

Waimate
District Council



[Publish Date]

Proposed Liability Management Policy 402

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PROPOSED

1.0 Purpose

- 1.1 This Liability Management Policy (“LMP”) outlines the objectives and approach that Waimate District Council (“the Council”) shall adopt to manage its treasury exposures

2.0 Scope

- 2.1 The policy is developed pursuant to the Local Government Act 2002 (“LGA”). For all borrowing activities it seeks compliance with Section 102 and Section 104 of the LGA. It discloses the Council’s principles of prudent financial management and risk mitigation strategies as they relate to the management of external debt.
- 2.2 For all financial market investing activities the policy seeks compliance with Section 102 and Section 105 of the LGA. It discloses the Council’s principles of prudent financial management and risk mitigation strategies as they relate to financial market investments.
- 2.3 The purpose of the policy is to establish a framework and guidelines within which the Council manages its treasury risks. While the Council does not seek to speculatively profit from its treasury activities, it recognises that active and prudent management of its treasury risks, within defined management parameters, will assist the council in achieving its overall commercial objectives.
- 2.4 It is recognised that the policy is an evolving document which can be amended and expanded to take account of changes in the Council’s operational activities and operating structure. The policy must be regularly monitored for compliance and appropriateness and, where necessary, the document updated with any changes to be approved by the full Council. Notwithstanding this, a formal review of the policy must be completed at least every three years, or more frequently if required.
- 2.5 It is also recognised the Council does not have a dedicated treasury function and the Corporate Services Group Manager (“CSGM”) will effectively be responsible for treasury risk management as well as other duties. Hence it is essential that the policy reflects this structure and the other internal resources available to assist in this area.

TREASURY OBJECTIVES

- 2.6 The objectives of the treasury function should be consistent with the Council’s overall commercial objectives, in particular recognising that the Council is a risk averse organisation which does not seek to profit from any speculative treasury activity. The primary objectives of the treasury function are to:
- a. Minimise the cost of the Council’s borrowing through monitoring and implementation of the most cost effective financing techniques giving consideration to balance sheet and other strategic limitations.
 - b. Mitigate the impact of interest rate volatility.

- c. Ensure the Council's continued ability to meet its financial obligations in an orderly manner, as and when they fall, due in both the short and long term, through active liquidity and funding risk management.
- d. Maintain dialogue and information flows to the Council's funding providers to enhance the commercial relationship between the parties.
- e. Ensure compliance with the Council's financing and borrowing covenants and ratios specified in this document.
- f. Safeguard the Council's financial market assets by establishing and regularly reviewing financial market investment parameters and treasury credit limits and then managing financial market exposures within these limits.
- g. Evaluate on an ongoing basis, the appropriateness of the current risk management processes.
- h. Maintain adequate internal controls to minimise operational risk while recognising the limited number of personnel who participate in the Council's treasury activities.
- i. Control cash in an effective and efficient manner.
- j. Produce accurate and timely information that can be relied on by the elected members and management of the Council that ensures policy compliance and maintains appropriate exposure monitoring procedures.

3.0 Responsibility – Organisational and Responsibility Structure

- 3.1 An effective policy requires a clear understanding and definition of the structure of the treasury function and the responsibilities of all personnel involved in treasury management.
- 3.2 The following personnel are primarily responsible for the management of the treasury activities of the Council:
 - a. Full Council (of elected members).
 - b. Chief Executive ("CE").
 - c. Corporate Services Group Manager ("CSGM").
 - d. Accountant
- 3.3 In addition to the above, the Council may retain on an ongoing or consultancy basis the services of an Independent Treasury Advisor.
- 3.4 The respective responsibilities of those personnel involved in the treasury function are detailed below.

Full Council

- a. Approves the policy document.
- b. Approves any risk management strategies outside the delegated authorities outlined in this policy document.
- c. Approves any amendments to the policy as recommended by the CE.

- d. Approves new borrowing facilities from the banking sector and capital markets upon the recommendation of the CE.
- e. Monitors and reviews the ongoing treasury risk management performance of the Council to ensure that the treasury function is operating in such a way as to ensure that the Council's strategic objectives are being met.

