Treasury Management Policies

1. Introduction

Marlborough District Council ("MDC") undertakes borrowing (Liability Management Policy) and investment activities (Investment Policy), which in total are referred to as treasury activity. MDC's treasury activities are carried out within the requirements of the Local Government Act 2002 ("LGA 2002"), its related amendments and other relevant local authority legislation.

This Treasury Management Policy provides the policy framework for all of MDC's borrowing and investment activities and defines key responsibilities and the operating parameters within which borrowing, investment and related risk management activities are to be carried out.

Key borrowing and investment objectives form the basis of the policies. These objectives, while consistent with corporate best practice, are subject to overall Council objectives, as stated in the Annual Plan and the Long Term Plan ("LTP").

The Liability Management Policy and the Investment Policy shall be reviewed and where necessary amended at least every three years. The Local Government Act 2002 Amendment Act 2010 states that Council does not need to go through the special consultative process to amend the Liability Management Policy and the Investment Policy. This Treasury Policy covers:

- Liability management.
- Investments.
- Foreign exchange.

MDC acknowledges that there are various financial risks such as interest rate risk, currency risk, liquidity and funding risk and credit risk arising from its treasury activities but operates under the assumption that being a risk averse entity it does not wish to incur unnecessary risks from its treasury activities.

MDC's Chief Executive has overall responsibility for the operations of Council. The Manager Corporate Finance – "CFO" has responsibility for the day to day operation of the treasury function and is assisted by other finance personnel as appropriate.

MDC does not undertake any treasury activity that is unrelated to its underlying cash flows or which is purely speculative in nature.

Legislative Requirements

The Liability Management and Investment Policies of the Treasury Management Policy are in compliance with the requirements of the LGA 2002.

2 Liability Management Policy

2.1 Purpose

MDC borrows for the following primary purposes:

- General debt to fund Council's capital works primarily on infrastructure assets. 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.
- Specific debt associated with significant "one-off" projects and non-financial investments from time to time.
- Borrowing through hire purchase, credit, deferred payment or lease arrangements in the ordinary course of Council business.
- Debt for energy efficiency projects.

2.2 Local Government Act 2002 Requirements

Section 104 of the LGA 2002 provides that the Liability Management Policy required to be adopted under section 102(4)(b) must state the local authority's policies in respect of liability management, including:

- Interest rate exposure.
- Credit exposure.
- Liquidity.
- Debt repayment.
- Specific borrowing limits.
- The giving of security.

2.3 Objectives

The objectives of the Liability Management Policy are consistent with market best practice and will take into account MDC's 10 year plans as set out in the LTP. The key Liability Management objectives in relation to borrowings are to:

- Prudently manage MDC's borrowing activities to ensure the ongoing funding of Council by ensuring that appropriate liquidity and funding risk management practices are adopted.
- Borrow only under Council approved facilities and as permitted by this policy.
- Minimise borrowing costs within prudent risk management control limits.
- Manage exposure to adverse interest rate movements.

- Ensure operational controls and procedures to protect MDC against financial loss, opportunity cost and other inefficiencies are maintained.

2.4 Funding

MDC may obtain funding utilising the following methods:

- Bank debt.
- Capital markets issuance comprising Fixed Rate Bonds, Medium Term Notes, Floating Rate Notes and Commercial Paper.
- New Zealand Local Government Funding Agency (LGFA)

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

  - Contribute a portion of its borrowing back to the LGFA as an equity contribution to the LGFA;
  - Provide guarantees of the indebtedness of other local authorities to the LGFA and of the indebtedness of the LGFA itself;
  - Commit to contributing additional equity (or subordinated debt) to the LGFA if required;
  - Subscribe for shares and uncalled capital in the LGFA; and
  - Secure its borrowing from the LGFA and the performance of other obligations to the LGFA or its creditors with a change over the Council's rates and rates revenue.
- Other sources of debt finance following the specific approval of Council.

