Australian Capital Territory

Financial Management (Investment and Borrowing) Guidelines 2005

Disallowable instrument DI2005–270

made under the

Financial Management Act 1996, s107 (Guideline-making power)

EXPLANATORY STATEMENT

Outline

These guidelines are issued in accordance with section 107 of the *Financial Management Act 1996* (the Act) and are one of a set of guidelines that replace provisions previously made through:

- *Financial Management Guidelines 2002*;
- *Financial Management Amendment Guidelines 2003 (No 1)*;
- *Financial Management Amendment Guidelines 2004 (No 1)*;
- *Financial Management Amendment Guidelines 2004 (No 2)*;
- *Financial Management Amendment Guidelines 2004 (No 3)*;
- *Financial Management Amendment Guidelines 2004 (No 4)*; and
- *Financial Management Amendment Guidelines 2005 (No 1)*.

The reissued set of financial management guidelines aims to be more accessible and easier to maintain, by grouping similar provisions with common amendment patterns into separate financial management guidelines.

This instrument, *Financial Management (Investment and Borrowing) Guidelines 2005*, prescribes the investment and borrowing requirements of both the Territory and territory authorities, replacing unchanged the corresponding provisions in sections 4A to 5, Part 3 and the Dictionary of the *Financial Management Guidelines 2002* as amended by the *Financial Management Amendment Guidelines 2004 (No 3)*.

Details of the Financial Management (Investment and Borrowing) Guidelines 2005

Part 1 – Preliminary

Clauses 1, 2, 3 and 4 are formal requirements. They refer to the name of the guidelines, the commencement date of the guidelines and explain the inclusion of a dictionary and notes in the guidelines.

Part 2 – Investment

Clause 5: The Territory utilises the services of specialist external fund managers to manage Territory investments. Clause 5 defines the requirements and obligations of an external fund manager, prescribes that a fund manager cannot be engaged without a formal written agreement (contract) being established, and describes the administrative processes and procedures that must be implemented by the Territory for monitoring and managing the contracts under which the external managers have been engaged.

Clause 6 prescribes the list of allowable asset classes into which Territory funds may be invested. The list includes cash and cash equivalents, derivatives, Australian shares, Australian property and pooled investment funds.

A provision for pooled investment funds is required to deal with situations where investment funds are placed in a fund that invests in prescribed investments. The fund pools the monies of multiple investors into a single vehicle with a common investment objective and strategy (eg unit trusts)

The individual investment contracts with external fund managers (see section 5 above) will, among other things, precisely specify the investment classes that may be used by the fund manager.

Clause 7 prescribes the territory authorities that are to undertake direct investments in a wider range of prescribed investments (see clause 6 above). This approval is subject to providing the Treasurer with an adequate investment plan (see clause 8 below).

The territory authorities prescribed in this clause have unique liability profiles that they are required to fund. Consequently, it is more efficient to allow these authorities to manage their investments directly, in accordance with the provisions of the Act and these Guidelines, rather than facilitating their requirements through the Treasurer investment alternative provided for under section 58 (1) (c) of the Act. In all other instances, the Treasurer will undertake investments on authorities' behalf in accordance with section 58 (1) (c) of the Act.

Clause 8 requires that prescribed territory authorities (see clause 7 above) permitted to invest surplus moneys in accordance with section 58 (1) (d) of the Act must comply with the investment plan approved by the Treasurer.

In order to ensure that investments made outside of the Treasurer's direct control are done so in a prudent and responsible manner, the investment plan requirement

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provides the Treasurer with details of the investment strategy and importantly the associated risks.

The investment plan sets out the bases upon which the investment objectives can be achieved through the adoption of processes that recognise long-term risk and return characteristics of a portfolio of combined asset classes.

Clause 9 defines the meaning of debt instruments for these guidelines. However, the definition excludes securities that are equity stocks, as this type of security is not credit rated.

Additionally, this clause also prescribes the minimum credit rating requirements that debt instrument investments must meet if they are to form part of a Territory investment portfolio. Standard & Poor's and Moody's ratings are used as they are recognised as the two most authoritative ratings agencies in the world. The short and long-term ratings stipulated complement each other (ie they are correlated ratings) to ensure there is no imbalance between short and long-term investment credit risk.

The credit rating restrictions are also applicable to debt instrument investments made outside of Australia. The credit rating restrictions are equivalent to the restrictions prescribed in the Superannuation Management Guidelines.

Part 3 – Derivatives

Clause 10 prescribes the uses and limitations of financial derivatives. These requirements have been modelled on guidelines issued by Australian Prudential Regulation Authority (APRA) for the Australian superannuation funds industry, particularly the Insurance and Superannuation Commission's Superannuation Circular No.II.D.7 "Derivatives" reissued in February 1997.

Consequently, under clause 10, the Territory may only use derivatives for the following purposes:

- to protect a portfolio against adverse price or currency movements;
- to provide additional liquidity to the investment portfolio;
- to reduce transaction costs; and
- to gain or alter (maintain) market exposures (position).

However, clause 10 also specifies that the Territory must not use derivatives for speculation, gearing or leveraging an investment portfolio. Additionally, the Territory must not use a derivative where the potential obligations arising from the underlying asset exposure represented by the derivative position are not covered by physical assets that are the equivalent to cash or can be readily converted to cash.

Clause 11 and **Clause 12.** Derivatives fall broadly into two groups, in terms of the structure of trading, settlement systems and characteristics of the contracts:

1. exchange-traded (ET) derivatives; and
2. over-the-counter (OTC) traded derivatives.

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Clause 11 allows the Territory to enter a transaction for an ET derivative where these are traded on a recognised exchange such as the Sydney Futures Exchange or the Australian Stock Exchange's derivatives market. Counterparty risk is much less of a concern with exchange-traded derivatives because the exposure is actually with the clearing house (exchange) not to another market participant.