Chief Executive

- a. Approves all debt related interest rate risk management strategies submitted by the CSGM.
- b. Determines in consultation with the CSGM the level of future core debt to be used for interest rate risk management purposes.
- c. Submits to the full council new or amended borrowing facilities which have been negotiated by the CSGM.
- d. Approves any amendments to the Treasury Policy recommended by the CSGM, prior to submission to the full council for approval.
- e. Checks external counterparty advices on treasury transactions to records generated internally by other staff.
- f. In the absence of the CSGM undertakes the following treasury transactions or delegates to the Accountant where permissible under his/her permissions.
 - Funding from bank facilities and the capital markets including the Local Government Funding Agency ("LGFA").
 - Interest rate derivative transactions relating to the hedging of the Council's debt.
 - Placing of deposits in the short term money market or fixed interest market.
 - Investing in bonds in the fixed interest market.

Corporate Services Group Manager

- a. Organises all new or amended borrowing facilities which shall then be submitted to the CE for approval and then to the full Council for final approval.
- b. Reviews the Treasury Policy every three years or more regularly if required which shall then be submitted to the CE for approval and then to the full Council for final approval.
- c. Develops all interest rate risk management strategies for approval by the CE.
- d. Determines in conjunction with the CE the level of future core debt is to be used for interest rate risk management purposes.
- e. Reports to the full Council and CE on overall treasury risk management issues on a regular basis.
- f. Manages the funding and liquidity activities of the Council.
- g. Maintains lender relationships with the banks and the capital markets including the LGFA.

- h. Undertakes all treasury transactions which will include but not be limited to the following:
 - Funding from bank facilities and the capital markets including the LGFA.
 - Interest rate derivative transactions relating to the hedging of the Council's debt.
 - Placing of deposits in the short term money market.
 - Investing in bonds in the fixed interest market.
- i. Monitors and reviews the ongoing treasury risk management performance of the Council to ensure compliance with the policy parameters.
- j. Prepares quarterly treasury reports.
- k. Checks external counterparty advices on treasury transactions to records generated internally by other staff.

Accountant

- a. Undertakes short term borrowing transactions with the bank or from the LGFA for terms not exceeding 90 days.
- b. Invests surplus cash for terms not exceeding 90 days.
- c. Checks external counterparty advices on treasury transactions to records generated internally by other staff.
- d. Assists the CSGM with the preparation of treasury reports.

4.0 Interest Rate Risk and Borrowing Policy

INTEREST RATE RISK MANAGEMENT

- 4.1 Interest rate risk management has the objective of containing the Council's interest rate exposures in order to:
 - a. Give a sufficient level of certainty to the Council's funding costs while, at the same time, allowing the Council to participate if interest rates and credit spreads move favourably.
 - b. Control variations in interest expense for the debt portfolio from year to year, taking into consideration any relevant budgetary assumptions.
 - c. Recognise the Council's exposure to the local and international economies and maintain sufficient flexibility in its interest rate risk management profile to enable the Council to respond when considered appropriate.
- 4.2 For the purposes of interest rate hedging, core debt projections should be supported by budgetary analysis contained in the Annual Plan and the Long Term Plan. Core debt is defined as the level of current and projected future debt as determined by the CSGM in consultation with the CE.
- 4.3 The Council will maintain fixed interest rate cover of its core debt within the control limits detailed in the table below. Fixed rate debt is defined as all debt that has at

least one more rate reset outstanding (typically quarterly), or has more than three months to maturity in the case of a fixed rate term loan. Compliance with these parameters is not necessary if debt is less than \$3.0 million.

| Fixed Rate Cover Percentages | | |
|-------------------------------------|----------------|----------------|
| Period | Minimum | Maximum |
| 0 to 2 years | 50% | 90% |
| 2 to 4 years | 25% | 75% |
| 4 to 8 years | 0% | 60% |

- 4.4 The CSGM is primarily responsible for the monitoring and managing the interest rate hedging profile of the Council. If the fixed rate cover is below or above the Fixed Rate Cover Percentages, the reasons for the non-compliance with the policy must be documented in an exception report.