2.5 Borrowing Management and Internal Controls

Council approves policy parameters in relation to borrowing activities.

Council approves, by resolution, the borrowing requirement for each financial year in the annual plan or LTP or by later resolution during the year.

Council considers the impact on its borrowing limits (section 2.10) as well as the size and the economic life of the asset that is being funded and its consistency with Council's LTP.

A resolution of Council is not required for hire purchase, leased, credit or deferred purchase of goods if:

- The period of indebtedness is less than 365 days; or
- The goods or services are obtained in the ordinary course of operations on normal commercial terms for amounts not exceeding in aggregate $50,000.
- MDC's borrowing activities are managed centrally through its accounting function. The accounting function is broadly charged with the following responsibilities:
  - Manage MDC's borrowing programme to ensure funds are readily available at margins and costs favourable to Council.
  - Raise authorised and appropriate borrowing, in terms of both maturity and interest rate strategies.
  - Manage the impact of interest rate risks by undertaking appropriate hedging activity in the financial markets.
  - Minimise adverse interest rate related increases on ratepayer charges and maintain overall interest costs within budgeted parameters.
  - Provide timely and accurate reporting of treasury activity and performance.

Council's systems of internal controls over borrowing activity include:

- Adequate segregation of duties among the core borrowing functions of deal execution, confirmation, settling and accounting/reporting.
- There are a small number of people involved in MDC's borrowing activity, however the risk from this will be further minimised by the following processes:
  - A documented approval process for borrowing activity.
  - Regular management reporting and review.
  - Regular operational risk control reviews by an independent audit function.
- Organisational, systems, procedural and reconciliation controls to ensure:
  - All borrowing activity is bona fide and properly authorised.
  - Reviews in place to ensure MDC's accounts and records are updated promptly, accurately and completely.

MDC is prohibited from borrowing in a foreign currency by section 113 of the LGA 2002.

2.6 Interest Rate Risk Management

Interest rate risk management refers to managing the impact that movements in interest rates can have on MDC's cash flows. This impact can be both favourable and unfavourable.

Interest is incurred on any bank funding facility, issuance of debt instruments and other borrowing arrangements. This policy recognises that the longer the term of borrowing, the greater the interest rate risk. A balance is achieved through having variable terms with regard to interest rate resets. The following table details the interest rate risk management parameters that MDC is required to adhere to for all externally sourced debt.

Fixed Rate Hedging percentages		
	Minimum Fixed Rate	Maximum Fixed Rate
0 to 2 years	40%	100%
2 years to 5 years	25%	80%
5 years to 10 years	0%	60%

Any hedging outside of these parameters must be approved by the Chair of Community and Finance Committee before being initiated and then reported accordingly.

Details of MDC's overall interest rate risk management position shall be reported to the Community and Finance Committee.

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

Fixed rate debt is defined as any debt that has an interest rate reset beyond 3 months.

MDC 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. Council may use interest rate risk management products to convert fixed rate borrowing into floating rate and floating rate borrowing into fixed or hedged borrowing.

2.7 Authorised Interest Rate Risk Management Instruments

Council may use the following interest rate risk management instruments to manage externally sourced debt:

- Interest Rate Swaps.
- Forward Rate Agreements.
- Interest Rate Options.
- Swaptions (options on swaps).
- Interest Rate Collar strategy, but only where the ratio of the face value and interest rate exposure on bought to sold legs is 1:1.

2.8 Counterparty Exposure

Interest rate hedging can only be undertaken with New Zealand Registered Banks with a minimum Standard and Poor's long term rating of 'A' or the Moody's Investors Service or Fitch Ratings equivalants.An up-to-date list of New Zealand Registered Banks and current credit ratings can be obtained from the Reserve Bank of New Zealand's website.

