Australian Capital Territory

Financial Management Guidelines 2002 –

Explanatory Statement

Disallowable Instrument DI2002-154

Outline

These guidelines are issued in accordance with section 67 of the *Financial Management Act 1996*. These guidelines replace the *Financial Management Guidelines 2001* and the *Financial Management (Amendment) Guidelines 2002*.

These guidelines update the *Financial Management Guidelines 2001* and the *Financial Management (Amendment) Guidelines 2002* with the following changes:

- Meaning of *debt instrument*
  - These guidelines amend the credit rating limitations that previously applied to debt instruments.
- Prescribed investments
  - These guidelines amend the list of prescribed investments. The list of allowable asset classes into which Territory funds may be invested has been expanded to meet revised investment objectives and strategies.
- Additional new Sections
  - A number of new sections have been inserted in the guidelines. These sections prescribe the control mechanisms and state the circumstances under which the use of derivatives will be allowed by fund managers, to ensure that the Territory investments are made within appropriate investment strategies. The prohibition on the use of financial derivatives was removed when the provisions of *Financial Management Legislation Amendment Act 2001* became effective from 12 January 2001.

Details of the Financial Management Guidelines 2002

Part 1 – Preliminary

Sections 1, 2, 3, and 4 are formal requirements. They refer to the name of the guidelines, the commencement date of the guidelines, declare that the dictionary at the end of the guidelines is part of the guidelines, and declare that notes in these guidelines are not part of the guidelines.

Section 5 (1) provides a meaning of debt instruments. This paragraph has been amended to clarify that "securities" excludes equity stocks in regard to debt instrument investments. The reason being that 'equity' type securities are not credit rated whereas fixed interest type debt is rated. The reference to debt instrument investments being issued outside of Australia has also been removed to make it clear that general government investments are restricted to within Australia only.

Section 5 (2) prescribes minimum credit rating requirements that debt instrument investments must meet if they are to form part of a Territory investment portfolio. The short and long-term ratings stipulated complement each other (ie they are correlated ratings) to ensure there is no inequity between short and long-term investment credit risk. The section has also been amended to include credit rating limitations in respect of debt instruments rated by Moody's credit rating agency. Standard & Poor's and Moody's are recognised as the two most prominent ratings agencies in the world.

Part 2 – Financial Statements

Sections 6 to 14 (inclusive) are unchanged from the provisions that previously appeared in the *Financial Management Guidelines 2001* and the *Financial Management (Amendment) Guidelines 2002*.

Part 3 – Investments

Section 15 (1) prescribes the list of allowable asset classes into which Territory funds may be invested and has been expanded to meet revised investment objectives and strategies. The expanded list now includes cash and cash equivalents; derivatives; Australian shares; Australian property; and pooled investment funds.

The addition of derivatives supports changes made by the *Financial Management Legislation Amendment Act 2001* that provided for the removal of the prohibition on the use of financial derivatives in the management of Territory investments.

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

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vehicle with a common investment objective and strategy. Unit trusts are an example of a pooled investment fund.

Investments made under this section are restricted to within Australia only.

Appointed external fund managers are required to enter into individual investment contracts with the Territory and these contracts, amongst other things, will precisely specify the investment classes to be utilised by the fund manager.

Sections 15 (2) to 15 (5) (inclusive) are unchanged from the provisions that previously appeared in the *Financial Management Guidelines 2001* and the *Financial Management (Amendment) Guidelines* 2002.

Section 16 prescribes the purposes for which derivatives may be used and importantly the prohibitions on derivative usage.

The uses of derivatives can be summarised as providing 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). In this regard, derivatives may not be used for speculation or gearing or leveraging an investment portfolio. Further, derivatives must not be used if the potential obligations arising from the underlying asset exposure represented by the derivative position are not covered by physical assets held in the portfolio that are the equivalent to cash or can be readily converted to cash.

In respect of the Australian Superannuation Funds Industry for example, the Australian Prudential Regulation Authority (APRA) recognises that derivatives are a legitimate part of the investment strategy for superannuation funds and are widely used for that purpose. Trustees of Superannuation Funds must ensure that derivatives are used in accordance with the Commonwealth legislation established for the purposes of protecting Superannuation Funds, the *Superannuation Industry (Supervision) Act 1993 (SIS)* and the guidelines set out in compliance circulars issued by APRA. Namely, the Insurance and Superannuation Commission's Superannuation Circular No.II.D.7 "Derivatives" reissued February 1997.

The uses and limitations for financial derivatives prescribed in this section have been modelled on the guidelines issued by APRA.

Section 17 and Section 18. Derivatives fall broadly into two groups, in terms of the structure of trading, settlement systems and characteristics of the contracts: exchange-traded derivatives; and over-the-counter (OTC) traded derivatives.

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 as such the provision outlined in section 18

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provide counterparty credit rating limitations to minimise the exposure to counterparty risk to the investment portfolio.

Exchange-traded derivatives are traded on a recognised exchange such as the Sydney Futures Exchange or the Australian Stock Exchange's derivatives market for example. 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.

Section 19. The approval to use derivatives and any specific restrictions on derivative usage is described in each individual investment mandate that is established with individual fund managers.

