

<b>Central Hawke's Bay District Council</b>	<b>POLICY MANUAL</b>	
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<b>INVESTMENT POLICY</b>	<b>Approved by:</b>	Council
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## INVESTMENT MIX

Council maintains investments in the following financial assets:

- **EQUITY INVESTMENTS** (covered in Section 1)
- **PROPERTY INVESTMENTS** (covered in Section 2)
- **FINANCIAL INVESTMENTS** (covered in Section 3)

## GENERAL POLICY

Council's philosophy in the management of investments is to optimise returns in the long term while balancing risk and return considerations. Council recognises that as a responsible public authority any investments that it does hold should be low risk, giving preference to conservative investment policies and avoiding speculative investments. It also recognises that lower risk generally means lower returns. Any new investments are approved by the appropriate delegated authority and on the recommendation of Council's advisors - First New Zealand Capital.

Council does not hold financial investments other than those involving specific reserves and cash management balances. In its financial investment activity, Council's primary objective when investing is the protection of the investment capital value and to minimise the risk of loss. Accordingly, only creditworthy counterparties are acceptable. Council's policy on managing credit risk is contained in Section 4.

Within the credit constraints contained in Section 4, Council also seeks to:

- Optimise investment returns.
- Ensure investments are liquid and sufficiently flexible.
- Diversify the mix of financial investments.
- Manage potential capital losses due to interest rate movements if investments need to be liquidated before maturity.

### 1. EQUITY INVESTMENTS

Council has equity investments in NZ Local Government Insurance Corporation Ltd (trading as Civic Assurance) and Tamatea Limited.

#### 1.1 NZ Local Government Insurance Corporation Ltd

##### ***Nature of Investment/Rationale for Holding***

The Council holds 8,290 shares. The purpose of the entity, in which most local authorities are shareholders, is to ensure that adequate insurance arrangements are available to local authorities at the lowest possible cost. The shares are not readily transferable.

***Disposition of Revenue***

Revenue earned from the shares is minimal. Any sale will require Council approval. Any disposition will be realised in a managed form and proceeds are taken to the Capital Projects Fund.

***Risk Management***

The investment will be managed by reviewing annually the performance, and the consideration of and approval of the Statement of Intent.

***Management Reporting and Procedures***

Annual Reports are received and reviewed by Staff. Election of Directors takes place at the AGM held at the Local Government New Zealand annual conference. The Council can vote by proxy.

***Specific Policy***

Council will continue to hold its shares in NZ Local Government Insurance Corporation Ltd whilst it continues to obtain insurance cover through the fund..

**1.2 TAMATEA LIMITED*****Nature of Investment/Rationale for Holding***

Tamatea Limited (Tamatea) is a company 100% owned by Council. Tamatea holds Council's 34% stake in Infracon Limited (Infracon). The shares in Infracon will not be disposed of without Council approval and are subject to Council's Significance Policy.

***Disposition of Revenue***

Revenue earned from the shares in Infracon is by way of dividend. It is expected that the dividend will be passed on in full to Council by Tamatea.

***Risk Management***

The investment will be managed by regular review of its performance, and by consideration of and approval of the Statement of Intent.

***Management Reporting and Procedures***

Audited Annual Reports are received and approved by Council. Election of Directors to Tamatea takes place in terms of the appropriate Council Policy - 1.3 Policy on *Appointment and Remuneration of Directors for Council Organisations*. In turn, by virtue of Infracon's constitution, Tamatea appoints two (2) of the six (6) directors to the Infracon Board.

***Specific Policy***

Council will continue to hold its shares in Tamatea whilst Council retains a business interest in Infracon.

## 2. PROPERTY INVESTMENTS

### ***Nature of Investment/Rationale for Holding***

Council's primary objective is to only own property (including land and buildings) that is necessary to achieve its strategic objectives as stated within the Long Term Plan (LTP), or deemed to be a core Council function. This definition excludes infrastructural service e.g. reserves and drainage. Council will generally acquire new property if it achieves Council's strategy objectives.

### ***Disposition of Revenue***

Council seeks to achieve an acceptable commercial rate of return to ensure minimal rating input.

Sale of property investments requires Council approval under Council's Significance Policy. Proceeds from the disposition of property investments are used firstly in the retirement of related debt and then are credited to the Capital Projects Fund.

### ***Risk Management***

The Council's investment in properties, other than reserves and those required for own occupation and infrastructural services, will not exceed 50% of total fixed assets.

### ***Management Reporting and Procedures***

As part of our LTP process, Council reviews the performance of its property investments and ensures that the benefits of continued ownership are consistent with its stated objectives.

### ***Specific Policy***

Council's policy is to dispose of any property that does not achieve a commercial return having regard to any restrictions on title or other requirements or needs to achieve Council objectives.