2.9 Liquidity and Funding Risk

Liquidity management refers to the timely availability of funds when needed, without incurring penalty costs. Funding risk management centres on the ability to re-finance or raise new debt at a future time at the same or more favourable pricing (fees and borrowing margins) and terms than that of existing facilities. A key factor of funding risk management is to reduce the concentration of risk at any one point in time so that if one-off internal or external negative credit events occur, the overall interest cost is not unnecessarily increased.

The following guidelines have been established to provide MDC with appropriate levels of liquidity at all times, as follows:

- Cash flow forecasts will be produced to assist in the matching of operational and capital expenditure to revenue streams and borrowing requirements.
- MDC will maintain its financial market investments in liquid instruments.

The following guidelines have been established to control funding risk:

- To avoid a concentration of debt maturity dates no more than 50% or $25 million (whichever is the highest) of debt can be subject to refinancing on a rolling 12 month basis.

2.10 Debt Repayment

Repayment of debt (interest and principal) is governed by:

- Affordability of debt servicing costs.
- Intergenerational equity principles.
- Maintenance of prudent debt levels and borrowing limits.

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

2.11 Borrowing Limits

In managing its borrowings, MDC will adhere to the following financial covenants:

- Earnings before interest and tax has to be at least 2.25 times net interest.
- Gross annual interest expense cannot exceed 12.5% of total operating revenue.
- Net cash flow from operating activities to exceed gross annual interest expense by at least two times.
- Net debt shall not exceed 175% of total revenue.

The actual ratios for the above covenants will be determined by Council and reviewed annually.

2.12 Security

All loans are secured over either the separate general and targeted rates of the District or Council assets.

Formal security over either the separate general and targeted rates of the District or Council assets requires prior Council approval.

2.13 Borrowing Mechanisms

In developing strategies for new borrowing (in relation to source, term, size and pricing) Council takes into account the following:

- Available and Council approved sources, terms and types of borrowing.
- MDC's overall debt maturity profile, to ensure concentration of debt is avoided at reissue/rollover time.
- Prevailing interest rates, margins and total cost relative to term and nature of the borrowing.
- The market's and Council's outlook on future interest rate movements.
- Legal documentation and financial covenants.

3. Investment Policy

3.1 Introduction

MDC holds financial investments which include:

- Special funds and reserves.
- Funds set aside for approved future expenditure.
- Proceeds from the sale of assets.
- Forestry.
- Temporary surpluses and working capital funds.

Council provides loans and advances to:

- MDC Holdings Limited.
- Community groups.
- Others.

Council holds equity investments which include:

- MDC Holdings Limited, which in turn holds investments in Port Marlborough Limited and Marlborough Airport Limited.
- Forestry related assets.
- New Zealand Local Government Funding Agency.

3.2 Local Government Act 2002 Requirements

Section 105 of the LGA 2002 provides that the Investment Policy required to be adopted under section 102(4)(c) must state the local authority policies in respect of investments, including:

- The mix of investments.
- The objectives in terms of which financial and equity investments are to be managed.
- The acquisition of new investments.
- An outline of the procedures by which investments are managed and reported on to the local authority.
- An outline of how risks associated with investments are assessed and managed.

3.3 Objectives

The objectives of this investment policy are consistent with market best practices and will take into account the requirements of MDC's Annual Plan and LTP. The key investment policy objectives are to:

- Prudently manage MDC's investment assets in the interests of the Council's district and its inhabitants and ratepayers, only for lawful purposes and so as to safeguard against loss.
- Manage investments in accordance with the LGA 2002 and the Trustee Act 1956; administer, manage and account for its funds and exercise the care, diligence, and skill that a prudent person of business would exercise in managing the affairs of others.
- Maximise investment income within a prudent level of investment risk. Council recognises that as a responsible public authority any investments that it does hold should be of relatively low risk. It also

recognises that lower risk generally means lower returns.

