Hedging - what is it?

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Hedging - what is it?

- Hedging is designed to provide certainty
- It's a risk mitigation strategy against fluctuating interest rates, commodities, or foreign exchange movements

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Hedging - interest rate movements

- Our discussion will focus on interest rate hedging
- What is the risk we are trying to avoid?
- There is a cost to have certainty via hedging, but there could be a even bigger one with taking a risk – i.e. uncertainty
- Finance Strategy – LTP – Financial Prudence (not taking undue risks)

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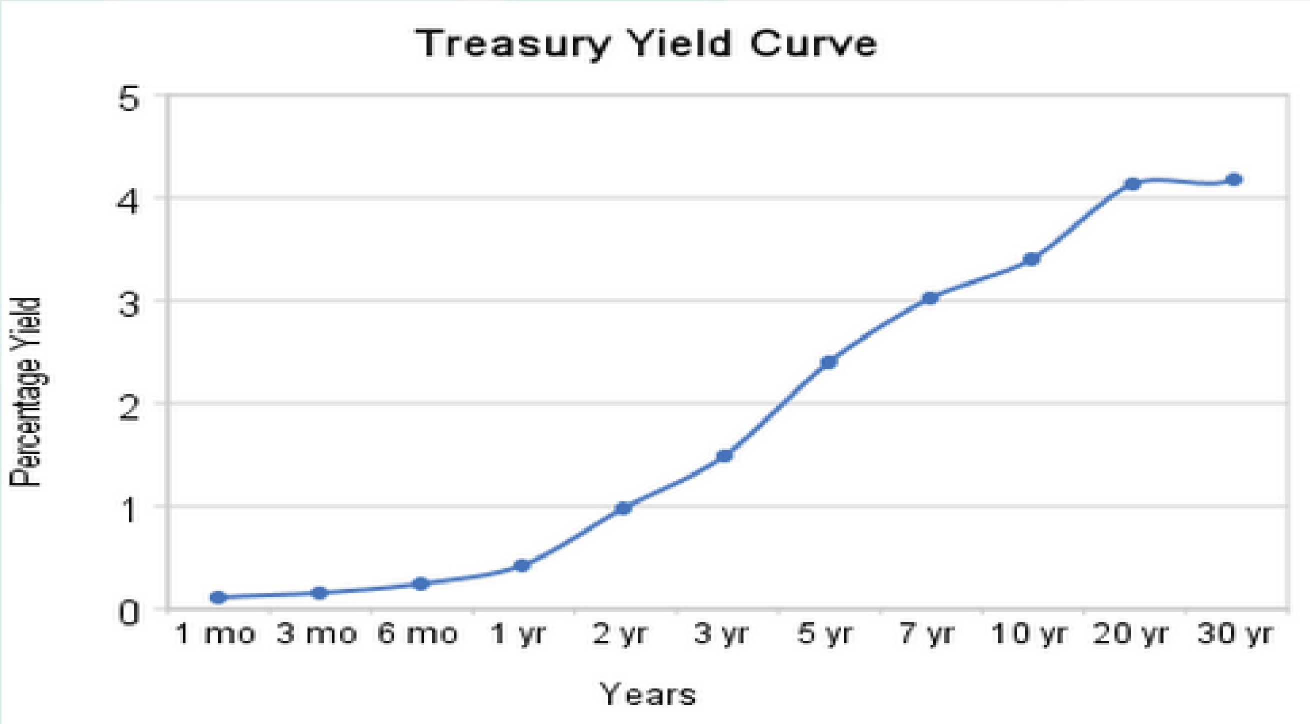
Fixed rate or Floating rate?

