

Parliament of the Commonwealth of Australia

**HOUSE OF REPRESENTATIVES STANDING
COMMITTEE ON FINANCIAL INSTITUTIONS AND
PUBLIC ADMINISTRATION**

**REPORT OF THE INQUIRY INTO ANAO
AUDIT REPORT NO. 6 1996-97 ON COMMONWEALTH
GUARANTEES, INDEMNITIES AND LETTERS OF
COMFORT**

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FOREWORD

This report covers the issues raised in the Audit-General's report no. 6 of 1996-97 entitled *Commonwealth guarantees, indemnities and letters of comfort*. The House of Representatives Standing Committee on Financial Institutions and Public Administration makes several significant recommendations as a result of its review of this highly critical report.

The review of this audit report reflects the Committee's continued interest in public sector management issues. The ANAO raised some very serious concerns about management of risk by some agencies in an area where Commonwealth exposure, while mostly low risk, is in aggregate a very large sum.

I thank the members of the Committee for their participation in the conduct of the review and in the preparation of this report. The Committee extends its appreciation to the ANAO and the other agencies which contributed to the review.

David Hawker MP
Chairman

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TERMS OF REFERENCE

The Standing Committee on Financial Institutions and Public Administration is empowered to inquire into and report on any matters referred to it by either the House or a Minister including any pre-legislation proposal, bill, motion, petition, vote or expenditure, other financial matter, report or paper.

Review of the Audit-General's audit report No. 6 of 1996-97 - Performance Audit - *Commonwealth guarantees, indemnities and letters of comfort.*

ACRONYMS AND ABBREVIATIONS

ANAO	Australian National Audit Office
APS	Australian Public Service
Defence	Department of Defence
DIST	Department of Industry, Science and Tourism
DPIE	Department of Primary Industries and Energy
EFIC	Export Finance and Insurance Corporation
Finance	Department of Finance
GBE	Government Business Enterprise
ISC	Insurance and Superannuation Commission

RECOMMENDATIONS

- 1 That the power of Commonwealth statutory authorities to accept liabilities, including contingent liabilities, be regularly reviewed by portfolio departments, in consultation with the ANAO and Finance, to ensure that the Commonwealth's interests are protected. (paragraph 2.15)
- 2 That agencies be required to follow the recommendations of the ANAO and Finance concerning the formal authorisation of officers to issue indemnities on behalf of a Minister. Each agency should also be required to provide a copy of its register of authorised officers to Finance on a regular basis. (paragraph 2.19)
- 3 That agency heads be required to take account of their responsibility with regard to management of the Commonwealth's contingent liabilities. Subject to ultimate Ministerial responsibility and accountability to the Parliament, it is the responsibility of agency heads to ensure the agency complies with guidelines and other instructions concerning contingent liabilities. (paragraph 3.12)
- 4 That agencies take account of the direction to include a limit where possible. Agencies should always attempt to measure the potential financial cost as part of risk assessment, either internally or with external assistance, and should keep a record of that assessment. Where a limit is not included, agencies should record the reason for that arrangement as part of the risk assessment. (paragraph 3.22)
- 5 That the Department of Finance in consultation with the ANAO issue a 'better administrative practice' document to provide agencies with more direct assistance on how to introduce and maintain a central register of contingent liabilities. (paragraph 3.29)
- 6 That agencies consider introducing contract registers, in particular with a view to addressing concerns about the increased emphasis on outsourcing Commonwealth functions. In the absence of a register, agencies should ensure that contingent liabilities in contracts, if any, are recorded separately on a Register of Guarantees, Indemnities and Letters of Comfort. (paragraph 3.40)
- 7 That Defence review its existing contracts and its contract management practices to ensure that its central record keeping and finance areas are fully informed of all contingent liabilities contained in contracts. (paragraph 3.41)
- 8 That agencies which report contingent liabilities to the public or to Ministers, review those values, in consultation with the ANAO where relevant, to ensure that they calculate the values accurately. (paragraph 3.60)

- 9 That the Department of Finance, in consultation with the ANAO, takes all steps necessary to ensure that whole of government risk reporting in the Statement of Risks provides an accurate description of the Commonwealth's exposure. (paragraph 3.61)
- 10 That Finance, in its review of the Commonwealth policy of self insurance, take account of the need for expertise in managing risk and the cost to departments of providing such expertise in-house or externally. (paragraph 3.88)
- 11 That the review of the governing legislation for EFIC under the Commonwealth's Legislation Review Schedule include consideration of the appropriate prudential regulation arrangements for EFIC where commercial risks are covered. (paragraph 3.97)
- 12 That the ANAO review the management of the Commonwealth's contingent liabilities, and agency compliance with the guidelines on issuing indemnities, guarantees and letters of comfort, in two years time. (paragraph 3.108)

CHAPTER 1

INTRODUCTION

1.1 On 17 September 1996, the Leader of the House, Peter Reith MP, referred to the Committee the Australian National Audit Office (ANAO) Report No. 6 1996-97 entitled *Commonwealth Guarantees, Indemnities and Letters of Comfort*. The performance audit set out to quantify the Commonwealth's exposure to guarantees, indemnities and letters of comfort. These instruments represent a contingent liability for the Commonwealth.

1.2 The Committee has also examined the management and reporting of the contingent liabilities of Commonwealth government business enterprises and statutory authorities, including derivatives. The ANAO performance audit did not cover the contingent liabilities of these agencies.

1.3 Contingent liabilities are defined as costs the Government will have to face if a particular event occurs.¹ Thus, these instruments have an implicit cost to taxpayers.

1.4 The ANAO adopted the following definitions for the purpose of the performance audit:

- A *guarantee* is a promise whereby one party promises to be responsible for the debt of, or performance obligations of another, should this party default in some way;
- An *indemnity* is a promise whereby a party undertakes to accept the risk of loss or damage another may suffer; and
- A *letter of comfort* is an instrument which is used to facilitate an action or transaction but is constructed with the intention of not giving rise to a legal obligation.²

1.5 Chapter 2 of this report discusses the extent of the Commonwealth's financial exposure through contingent liabilities. It also discusses the ability of agencies to bind the Commonwealth to potential liabilities through issuing guarantees and indemnities.

1.6 The ANAO performance audit identified some serious shortcomings in the management and accountability arrangements for guarantees, indemnities and letters of comfort. As a result the Commonwealth is not informed about or aware of the potential losses that might arise. In too many cases the risk attached to these instruments is not managed at all. Moreover there is a lack of understanding amongst Commonwealth agencies of the need to manage risk. Commonwealth agencies use these instruments intending to assist the Government's operations. However, the ANAO had become aware of problems, through performance audits of some asset sales and concerns expressed by public sector managers.³

1 *Budget strategy and outlook 1997-98*. Budget Paper No 1. May 1997. Canberra, AGPS, p 2-35.

2 ANAO. 1996. *Audit report no. 6 1996-97: Commonwealth guarantees, indemnities and letters of comfort*. Canberra, AGPS, p 3.

3 *Ibid* p 4.

1.7 One example is the sale of the Moomba to Sydney gas pipeline. As part of the sale, the Commonwealth made payments to release it from performance guarantees and contractual obligations given to the Coopers Basin Gas Producers and the Australian Gas Light Company. The relevant Minister had signed the documents for the guarantees in 1974. (A discussion of the guarantees is at Appendix 3.) The payments of \$50 million compare to the net sale proceeds of \$260 million.⁴ Thus the guarantees reduced the net sale proceeds significantly.

1.8 In evidence to the Committee, witnesses noted improvements in the management and monitoring of guarantees, indemnities and letters of comfort. The ANAO advised the Committee that the audit report should improve management and reporting.

The value of this audit, as I see it, has been in raising the awareness of agencies about managing the exposures associated with these instruments. This awareness raising, combined with the audit recommendations and the developments we have seen with respect to accrual accounting and reporting, should see a significant improvement in administration in this area.⁵

1.9 The ANAO noted that the audit report tied in with other changes to the financial management framework:

...the move to commercial accounting, accrual accounting and reporting could be expected to make a significant difference in this area because, when the Commonwealth used to cash account, you only worried about the cash in and the cash out, and guarantees, indemnities, assets and liabilities were something outside the accounting framework.⁶

1.10 Evidence to the Committee indicated that agencies are beginning to take appropriate action to raise the management of the Commonwealth's contingent liabilities to an acceptable standard. Chapter 3 of this report discusses these improvements, and includes the Committee's comments and recommendations. In its discussion, the Committee is mindful that the ANAO is planning to conduct a follow up audit. The follow-up audit should further improve agencies' awareness of these issues.