APPROVED DERIVATIVE INTEREST RATE RISK MANAGEMENT INSTRUMENTS

- 4.5 The approved derivative interest rate risk management instruments are as follows with definitions and examples of these instruments contained in Appendix 2.
- a. Fixed interest rate swaps, including forward starting swaps.
 - b. Forward Rate Agreements (“FRA”).
 - c. Interest rate options – includes caps, swaptions and collars. For a collar the amount of the sold option must match the amount of the purchased option.
- 4.6 Options on hedging floating rate debt with an exercise rate greater than 2.00% above the equivalent period interest rate at the time of inception cannot be counted as part of the fixed rate cover percentage calculation. For example a two year cap at 5.00% would only count as a fixed rate hedge if the underlying swap rate at the time of inception was greater than 3.00%.
- 4.7 In addition to the above derivative instruments, Fixed Rate Term Loans may also be used to manage the Council’s interest rate risks.

FUNDING RISK MANAGEMENT

- 4.8 Funding risk is defined as an inability to secure access to external lines of credit sufficient to enable the Council to achieve its strategic short term and long term objectives where the financial requirements to achieve those goals exceed the funds being generated from operating activities.
- 4.9 Funding risk covers both working capital requirements and core debt.
- a. The Council must approve all new debt funding facilities and/or revision to the parameters of existing debt funding facilities.
 - b. To ensure that all of the Council’s debt is not exposed to excessive refinancing risk at any one time, 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 \$3.0 million.

- c. The CSGM must renegotiate/replace maturing bank funding facilities on a timely basis. Specifically, the CSGM must obtain an indicative letter of offer no later than two months before the maturity of any bank facility.

LIQUIDITY RISK MANAGEMENT

- 4.10 Liquidity risk management has the objective of ensuring that adequate liquid assets and funding sources are available at all times to meet the short term commitments of the Council as they arise in an orderly manner. Appropriate cash flow reporting mechanisms will be maintained to monitor The Council's estimated liquidity position over the next twelve months.
- 4.11 To manage liquidity risk the Council must maintain committed funding facilities at a minimum of 110% of the projected peak debt level over the ensuing twelve month period.
- 4.12 Liquidity is defined as external debt plus committed loan facilities plus liquid investments divided by external debt

COUNTERPARTY RISK MANAGEMENT FOR BORROWING AND INTEREST RATE RISK MANAGEMENT

- 4.13 The management of counterparty credit risk in relation to the Council borrowing and interest rate risk management activities has the objective of minimising financial loss through the default of a financial counterparty, usually a financial institution, due to the financial insolvency of the counterparty, the inability of the counterparty to perform due to country decree, or any other circumstance such as an adverse market event. The purpose of counterparty credit limits is to limit the loss that the Council may incur if a counterparty was to default or be unable to meet its obligations.
- 4.14 The Council's exposure to counterparty credit risk will be managed by entering into financial market transactions and funding arrangements with only approved counterparties. Approved counterparties are defined as follows:
 - a. An approved counterparty must be a New Zealand Registered Bank or financial institution with a long term credit rating of 'A-' or above by S&P Global Ratings ("S&P"), or the Moody's Investors Service ("Moody's) or Fitch Ratings ("Fitch") equivalents.

LOCAL GOVERNMENT FUNDING AGENCY

- 4.15 The Council may borrow from the New Zealand LGFA and, in connection with that borrowing, may enter into the following related transactions to the extent it considers necessary or desirable:
 - a. Contribute a portion of its borrowing back to the LGFA as an equity contribution to the LGFA.
 - b. Provide guarantees of the indebtedness of the LGFA.
 - c. Commit to contributing additional equity (or subordinated debt) to the LGFA if required.

- d. Subscribe for shares and uncalled capital in the LGFA and.
- e. 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.

BORROWING LIMITS

- 4.16 Council will borrow to fund its total funding needs in accordance with the Annual Plan. Borrowing includes funding of short term working capital and long term capital investment. In general terms, Council approves borrowing through the Annual Planning process with public disclosure by way of resolution.
- 4.17 Ratios based on revenue and debt servicing are used for measuring a prudent borrowing level. The Council borrowing limits are based on the following LGFA ratios:
 - a. Net interest will not exceed 20% of total revenue.
 - b. Net debt will not exceed 175% of total revenue.
 - c. Net interest will not exceed 25% of annual rates.

5.0 Internal Borrowing

OBJECTIVE

- 5.1 Council's primary objective in funding debt internally is to use cash held in capital replacement, depreciation, separate rate, and special and trust funds effectively by establishing an internal loan portfolio that provides funding to internal cost centres. This creates operational efficiencies as savings are created by eliminating the 'bankers margin' that would be owing through Council simultaneously investing and borrowing with the bank.