- There are two types of interest bearing debt
- **Fixed rate** - the interest rate remains constant over life of the debt
- **Floating rate** - the interest rate on the debt is re-priced generally every 90 days

Borrowing fixed or floating?
USA Example



Floating rate is generally cheaper than fixed rate – but interest rates change over time –

90 days is 0.25%, 10 years is 3.5%

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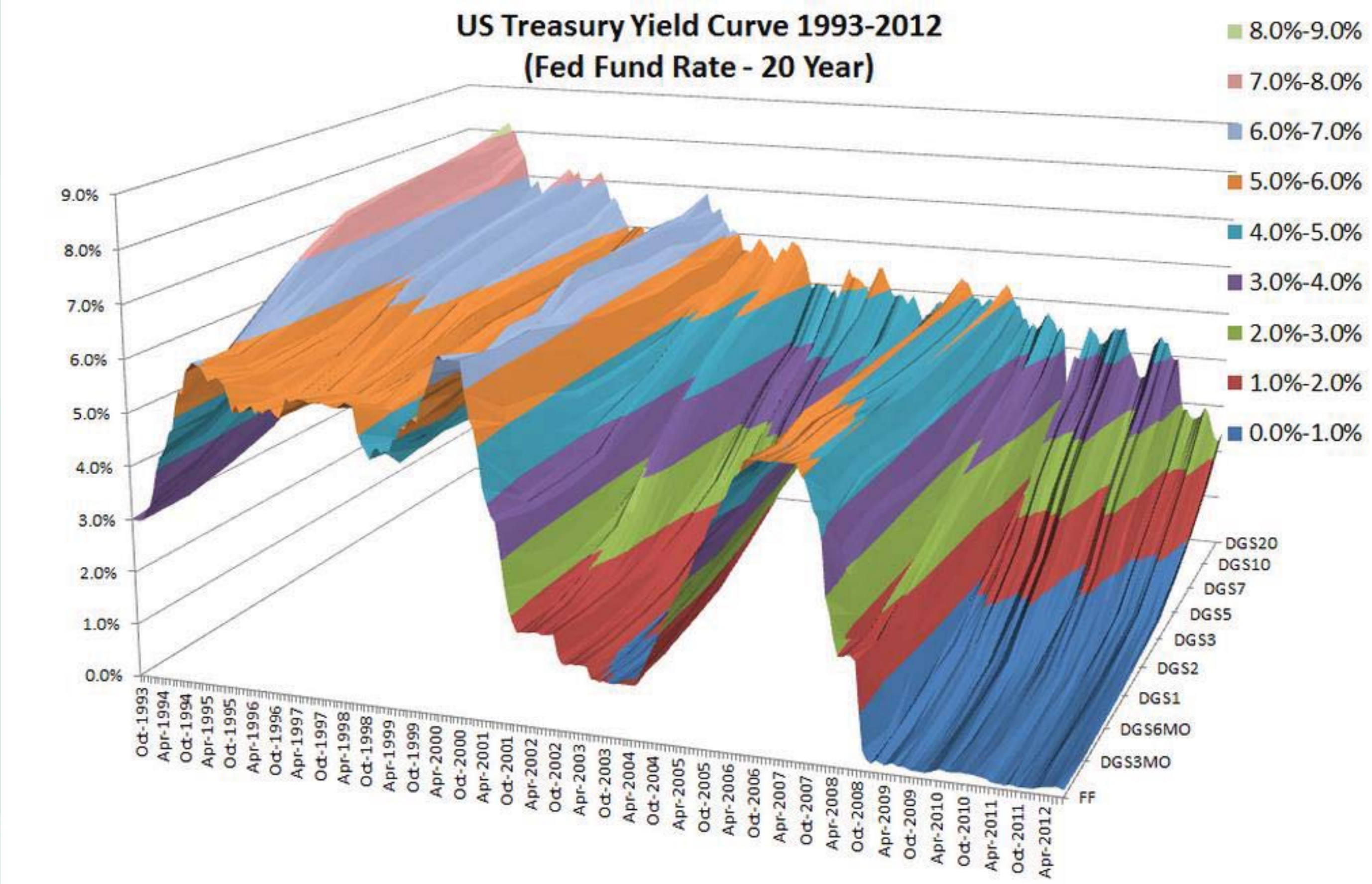
Borrow fixed or floating?