1.11 The inquiry received thirteen submissions from government agencies and one private firm. A list of the submissions is at Appendix 1. The Committee held five public hearings through November 1996 to June 1997. A list of the hearings and witnesses is at Appendix 2.

4 ANAO. 1995. *Audit report No. 10 1995-96: Sale of the Moomba to Sydney gas pipeline*. Canberra, AGPS; and evidence pp 10-11.

5 Evidence p 5.

6 Evidence p 12.

CHAPTER 2

COMMONWEALTH EXPOSURE

Extent of Commonwealth contingent liabilities

2.1 The Australian National Audit Office (ANAO) conducted its audit looking at a subset of the Commonwealth's overall contingent liabilities — formal liabilities as guarantees, indemnities and letters of comfort. Within this subset there is a wide range of liabilities. Some agencies have a statutory performance guarantee, such as the Export Finance and Insurance Corporation (EFIC). The guarantee applies to all of EFIC's commitments. In contrast the Australian Wheat Board has a statutory guarantee for certain borrowings. The guarantee does not apply to all borrowings, and does not apply to other commitments. A range of monitoring arrangements, borrowing limits or other administrative controls cover loan and non-loan guarantees.

2.2 Indemnities cover a wide range of circumstances. Large indemnities are sometimes provided through the Department of Communications and the Arts Commonwealth Indemnity Scheme. The scheme provides indemnities to cover selected cultural exhibitions. There are also many indemnities for which there is no specified financial limit, such as the indemnity to CSL Ltd relating to the supply of blood products.¹ The Department of Defence (Defence) uses indemnities extensively as part of its activities. These include many indemnities issued by the Defence Acquisition Organisation for assets under construction, such as naval ships.²

2.3 The performance audit identified at least \$222 billion in value of guarantees, indemnities and letters of comfort. This figure does not include a large number of indemnities which have no specified financial limit. The ANAO also consider that they have not captured all of these instruments, because of the poor record keeping of departments. The ANAO went to departments three times to collect this information.

...in the first instance we were starting to get some conflicting information in fieldwork, particularly in regard to numbers and the actual instruments. So we asked for that confirmation. Every time we asked for that, we would turn over something that was slightly different, which gave us the impression that there was more out there.³

2.4 Adding up the financial limits on formal contingent liabilities reveals little about the true risk to the Commonwealth. The risk depends largely on the management and monitoring of the contingent liabilities. The ANAO report highlights the need for improvements to the management and monitoring arrangements of departments.

1 Evidence p 9. See also ANAO. 1995. *Audit report no. 14 1995-96: The sale of CSL*. Canberra, AGPS.

2 Evidence p S80.

3 Evidence p 12.

2.5 The largest exposures appear to be well managed. It is highly unlikely the Commonwealth will ever have to make payments under those guarantees. The largest exposure recorded by the ANAO was for the Commonwealth Bank of Australia (on-balance sheet) with a value of \$91 billion at 30 June 1995.⁴ Under the terms of the *Commonwealth Bank Sale Act 1995*, the Commonwealth has guaranteed various liabilities of the Bank, relating to both on-balance and off-balance sheet liabilities. At 30 June 1996 this guarantee had a value of \$325 billion.⁵ This guarantee covers obligations which are subject to the reporting and prudential supervision requirements of the Reserve Bank, including risk capital requirements.

2.6 In addition to formal instruments, there are non-formalised liabilities that exist through the conduct of Commonwealth business. This includes legal, political or public interest obligations arising from the actions of the Commonwealth or Commonwealth agencies. One example raised in evidence to the Committee was the possible extent of the Commonwealth's obligation to stand behind its agencies.

Under its political and public interest obligations, one would need to consider whether any government could realistically stand by and let a Commonwealth entity become insolvent to the point of destruction of the Commonwealth's usually very considerable investment in the enterprise.⁶

...the question must be asked as to whether the Commonwealth can limit its liability at law for agencies and authorities which it has created for public purposes. Regardless of the form of support indicated in legislation, that same legislation always deals with the power of the agency or authority to borrow moneys, and to varying degrees requires the relevant minister to approve such borrowings... it would not be difficult to build a case that the Commonwealth has the obligation to ensure that those debts can be repaid.⁷

2.7 The Committee asked Wool International how much it could have borrowed without the benefit of a government guarantee. The response was that it could have continued borrowing because of an implicit guarantee.

Prior to the governing legislation of the Australian Wool Corporation being amended to provide for guarantees of borrowings in early 1990, several hundred million dollars had been raised under approved borrowing programs. It is most likely that the Australian Wool Corporation could have continued borrowing for quite some time given the implied guarantee that emanates to a statutory authority performing a function bestowed on it by legislation.⁸

2.8 Another example is the general indemnity provided under Finance Direction 21 to Commonwealth officers. Finance Direction 21 expresses the Executive Government's commitment to defending its officers against legal claims relating to their official duties. The Commonwealth will also accept comparable liability for the reasonable actions of other persons performing Commonwealth functions.⁹

4 ANAO. 1996. *Audit report no. 6 1996-97: Commonwealth guarantees, indemnities and letters of comfort*. Canberra, AGPS p 73.

5 *Budget strategy and outlook 1997-98*. Budget Paper No 1. May 1997. Canberra, AGPS, p 2-45.

6 Evidence p 26.

7 Evidence p 50.

8 Evidence pp S66-67.

9 Evidence pp S46-47.

2.9 The proposed Commonwealth Authorities and Companies Act will empower Commonwealth authorities to indemnify their directors and officers themselves. The existing indemnity will be withdrawn from this application.¹⁰

Power to incur liabilities

2.10 The power of a statutory authority to accept liabilities on behalf of the Commonwealth or on their own behalf varies between agencies. These liabilities may or may not be covered by an explicit guarantee. However, the recipient of an agency's guarantee or other commitment might consider that the Commonwealth guarantees the contingent liability implicitly, in full or in part. There is a question as to whether the Commonwealth can limit liabilities which may arise from the contingent liabilities of a statutory authority.

2.11 Wool International suggests that there be a commonality of the borrowing powers for statutory authorities. It also suggests that there be an explicit acknowledgment that the Commonwealth will meet the liabilities of the agency.¹¹ The Committee expects that Finance will consider the appropriate arrangements for situations where an implied guarantee is often taken to exist.

2.12 The governing legislation of statutory authorities should place appropriate restrictions on the ability of an authority to accept contingent liabilities and provide guarantees. For example the National Standards Commission has the authority, under its governing legislation, to guarantee loans for the purposes of metrology.¹² Appropriate restrictions could include a financial limit on the value of loans for which the authority can provide a guarantee, or a requirement that loan guarantees be approved by the portfolio department.

2.13 Some liabilities are managed closely, such as the guarantee of the Australian Wheat Board borrowings under section 77 of the *Wheat Marketing Act 1989*. The Act requires that the Minister must approve any borrowings which the guarantee covers.¹³

2.14 There is a strong case for departments, in consultation with the ANAO and Finance, to review the power of statutory authorities to accept contingent liabilities. This is to ensure that the Commonwealth's interests are protected. Reviews should be well documented and accountable to Ministers. The Committee recommends that the ANAO, as part of its follow-up audit, report on action taken by agencies to monitor and manage the ability of statutory authorities to accept contingent liabilities.

10 Ibid. Note that at the time of writing the proposed legislation had not been passed by Parliament.

11 Evidence p S16.

12 *National Measurement Act 1960*, section 18.

13 Evidence p S21.

2.15 Recommendation 1

That the power of Commonwealth statutory authorities to accept liabilities, including contingent liabilities, be regularly reviewed by portfolio departments, in consultation with the ANAO and Finance, to ensure that the Commonwealth's interests are protected.

2.16 The ANAO report discusses the ability of departmental officers to issue indemnities on behalf of the Commonwealth. Ministers may authorise an officer to issue indemnities on their behalf. There is no requirement for Ministers to issue formal instruments to so authorise officers. According to the ANAO, there is often no limit on the value of the indemnity that an officer may authorise, even though it is good practice have a limit. The ANAO recommended agencies review their authorisation arrangements (recommendation (7)).¹⁴

2.17 Finance, in conjunction with ANAO and Attorney-General's Department have issued revised guidelines for the issuing of indemnities, guarantees and letters of comfort.¹⁵ The guidelines recommend that authorisation of officers to issue Commonwealth indemnities be through formal instruments. In addition, the authorisation should be for specific categories of indemnities and contain specific financial limits. Finance notes: '...however, it is a matter for Ministers to decide each case on its merits.'¹⁶ The guidelines also recommend that agencies maintain an up-to-date central register of all officers authorised to issue indemnities.