LEGAL COMPLIANCE

- 5.2 Internal borrowing was authorised by the Local Government (Rating) Act 2002. Council considers that by applying available funds against debt through an internal debt management process is using its funds to most efficient use at low risk.

GENERAL POLICY

- 5.3 The internal loan portfolio is used as an input into determining Council's external debt requirements. Where possible, reserves are used to reduce external debt, effectively reducing Council's net interest cost. Where debt financing is approved by the Annual or Long Term Plan, Council in setting the treasury strategy will determine the effectiveness of using either external or internal debt.

PRINCIPLES

- 5.4 The following principles apply to the management of Council's internal loan portfolio:

- a. The internal loan is recorded on a schedule of internal loans and reported to Council through the Annual Report.
- b. Principal amounts are repaid annually and interest repaid in quarterly instalments.
- c. Loan terms are agreed on establishment of the loan and determined on a table mortgage basis.
- d. Interest is charged to each internal loan and for short-term operational deficits in separate rate accounts.
- e. Interest will be paid to separate rate, depreciation reserves and special and trust funds quarterly, based on the prior 30 June end of year balance.
- f. All rate income collected for the purpose of a loan will be repaid to the loan. Where the actual interest rate varies from the budgeted interest rate, Council first applies the interest charge then holds the balance of the income in reserve.

INTEREST RATES

- 5.5 Interest rates applied to the internal investments and debt are calculated and set annually using the following guidelines:
- a. Council estimates the likely internal borrowing interest rate.
 - b. The interest rate is based on Council's actual weighted average cost of funds and takes into account the following factors:
 - Estimated earnings on cash invested.
 - Estimated cost of external borrowings.

FOREIGN EXCHANGE

- 5.6 From time to time Council has foreign exchange exposure through the occasional purchase of foreign exchange denominated goods and services.
- 5.7 Where possible, all supplier invoices are raised in New Zealand Dollars. Where this is not possible, all significant commitments (above NZD \$100,000) 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.
- 5.8 Council does not borrow or enter into incidental arrangements within or outside New Zealand in currency other than NZ currency.

6.0 Operations and Procedures

INTRODUCTION

- 6.1 Arranging and agreeing transactions with external counterparties must occur within a framework of control and accuracy. It is vital to the internal control of the Council that all transactions are captured, recorded, reconciled and reported in a timely manner within a process that has the 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 due to inadequate transaction recording and reporting systems should not be allowed to occur.

TRANSACTION ORIGINATION

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

Funding from Banks, the LGFA and the Capital Markets and Entering into Financial Market Investment Transactions

- a. Funding from bank facilities, the capital markets and the LGFA or entering into financial market investment transactions with an approved counterparty entails the personnel of the Council, who are authorised to undertake these activities, verbally or by email agreeing with the counterparty the amount, type of debt or investment instrument, term selection and rate accepted.
 - b. Once the deal is agreed details of the transaction shall be entered on the relevant internal system.
 - c. Once the confirmation of the transaction is received the details should then be checked by someone other than the person who entered into the transaction in the first place to ensure that the external confirmation is in accordance with the details on the Council's internal system.
- 6.3 Any discrepancies in the above procedures should be immediately communicated to the counterparty so that the correct details of the deal can be agreed. A report on the error shall be prepared by the person who transacted the deal in the first place and submitted to the CE for sign-off. Where the CE has transacted the deal, the report shall be submitted to the CSGM. In this way there, is a clear division of responsibility and a self-checking system.

Interest Rate Derivative Products

- 6.4 Transacting interest rate derivative products with an approved counterparty entails the personnel of the Council who are authorised to undertake these activities, verbally or by email agreeing with the counterparty the amount, term selection and rate accepted.
- a. Once the deal is agreed details of the transaction shall be entered on the relevant internal system.
 - b. Once the bank confirmation of the transaction is received, the details should be checked by someone other than the person who entered into the transaction in the first place to ensure that the bank confirmation is in accordance with the details on the internal system.

- 6.5 Any discrepancies in the above procedures should be immediately communicated to the counterparty so that the correct details of the deal can be agreed. A report on the error shall be prepared by the person who transacted the deal in the first place and submitted to the CE for sign-off. Where the CE has transacted the deal, the report shall be submitted to the CSGM. In this way there, is a clear division of responsibility and a self-checking system.