USA Example – Yield Curve over time



The 3 month rate (floating rate) has varied between 7% in 1999 and 0.2% in 2012

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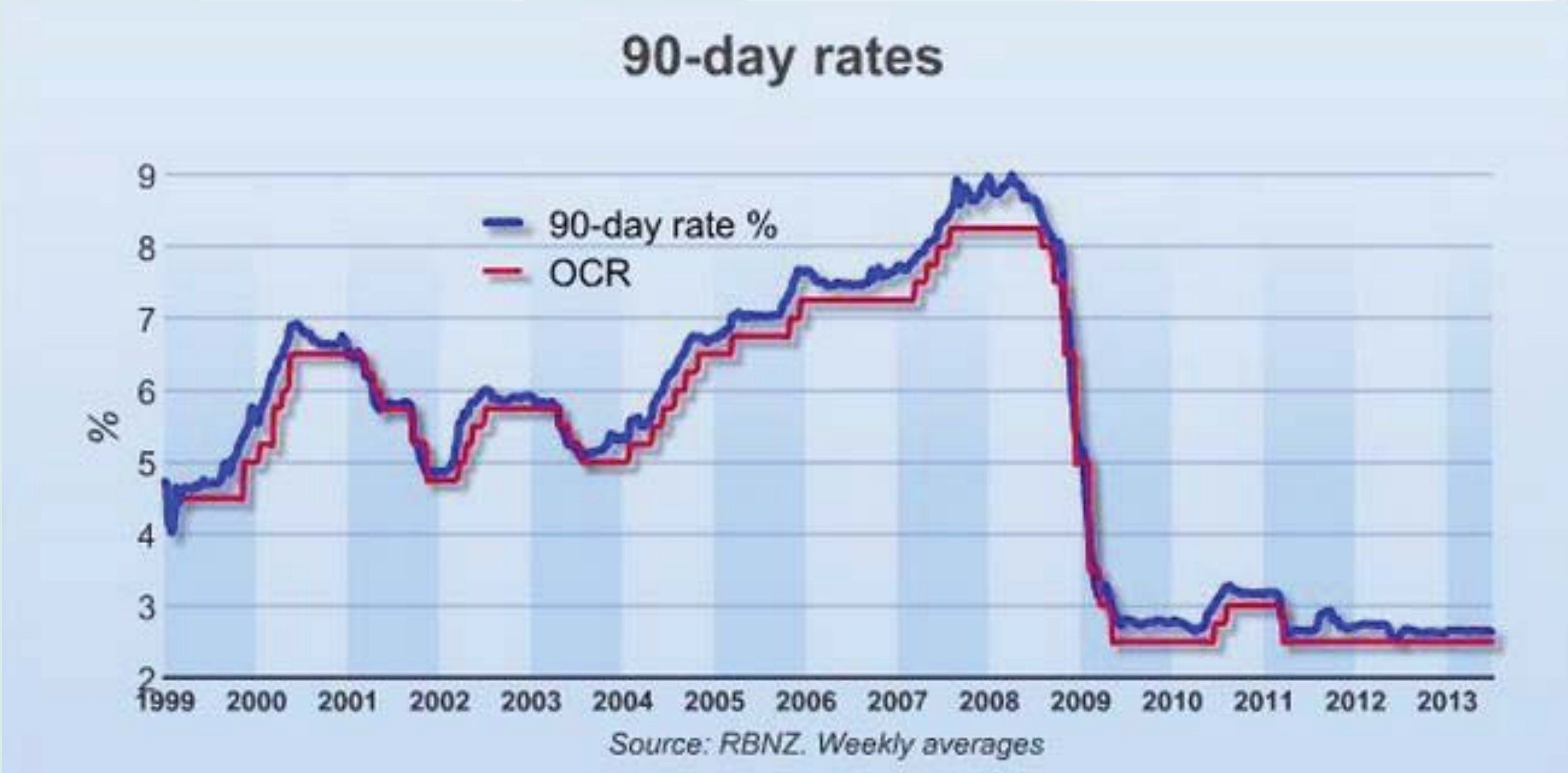
Graph of 90 Day Floating rate

