

Investment of Public Funds and Commonwealth Debt Management

Audit Report No. 22, 2004–05

Introduction

Background

- 2.1 The Department of Finance and Administration (Finance) is responsible for developing and maintaining the financial framework for Commonwealth public sector. The framework is aimed at providing a public sector which focuses on effective governance, sound financial management, and proper accountability. At July 2005, the financial framework included 86 departments and agencies which fall under the *Financial Management and Accountability Act 1997* (the FMA Act); and 104 entities subject to the *Commonwealth Authorities and Companies Act 1997* (the CAC Act).¹ FMA Act agencies are those which are financially part of the Commonwealth (and form part of the General Government Sector); while CAC Act bodies are Commonwealth statutory authorities or

1 The FMA Act and CAC Act can be viewed at: <http://www.finance.gov.au/finframework/>, accessed November 2005.

companies in which the Commonwealth has at least a direct controlling interest.²

- 2.2 The general default arrangement for FMA Act bodies is that a single body – the Australian Office of Financial Management (AOFM) – manages the investment of surplus cash. However, in some circumstances, FMA Act agencies have sought and obtained approval to make investments on their own behalf. Currently there are 13 such agencies, which are mostly involved in some form of quasi-commercial activity.³
- 2.3 Sections 18 and 19 of the CAC Act allow surplus funds to be invested on deposit with a bank; or in securities of the Commonwealth or a State or Territory; or in securities guaranteed by the Commonwealth, a State or Territory. Section 18 of the CAC Act also allows CAC bodies to invest in any other manner as approved by the Minister for Finance. Section 19 allows Government Business Enterprises (GBEs) and Statutory Marketing Authorities (SMAs) to invest surplus funds in any other manner that is consistent with sound commercial practice.⁴
- 2.4 At 30 June 2004, Commonwealth entities reported financial investments of some \$20.208 billion. Around \$14 billion is managed by the AOFM, leaving \$6 billion invested by other FMA Act and CAC Act entities.
- 2.5 For both the AOFM and individual agencies, it is important that the investment of public funds be prudently managed in accordance with the legislative framework. Investment activity involves a trade-off between risk and return. In this context, it is generally considered that the Commonwealth has a low tolerance for financial risk, which limits investment activity to low-risk assets. This is reflected in the legislative framework governing Commonwealth entities' investing activities, as outlined above. In particular:
- not all entities are permitted to invest; and
 - for most entities, where investment is permitted, the types of authorised investments are generally very limited.
- 2.6 The differing levels of control exerted by the Parliament over the investments of entities under the FMA and CAC Acts affect the management and reporting of risk. Responsibility for compliance and

2 Finance, internet site: <http://www.finance.gov.au/finframework/>, accessed November 2005.

3 Finance, *Transcript of Evidence*, 5 September 2005, p. 11.

4 ANAO Audit Report no. 22, 2004-05, *Investment of Public Funds*, Commonwealth of Australia, January 2005, p. 25. The audit focused on Section 18 of the CAC Act.

proper management under these Acts lies with the Chief Executives of FMA Act agencies and directors of CAC Act bodies.

Audit objectives

- 2.7 The objective of the audit was to examine the investment of public funds by selected entities, including:
- compliance with relevant legislation, delegations and instructions;
 - the value for money of investment strategies; and
 - reporting of investment activities.
- 2.8 Six entities were selected for audit. These included the following FMA Act agencies:
- the Aboriginal and Torres Strait Islander Commission (ATSIC), in respect of the Land Fund Special Account;
 - the Department of Veterans' Affairs (DVA), in respect of the Defence Service Homes Insurance Scheme Special Account; and
 - the Insolvency And Trustee Service Australia (ITSA) in respect of the Common Investment Fund.
- 2.9 The audit also included the following CAC Act agencies:
- the Special Broadcasting Service Corporation (SBS);
 - the Australian Nuclear Science and Technology Organisation (ANSTO); and
 - the National Museum of Australia (NMA).
- 2.10 The six entities had aggregate investments of \$1.64 billion as at 30 June 2004 and realised investment earnings of some \$80.4 million during 2003–04.
- 2.11 In addition to the specific entities selected for their investment activities, Finance and the Treasury were included in the audit because of their responsibilities associated with the FMA Act and the CAC Act. The ANAO also undertook a desk audit of other Commonwealth statutory authorities' investment activities, relying on the most current financial statement disclosures publicly available at the time of audit fieldwork.