SETTLEMENT PROCEDURES

- 6.6 All transactions are to be confirmed and reconciled to external confirmations and internal documentation before settlement.
- 6.7 All transactions processed through the company bank accounts must conform to the Council's internal procedures and controls, and be reconciled to internal documentation and external confirmation(s).

7.0 Cash Management

- 7.1 The CSGM and the Accountant are responsible for day to day cash and short term debt management activities. Specifically this will include the following:
- a. Ensure that appropriate cashflow projections are maintained, with the objective of managing an optimal cash position within approved parameters.
 - b. Undertake short term borrowing functions as required, thus minimising overdraft costs.
 - c. Ensure efficient cash management through improvements to the accuracy of forecasting.
 - d. Minimise fees and bank charges by optimising bank accounts, facility structures and merchant service agreements.
 - e. When operating as a net borrower, surplus funds will normally only be permitted only to be invested on a short term basis, usually until the next opportunity to repay debt. However exceptions to this may occur where it is prudent to do so, for example, the pre-funding of debt which is placed on term deposit until the funds are required.

8.0 Reporting

QUARTERLY FUNDING AND DEBT PROFILE REPORT

- 8.1 This report forms the basis for the reporting of the Council's funding and associated interest rate risk management activity and provides the elected members and management with details about the Council's borrowing activities. The report shall contain the following:
- a. Total debt facility utilisation, including any debt sourced from a bank, the capital markets and the LGFA.
 - b. Interest rate maturity profile against percentage hedging limits.
 - c. New hedging transactions completed - interest rate risk management.

- d. Weighted average cost of funds.
- e. Funding profile against the policy limits.
- f. Liquidity profile against the policy limits.
- g. Exception reporting as required.
- h. Summary of any unresolved exception reports.
- i. Statement of policy compliance.
- j. Commentary on economic conditions and the debt markets.

QUARTERLY INVESTMENT REPORT

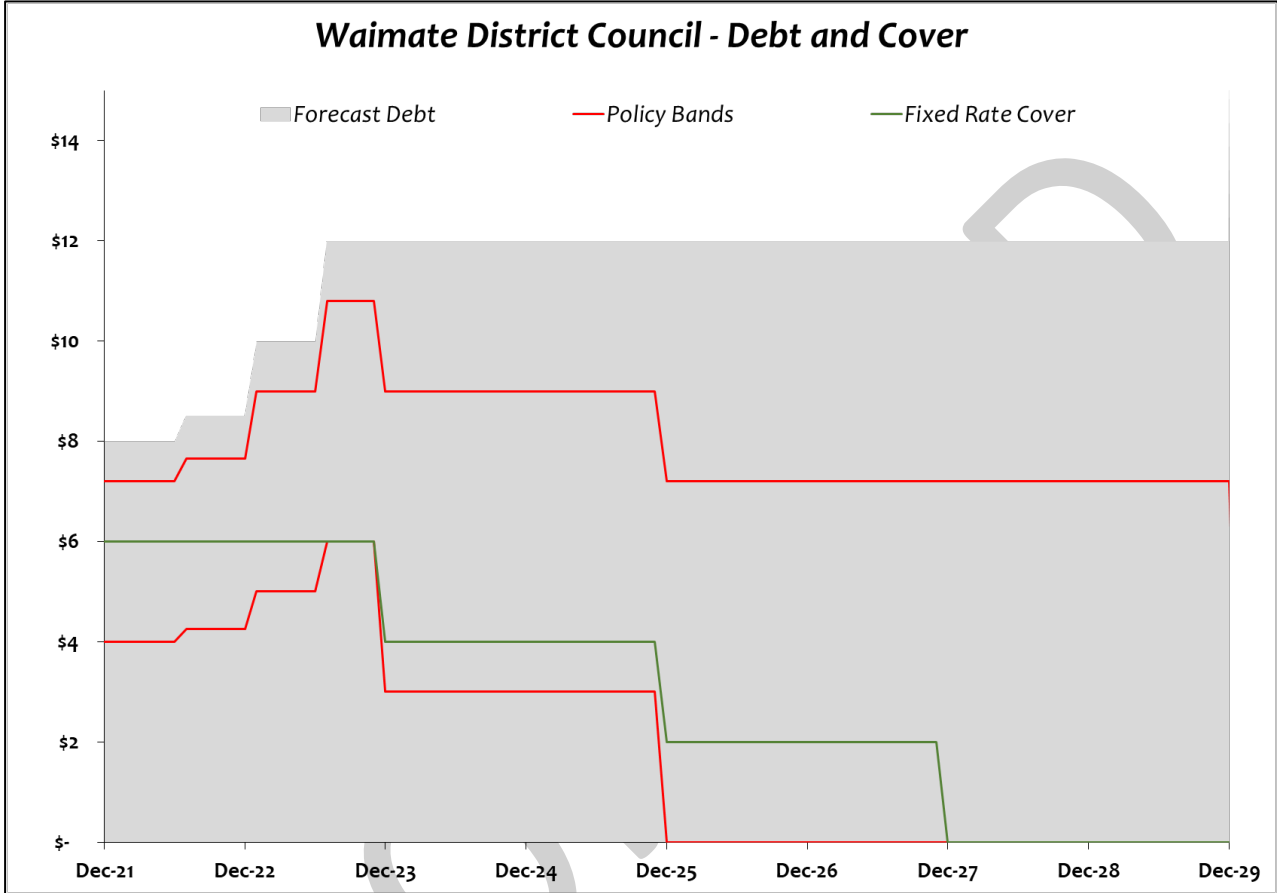
8.2 This report forms the basis for the reporting of the Council's financial market investment activities provides the elected members and management with details about the Council's financial market investment activities. The report shall contain the following:

- a. Total nominal value of the investment portfolio.
- b. Details of individual investments.
- c. Asset class percentages.
- d. Credit rating profile.
- e. Maturity profile.
- f. Weighted average yield of the portfolio.
- g. Statement of policy compliance.
- h. Commentary on economic conditions and the financial markets.

9.0 Document Control

| | |
|---|----------------------------------|
| Document owner: | Corporate Services Group Manager |
| Effective: (via adoption of LTP 2021-2031) | [Publish Date] |
| Previous review date(s): | 30 June 2015 30 January 2018 |
| Next review date: | June 2024 |
| Policy can only be amended by: | Resolution of Council |
| Council resolution number: | 2021/110 |

Appendix 1: Sample Debt and Cover graph



THE GIVING OF SECURITIES AND GUARANTEES

Security

Council will offer security via a Debenture Trust Deed which is recognised as an industry standard for local authorities. A Debenture Trust Deed is a deed entered into between a local authority and a trustee under which the local authority grants a security interest in its rates and rates revenue to the trustee to hold on behalf of holders of "stock" issued under the Debenture Trust Deed.

Appendix 2: Approved Derivative Interest Rate Risk Management Instruments

The following is a list of approved interest rate risk management instruments:

- a. Forward rate agreements (“FRA”).
- b. Interest rate swaps (“IRS”).
- c. Option on a swap (“Swaption”).
- d. Interest rate options.
- e. Interest rate collar.

Products which create a contingent risk on the Council, for example, ratio options, are expressly prohibited.

EXAMPLES OF THE USE OF DERIVATIVE RISK MANAGEMENT INSTRUMENTS

Forward Rate Agreement

An agreement between the Council and a bank counterparty protecting the Council against a future adverse interest rate movement. The Council and the counterparty agree to a notional future principal amount, the future interest rate, the date and the benchmark rate.

Objective

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

Example

The Council wishes to provide certainty on a portion of its floating rate borrowings over the event risk posed by an expected change in monetary policy at a point in the future. A borrower’s FRA is purchased in say, December, at 2.50% for protection through the December to March period. It is described as a 3X6 FRA, i.e. the rate applies to a borrowing for three months starting in three months’ time.

Outcome

If, on the rate set date in December, the three month interest rate has climbed to, say, 3.00%, the Council receives the difference between this and the FRA rate of 2.50%. The Council then borrows at 3.00% with the payment received making the effective base borrowing rate 2.50%.

If, on the rate set date in December, the three month interest rate has dropped to, say, 2.00%, the Council pays the difference between this and the FRA rate of 2.50%. The Council then borrows at 2.00% with the payment made making the effective base borrowing rate 2.50%.

Interest Rate Swap

An interest rate swap is an agreement between the Council and a bank counterparty protecting the Council against a future adverse interest rate movement. The Council pays (or receives) a fixed interest rate and receives (or pays) a floating interest rate. The parties agree to a notional principal amount, the future interest rate, the settlement dates and the benchmark floating rate.