- Ensure the integrity of MDC's financial market investments by only investing in appropriate organisations and financial market instruments as specified in this policy.
- Ensure investments are maintained at an appropriate level of liquidity to enable the provision of cash flow when required.
- Manage the potential risk due to adverse interest rate movements.
- Maintain relationships with financial market participants, to enable MDC to carry out its financial market investment activities in an efficient and practical way.
- Regularly review the performance and credit-worthiness of all investments.
- Maintain operational controls and procedures to best protect Council against financial loss, opportunity cost and other inefficiencies.

3.4 Investment Management and Internal Controls

Council approves policy parameters in relation to investment activities.

MDC's investment activities are managed centrally through an accounting function and takes the following into consideration when deciding on the suitability of any investment:

- The desirability of diversifying investments.
- The nature of existing investments.
- The risk of capital loss or depreciation.
- The potential for capital appreciation.
- The likely income return.
- The length of the term of the proposed investment.
- The marketability of the proposed investment.
- The effect of the proposed investment in relation to tax liability.
- The likelihood of inflation affecting the value of the proposed investment.

Council's systems of internal controls over investment activity include:

- Adequate segregation of duties among the core investment functions of deal execution, confirmation, settling and accounting/reporting. There are a small number of people involved in investment activity, however the risk from this will be further minimised by the following processes:
  - A documented approval process for investment activity.
  - Regular management reporting and review.
  - Regular operational risk control reviews by an independent audit function.
- Organisational, systems, procedural and reconciliation controls to ensure:
  - All investment activity is bona fide and properly authorised.
  - Reviews are in place to ensure MDC's accounts and records are updated promptly, accurately and completely.
- Overall assessment of performance of funds management.

3.5 Financial Market Risk Management

MDC's primary objective when investing is the protection of its capital. Accordingly, only creditworthy counterparties are acceptable. Specifically, MDC minimises its credit exposure by ensuring that all financial market investments meet the criteria outlined in the following table. These limits are cumulative and relate to the combined 'short and long' term funds portfolios.

Liquidity risk is managed by ensuring that all investments are readily tradable on the secondary market. In practice this is achieved by the credit rating and financial market instrument criteria contained in the investment table.

Counterparty risk shall be managed by only permitting financial market transactions with New Zealand Registered Banks with a minimum Standard and Poor's long term rating of 'A' or the Moody's Investors Service or Fitch Ratings equivalents and full members of the New Zealand Stock Exchange.

Authorised Investment Criteria				
Authorised Asset Classes	Overall Portfolio Limit as a Percentage of the Total Portfolio	Approved Financial Market Investment Instruments (must be denominated in NZ dollars)	Credit Rating Criteria – Standard and Poor's (or Moody's or Fitch equivalents)	Limit for each issuer subject to overall portfolio limit for issuer class
New Zealand Government or Government Guaranteed	100%	• Government Stock • Treasury Bills	Not Applicable	Unlimited
Rated Local Authorities*	70%	• Commercial Paper	Short term S&P rating of A1 or better	$3.0 million
		• Bonds/MTNs/FRNs	Long term S&P rating of A- or better Long term S&P rating of A+ or better Long term S&P rating of AA or better	$2.0 million $3.0 million $5.0 million
Local Authorities where rates are used as security*	60%	• Commercial Paper • Bonds/MTNs/FRNs	Not Applicable	$2.0 million $2.0 million
New Zealand Registered Banks	100%	• Call/Deposits/Bank Bills/Commercial Paper	Short term S&P rating of A1 or better	$10.0 million
		• Bonds/MTNs/FRNs	Long term S&P rating of A- or better Long term S&P rating of A+ or better	$2.0 million $5.0 million
State Owned Enterprises	70%	• Commercial Paper	Short term S&P rating of A1 or better	$3.0 million
		• Bonds/MTNs/FRNs	Long term S&P rating of A- or better Long term S&P rating of A+ or better	$1.0 million $3.0 million
Corporates*	60%	• Commercial Paper	Short term S&P rating of A1 or better	$2.0 million
		• Bonds/MTNs/FRNs	Long term S&P rating of A- or better Long term S&P rating of A+ or better Long term S&P rating of AA or better	$1.0 million $2.0 million $3.0 million
Financials*	30%	• Commercial Paper	Short term S&P rating of A1 or better	$2.0 million
		• Bonds/MTNs/FRNs	Long term S&P rating of A- or better Long term S&P rating of A+ or better Long term S&P rating of AA or better	$1.0 million $2.0 million $3.0 million

* The combined holding of Rated Local Authorities and Local Authorities shall not exceed 70%. Also the combined holding of Corporates and Financials shall not exceed 70%.