## 3. FINANCIAL INVESTMENTS

Council maintains financial investments for the following primary reasons:

- To invest the proceeds from the sale of assets.
- To invest amounts allocated to specific reserves e.g. Catastrophic Fund.
- To invest funds allocated for approved future expenditure.
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Interest income earned on financial investments relating to specific reserves is allocated to those accounts annually based on the opening balance. Council reviews financial investment performance through standard management reporting.

### ***Investment Objectives***

Council's primary objective when investing is the protection of its investment. Accordingly, only creditworthy counterparties are acceptable. Creditworthy counterparties are selected on the basis of their current Standard and Poors (S&P) rating which must be "strong" or better. Credit ratings are monitored on a three monthly basis by the Corporate Services Manager from updated S&P advices/advice from Council's advisor First NZ Capital.

The Corporate Services Manager approves an investment strategy within the scope and parameters of this Policy and as recommended by Council's advisors - First NZ Capital.

The following principles capture the above objectives and form the key assumptions of the operating parameters:

- Credit risk is minimised by placing maximum limits for each broad class of non-Government issuer, and by limiting investments to local authorities, registered banks, strongly rated SOE's, and corporates within prescribed issuer and portfolio limits.
- Liquidity risk is minimised by ensuring that all investments must be capable of being liquidated in a readily available secondary market.
- Council invests in approved instruments which include:
  - Government investments <sup>1</sup>
  - Registered bank investments <sup>2</sup>
  - Local authority investments <sup>3</sup>
  - SOE and corporate investments <sup>4</sup>

Definitions for approved financial investment instruments are included in Appendix 1.

#### ***Interest Rate Risk Management***

Council's investments give rise to a direct exposure to a change in interest rates, impacting the return and capital value of its investments.

Interest risk is minimised by investing in fixed rate bonds and deposits spread over a range of maturities.

The Corporate Services Manager approves interest rate risk management strategy as recommended by Council's Investment Advisors, who monitor the interest rate markets on a semi-annual basis, evaluating the interest rate outlook and determining the interest rate profile to adopt for investments. Details of approved interest rate risk management instruments are contained in Appendix 2.

#### **4. SINKING FUNDS**

Council is not required to use specific funding mechanisms and accordingly Council does not establish sinking funds for new borrowing. Established sinking funds are wound down as loans mature or are used to repay existing borrowing at the earliest opportunity.

A specific fund for retirement of maturing debt has been created. Funds will be transferred to this fund from time to time.

#### **5. Foreign Exchange Policy**

Council has minor foreign exchange exposure through the occasional purchases from foreign suppliers. Unless the purchase will exceed NZ\$100,000 (where the commitment would be hedged using forward foreign exchange contracts), payments will be settled at spot rates on the day.

- 1 Authorised instruments include: treasury bills and government stock.
- 2 Authorised instruments include: money market call deposits, money market term deposits, negotiable certificates of deposit, registered certificates of deposit and bank bills.
- 3 Authorised instruments include: local authority stock, bonds and promissory notes and local authority debentures.
- 4 Authorised instruments include: commercial paper, promissory notes and corporate bonds.

## **APPENDIX 1**

### **APPROVED FINANCIAL INVESTMENT INSTRUMENTS**

Investment instruments available in the market (excluding equities and property) can generally be discussed under four broad categories relating to the issuer of these instruments.

#### **1. NEW ZEALAND GOVERNMENT**

- **Treasury bills** are registered securities issued by the Reserve Bank of New Zealand (RBNZ) on behalf of the Government. They are usually available for terms up to a year but generally preferred by investors for 90 day or 180 day terms. They are discounted instruments, and are readily negotiable in the secondary market.
- **Government stocks** are registered securities issued by the RBNZ on behalf of the Government. They are available for terms ranging from one year to twelve year maturities. Government stocks have fixed coupon payments payable by the RBNZ every six months. They are quoted on a semi-annual yield basis and are priced on a discounted cashflow basis. They are readily negotiable in the secondary market.

#### **2. LOCAL AUTHORITIES**

**Local Authority stocks** are registered securities issued by a wide range of local government bodies. They are usually available for maturities ranging from one to ten years. A fixed coupon payment is made semi-annually to the holder of the security. They are negotiable and can usually be bought and sold in the secondary market.

#### **3. REGISTERED BANKS**

- **Call and term deposits** are funds accepted by the bank on an overnight basis (on call) or for a fixed term. Interest is usually calculated on a simple interest formula. Term deposits are for a fixed term and are expected to be held to maturity. Term deposits are not negotiable instruments. Termination prior to maturity date can often involve penalty costs.
- **Registered certificates of deposit (RCD)** are securities issued by banks for their funding needs or to meet investor demand. They are registered at the RBNZ or held on behalf of by the dealing bank. Details include the name of the investor, face value and maturity date. Ownership can be transferred by electronic transfer only. RCDs are priced on a yield basis and issued at a discount to face value or a grossed up basis. They are generally preferred over term deposits because investors can sell them prior to maturity without suffering penalty interest costs common to term deposits.
- **Bank bills** are bills of exchange drawn or issued, usually by a corporate borrower and accepted or endorsed by a bank. The investor is exposed to bank credit risk when investing in such instruments. Bank bills are readily available for any maturity up to 180 days,

although 30 to 90 day terms are more common. They are quoted on a yield basis and priced on a discount basis. Investors in bank bills can sell the bills prior to maturity date.