The limitations that are prescribed that specifically deal with the restrictions on using derivatives for speculation, and gearing or leveraging are: an investment fund manager must ensure that if derivatives are held for a Territory investment portfolio - (a) the net market exposure, being 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; and (b) the net market exposure of the portfolio at no time exceeds the net market value of the portfolio.

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.

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 then uses 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 was 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 which 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.

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

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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 will be detailed in the fund manager agreements of engagement. These will be made publicly available in accordance with the requirements of the *Public Access to Government Contracts Act 2000*.

Fund managers will be required to report to the Territory on a daily 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. 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.

Section 20. This provision has been provided in the financial guidelines to endeavour to maintain consistency between the Territory's derivative controls and usage the controls and usage limitations prescribed for the Australian Superannuation Fund Industry.

Section 21. For a number of years now the Territory has utilised the services of specialist external fund managers to manage Territory investments. This section has been included to make clear the requirements and obligations of an external fund manager, advise that a fund manager cannot be engaged without a formal written agreement (contract) being established, and to also describe the administrative processes and procedures that must be implemented by the Territory for the purpose of monitoring and managing the contracts under which the external managers have been engaged.

Section 22. In addition to the written agreement that an external funds manager must enter into (s.21), 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

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the use of derivatives, and its processes checking on actual compliance with the controls. The RMS establishes the framework for derivatives used 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 managers 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.

Section 23. The objective of this section is to establish a formal process of reporting the Territory's investment portfolio's exposure to derivatives to the Treasurer. 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.

Part 4 – Miscellaneous

Section 24 is unchanged from the provisions that previously appeared in the *Financial Management Guidelines 2001* and the *Financial Management (Amendment) Guidelines 2002*.

Section 25 is a formal requirement that declares what previous guidelines are being repealed.

Dictionary

The following new definitions have been inserted to assist with the interpretation of many of the new terms that form part of the financial guidelines:

> ***counterparty***, to a derivative an investment fund manager has entered into, is the other party to the contract.
>
> ***cover***, in derivative positions to increase exposure, means assets covering potential liabilities in the position that are cash, equivalent to cash or can be converted to cash within the settlement period.
>
> ***cover***, in derivative positions to reduce or eliminate exposure, means the assets for which the derivatives are a reasonable hedge.

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derivative means a financial asset or liability whose value depends on, or is derived from, the value of an underlying asset or liability or performance of an index, and includes the following:

forward rate agreements;

futures;

forwards;

swaps;

options;

share ratio futures;

warrants.

derivative exposure, for an investment portfolio, means the total derivative exposure of the portfolio.

ET derivative (exchange traded derivative) means a derivative created and traded on a recognised exchange.

forward means a binding agreement to buy or sell a commodity, currency or security at a fixed time in the future at a price agreed on or before a future date.

forward rate agreement means a contract for borrowing or lending at a stated interest rate over a stated time period that begins on a future date.

future means a binding agreement to buy or sell a commodity or security at a fixed time in the future at a price fixed when the agreement is entered into.

gearing or leveraging, for an investment, means the use of various financial instruments or borrowed capital to increase the potential return of the investment or to increase the exposure without making the underlying cash available.

investment fund manager—see section 21 (Engagement of investment fund managers).

liquid assets means cash, cash equivalents or assets readily convertible into cash.

Moody's means Moody's Investors Service Pty Ltd.

net market exposure, for an investment portfolio, means the total derivative exposure and physical exposure of the portfolio.

option means a right, without an obligation, to buy or sell a commodity, currency, security or futures contract.

OTC derivative (over-the-counter derivative) means a derivative not listed on any exchange that has been structured to meet the particular needs of the person buying it.

physical exposure, for an investment portfolio, is the net market value of the portfolio's underlying assets and securities that do not depend on the value of an underlying asset.

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recognised exchange means a formal exchange for trading derivatives and securities which is established by and regulated under the relevant law where the trading takes place.

Examples of recognised exchanges

- Australian Stock Exchange
- Sydney Futures Exchange

share ratio future means a futures contract based on the relative movements between the price of a specified share and a market index.

speculation means investment activity of any of the following kinds:

(a) investment activity that takes the exposure of an investment portfolio to a class of assets beyond the exposure appropriate in accordance with any investment strategy, guideline or requirement formulated for the portfolio;

(b) investment activity that takes the risks for an investment portfolio beyond the risk allowed by any investment strategy, guideline or requirement formulated for the portfolio;

(c) investment in uncovered derivatives;

(d) investment activity that circumvents limitations on borrowing for the portfolio.

Standard & Poor's means Standard & Poor's Pty Ltd.

strategic asset allocation, for an investment portfolio, means the long-term target weightings given to particular investments such as shares, fixed interest, property and cash.

swap means a binding agreement between 2 parties to trade the cashflows corresponding to different securities without exchanging the securities directly (including currency swaps and interest rate swaps).

Territory investment portfolio means a portfolio of investments made under the Act, section 38 (1) and money provided for making the investments.

underlying asset means an asset on which a derivative contract is based.

warrant means a right, without an obligation, to buy shares at a fixed price over a specified time period.

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