MTN is Medium Term Note and FRN is Floating Rate Note.

As long as it is practical Investments that no longer comply with the minimum credit rating criteria must be sold within two months of the downgrade being notified, unless Council formally approves the continued holding of the investment.

3.6 New Zealand Local Government Funding Agency (LGFA)

Despite anything mentioned earlier in this Investment Policy, the Council may invest in shares and other financial instruments of the New Zealand Local Government Funding Agency Limited (LGFA), and may borrow to fund that investment. The Council's objective in making any such investment will be to:

- Obtain a return on the investment; and
- Ensure that the LGFA has sufficient capital to become and remain viable, meaning that it contuse as a source of debt funding for the Council.

Because of this duel 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 alternative investments.

If required in connection with the investment, the Council may also subscribe for uncalled capital in the LGFA.

3.7 Interest Rate Risk Management

Interest rate risk refers to the impact that movements in interest rates can have on MDC's cash flows. MDC's financial investments give rise to direct exposure to interest rate movements. Interest rate risk is managed by Council as part of its overall investment strategy.

The following interest rate risk management instruments in relation to investment are approved by Council:

- Interest Rate Swaps.
- Interest rate options.
- Forward Rate Agreements.

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

3.8 Duration Control for Long Term Funds Portfolio ("LTFP")

Duration calculates the effective average term of an investment portfolio by combining all individual investments and weighting all the cash flows using a series of net present value calculations. Duration is then reported as the average life of the portfolio as if it was effectively one investment instrument, eg; 2.9 years.

The duration for the LTFP shall be controlled by referencing its duration against an appropriate external benchmark. MDC is able to vary the duration of the portfolio by no more than 25% either side of the benchmark portfolio's duration. Compliance with the duration control is not required if the nominal value of the portfolio is less than $5 million.

3.9 Benchmarking

Benchmarking measures the performance of a portfolio against an appropriate external benchmark, thus providing MDC with an indication as to the effectiveness and suitability of the current investment parameters and the manner in which the parameters are being implemented at an operational level.

MDC shall benchmark the performance of the LTFP against the performance of an appropriate external benchmark portfolio. Compliance with the benchmarking standard is not required if the nominal value of the portfolio is less than $5 million.

3.10 Equity Investments

MDC reviews the performance of the trading enterprises at least annually to ensure that strategic and financial objectives set are being achieved. In particular the Council reviews the financial returns and the present and future values of these investments.

Significant dispositions and acquisitions require Council approval.

All income is reflected in the consolidated MDC accounts with dividend income reflected in the MDC accounts as revenue.

It is not contemplated that MDC will make any future equity investments, to do so would require a specific Council resolution.

3.11 Loans and Advances

These are made to:

- Trading enterprises on an arms length basis and in accordance with normal commercial practice.
- Community organisations to facilitate the ongoing provision of community services or recreational opportunities. These are usually at a lower than commercial interest rate.

Council sets the criteria to apply for any other loans or advances as they are granted. It is normal that MDC secures loans and advances against the assets of the organisation and obtains personal guarantees where appropriate. MDC as a rule is not a lender of money.

Interest and principal repayments are monitored to ensure they comply with loan agreements.

4. Foreign Exchange Policy

MDC may incur foreign exchange exposures through the occasional purchase of foreign exchange denominated plant, equipment and services. All significant commitments defined as an exposure in excess of NZD50,000 equivalent are hedged using foreign exchange contracts.

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