Objective

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

Example

The Council fixes its interest rate on a quarterly basis on a portion of its planned borrowings by entering into a three year fixed rate swap at 2.75%. The floating rate reference is three month BKBM FRA rate.

Outcome

On a swap reset date, the three month BKBM FRA rate is at, say, 3.25%. The Council borrows from its bank the principal, for three months at 3.25% plus the Council's margin. At the same time the bank pays the Council 3.25% on the principal amount for a three month period. The Council then pays the bank 2.75% on the principal amount for a three month period. This process is repeated at each reset date over the life of the interest rate swap. This means that The Council's effective interest rate is 2.75% plus its margin over the life of the interest rate swap. In practice, cashflows would be netted off if the swap and the underlying borrowing facility were with the same bank.

Forward Start Interest Rate Swap

Objective

To provide the Council 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.

Example

The Council's strategic plan necessitates an increase in debt levels, the funding for which will be obtained from the LGFA. The debt is planned to be obtained from the LGFA in six months' time and the Council wishes to secure its borrowing costs and thus enters into a five year swap with a six month forward start date at a rate of 3.00%. The Council would enter into a five year fixed rate swap with a commencement date six months hence.

Outcome

Regardless of where interest rates are in six months' time the Council has locked in its effective base borrowing rate at 3.00%.

Options on a Swap – Swaption

Objective

To provide the 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 and for an agreed period. A swaption is an option on a swap and requires a premium to be paid.

Example

The Council wishes to secure a worst case rate for borrowings for a five year period in six months' time. There is a view however that interest rates will not move sharply higher and a decision is taken not to lock into a swap. A swaption is purchased at 3.25% for a cost equivalent to 5.5 basis points or \$2,500 per million.

Outcome

If, at the time the borrowings commence, the five year swap rate has moved above 3.25%, The Council exercises the swaption and borrows at 3.25%. (All up cost is effectively 3.305%, the worst case rate). If, at the time the borrowings commence, the five year swap rate has fallen to 2.75%, the Council abandons the swaption and borrows at 2.75%. (All up cost is effectively 2.805%). Swaptions can also be cash settled, for example the purchaser would receive payment if at maturity it was in the money and then physically borrow at the market rate. Whether it is exercisable or cash settled is usually determined at commencement.

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. The Council and the counterparty agree to a notional future principal amount, the future interest rate, the benchmark dates and the benchmark floating rate (usually BKBM FRA rate).

Objective

To provide the Council with worst case cover on its interest rate cost on an agreed principal amount for an agreed period. Rate sets are typically at three monthly intervals. A premium is payable for entering into an interest rate option.

Example

The Council wishes to secure a worst case rate over the event risk posed by a change in monetary policy. There is a view however that interest rates will not move sharply higher as a result of the event risk and a decision is taken not to lock into a forward start swap. An option is purchased at 3.25% for a cost equivalent to 35 basis points or \$14,560 per million. It is for 5 years and is priced at three monthly intervals.

Outcome

If, on any of the rate set dates the 90 day bank bill rate has moved above 3.25% the Council exercises the option and borrows at 3.25%. If on any of the rate set dates interest rates have fallen below 3.25% the Council walks away from the option and borrows at the prevailing three month bank bill rate. This exercise will be repeated every three months over the life of the option.

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 the Council with certainty as to its interest rate cost on an agreed principal amount for an agreed period, but at the same time, avoids the need to pay an up-front premium.

Example

The Council wishes to secure a worst case base borrowing rate of 3.25% for the next five years, but wishes to avoid paying a premium. In exchange for the worst case protection at 3.25%, the Council accepts a best case outcome of 2.50%. In this structure the Council has bought and sold options, with the respective option premiums offsetting each other. On each quarterly rate set date the Council will have a rate between 3.25% and 2.50%, these being the parameters of the collar.

Outcome

If, on any rate set date the three month interest rate is in excess of 3.25%, the Council exercises its option and pays a base rate of 3.25%, for that three month period, its worst case rate. If on any rate set date the three month interest rate is below 2.50%, the bank exercises its option on the Council and forces the Council to pay 2.50%. If on any rate set date the three month interest rate is between 3.25% and 2.50%, the Council borrows at the prevailing market rate.