2.18 If not monitored and controlled properly, the ability of officers to commit the Commonwealth to large contingent liabilities without the Minister's approval is potentially of great concern.

2.19 Recommendation 2

That agencies be required to follow the recommendations of the ANAO and Finance concerning the formal authorisation of officers to issue indemnities on behalf of a Minister. Each agency should also be required to provide a copy of its register of authorised officers to Finance on a regular basis.

14 ANAO. 1996. op cit pp 37-38.

15 Finance Circular 1997/06: *Potential Liabilities and Losses*. The circular replaces the previous Circular 1989/11: *Guidelines for the Issuing of Commonwealth Indemnities*.

16 Evidence p S46.

CHAPTER 3

MANAGEMENT AND MONITORING ARRANGEMENTS

Role of the Departments

3.1 The Australian National Audit Office (ANAO), the Department of Finance (Finance) and the portfolio departments perform distinct functions in the management and monitoring of contingent liabilities of the Commonwealth. The Committee received evidence explaining the roles of different agencies.

3.2 Subject to ultimate Ministerial responsibility and accountability to the Parliament, agency heads are responsible for the management and monitoring of contingent liabilities under their portfolio. The proposed Financial Management and Accountability Act will include a provision which makes clear that the head of the agency is responsible for the administration of the department.¹ (The Parliament has yet to pass this legislation.) The ANAO is clear on this issue:

There has not been the ongoing monitoring; there has not been the ongoing reporting. That responsibility, even within the existing Finance framework, resides very clearly with agency heads, and I would suggest that is where it should reside.²

3.3 Finance is responsible for advising on and administering the Commonwealth's financial framework. A good framework is essential to achieving good management. In this way Finance's role is to promote good administrative practice.

Finance is very conscious of the fact that good frameworks are a prerequisite to good management performance. We acknowledge that we need to do more to ensure that good public policy outcomes are achieved.³

3.4 For example, in May 1997, Finance, in conjunction with the ANAO and Attorney-General's Department, issued revised guidelines for the issuing of indemnities, guarantees and letters of comfort.⁴ It is up to agency heads to emphasise the importance of the guidelines to relevant staff within their agencies.

3.5 In evidence to the Committee, the Department of Primary Industries and Energy (DPIE) and the Department of Defence (Defence) responded positively to the release of the revised guidelines.

1 Evidence p 18.

2 Evidence p 15.

3 Evidence p 26.

4 Finance Circular 1997/06: *Potential Liabilities and Losses*.

My overall reaction to it, having only just received it and read it in the past couple of days, is that it provides a useful basis for defence in terms of high level policy.⁵

My initial view of the latest Department of Finance material is that it is much clearer; it is a very well written document that actually specifies, at least in broad, the full range of things that we have to cover off. We see it as a good response to the sorts of directions that were set out in the audit report.⁶

3.6 The guidelines work towards raising the awareness of agencies concerning risk management of off-balance sheet exposures, in line with ANAO recommendation 2. The guidelines also incorporate ANAO recommendations 5, 6, 7, 10, 11 and 14. The Committee welcomes the revised guidelines, and congratulates the three agencies which produced the guidelines. The guidelines are an important step in improving the management of the Commonwealth's guarantees, indemnities and letters of comfort.

3.7 Finance claims that it does not have the role of enforcing the provisions of its guidelines. Instead Finance relies on the ANAO to report on compliance. The ANAO accepts that role. The powers of the ANAO to examine records and report on performance are set out in the *Audit Act 1901*.⁷ The ANAO and Finance noted the following:

...we have a responsibility to report in terms of what we find either during our financial statement audits or part of this process.⁸

In the course of its audits, the ANAO often reports on compliance. Finance, therefore, considers that the ANAO is an effective vehicle to provide this information through its audit reports.⁹

3.8 The Committee expects that the ANAO, in its next round of financial statement audits will check that agencies comply with the revised guidelines for issuing indemnities, guarantees, and letters of comfort.

3.9 When the ANAO makes recommendations for improvements, Finance examines audit reports under the Auditor-General's follow-up arrangement. Finance asks agencies to report remedial action on any audit recommendation or adverse finding that the agency has not addressed adequately in the context of the audit.

3.10 While this is a thorough process, it cannot guarantee good management. It has taken several years for the ANAO to identify problems with the management of the Commonwealth's guarantees and indemnities. The ANAO report makes it clear that agencies failed to follow all the instructions in the previous Finance circular on issuing indemnities, produced in 1989. Finance and the ANAO rely on agencies to follow guidelines and to report their activities accurately.

3.11 For the Commonwealth's exposures to be appropriately recorded and monitored, agency heads must accord good financial management a high priority. While other areas of

5 Evidence p 115.

6 Evidence p 102.

7 Legislation to replace the Audit Act has been introduced into Parliament, but has yet to be passed.

8 Evidence p 18.

9 Evidence p S55.

financial management may demand more attention, there is no room for neglecting the management of the Commonwealth's contingent liabilities.

3.12 Recommendation 3

That agency heads be required to take account of their responsibility with regard to management of the Commonwealth's contingent liabilities. Subject to ultimate Ministerial responsibility and accountability to the Parliament, it is the responsibility of agency heads to ensure the agency complies with guidelines and other instructions concerning contingent liabilities.

Preparation of formal instruments

3.13 The ANAO report raised a concern that agencies were not including limits in their instruments for indemnities. The lack of limits in indemnities needs to be kept in perspective — these instruments make up a small proportion of the overall contingent liabilities of the Commonwealth. Nevertheless, it is not acceptable for agencies to issue such instruments without a financial or time limit, other than in exceptional circumstances where a limit would be inappropriate.

3.14 The revised guidelines for issuing indemnities, guarantees and letters of comfort state that indemnities should contain a financial limit where possible. It also notes that agencies should always attempt to measure the potential financial cost as part of risk assessment. The guidelines also note that an agency may need to seek outside help where expertise is not available in the agency.¹⁰

3.15 None of Finance's portfolio indemnities, as recorded in the ANAO report, specify a financial limit. Out of concern that Finance is not providing a good example for other agencies, the Committee asked Finance to give reasons for there being no limits. Finance provided several reasons why its indemnities, which relate to asset sales, do not have a limit:

This is because indemnification is usually appropriate in a sale context where the extent of exposure and the risk of exposure are incapable of being ascertained in a proper or efficient manner by the Commonwealth. In other circumstances, techniques such as insurance may be more appropriate.

To ascribe a possible value to such indemnities would require an assessment of the risk of the indemnity being invoked and of the costs that would arise in such circumstances. These calculations are inherently impracticable. Further, to ascribe 'expected' values could compromise the Commonwealth's financial position if these indemnities were subsequently to be invoked.

In most cases the highest likelihood is that the indemnity will not be invoked, and if it was to be invoked, the expected cost would be the costs of defending a

10 Finance Circular 1997/06: *Potential Liabilities and Losses*, pp 4 and 8.

legal action brought against the indemnified party. Only in the event that such action was successful would other costs arise.¹¹

3.16 The Committee remains unconvinced that quantifying the exposure and assessing risk are impracticable, except in exceptional circumstances. The Committee considers that the lack of limits in indemnities could compromise the Commonwealth's financial position. The inclusion of limits in an indemnity is not necessarily ascribing an expected cost. Limits are intended to place a cap on the potential liability in case the indemnity is invoked, regardless of how remote the risk. If any department is unable to calculate appropriate limits then it should seek external assistance.

3.17 It is possible to assess the risks of indemnities even where it may appear to be very difficult. The Export Finance and Insurance Corporation (EFIC) places limits in all of its contingent liabilities because the nature of its business makes limits essential.

We basically are obliged, through our legislation and through the kinds of products we provide, to set a limit on the amount of our exposure every time we enter into such a transaction. It is the aggregation of those individual transactional limits that result in our being able to measure our exposure and report to government.¹²

3.18 The Committee supports the advice in the guidelines on issuing indemnities, guarantees and letters of comfort about including limits. The Committee expects that Finance, when issuing indemnities as part of future asset sales, will give careful consideration to including limits.