OTC contracts are privately negotiated between two counterparties, typically banks or investment banks and their clients, and are specifically tailored to customer needs. Due to OTC contracts being privately negotiated, a level of counterparty risk arises and, consequently, clause 12 prescribes certain counterparty credit rating limitations to minimise the exposure to counterparty risk to the Territory's investment portfolio.

Clause 13. Each written agreement established with individual fund managers (see clause 5 above) also includes a description of any approval to use derivatives and specific restrictions on that usage. Any approval provided under an agreement must read in conjunction with the limitations prescribed under clause 13. These require that an investment fund manager must ensure that where derivatives are held for a Territory investment portfolio:

a the net market exposure (ie the derivative exposure plus the physical exposure) will not result in the portfolio's actual asset allocation exceeding the strategic asset allocation limits specified in the agreement of engagement of the investment fund manager;

b the net market exposure of the portfolio at no time exceeds the net market value of the portfolio; and

c the liquid assets of the portfolio at all times have a total value sufficient to cover the total derivative exposure of the portfolio.

Consequently, a fund manager that is instructed to invest across a variety of assets types must ensure that the exposure of the portfolio to each asset class (combined physical and derivative exposure) does not go beyond the limits provided in the investment management agreement – this prevents speculation. For example, the manager may be required to invest in Australian Equities (50% of total allocation), International Equities (25% of total allocation) and Australian Bonds (25% of total allocation). Speculation occurs if the net exposure of each of the asset classes within the portfolio (combined physical and derivative exposure) exceeds any of the prescribed limits.

Additionally, the total value of the physical stocks and net market exposure cannot exceed the amount of funds available to the fund manager – this prevents gearing. An example of when a portfolio is geared follows. If a fund manager has $100 invested in shares, it may use the shares as collateral to buy another $50 in share derivatives on margin. The net market exposure to shares is now $150, while the physical exposure is $100 ($150 minus the margin debt of $50). The portfolio is therefore 50% geared. A gearing strategy works to magnify value in the direction of the market. If the value of the underlying shares were to decrease, the size of the loss would be magnified by the borrowings. In this situation, the portfolio may be required to repay part of the loan, a "margin call", and thus be left with loan obligations that the portfolio is unable to meet. Due to the riskiness of gearing strategies, the use of derivatives for gearing is prohibited in respect of a Territory investment portfolio.

Similarly, an investment portfolio must at all times hold assets (cash or cash equivalent) of sufficient value at least equal to or higher than the amount of derivative exposure of the portfolio – this ensures sufficient liquidity to cover derivative positions. Therefore, the total derivative exposure cannot exceed 50% of the amount available in the portfolio for investment purposes.

The strategic asset allocation limits, specific derivative limitations, as well as all other restrictions imposed on fund managers are detailed in the fund manager agreements of engagement. These are made publicly available in accordance with the requirements of the *Public Access to Government Contracts Act 2000*.

Fund managers are required to report to the Territory on a periodic basis and provide reports that show compliance with the prescribed derivative usage limitations. In the event that a fund manager breaches the investment management agreement that results in a loss to the Territory, the fund manager will meet the extent of the loss plus any related costs, any gains will be to the credit of the Territory. The terms of the investment management agreements will include provisions for termination in the event of a breach of the agreement.

The Territory's Master Custodian will be responsible for, amongst a number of services, providing a mandate monitoring service. This involves reviewing the investments of the external fund managers to identify if there have been any breaches of applicable investment mandates. Investment mandate monitoring includes the monitoring of fund managers' usage of derivatives in the Territory investment portfolios and the provision of derivative exposure reports to the Territory. The Custodian will measure and report on derivative usage at the end of each month plus undertake random testing on at least one other day during each month.

Clause 14 supports clause 10 to ensure that consistency is maintained between the Territory's derivative controls and usage the controls and usage limitations prescribed for the Australian Superannuation Fund Industry.

Clause 15 prescribes that, in addition to the written agreement that an external funds manager must enter into (see clause 5 above), any funds manager that will be using derivatives in the management of a Territory investment portfolio must also provide the Territory with a Risk Management Statement (RMS).

A fund manager's RMS is required to provide a comprehensive description of the policies it has in place for the use of derivatives, the internal controls on the use of derivatives, and its processes checking on actual compliance with the controls. The RMS establishes the framework for derivatives use and is to provide a link to the investment portfolio's strategy. The RMS is required to address all detailed aspects of derivatives use and control by the party responsible for implementation of derivative investment decisions including; the purpose of derivative use; the restrictions on the use of derivatives; control processes; structure of risk management approach; processes and systems for calculating and monitoring portfolio market exposure; and external audit and reporting requirements.

A fund manager's RMS must satisfy the Territory that it has appropriate policies for the use of derivatives, adequate controls on the use of derivatives, and adequate checks on compliance with those controls. These policies and controls should prevent any improper use of derivatives. In addition, the RMS provided must be consistent with any applicable guidelines issued by APRA.

Clause 16 establishes a formal process of informing the Treasurer about the Territory's investment portfolio's exposure to derivatives. A monthly reporting arrangement is regarded as an essential component of internal risk management processes of ensuring that the Territory's investments are being managed in accordance with the conditions of the investment contracts and the relevant Territory Legislative requirements.

Clause 17 revokes the *Financial Management Guidelines 2002*, as the investment and borrowing provisions are the last to be replaced by the reissued set of 2005 guidelines.

Dictionary

The Dictionary defines particular terms used in this instrument. The definitions provided remain unchanged from those included in the Dictionary of the *Financial Management Guidelines 2002* as amended by the *Financial Management Amendment Guidelines 2004 (No 3)*.

End