rate collar type option strategies

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

5.4. Liquidity

Council's ability to readily attract cost effective borrowing is largely driven by its ability to maintain a strong balance sheet as well as its ability to rate, manage its image in the market, and its relationship with its banker.

To ensure funds are available on repayment of debt, reserves are maintained in liquid assets *and importantly, funds are available through committed bank facilities. Futhermore, Council maintains a line of available credit in the form of a bank overdraft with its principle bankers of $500,000.*

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 Council's control, Council ensures debt is spread over a band of maturities and ensures that:

No more than 33% of total borrowing is subject to refinancing in the next financial year. *Council may take advantage of committed bank facilities with guaranteed rollover facilities to achieve this.* Total borrowing includes existing and forecast borrowing.

5.4.1 Liquidity Profile Throughout Council's Typical Year

Significant Monthly Outgoings.

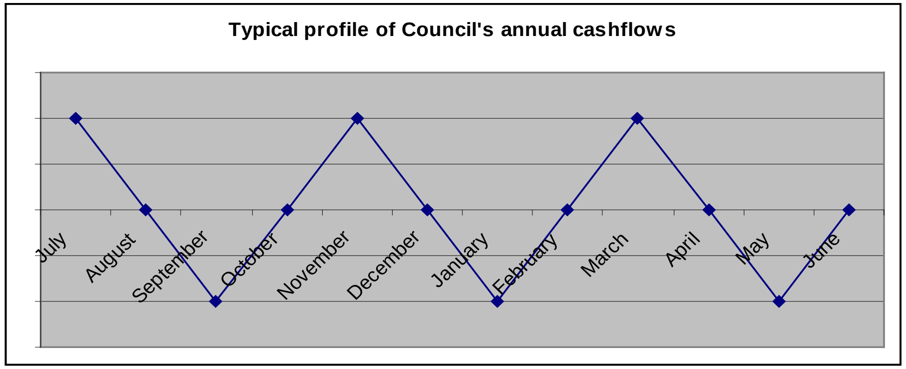
The most significant monthly outgoing for Council is accounts payable, in the form of sundry creditors. These are typically incurred at a relatively uniform rate for each month of the financial year with the exception that due to operational requirements for road construction and maintenance significant roading expenditures may be incurred in Council's last quarter (April/May/June).

Significant Monthly Incomings

Council's most significant income type is rates. Council rates are due to be paid in four instalments throughout the financial year as follows:

For Period	Due
July/August/September	Third Friday in August
October/November/December	Third Friday in November
January/February/March	Third Friday in February
April/May/June	Third Friday in May

Note also that Council in line with good Financial Management, promotes prompt payment and advance payments of its rating charges and typically achieves a very high proportion of rates instalment paid by month end in August, November, February and May.



Because of the patterns of cashflow incomings and outgoings above, Council typically operates with adequate liquidity from rates cashflow, to meet sundry creditors in the months of August, November, February and May. Any cashflow surplus to expenditure requirements in those months is deposited to a call account with Council's principle bankers, in order to maximise interest earned. In months where rates incoming cashflow is not sufficient to meet expenditure requirements, funding is drawn firstly from Council's interest bearing call account, and secondly, Council may draw on it's bank overdraft facility.

Impact on Liquidity ratio requirement

For these reasons, the traditional measure of balance sheet solvency of current liabilities being matched by current assets on a 1:1 basis at all times, is not appropriate or necessary in order for Council to meet it's obligations to pay sundry creditors.

For the purposes of liquidity management, Council uses its line of credit in the form of unused bank overdraft with it's principal bankers, to meet financial outgoings.

5.5. Credit Exposure

The council may be exposed to credit risk in circumstances where a deterioration occurs, of the credit rating of an entity with whom the council has placed investments or has concluded financial derivate contracts or has concluded a major supply, construction or service contract.

In order to safeguard the council against such risk the following guidelines have been adopted:

- Investments are only placed with parties that meet certain minimum credit ratings and only up to certain limits.
- Financial derivative contracts are only to be concluded with registered banks with certain minimum credit ratings.
- All parties with whom the council intends to conclude major contracts will be subject to formal credit approval.
- Tenders for contracts will note that unacceptable credit reviews of a tenderer will be grounds for discretionary rejection of a tender.

5.6. Debt Repayment

Term of debt repayment should be aligned with expected life of the intergenerational asset funded or the expected period of Council involvement in an economic development initiative. NOTE that the funding will be so aligned but external borrowings may be repaid on a shorter term to minimise interest costs to the Council.

Council repays borrowings from either asset sale proceeds or from general reserves, including accumulated depreciation reserves.

5.7. Specific Borrowing Limits

In order to protect Council from a heavily debt weighted balance sheet, the following borrowing limits will be observed:

Limit will be the lowest after considering each of the following:-

- The gross annual interest expense of all borrowings will not exceed 20% of total annual rates income. Rates income 2001 annual accounts : $3,986,000 limit = $796,800, (i.e. $6M @ 10% could be borrowed resulting in an interest expense of $600,000).

  OR

- Net cash inflow from operating activities exceed gross annual interest expense by two times. Net cash inflow 2001 annual accounts = $1,402,000, ∴ Interest expense limit would have been $701,000.

  OR

- Debt to total income ratio of not more than five times. 2001 Annual income = $6,916,000.

5.8. The Giving of Securities and Guarantees

5.8.1. Security

Council offers deemed special rates as security for its borrowing programmes. From time to time, with prior Council approval, security may be offered by providing a charge over one or more of Council's assets, or a charge over rates.