3.19 While there may be some circumstances in which including a financial or time limit is not suitable, there should always be a risk assessment. Agencies should record that assessment so that they can later examine the assessment and refine risk management arrangements. Such records also provide a degree of accountability. Agencies ought to record the reasons for not including formal limits.

3.20 Finance considers that the revised guidelines will raise the profile of these instruments, and improve the preparation of indemnities.¹³ All relevant staff in an agency need to be made aware of the requirement to include limits. This should not be a difficult task, and agencies could take a lead from Defence, which has to disseminate this information to small units over a wide geographic area.

...we have written to the program coordinators for dissemination to the areas ... that are responsible to them advising of the range of activities that we would like to see on the register, which obviously includes that amount.¹⁴

3.21 The goal of including limits is to assist risk management. Limits can assist management of the individual contingent liability, and overall risk management for the department and whole of government. Agencies should be aware that providing limits is an important part of risk management, both for the individual agency and whole of government.

11 Evidence p S49.

12 Evidence p 95.

13 Evidence p S44.

14 Evidence p 117.

The Committee expects that the ANAO will look carefully at the inclusion of limits in formal contingent liabilities as part of its proposed follow-up audit.

3.22 Recommendation 4

That agencies take account of the direction to include a limit where possible. Agencies should always attempt to measure the potential financial cost as part of risk assessment, either internally or with external assistance, and should keep a record of that assessment. Where a limit is not included, agencies should record the reason for that arrangement as part of the risk assessment.

3.23 Subrogation clauses are another condition which the ANAO recommends agencies include in indemnities (recommendation (5)). The guidelines on issuing indemnities, guarantees and letters of comfort advise that indemnities should contain subrogation clauses. The guidelines note that a subrogation clause provides ‘the right to exercise the option of conducting, or participating in, the defence of claims against the indemnified party, and to require full assistance from that party.’¹⁵ The Committee supports this advice.

3.24 The ANAO found examples of instruments issued without due consideration of the risks attached. The ANAO was informed of cases where indemnity agreements failed to hold the agency harmless for events outside the intended terms of the contract.¹⁶ As a risk prevention measure, the ANAO recommended that agencies entering into any form of commercial arrangement should undertake a formal process of contract vetting (recommendation (14)). Agencies generally responded positively to this recommendation. The Committee agrees that contract vetting is a prudent measure for agencies to adopt.

Records management

3.25 With regard to records management, the ANAO concluded in its report that ‘there were significant deficiencies in agencies’ compliance with Department of Finance guidelines and directions.’¹⁷ The ANAO recommended that all relevant agencies conduct a review of their records to ensure that they have a complete register of all Commonwealth guarantees, indemnities and letters of comfort within their portfolio (recommendation (1)).

3.26 The standard of records management varied between the instruments being managed and within departments. The ANAO stated that it is not easy to point to any one agency as an example of good management.

If there were examples of good practice they tended to be in specific areas. You might have one part of the agency, for example, communications and the arts, who have an extremely good system running for the indemnification of

15 Finance Circular 1997/06: *Potential Liabilities and Losses*, p 9.

16 ANAO. 1996. *Audit report no. 6 1996-97: Commonwealth guarantees, indemnities and letters of comfort*. Canberra, AGPS, p 54.

17 Ibid p xvii.

Commonwealth exhibitions et cetera. But another part of the department was grossly deficient in certain areas.¹⁸

3.27 The Committee heard in evidence from the ANAO and Finance that the requirement to maintain records is reasonable. Once in place registers should be simple to maintain. Departments have little excuse for poor record keeping of contingent liabilities.

That is what we advocate—maintaining registers and maintaining documentation. We think that is quite achievable and we do not believe it would involve a great deal of administrative expense.¹⁹

Technically, information systems within agencies such as central registers should be easy to establish. Practically, the maintenance of those registers requires a commitment from agency management...²⁰

3.28 Finance has chosen to establish an electronic register to record its guarantees, indemnities and letters of comfort. Finance notes that it is up to agencies to determine how they will meet their obligations to record instruments.²¹ While accepting this arrangement, the Committee considers that agencies would benefit from more direct assistance on how to record contingent liabilities. For example, a ‘better administrative practice’ document on keeping a register of contingent liabilities could provide such assistance.

3.29 Recommendation 5

That the Department of Finance in consultation with the ANAO issue a ‘better administrative practice’ document to provide agencies with more direct assistance on how to introduce and maintain a central register of contingent liabilities.

3.30 The Committee heard evidence from Finance and Defence on the difficulties facing Defence in implementing a central register for all its indemnities. For example, Defence does not include unexploded ordnance on Defence land in its indemnities records.²² Finance noted that Defence’s indemnities are typically very general indemnities involving damage to property as part of military activity. Maintaining detailed registers of such contingent liabilities would provide little practical benefit. Mr Kennedy noted that there needs to be some balance in such a case.

At the other end of the spectrum, you might have an indemnity that the Commonwealth issues through the Department of Defence, say, to Australian Defence Industries for the transportation of ordnance on public roads. Certainly they should have some kind of record of that kind of indemnity, not on a truck basis but that that does exist and that it is a standing indemnity.²³

3.31 The ANAO note in its report that it considers the greatest risk of non reporting is where instruments are in a contract or correspondence, and hence fail to be recorded

18 Evidence p 6.

19 Evidence p 12.

20 Evidence p S44.

21 Evidence p S44.

22 Evidence p S79.

23 Evidence p 39.

separately.²⁴ The ANAO expressed concern that departments could not locate easily all their guarantees and indemnities as part of the ANAO census. Thus the ANAO spent a great deal of time chasing up these instruments.

It certainly was not a commercial approach. In the commercial field you would have these locked down quite specifically. One of the problems they do have is the fact that the Commonwealth does not keep contract registers. Anything that is in contracts, unlike a private firm where you have a company seal, et cetera, we do not have that. It would be debatable whether many departments could, at any time, locate all their contracts.²⁵

3.32 To address this concern, the ANAO recommended that agencies consider introducing contract registers (recommendation (8)).

3.33 In its inquiries the Committee found that the Department of Defence had significant indemnities included in the prime contract for the building of the Collins class submarines.²⁶ While the project area with direct responsibility for the contract knew of the indemnities, the central financial areas of the department had no record of the indemnities.

3.34 In effect the Commonwealth has provided an indemnity which covers 'builders risk'. As such the indemnity covers loss or damage to the submarines and other specialised equipment until the submarine is delivered. The value of the indemnity for the first submarine, as building approached completion, would have been around \$500 million. However, the indemnity includes no formal financial limit. The Commonwealth only had to make one payment of \$1.5 million under the indemnity as part of the construction of the first submarine. This was a result of the submarine colliding with the wharf, causing damage to a sonar dome. The ANAO will report on a performance audit of the submarine project, which will include discussion of the nature and value of the indemnities.

3.35 The Committee is surprised that Defence did not have such indemnities in its central records, and is concerned that this example may be indicative of more common practice within Defence. In addition, the Committee is of the view that such an indemnity could easily have included a financial limit. Defence informed the Committee that work is currently being undertaken to ensure that indemnities within contracts are also included in the registers for indemnities.²⁷ The Committee recommends that the ANAO conduct a performance audit of Defence's contract management more generally to ensure that appropriate risk management practices are adopted.

3.36 The guidelines on issuing indemnities, guarantees and letters of comfort note that keeping a register of contracts 'has the potential to assist agencies'. The guidelines also note that agencies may decide to list only those contracts above a threshold. Keeping a register is not a requirement, and the guidelines note that it is for the managers of agencies to decide the scope and form of contract registers.²⁸

24 ANAO. op cit p 41.

25 Evidence p 19.

26 Evidence pp S74-77.

27 Evidence p S82.

28 Finance Circular 1997/06: *Potential Liabilities and Losses*, p 11.

3.37 For example, the different program areas within DPIE keep various contract registers. There is no central contract register.²⁹ Defence noted that meeting this recommendation would impose an inappropriate resource burden on Defence, and that keeping a register of guarantees, indemnities and letters of comfort would be sufficient.³⁰

If we got recommendation (1) right—in other words, if we kept a complete register of all indemnities, guarantees and undertakings, whether they are in contracts or anywhere else—my thinking at least is that perhaps we could satisfy the recommendation (8) requirement by satisfying recommendation (1).³¹

3.38 Finance considers that for itself the cost of maintaining a contract register outweighs the benefits.

In view of the low volume of indemnities issued by Finance itself and after taking into consideration the cost-benefit of creating such a separate contract register, it is considered that Finance's own Register for Guarantees, Indemnities and Letters of Comfort is appropriate to meet the Department's own requirements.³²

3.39 The guidelines note concern that departments take care with indemnities in contracts, especially given the increasing emphasis on outsourcing Commonwealth functions.³³ This gives added weight to the suggestion that agencies maintain contract registers which, inter alia, record indemnities or other contingent liabilities contained in a contract. Legal disputes arising from indemnities in contracts take some time to resolve and may complicate future government activity. While there will always be some contingencies which will require payments, it is vital that mismanagement of indemnities does not become systemic.