New Zealand example



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Managing interest rate risk

A solution might be to have:

- All borrowing done with fixed rate
- No floating rate allowed
- Opportunity can be lost by not having some floating rate
- Limited ability to change position if interest rates are moving

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How the Council manages its debt

- All Council debt is borrowed at a floating interest rate i.e. re-priced every 90 days
- Funds are borrowed for various terms, overnight, 90 days to 10 years
- Interest rates on Councils debt is managed separately

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How is the Council’s interest rate risk managed?

- The floating interest rate can be switched into fixed rate with an interest rate swap
- An interest rate swap can be for a short time i.e. 6 months or a long time i.e. 10 years
- How and why we do this is governed by our Treasury Risk Management Policy

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What is an interest rate swap?

- It's <u>not</u> investing or borrowing money
- It converts or exchanges one interest payment cash flow for another
- It is an agreement between a bank and us governed by an ISDA agreement
- It is settled every 90 days with a payment/receipt between us and the bank

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Example of a SWAP

- WRC enters into a swap to ensure a fixed interest rate for 1 year at 3.5% on 1 January
- WRC borrow funds at a floating interest rate (each 90 days the rate is re-priced) and rates were:
  - 4.25%, 3.75%, 3.5%, 3.00% on 1 March, 1 June, 1 September, 1 December
  - Borrowed $10 million from LGFA

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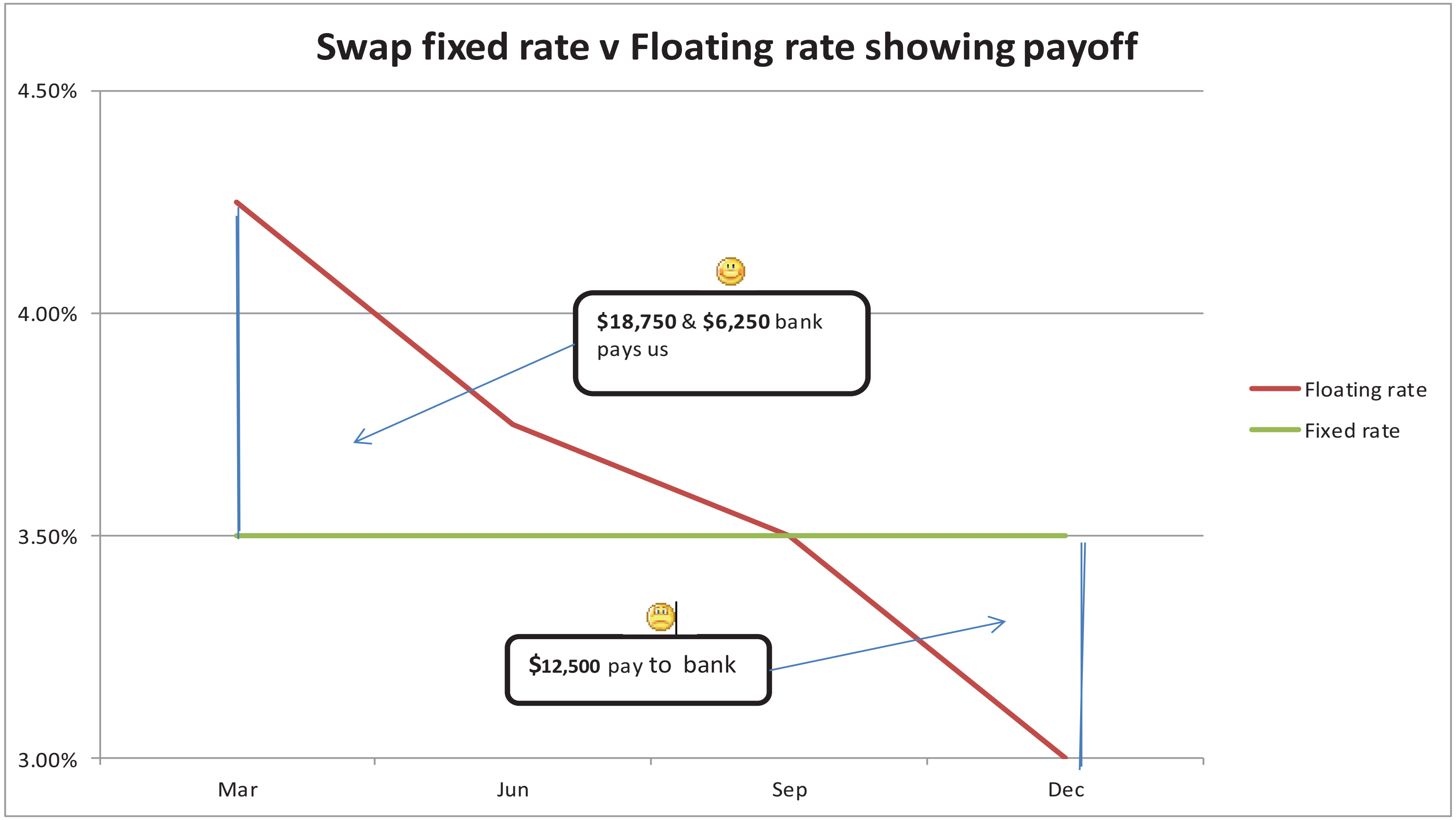
Example of a SWAP