5.8.2. Guarantees

Council provides a financial guarantee from time to time to community organisations. Council approves all guarantees and prior to approval reviews the organisation's latest financial reports.

Financial statements are received annually. Should the guarantee be called upon, Council will take immediate steps to recover the money.

Council may act as guarantor to bank loans for an incorporated organisation which provides, improves, or develops amenities for recreation, amusement or the instruction of the public.

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

- A six monthly unaudited financial report within three months of the first six months of the financial year, and
- An annual audited financial report within four months of the balance date, and
- that the bank lending the money to the qualifying organisation, be required to provide Council with a financial statement each year that shows the principal outstanding at the end of each period, and payment made during the year.

The guaranteed loan shall be for a maximum of three years, with a right of renewal.

6. APPENDIX 1

6.1. Approved Borrowing Instruments

6.1.1. Bank Sourced Borrowing

Bank overdraft facilities are seen as the most flexible facility for day-to-day short term borrowings, but inevitably at a higher interest cost than longer term facilities, so primarily to be used where the term of borrowing is expected to be less than three months.

6.1.2. Revolving Credit Facilities (Variable Amount Term Loans)

Revolving credit facilities are similar from a borrower's perspective, except interest is paid in arrears rather than upfront as in the case of bank bills. Revolving credit facilities are usually for a term of up to three years but may be for as long as five years and like bank bills drawings under the facility are priced off the bank bill buy rate. Most facilities allow for the borrowers to draw up to the facility amount in various tranches of debt and for various terms out to a maximum term of the maturity date of the facility. Like bank bills most borrowers use these facilities to borrow on a 90 day basis.

Within Council's variable amount term loan limit, borrowing amounts may be separately identified and "ring fenced" to a known term and known interest rate cap, in order to align with the term and known interest income of a Council long term project by the use of a hedging instrument.

Costs

The principal costs are the same as with bank bills, the lending bank's yield sets the base rate at the time of lending, an arrangement fee, an acceptance fee and a line fee (expressed in basis points or percentage per annum) and the margin. Acceptance fees, arranger fees, line fees and margins in aggregate normally range between 35-300 basis points (i.e. 0.35% - 3.00%), depending on the credit worthiness of the borrower.

6.1.3. Short Term Money Market Lines

Short term money market loans or cash loans can be Committed or Uncommitted. A customer pays for a guarantee of the availability of the funds in a Committed Loan. In an Uncommitted Loan, funds are provided on a best endeavours basis and no line/commitment fee is payable. In addition to a line fee, a margin may be charged on any line usage.

The minimum amount for a cash loan is $1,000,000. Smaller loans can be arranged, although the interest rate quoted will be a reflection of the size of the loan.

The main usage of cash loans is to cover day-to-day shortfalls in funds. The interest rate is governed by the term of the borrowing and the implied or implicit credit rating of the borrower. Cash loans are short term only and are normally drawn for a term of one (overnight) to seven days. Interest collection can be daily.

6.1.4. Bank Bill facilities

Council has a committed bank overdraft. Overdraft facilities are utilised as little as practical, i.e call funds are utilised to meet day-to-day expenses where possible.

An unconditional order in writing, addressed by one person to another signed by the person giving it, requiring the person to whom it is addressed to pay on demand, or at fixed or determinable future time, a sum certain in money to, or to the order of a specified person, or to bearer.

Bank bill facilities are normally for a term of up to three years but may be for as long as five years. Bank bills are bills of exchange, drawn or issued usually by the original borrower and accepted or endorsed by a bank.

For a Bank Accepted Bill, the bank makes the payment of the face value of the bill on maturity. Most bank bills traded in the New Zealand market are Bank Accepted Bills.

Bank Endorsed Bills have been endorsed by a bank with another part as acceptor. In the event of default of the original acceptor, payment can be sought through the chain of endorsers to the bill.

An investor in bank bills can sell the bills prior to maturity date and receive the cash. Bank bills are a longer term borrowing instrument than cash loans. Bills are normally drawn for terms of 30, 60 or 90 days with a few being drawn for 180 days. The 90 day bank bill is the underlying traded benchmark instrument for the short end of the market.

Costs

The principal costs to the borrower are the discounting bank's yield at which it discounts the bill at the time of drawdown, an arrangement fee, an acceptance fee and a line fee (expressed in basis points or percentage per annum) and margin. Acceptance fees, arranger fees, line fees and margins in aggregate normally range between 35 – 300 basis points (i.e. 0.35% - 3.00%), depending on the credit worthiness of the borrower.

6.2. Local Authority Bonds

Local Authority Bonds are issued by a variety of local governments by tender or private placement. The Bonds are registered securities. They are repayable on a fixed date, and are generally issued for terms ranging from one to fifteen years.

Local Authority Bonds are quoted on a semi annual yield basis and priced on a discounted cashflow basis. A fixed coupon payment is made semi annually to the holder of the security.

6.3. Structured and Project Finance

Project and structured financing matches up debt to suit the quantifiable income stream from the project. This type of financing is appropriate for the funding of standalone assets which are able to be ring-fenced and over which security can be taken. The sort of assets to which this usually applies are assets which are transferable, and for which an international equity market exists, e.g. infrastructural assets. The owner of the asset usually retains an equity interest in the asset.

7. PUBLICATION DETAILS

All inquiries or suggestions regarding this Document should be referred to:-	Policy Analyst
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