Audit conclusion

- 2.12 Overall, the ANAO found that, for a number of entities, there had been instances of shortcomings in the management of the investment of public

funds. The ANAO found that some FMA Act agencies were holding investments not authorised by the relevant legislation. For CAC Act agencies, the ANAO found that records maintained by Treasury and some entities were both inaccurate and incomplete.

- 2.13 The ANAO also reported that consistently sound governance and reporting processes had yet to be developed and implemented by all audited entities. The report noted the need for entities to implement investment strategies that both comply with the investment parameters imposed by the Parliament, and optimise risk-adjusted returns.

ANAO recommendations

- 2.14 The ANAO made the following recommendations:

Table 2.1 ANAO recommendations, Audit report no. 22, 2004-05

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| 1. | <p>ANAO <i>recommends</i> that, as a priority, internal controls over the implementation of the Land Fund's investment strategy be enhanced by:</p> <ul style="list-style-type: none"> a) segregating the roles of investment adviser and security custodian; b) conducting an open competitive tender and signing formal contracts for the provision of investment advice and custodial services; and c) wherever possible, obtaining more than one quote for each proposed investment, and/or comparing quotes to published market rates. <p><i>All responding entities agreed, with one agreeing in principle.</i></p> |
| 2. | <p>ANAO <i>recommends</i> that entities investing public funds document, and regularly review, an investment strategy and approach.</p> <p><i>All responding entities agreed, with one agreeing in principle.</i></p> |
| 3. | <p>ANAO <i>recommends</i> that entities investing public funds manage the risk of counterparty default on their investments by preparing, documenting and implementing credit risk management policies and procedures.</p> <p><i>All responding entities agreed, with one agreeing in principle.</i></p> |
| 4. | <p>ANAO <i>recommends</i> that entities investing public funds:</p> <ul style="list-style-type: none"> a) implement procedures that, wherever practicable, maximise competitive processes in the selection of individual investments; and b) where open and effective competition is not possible, assure themselves that returns are being maximised by comparing the terms of proposed investments to published market rates. <p><i>All responding entities agreed, with two agreeing in principle.</i></p> |
| 5. | <p>ANAO <i>recommends</i> that reporting of interest rate exposures be improved by the Department of Finance and Administration providing guidance to entities on the preferred approach to calculating and reporting weighted average interest rates.</p> <p><i>All responding entities agreed, with two agreeing in principle.</i></p> |
| 6. | <p>ANAO <i>recommends</i> that the Department of the Treasury prepare and maintain a comprehensive and accurate record of all investment approvals provided by the Treasurer, and their current status.</p> <p><i>All responding entities agreed, with one agreeing in principle.</i></p> |

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7. ANAO *recommends* that compliance with legislated restrictions on investing activities be promoted by:
- a) Chief Executives/directors ensuring that adequate priority and resources are allocated to achieve compliance with statutory requirements;
 - b) entities that invest public funds, integrating compliance with legislative restrictions on investing activities with their governance structures and risk management strategies; and
 - c) where necessary, relevant central agencies issuing guidance to investing entities to explain the legislative framework for investing public funds.
- All responding entities agreed, with one agreeing in principle.*
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The Committee's review

2.15 The Committee held a public hearing on 5 September 2005, with the following witnesses:

- Finance;
- The Treasury;
- Department of Veterans' Affairs (DVA); and
- Department of Immigration, Multicultural and Indigenous Affairs (DIMIA).⁵

Governance

Investment strategies

2.16 The ANAO found that investment strategies did not exist or were out of date for three of the six audited agencies.⁶ The ANAO recommended that entities investing public funds document and regularly review an investment strategy and approach.⁷

Department of Veterans' Affairs

2.17 DVA had not reviewed its investment strategy since its initial development in 1995, when the investment portfolio was valued at \$22 million. The ANAO found that at 30 June 2004, the DVA had

5 Since retitled the Department of Immigration and Multicultural Affairs (DIMA) following a reallocation of portfolio responsibilities.

6 The Insolvency and Trustee Service Australia (ITSA) and the Australian Nuclear Science and Technology Organisation (ANSTO) did not have a policy; and DVA's Defence Service Homes Insurance Scheme (DSHIS) investment strategy had not been reviewed for nine years.