3.40 Recommendation 6

That agencies consider introducing contract registers, in particular with a view to addressing concerns about the increased emphasis on outsourcing Commonwealth functions. In the absence of a register, agencies should ensure that contingent liabilities in contracts, if any, are recorded separately on a Register of Guarantees, Indemnities and Letters of Comfort.

3.41 Recommendation 7

That Defence review its existing contracts and its contract management practices to ensure that its central record keeping and finance areas are fully informed of all contingent liabilities contained in contracts.

3.42 The ANAO found examples of the loss, destruction or misplacing of financial documents which raised concerns about the Commonwealth's exposure through these

29 Evidence p 108.

30 ANAO. *op cit* p 42.

31 Evidence p 115.

32 Evidence p S60.

33 Finance Circular 1997/06: *Potential Liabilities and Losses*, p 8.

instruments.³⁴ One example is the indemnity provided to Optus for \$300 million. That indemnity arose out of the portfolio department losing the promissory notes issued as part of the Aussat sale.³⁵ The Committee is very surprised that such a loss could occur.

3.43 Consequently the ANAO recommended that agencies review their physical security measures with a view to establishing appropriate safe custody arrangements for the documents associated with Commonwealth guarantees, indemnities and letters of comfort (recommendation (9)). Finance agreed, noting that this is a matter for individual agencies to address. The Committee strongly endorses this recommendation.

Review and evaluation of contingent liabilities

3.44 The review and evaluation of contingent liabilities covers the review of processes for issuing instruments, as well as evaluation of the benefit of the liability to the Commonwealth. The ANAO recommended that agencies regularly review the effectiveness of their reporting and monitoring arrangements for guarantees, indemnities and letters of comfort to ensure that the Commonwealth's interests are protected for the legal duration of the instruments (recommendation (10)).

3.45 The ANAO also recommended that agencies establish well documented procedures to ensure the effective review and evaluation of their financial exposures as a result of Commonwealth guarantees, indemnities and letters of comfort (recommendation (11)).

3.46 Finance agrees with this recommendation. The guidelines on issuing indemnities, guarantees and letters of comfort notes that all indemnities and guarantees should be reviewed periodically. The guidelines state that the aim of such reviews is to ensure that the indemnities and guarantees '...are still the most appropriate means of achieving the particular benefits they were intended to deliver.'³⁶

3.47 The recommendations to review guarantees and indemnities reflect general good practice for financial management. For example, EFIC usually maintains contact with the parties on whose behalf it issues guarantees and indemnities.

EFIC's standard documentation requires the parties on whose behalf the guarantees and indemnities are issued to submit regular financial reports and other material to EFIC. In this manner an assessment of the changing risks can be made.³⁷

3.48 With regard to the indemnity provided to Geosafe Australia, DPIE told the Committee that it would review that indemnity. The indemnity covers persons working in radioactive areas as part of the Maralinga Rehabilitation Project. Although there was limited commercial

34 ANAO. op cit pp 42-43.

35 Evidence p 6. The then Department of Transport and Communications issued the notes. When the notes became payable in 1995, the department with portfolio responsibility was the Department of Communications and the Arts.

36 Finance Circular 1997/06: *Potential Liabilities and Losses*, p 10.

37 Evidence p S3.

nuclear indemnity insurance available at the time the indemnity was issued, more suitable insurance could become available at a later date.

Yes, we would review that in due course, and each time we would get to the stage of reviewing the contract and that is one of the things we would take into account.³⁸

3.49 The Committee considers that it is good practice for agencies to review contingent liabilities regularly, and supports the ANAO recommendations.

Reporting

3.50 Departments must report potential liabilities in annual financial statements. This is required in accordance with the Minister for Finance's Guidelines for the Financial Statements of Departments. (The Minister issued revised Guidelines recently.) In addition Finance requests information from departments periodically for inclusion in the Whole of Government financial statements and the Statement of Risks.

3.51 However, the ANAO found that departments were not complying with the Guidelines, which required reporting of guarantees and undertakings. The ANAO was also concerned the Guidelines resulted in the partial presentation of information of off-balance sheet contingent liabilities. Better reporting should bring greater public accountability, which should result in improved management.³⁹

3.52 The ANAO recommended that the Department of Finance, in consultation with agencies and cognisant of commercial sensitivities, review the disclosure and reporting arrangements of Commonwealth guarantees, indemnities and letters of comfort with the aim of ensuring their transparency and appropriate monitoring procedures (recommendation (3)). The ANAO also recommended that the Department of Finance, in consultation with agencies, examine options for improved accountability practices which embody comprehensive recording of material Commonwealth guarantees, indemnities and letters of comfort (recommendation (13)).

3.53 The Minister for Finance issued revised *Guidelines for the Financial Statements of Commonwealth Departments* in June 1997, and revised *Guidelines for the Financial Statements of Commonwealth Authorities* in July 1997. One change in the Guidelines is that departments and authorities must report off-balance sheet contingent liabilities in a schedule to the financial statements — the *Schedule of Contingencies*. Previously these instruments were reported in a note. This will give greater prominence to these liabilities, and thus improve the reporting of these instruments in agencies' annual reports and to Finance.

3.54 The Guidelines provide a standard form for the schedule and describe the nature of information to be reported. The Guidelines note the following:

38 Evidence p 106.

39 ANAO. op cit pp 48-50.

Disclosures of contingencies should be sufficient to enable assessments of both the nature of, and the uncertainties which affect those contingencies and show separately any contingencies (or groups of contingencies) involving different levels of uncertainty as to possible gain or loss.⁴⁰

3.55 Finance is also examining the manner in which it reports contingent liabilities in consolidated whole of government financial statements.⁴¹ Some changes have already been made. Contingent liabilities now receive greater emphasis in the whole of government financial statements.⁴² The Budget papers and the Mid-Year Economic and Fiscal Outlook also include a 'Statement of Risks'. That Statement lists each of the Commonwealth's known contingent liabilities with a possible impact greater than \$20 million in any one year.⁴³ The Statement of Risks provides a good discussion of the Commonwealth's contingent liabilities.

3.56 Parliamentary and public scrutiny is vital to achieving accountability in public sector use of contingent liabilities. In the case of Commonwealth departments and statutory authorities, there is a need for greater accountability in the use of these instruments. This warrants more prominent reporting of contingent liabilities at an agency level in annual reports, and for whole of government reporting. Thus the Committee supports the requirement for departments and authorities to report contingencies in a schedule rather than a note, even though this is not normal commercial practice. The Committee expects that Finance will also consider whether similar reporting requirements should apply to government business enterprises.

3.57 In the course of the inquiry the Committee found Commonwealth guarantees for which different sources gave differing values for the same date. One example was the value of the Commonwealth's performance guarantee of EFIC. The values given by the Department of Industry, Science and Tourism (DIST) in its annual report differed from the values in the ANAO report. The different values are reproduced in table 3.1. Most of the difference was due to a transcription error in the annual report.

3.58 DIST advised the Committee that the value for its annual report is calculated by a method which did not accurately measure the Commonwealth guarantee. DIST stated that in future the value in the annual report will reflect the use of the Commonwealth's guarantee.⁴⁴ The Committee expresses its concern that this example may reflect wider misunderstanding about calculating the Commonwealth's exposure.

3.59 The Committee also found inconsistencies in the values of Commonwealth contingent liabilities reported in the Statement of Risks in Budget paper no. 1 1997-98. For example, in its annual report for 1995-96, DPIE reported both the 'principal covered' and 'balance outstanding' for each loan guarantee. However, the Statement of Risks reported either both values, the face value only, or the balance outstanding only. The Committee is concerned that

40 Department of Finance. July 1997. *Financial Statements of Commonwealth Authorities*. Canberra, Department of Finance, p 9; and Department of Finance. June 1997. *Financial Statements of Commonwealth Departments*. Canberra, Department of Finance, p 11.