SWAP TRANSACTION					DEBT PAYMENT	
90 Day rate	Fixed Swap rate	Diff	Difference $ based on $10M for 90 Days	Action	WRC pays the LGFA 90 day interest cost	Net Position $
A	B	A-B	A-B = **C**		A*$10m/90 Days= **D**	**C-D**
4.25%	3.50%	0.75%	18,750	Bank pays WRC	106,250	87,500
3.75%	3.50%	0.25%	6,250	Bank pays WRC	93,750	87,500
3.50%	3.50%	0.00%	-	No exchange of funds	87,500	87,500
3.00%	3.50%	-0.50%	(12,500)	WRC pays Bank	75,000	87,500
Net $ received from the Swap			12,500		362,500	350,000
						362,500
			$350,000/$10,000,000 = 3.5%			12,500

Example of a SWAP



NB: The Bank lay-offs the Swap to someone else

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Treasury Risk Management Policy

- Policy sets out the parameters under which we manage our interest rate risk
- Reviewed periodically* and any changes are advocated/supported by our Treasury Advisors –PWC and approved by Council
- Policy provides latitude to take some view on interest rates - reviewed at least quarterly by PWC

*At least every three years

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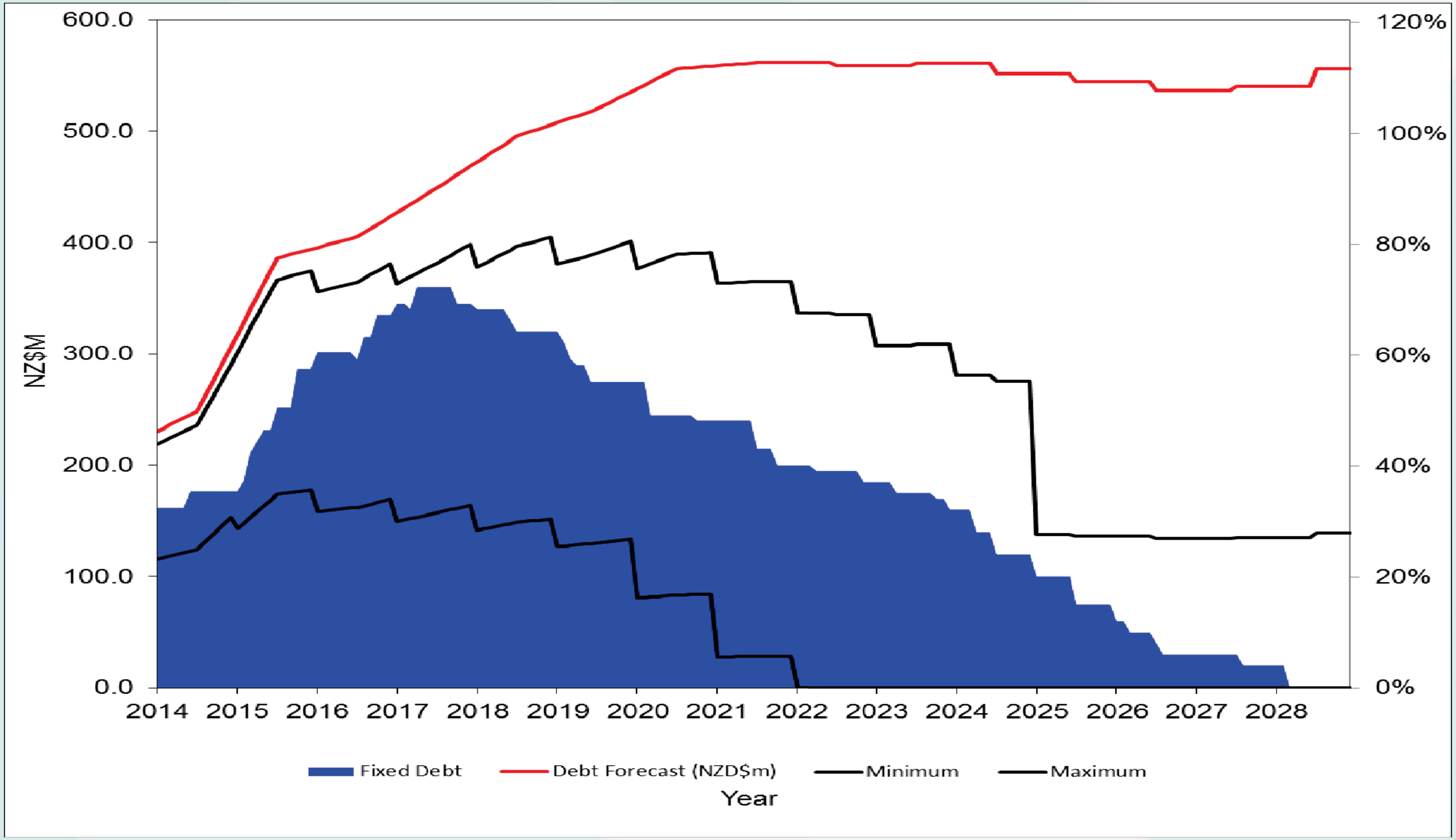
Interest rate Hedging Policy parameters