7 ANAO Audit Report no. 22, 2004-05, *Investment of Public Funds*, Commonwealth of Australia, January 2005, p. 36. The ITSA, ANSTO and DVA agreed with the recommendation.

investments of over \$58 million.⁸ At the public hearing in September 2005, DVA told the Committee that amount had increased to \$61 million.⁹ DVA told the Committee that its funds manager, UBS Global Asset Management, currently receives 0.2 per cent of the investment value as a fee for service. This equates to roughly \$120 000 per annum.¹⁰

2.18 DVA advised that the department had initiated a review of its funds management arrangements, including market testing to assess the value for money in the current arrangements with UBS, and a consideration of managing funds investment in-house.¹¹

2.19 DVA subsequently reported in May 2006 that an external investment consultant had comprehensively reviewed the Defence Service Homes Insurance Scheme's Investment Management Policy and the policy had been updated. Processes have been put in place to ensure the policy is reviewed annually.¹²

2.20 An independent consultant is developing a model for DVA, to:

enable the Scheme to perform internal investment performance benchmarking and market testing on a regular basis to ensure consistent strong returns and value for money for investment management services. As a part [of its] development, the model will be applied to the current environment in a market testing exercise.¹³

The Land Fund

2.21 In 1995 the Aboriginal and Torres Strait Islander Land Fund Special Account (the Land Fund) and the Indigenous Land Corporation (ILC) were established, to provide a secure and ongoing source of funds to the ILC to provide economic, environmental, social and cultural benefits for Aboriginal people and Torres Strait Islanders. At the time the Land Fund was administered by the Aboriginal and Torres Strait Islander Commission. However, following the close-down of ATSIC from July 2005, administration of the Land Fund Special Account was moved to the

8 ANAO Audit Report no. 22, 2004-5, p. 81.

9 DVA, *Transcript of Evidence*, 5 September 2005, p. 13.

10 DVA, *Transcript of Evidence*, 5 September 2005, p. 5 and 12. DVA advised that when UBS was first appointed as funds manager in 1995, the management fee was set at 0.45 per cent. The fee has been renegotiated several times since 1995, and is currently set at 0.2 per cent. DVA submission no. 4, p.2.

11 DVA, *Transcript of Evidence*, 5 September 2005, p. 3.

12 DVA, submission no. 6.

13 DVA, submission no. 6.

Department of Immigration, Multicultural and Indigenous Affairs (DIMIA).

- 2.22 The legislation which established the Land Fund provided that between 1995-96 and 2003-04 (defined in the Act as 'Category A Years'), the Australian Government made an annual appropriation of \$121 million (indexed to 1994 values) to the Land Fund. The aim was for the fund to be built up to become a self-sustaining capital fund by 30 June 2004. The target amount was \$1.33 billion.¹⁴ At 30 June 2004 the Land Fund was valued at \$1.34 billion – thereby meeting the target.¹⁵
- 2.23 A Consultative Forum, comprising two ILC Directors, and the Finance Minister's Delegate (previously the Chief Financial Officer of ATSIC, and subsequently the Director, Financial Management and Reporting, DIMIA), is required to meet at least two times each financial year, to discuss the investment policy of the Land Fund.
- 2.24 In 1995, at the request of the Consultative Forum, ATSIC contracted an international investment consultant to provide a business plan for the Land Fund. The ANAO found that although the consultancy was originally intended to be completed by December 1995, the same firm has been contracted, with no competitive tender, since 1995. Subsequent contracts have been for provision of strategic reviews, reinvestment program advice, and investment reporting, rather than business planning as in the original contract. Total fees paid under these contracts from 1995 to June 2004 amounted to \$655 200.¹⁶
- 2.25 The ANAO also found that separate to the firm engaged to provide investment advice, most Land Fund investments were made through the institutional banking divisions of a large Australian bank. The bank provided three services to the Land Fund:
- investment advice;
 - purchase and sale of securities and provision of cash accounts; and
 - custodial services with respect to securities.
- 2.26 The ANAO found that in the seven years this arrangement was in place, ATSIC never tendered any of the above roles. Competitive quotes from other providers were not obtained by ATSIC, nor had ATSIC signed any

14 DIMIA, *Annual Report 2004-05*, available at: http://www.immi.gov.au/annual_report/annrep05/html/land_fund_account.htm, accessed November 2005.