41 Evidence p S58.

42 Evidence p 30.

43 *Budget strategy and outlook 1997-98*. Budget Paper No 1. May 1997. Canberra, AGPS, p 2-36; and *Mid-Year Economic and Fiscal Outlook 1996-97*. Jan 1997. Canberra, AGPS, p 75.

44 Evidence pp S69-70.

the Statement of Risks does not accurately describe the Commonwealth's contingent liabilities. Examples are shown in table 3.2.

Table 3.1: Different reported values of the Commonwealth guarantee of EFIC (\$ million) as at 30 June 1995

Source

<i>DIST financial statements 1995-96 (as printed in annual report)</i>	
Contracts of guarantees and insurance	5 881
Loans	2 964
National Interest Provisions	972
Total	9 817
<i>DIST financial statements 1995-96 (corrected)</i>	
Contracts of guarantees and insurance	1 945
Loans	2 964
National Interest Provisions	972
Total	5 881
<i>ANAO report no. 6 1996-97</i>	
Loan guarantees	3 354
Non-loan guarantees	2 956
Total	6 310

Sources: *DIST annual report 1995-6*, p 227; *Evidence pp S69-70*; and *ANAO. op cit pp 72-73*.

Table 3.2: Reporting of 'face value' versus 'balance outstanding' of loan guarantees

<i>Loan guarantees</i>	<i>DPIE annual report, as at 30 June 1996</i>	<i>Statement of Risks values (extract, underline added)</i>
Snowy Mountains Hydro-Electric Authority	Principal: \$257.4 million Balance: \$139.1 million	At March 1997 the <u>face value</u> of guaranteed borrowings was \$212.5 million, with the <u>net amount</u> guaranteed ... being \$105.8 million.
Wool International	Principal: \$2837.6 million Balance: \$1083.4 million	...contingent liabilities to Wool International total \$762 million at 31 March 1997.
Queensland Fish Management Authority	Principal: \$40.9 million Balance: \$11.6 million	The Commonwealth has guaranteed a loan <u>up to a maximum</u> of \$40.9 million...

Sources: *DPIE annual report 1995-6*, p 227; and *Budget Paper no. 1 1997-98*, pp 2-44, 2-45.

3.60 Recommendation 8

That agencies which report contingent liabilities to the public or to Ministers, review those values, in consultation with the ANAO where relevant, to ensure that they calculate the values accurately.

3.61 Recommendation 9

That the Department of Finance, in consultation with the ANAO, takes all steps necessary to ensure that whole of government risk reporting in the Statement of Risks provides an accurate description of the Commonwealth's exposure.

3.62 The ANAO census did not cover the Commonwealth's exposure from guarantees relating to financial derivatives. As part of its inquiry, the Committee was concerned about the use of financial derivatives by Commonwealth agencies which are not subject to rigorous prudential supervision.

3.63 Although it is no longer a Commonwealth agency, the Commonwealth Bank has benefited from Commonwealth guarantees over the past few years. The Commonwealth Bank had face value exposures through financial derivatives as at 30 June 1995 of \$209.2 billion.⁴⁵ However, it is supervised by the Reserve Bank of Australia, which monitors the use of derivatives by the entities under its supervision.

3.64 Two examples of agencies which are not subject to such independent regulation are EFIC and the Australian Wheat Board. EFIC uses derivatives to manage its risks, including currency and interest rate swaps, CPI linked swaps, equity index linked swaps, futures, forward rate agreements and forward currency agreements. EFIC uses the Reserve Bank of Australia guidelines to measure counterparty risks, and only deals with those with a rating of at least AA-.⁴⁶ The Australian Wheat Board also uses derivatives. The Australian Wheat Board has a number of arrangements in place to manage its risks.⁴⁷ These agencies report to the relevant Minister, and are subject to independent audit. However, they are not subject to independent regulation of their financial management.

3.65 The Committee notes that, for agencies which make substantial use of financial derivatives, there are usually appropriate risk management systems in place. However, the Committee is of the view that an agency other than the portfolio department should supervise the use of derivatives by Commonwealth agencies.

3.66 Under the Guidelines for Financial Statements, departments and authorities are required to comply with relevant Australian Accounting Standards. This requires compliance with Australian Accounting Standard 33 *Presentation and disclosure of financial instruments*. This standard will require disclosure of financial derivatives for financial years ending on or after 31 December 1997.⁴⁸ AAS 33 states that its purpose is to 'enhance

45 ANAO. op cit p 6.

46 Evidence p S3.

47 *Australian Wheat Board Annual Report 1995-96*. Feb 1997. Melbourne, AWB, pp 72-73.

48 Evidence p S53.

financial report users' understanding of the significance of recognised and unrecognised financial instruments to an entity's financial position, performance and cash flows'.⁴⁹

3.67 Derivatives are a useful, and in some circumstances essential, risk management tool in that they may be '...a very cost-effective, efficient and expeditious way to transfer, hedge or adjust a financial risk or an exposure...'.⁵⁰ However, the monitoring of the use of these instruments could become a concern. The Committee notes that the Reserve Bank and the Insurance and Superannuation Commission (ISC) monitor the use of derivatives by agencies under their supervision.

3.68 The Committee expects that Finance will monitor the reporting of derivatives by agencies to ensure that the new accounting standard is providing useful information. The Committee recommends that Finance and the ANAO examine the use of derivatives by Commonwealth agencies. This would aim to ensure that appropriate management and monitoring arrangements are in place to protect the Commonwealth's interests.

Importance of risk management planning in the public sector

3.69 In its performance audit the ANAO sought to determine the extent of risk management that departments applied to guarantees, indemnities and letters of comfort. The preparation of instruments, reporting, records management and review and evaluation processes all fall under the general banner of risk management. This section discusses the need for broad risk management arrangements.

3.70 There is no formal requirement for agencies to have corporate risk strategies. The ANAO found that the extent to which departments carried out systematic risk assessment varied considerably between departments, as well as across instruments.⁵¹

3.71 Finance notes that agencies are required to manage risk continuously and '...the management of risk is an integral part of the APS reform program.'⁵² Price Waterhouse supports the identification and management of risk in the public sector.

Risk Management, encompassing the identification, measurement and management of risks facing organisations, is an increasingly important area for all organisations in both the public and private sectors...⁵³

3.72 The ANAO recommendation 4 is that, where applicable:

- agencies develop a risk management plan for the management of off-balance sheet liabilities; and

49 AAS 33 paragraph 3.1.1.

50 Companies and Securities Advisory Committee. June 1997. *Regulation of On-exchange and OTC Derivatives Markets: Final Report*. Sydney, CASAC, p 17.

51 ANAO. op cit pp 30-31.

52 Evidence p S52.

53 Evidence p S35.

- there be an explicit link between the risk management plan for off-balance sheet liabilities and their corporate risk management plan to ensure effective and consistent management of Commonwealth guarantees, indemnities and letters of comfort.

3.73 Finance is revising its own risk management plan and will include a risk management plan for off-balance sheet liabilities.⁵⁴

3.74 The Management Advisory Board and its Management Improvement Advisory Committee publication *Managing Risk - Guidelines for Managing Risk in the Australian Public Service* is a source of guidance for risk management practice. The ANAO *Better practice guidelines for the management of Commonwealth guarantees, indemnities and letters of comfort*, attached to Finance Circular 1997/6, is also a useful resource for departments. Finance noted that the Finance Minister will be empowered to issue Finance Minister's Orders as part of the proposed Commonwealth Authorities and Companies Act. 'An exposure draft of the proposed orders incorporates a requirement to report on the dynamics of the reporting entity, including strategies to manage both the risks and opportunities it faces.'⁵⁵

3.75 Wool International was concerned that there is little review of the skill with which an agency or authority manages its liabilities, other than through audit. Wool International considers that further guidance is needed for statutory authorities, in addition to the legislative framework for reporting:

...it is not clear how qualified auditors may be to assess the performance of the management of liabilities without a benchmark. Development and distribution of a "better practice guide" in relation to financial risk management for agencies and authorities would we believe be a useful tool for standardising management practices.⁵⁶

3.76 Those statutory authorities involved in marketing and government financial businesses which gave evidence to the Committee tend to have well developed risk management arrangements.⁵⁷ In most cases these arrangements are being refined and extended. The Housing Loans Insurance Corporation has undergone extensive changes to its risk management arrangements in recent times. This is part of a restructuring process which includes becoming subject to the supervision of the ISC.