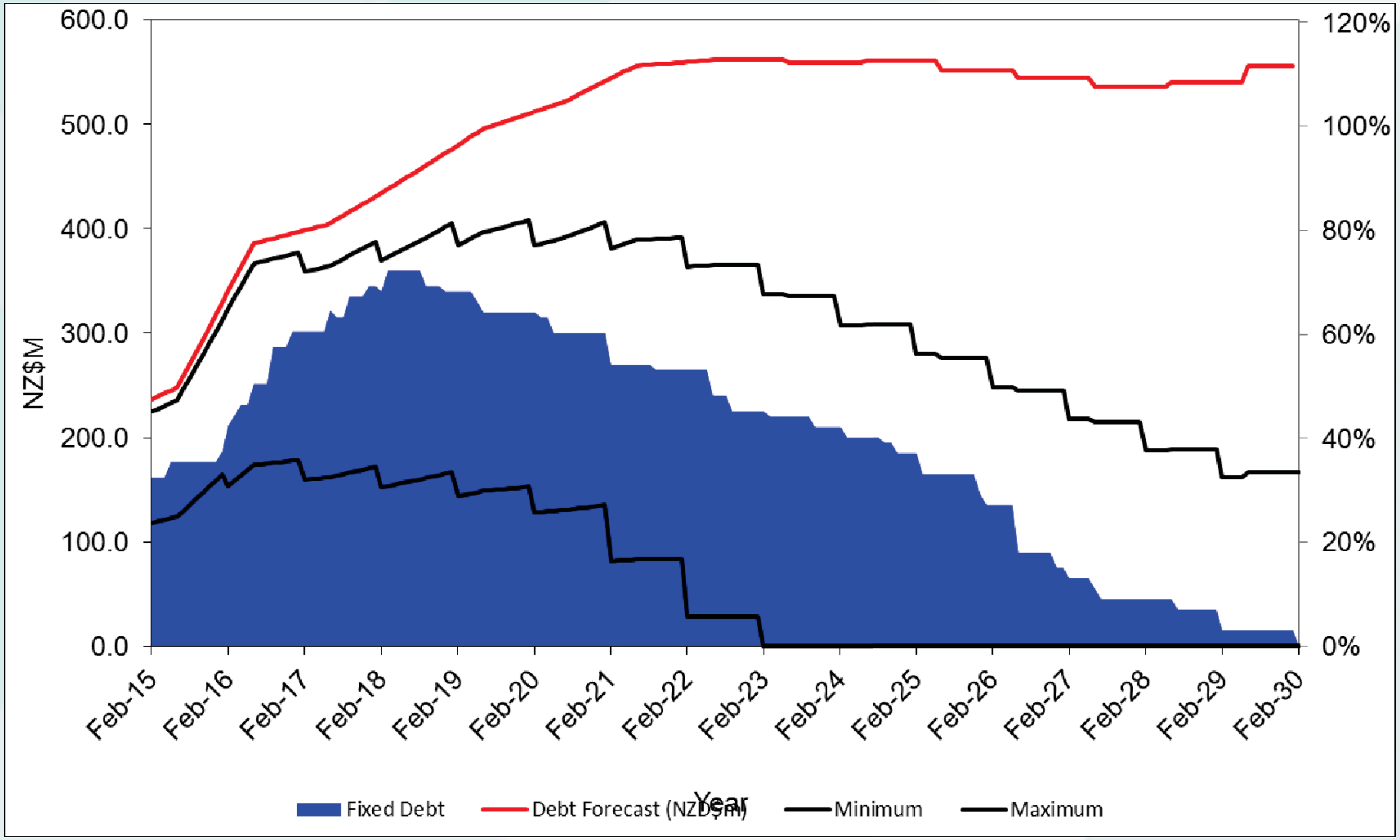
Debt Interest Rate Policy Parameters

	Debt Period Ending	Forecasted Debt Amount	Minimum fixed Debt	Maximum fixed Debt	Actual	Compliant (Y/N)
31/12/14	Current	231	50%	95%	70.1%	Yes
31/12/15	Year 1	317	45%	95%	55.7%	Yes
31/12/16	Year 2	396	40%	90%	67.0%	Yes
31/12/17	Year 3	427	35%	85%	70.2%	Yes
31/12/18	Year 4	472	30%	80%	67.7%	Yes
31/12/19	Year 5	508	25%	75%	54.2%	Yes
31/12/20	Year 6	538	15%	70%	44.6%	Yes
31/12/21	Year 7	559	5%	65%	35.8%	Yes
31/12/22	Year 8	562	0%	60%	32.9%	Yes
31/12/23	Year 9	559	0%	55%	28.6%	Yes
31/12/24	Year 10	561	0%	50%	17.8%	Yes
31/12/25	Year 11	551	0%	25%	10.9%	Yes
31/12/26	Year 12	545	0%	25%	5.5%	Yes
31/12/27	Year 13	537	0%	25%	3.7%	Yes
31/12/28	Year 14	540	0%	25%	0.0%	Yes