#### 4. CORPORATES

- **Corporate bonds** are generally issued by companies with good credit ratings. These bonds can be registered securities or bearer instruments. There are two types of bond, the medium term note (MTN) and the floating rate note (FRN). The MTN has a fixed coupon payment that is paid semi-annually to the holder of the security. They are priced on a semi-annual yield basis and are issued at a discount/premium to face value. The interest on the FRN is set on a floating rate basis usually off the 90 day bank bill bid rate. Corporate bonds are negotiable and can be bought and sold in the secondary market.
- **Promissory notes** are issued by borrowers who usually have a credit rating and standing in the market that is sufficient to enable the notes to be issued without endorsement or acceptance by a bank. The notes are usually underwritten by financial institutions to ensure that the borrower obtains the desired amount of funds. Promissory notes are issued with maturities ranging from 7 days to over one year. The common maturities are for 30 and 90 days. The face value of the note is repaid in full to the bearer on maturity.

### APPENDIX 2

#### APPROVED INTEREST RATE RISK MANAGEMENT INSTRUMENTS

1. Investment Instruments
2. Definitions

##### 1. INVESTMENT INSTRUMENTS

The following interest rate risk management instruments are available following approval by the Council.

- Fixing through physical investment instruments e.g. term deposits.
- Floating through physical investment instruments e.g. call deposits.
- Forward rate agreements.
- Interest rate swaps.
- Purchase of interest rate options products including floors.
- Interest rate collar type option strategies.

The interest rate risk management instruments detailed below are not permitted for use:

- Selling interest rate options for the primary purpose of generating premium income are not permitted because of its speculative nature.
- Structured or leveraged interest rate option strategies where there is any possibility of Council's total interest income decreasing in an increasing interest rate market or where Council's total interest income is decreasing faster than the general market rate.
- Interest rate futures contracts, mainly for administrative ease.

##### 2. DEFINITIONS

## **BKBM**

The bank bill mid market settlement rate, as determined at 10.45 am each business day on Reuters page BKBM. This is the standard rate for the settlement of interest rate swaps, forward rate agreements and interest rate floors, caps and collars.

## **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.

This product is either used where there is some uncertainty in the underlying debt exposure or the outlook for interest rates is favourable but the policy requires some form of protection.

## **Forward Rate Agreement**

An agreement between Council and a counterparty (usually a bank) protecting Council against a future adverse interest rate movement for a specified period of time. Council and the counterparty agree to a notional future principal amount, the future interest rate, the benchmark dates and the benchmark rate (usually BKBM). This definition includes the bond forward rate agreement where the benchmark rate is the underlying government bond yield.

This product is particularly useful where the underlying debt exposure is certain and Council's dominant view is that yields will rise above current levels.

## **Interest Rate Collar Strategy**

The combined purchase (sale) of a floor or cap with the sale (purchase) of another floor or cap. This can be a zero premium cost strategy. See the interest rate option for further details.

This product can be used by both an investor and a borrower. From a borrower's perspective, this product is transacted to provide a limited amount of participation in a downward movement in interest rates to an agreed strike rate. If the interest rate continues to move downwards, Council cannot participate in any movement beyond the strike rate. If interest rates move in an unfavourable direction (upwards) then the predetermined strike rate provides certainty through a known worst case rate.

For an investor, the zero cost collar allows some participation in an increase in rates and provides a worst case rate if interest rates decline.

This product outperforms the forward rate agreement if rates fall but under performs if rates rise. This product would be used by a borrower, for known exposures, where the interest rate is expected to decline moderately from current levels.

## **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 invest (described as a floor) or borrow (described as a cap) at a future date for a specified period. 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 option products include caps, floors, swaptions and bond options.

From a borrower's perspective, these products offer Council maximum flexibility, protecting Council from a rise in rates but allowing full participation in a fall in rates. When used by an investor, this product protects Council from a decline in rates and allows full participation in rising rates.

This product is used either where there is some uncertainty in the underlying debt exposure or the outlook for interest rates is favourable but the policy requires some form of protection.

### **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, term of the contract, interest rate and the benchmark rate (usually BKBM).

This product is particularly useful where the underlying debt exposure is certain and Council's dominant view is that interest rates will rise above current levels. As an investor, the swap is used when the dominant view is that rates will fall from current levels.

### **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.