3.77 The Committee recommends that departments develop risk management plans appropriate for their circumstances. At present, there appears to be a haphazard approach to risk management by some agencies. The Committee expects that agencies will cooperate with the ANAO, Finance, and other relevant agencies in developing risk management plans, and responding appropriately to the ANAO recommendations.

54 Evidence p S58.

55 Evidence p S58. Parliament has yet to enact the proposed Act.

56 Evidence pp 52-53.

57 Agencies which gave evidence were Wool International, the Australian Wheat Board, Export Finance and Insurance Corporation and the Australian Industry Development Corporation.

3.78 The ANAO also noted that ‘...no explicit strategy has been developed which draws the attention of agencies to the need for transparent risk management of Commonwealth guarantees, indemnities and letters of comfort.’⁵⁸ The ANAO considered that central agencies, notably the Department of Finance, should play a more active role in encouraging higher standards. Thus the ANAO recommended that Finance prepare an explicit strategy to manage the Commonwealth’s overall risk associated with guarantees, indemnities and letters of comfort (recommendation (12)).

3.79 Finance notes in response that the Government now reports against the Charter of Budget Honesty. As part of the Charter, the Government in the Budget now reports an overview of its strategies for managing its fiscal risks, including contingent liabilities, in the Statement of Risks. The Charter provides the framework within which the Government addresses its financial risks.⁵⁹

3.80 The Committee supports these actions and expects that Finance will continue to give thought to ways of managing the Commonwealth’s overall risk exposure associated with guarantees, indemnities and letters of comfort.

3.81 The ANAO considers that agencies need to price risk in order to encourage risk retention or risk transfer. This would encourage a more prudent approach to the issuing of guarantees, indemnities and letters of comfort. The ANAO suggests some options to encourage pricing of risk in the public sector, such as:

- A universal payment system for contingent liabilities. An example of this is the levy charged on borrowings of Commonwealth government business enterprises (GBEs) to cover the explicit or implicit guarantees arising from their government owned status.
- A system which applies a risk weighting to instruments and applying an ad valorem charge. An example of this practice is the risk weighted capital requirements used by the Reserve Bank in its supervision of banks.⁶⁰

3.82 The ANAO recommended that the Department of Finance, in consultation with relevant agencies, examine the application of appropriate risk based systems to the management and pricing of risk pertaining to Commonwealth guarantees, indemnities and letters of comfort (recommendation (15)). The Department of Finance noted that it will address this matter in the context of the review of the Commonwealth’s policy of self insurance, discussed below.⁶¹

3.83 The ANAO discussed the possibility of transferring Commonwealth risk to some form of commercial insurance. Commonwealth policy with regard to insurance is that the Government carries its own risk. There are some important exceptions, such as the requirement that managing organisations in the Commonwealth Indemnity Scheme to pay an ‘excess’.⁶² Another example is where Defence obtained commercial insurance to cover the

58 ANAO. op cit p 46.

59 Evidence pp S60-61.

60 ANAO. op cit pp 56-57.

61 Evidence p S61.

62 ANAO. op cit pp. 59-61.

indemnity for air traffic control for the Bi-Centennial Air Show.⁶³ The ANAO recommended that the Department of Finance review the merits of the Commonwealth carrying all the risk associated with guarantees, indemnities and letters of comfort (recommendation (16)).

3.84 The audit report notes that the Victorian and NSW Governments operate their own managed insurance funds. These arrangements impressed the ANAO:

One of the things that really stood out was this concept of having somebody who was a risk management consultant who reviewed contracts, reviewed exposures and decided before you entered into one what you should do or indeed whether you should enter into it. They have a very systematic approach and an extremely commercial approach.⁶⁴

3.85 The Department of Finance was more positive about the policy that the Commonwealth carry its own risk.

Over a period of time, the cost of [commercial] insurance would even out or be slightly more expensive, given that there is a profit margin for the insurer.

It is an issue for the Commonwealth about whether it wishes to continue to get the benefits of not paying insurance premiums to outside parties and to pool its own risk, or whether it wants to give up that economy and require its operating units to take out insurance.⁶⁵

3.86 Finance informed the Committee that there is to be a review of the Commonwealth's policy of self insurance. This review will include general consideration of risk based systems for the management and pricing of risks.⁶⁶

The question of providing managers with the right incentives to treat their risks will be central to the review. The review will look carefully at managed fund arrangements operated by various state governments. It is expected that any revised arrangements will be in place by 1 July 1998.⁶⁷

3.87 The Committee is concerned that there be appropriate risk management when departments retain insurable risk. This requires that departmental officers have the appropriate skills to carry out this task. The Committee expects that Finance, as part of its insurance review, will consider not only expanding use of commercial insurance, but also refining the Commonwealth's self-insurance arrangements. The latter would include improved risk assessment arrangements.

3.88 Recommendation 10

That Finance, in its review of the Commonwealth policy of self insurance, take account of the need for expertise in managing risk and the cost to departments of providing such expertise in-house or externally.

63 Evidence p S79.

64 Evidence p 21.

65 Evidence p 42.

66 Evidence p S61.

67 Evidence pp S47-48.

Supervision of government business enterprises and statutory authorities

3.89 The GBE monitoring arrangements play a substantial role in risk management with regard to the Commonwealth's contingent liabilities, because of the large exposure through these entities. GBEs are monitored in accordance with the Accountability and Ministerial Oversight Arrangements for Government Business Enterprises.⁶⁸

3.90 Departments have a role in supervising the entities under the portfolio. For example, DIST has several roles in overseeing EFIC:

- the secretary is a member of the EFIC board, and therefore involved in board decisions;
- the department advises the minister from time to time on EFIC's exposures; and
- EFIC reports regularly to the department and the minister.⁶⁹

3.91 EFIC's transactions may be listed against its own Commercial Account or against the National Interest Account. The National Interest Account carries transactions, approved by the Minister to be in the national interest, which are outside the parameters of EFIC's Commercial Account (either because of risk or size).⁷⁰ The Committee put the question of whether the ISC might play some role in overseeing EFIC. DIST responded by stating that it considers that the current mechanism for accountability is adequate.⁷¹

3.92 Finance noted that there is a case for EFIC being monitored by the ISC for competitive neutrality reasons. On the prudential controls for EFIC, Finance noted:

...EFIC has had strong prudential controls in place ... the Board is required to manage the Corporation in a prudential manner, preserve EFIC's financial viability while providing capacity for growth.⁷²

3.93 EFIC reports to DIST and to the Minister regularly. For 1995-96, a contractor for the ANAO audited EFIC. However, the Committee expresses its continued concern that there is little independent review of EFIC's financial management of its Commercial Account. This concern extends to any GBE involved in complex financial arrangements.

3.94 Following the recent review of GBE governance arrangements, the Government adopted new arrangements which took effect from 1 July 1997. A key change in the arrangements is to include the Minister for Finance in the oversight of GBEs, as a joint 'shareholder' with the Minister(s) responsible for the portfolio in which the GBEs are located.⁷³ The final report from the review notes that in the state governments, the governance framework generally adopts this arrangement:

68 Evidence p S53.

69 Evidence pp 94-95.

70 *Export Finance and Insurance Corporation Australia annual report 1996*. Nov 1996. Sydney, EFIC, pp 36, 61.

71 Evidence p 95.

72 Evidence p S56.

73 *Government Business Enterprises: new governance arrangements*, Hon John Fahey MP, Press Release (Minister for Finance), 32/97, 30 June 1997.

Typically ... there is some separation of the shareholder responsibilities along the lines of each Minister's interests. That is, the portfolio Minister is concerned with the quality of the GBE's goods and services, ... whilst the economic Minister is concerned with GBE financial performance and returns, operational efficiency, quality of its planned investments, strategic direction and risk profile.⁷⁴

3.95 The Committee supports the new arrangement. Greater focus on the financial performance of GBEs is a welcome step in improving the management of the Commonwealth's exposure through these entities.

3.96 The Government has agreed that these arrangements will not be implemented in respect of EFIC at this time. As part of national competition policy, under the Commonwealth's Legislation Review Schedule, review of the governing legislation for EFIC is due to commence in 1998-99.⁷⁵ The Committee expects that the appropriate form of supervision and accountability for EFIC will be examined as part of that review, if not before. EFIC does not pay for its supervision, whereas commercial insurance providers supervised by the ISC pay supervision levies.