Hedging parameters - Graphically



Hedging parameters – Graphically showing new policy adjustment



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Financial Instruments valuations

- Swaps valued regularly, reported quarterly via our Investment Management Report
- Accounting driven entries passed on 30 June
- **Balance sheet** valuation reflect the current position if swap cancelled today
- **Profit and Loss** account amounts represent the **changes** between years
- Valuations vary as interest rate move

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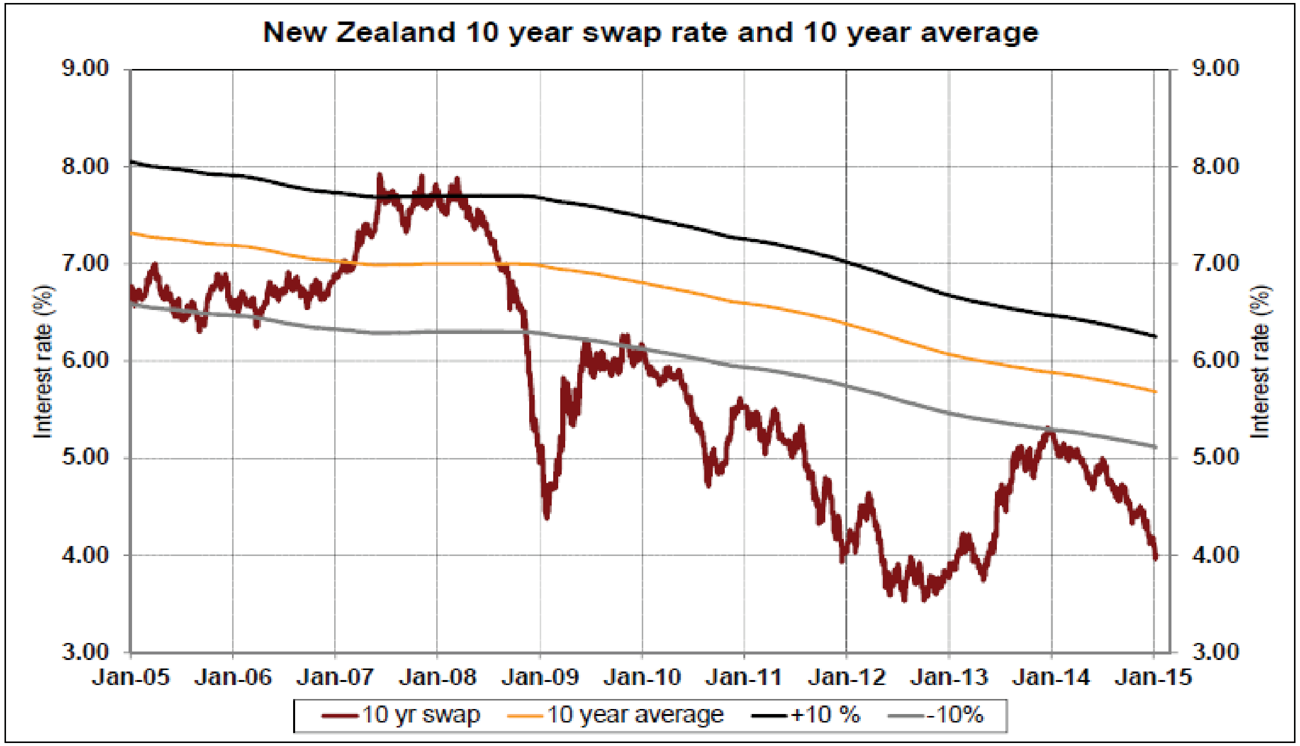
Current rates are well below average

At 3.99% the NZ 10 year swap rate is currently 30% below the 10-year rolling average of 5.68%.



We have recently extended some swaps out in the 2024-2030 area
See hedging parameters graphs

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