3.97 Recommendation 11

That the review of the governing legislation for EFIC under the Commonwealth's Legislation Review Schedule include consideration of the appropriate prudential regulation arrangements for EFIC where commercial risks are covered.

3.98 Under arrangements introduced in January 1997, where non-GBE authorities seek to borrow funds from the financial markets, they are required to submit corporate plans in support of applications for approval of borrowings. This should provide some assurance that authorities are capable of managing their liabilities. In addition Finance monitors the contingent liabilities of statutory authorities through the requirement for agencies to submit annual financial statements in accordance with the Financial Statement Guidelines.⁷⁶

3.99 The Committee recommends that the ANAO (and its contractors), in its next round of financial statement audits, give attention to the contingent liabilities of Commonwealth GBEs and statutory authorities.

Non-compliance

3.100 There is a question of how to deal with agencies or areas which do not follow Finance directions and guidelines. Appropriate monitoring and incentives to comply are necessary for good administration. Poor performance requires correction. Finance has required departments to report guarantees, indemnities and letters of comfort to the Minister for Finance for a

74 Humphry, R. March 1997. *Review of GBE governance arrangements*. Canberra, Department of Finance, p 20.

75 *Commonwealth Legislation Review Schedule*. 1996. Canberra, AGPS, p 8.

76 Evidence p S53.

number of years. However the ANAO audit is only now showing that agencies have not done this to the extent required.

3.101 The ANAO plays a significant role in detecting problems, and then chasing-up agencies to ensure they make changes to correct deficiencies. The ANAO does this through performance audits, and also through annual financial statement audits.⁷⁷ Finance review any shortcomings every 6 months until each agency makes a satisfactory response. If Finance is not satisfied with an agency's response, Finance can take the issue to the Minister for Finance, who reports the matter to the Prime Minister.⁷⁸ This process will be more significant in future given the greater responsibility being taken by Chief Executives of departments.

3.102 Complete compliance with Finance directions and guidelines cannot be guaranteed. To the extent that agencies fail to report their exposures there is a gap in Finance's knowledge for its task of overseeing the financial management framework. The Committee expects that agencies will take very seriously their obligations to report to the Department of Finance.

3.103 Finance considers that an important incentive to minimise risk is the expectation that agencies contribute to any losses. The intention is that this will motivate managers to minimise risk because of the constraints on their resources. Finance provided two examples of where this expectation has been put into practice. First, the Department of Defence has paid \$6.6 million towards the costs of an indemnity issued as part of the sale of AeroSpace Technologies of Australia. Second, the (then) Department of Arts, Heritage and the Environment contributed around \$12,500 in savings toward costs associated with damage in 1984 to a Picasso painting.⁷⁹ While noting this expectation, the Committee is of the view that these examples are paltry and not indicative of a major financial penalty or incentive.

3.104 Apart from this expectation for agencies to contribute to losses, the main incentive is that Chief Executives are responsible for ensuring that the agency complies with guidelines on contingent liabilities. Chief Executives are accountable for the performance of their agency.

3.105 This highlights the need for agencies to implement a risk management framework to prevent any problems, and for appropriate monitoring of agency activity. Allowing poor management to continue until disciplinary action is required, such as dismissing a Chief Executive, does not remove the consequences of poor risk management.

Conclusion

3.106 The ANAO audit has proven to be very useful in providing incentives to improve the management of the Commonwealth's exposure through guarantees, indemnities and letters of

77 Evidence p 33.

78 Evidence p 37.

79 Evidence p S52.

comfort. As DIST commented, ‘...it does sharpen the mind remarkably.’⁸⁰ Nevertheless there remains much for Commonwealth agencies to address.

3.107 The Committee expects that agencies will follow the recommendations of the ANAO, as is appropriate, with the aim of lifting the standard of management of the Commonwealth’s risk. The Committee supports the revised guidelines on issuing Commonwealth indemnities, and the risk management guidelines of the Management Advisory Board. The Committee commends these sources of advice to agencies. The Committee also considers there is a need for ongoing oversight of agency risk management by the ANAO.

3.108 **Recommendation 12**

That the ANAO review the management of the Commonwealth’s contingent liabilities, and agency compliance with the guidelines on issuing indemnities, guarantees and letters of comfort, in two years time.

David Hawker MP
Chairman
1 September 1997

80 Evidence p 97.

APPENDIX 1

INDEX OF SUBMISSIONS

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2	Civil Aviation Safety Authority
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APPENDIX 2

LIST OF HEARINGS AND WITNESSES

Canberra, Thursday 21 November 1996

Australian National Audit Office

Mr Ian McPhee, National Business Director
Mr Colin Cronin, Executive Director, Performance Audit
Mr Denzil Bourne, Senior Director, Performance Audit
Ms Frances Holbert, Director, Performance Audit

Canberra, Thursday 27 February 1997

Department of Finance

Mr Peter Saunders, First Assistant Secretary, Resource Management Framework
Mr Maurice Kennedy, Assistant Secretary, Financial Management Advisory Branch
Mr Arthur Richardson, Assistant Secretary, Government Business Enterprise and Commercialisation Policy Branch
Mr Dean Wallace, Assistant Secretary, Accounting Framework Branch
Mr Timothy O'Brien, Director, Accountability Projects Section

Melbourne, Monday 21 April 1997

Australian Wheat Board

Mr John Lawrenson, Managing Director
Mr Peter McKeown, General Legal Counsel/Board Secretary
Mr Peter Doyle, General Manager, Corporate

Wool International

Mr Ross Bawden, Manager, Inventory/Property

Canberra, Monday 2 June 1997

Department of Industry, Science and Tourism

Mr Don Smale, Assistant Secretary, International Branch
Mr Michael Roberts, Director, Export Credit Policy

Export Finance and Insurance Corporation

Mr Slater Smith, General Manager, Credit Policy & Risk Management
Mr John Collins, Head of Credit

Canberra, Monday 16 June 1997

Department of Defence

Mr Ken Moore, Assistant Secretary, Resources Policy and Programs
Miss Dianne Leak, Director, Costings Policy

Department of Primary Industries and Energy

Mr Martin Dolan, Assistant Secretary, Finance Branch
Mr David Mitchell, Director, Finance Branch

APPENDIX 3

SALE OF THE MOOMBA TO SYDNEY GAS PIPELINE

The source of the information contained in this appendix is the Australian National Audit Office (ANAO) audit report no. 10, 1995-96.

Initially the Moomba to Sydney gas pipeline was to be built by the Australian Gas Light Company (AGL) in agreement with the Coopers Basin Gas Producers (the Producers). However, the Commonwealth government did not permit AGL to proceed with the construction of the pipeline. The Commonwealth undertook to fulfil AGL's contractual obligations relating to the construction and operation of the pipeline.

The Commonwealth government established a statutory authority, 'the Pipeline Authority' (the Authority), in 1973 to manage the Commonwealth's responsibilities. The Authority took over these responsibilities through an agreement with AGL and the Producers in 1974, including a haulage agreement between AGL and the Authority.

A Commonwealth guarantee was given to AGL for the performance of the Authority to meet its contractual obligations, and also to meet specified technical standards. The Producers were also given a Commonwealth guarantee of the performance of the Authority.

As a result of the agreements, the Producers and AGL each had several rights, including:

- to have absolute priority for the carriage of their gas purchased by AGL;
- to have their gas carried along the pipeline on terms no greater than for any third party; and
- veto over any transfer of ownership of the pipeline.

The existence of the guarantees and contractual obligations made the sale very complex and difficult.

The Government initiated the first sale attempt late in 1989. The existing haulage contract with AGL reduced the value of the pipeline to potential buyers because of the limited revenue possibilities. The Government attempted to pass legislation which would increase the haulage charge. The bill failed to pass the Senate in 1990 - one of the stated reasons included that the bill sought to override contractual obligations.

In addition, AGL initiated legal action in 1990. AGL claimed that the attempted sale did not acknowledge AGL's right of first refusal on the sale of the pipeline. The NSW Supreme Court ruled that AGL held an enforceable right of refusal against the Commonwealth.

In 1991 the Government cancelled the first sale attempt.

The Government announced a second sale attempt in the 1992-93 Budget. This sale attempt was successful.