15 ANAO Audit Report no. 22, 2004-05, p. 31.

16 Audit Report no. 22, 2004-05, p. 29.

contract with the bank. The ANAO noted an absence of performance benchmarks and no transparent cost structure on the margins being charged on investment transactions.¹⁷

2.27 The ANAO expressed concern at this arrangement and recommended that internal controls over the Land Fund's investment strategy be enhanced by segregating the roles of investment adviser and security custodian; conducting an open tender process and signing formal contracts for service; and obtaining more than one quote for each proposed investment, and/or comparing quotes, where possible.¹⁸

2.28 At the hearing, the Committee questioned DIMIA about its implementation of this recommendation. DIMIA advised that it was in the process of tendering for an investment adviser, investment manager and a security custodian for the Land Fund. The selection of the investment adviser was happening first, in order to establish a benchmark figure for the fund's return.¹⁹ The contract for the investment adviser will run for three years, with a two-year provision to roll on if the Consultative Forum is satisfied with the performance. The maximum contract length is five years.

2.29 DIMIA advised that following appointment of an investment adviser, it will commence a tender process for appointment of an investment manager. DIMIA's representative stated that in-house provision of investment management is one option being considered by the Consultative Forum:

We have structured our affairs so that we could go either way...the awarding of this contract to an investment manager will only go ahead if it is cost effective to do so. The increased returns have to more than offset the increased fees. If that condition does not hold, we will retain the running of the portfolio in-house.²⁰

2.30 On 27 January 2006, the office of Indigenous Policy Coordination, including management responsibility for the Land Fund, was transferred to the new Department of Family, Community Services and Indigenous Affairs (FaCSIA). FaCSIA advised the Committee that the investment adviser had been appointed prior to this transfer of responsibilities. Responses to the tender for appointment of an investment manager closed

17 Audit Report no. 22, 2004-05, pp. 30 - 31.

18 Audit Report no. 22, 2004-05, p. 32.

19 DIMIA, *Transcript of Evidence*, 5 September 2005, p. 24.

20 DIMIA, *Transcript of Evidence*, 5 September 2005, p. 24.

in March 2006 and are currently being evaluated with input from expert advisers. A decision is expected to be made by the end of June 2006.²¹

- 2.31 The Committee also asked about Finance representation or observation of the Consultative Forum. DIMIA responded that under the legislation, Finance cannot have a formal role on the Forum. However, Finance representatives had attended Forum meetings as observers on a number of occasions, including two of the last three Consultative Forum meetings.²²

Credit risk

- 2.32 Credit risk is the risk that a counterparty may default on its obligations, leading to a financial loss for the Commonwealth. Credit risk also includes the rating of a counterparty and the potential for loss on an investment in an instrument where the counterparty's rating is downgraded. The Commonwealth is exposed to credit risk when it invests public funds.²³
- 2.33 While the legislative restrictions on investments which apply to many Commonwealth agencies reduce their exposure to credit risk, it is still important for investing agencies to develop credit risk management policies and procedures that address both the probability, and economic consequences, of counterparty default or downgrading. This is particularly important for those agencies managing large amounts of money, for example the Land Fund's investment portfolio of more than \$1.4 billion.
- 2.34 Four of the six audited agencies did not have credit risk policies and procedures in place.
- 2.35 The ANAO found that ATSIC (Land Fund) and the National Museum of Australia had addressed credit risk in their overarching policy and procedures documents. Each had given explicit consideration to the credit ratings of institutions with which they planned to invest. However, while NMA had complied with its credit risk policy, ATSIC had not. While ATSIC's credit risk policy limited investments to institutions with a credit rating of A- or higher, there were a number of BBB and BBB+ rated investments. At 30 June 2004, the BBB or BBB+ investments totalled \$28.7 million.²⁴

21 Pers. Comm. Tim Youngberry, CFO FaCSIA. 26 May 2006.

22 DIMIA, *Transcript of Evidence*, 5 September 2005, p. 28.

23 ANAO Audit Report no. 22, 2004-05, p. 37.

24 Audit Report 22, 2004-05, p. 38.

- 2.36 While SBS did not have an overarching policy for credit risk management, the ANAO found that in investment planning and tendering for annuity investments, SBS had regard to credit risk. SBS told the ANAO that it would develop a formal credit risk policy to reflect its long established procedures.
- 2.37 The ANAO found that ANSTO made only a brief mention of credit risk in its investment documents.
- 2.38 At the time of the audit, DVA did not have any current credit risk policy and procedures in relation to its DSHIS investments. However, the investment strategy (developed in 1995) proposed an investment approach that was to minimise risk and ensure adequate liquidity while seeking to maximise returns. With a concentration in low risk investments, DVA considered that the advantages of diversification across fund managers would be less important than obtaining quality advice and service from a manager responsible for the whole portfolio.
- 2.39 The ANAO found that ITSA did not address credit risk management in its investment documents. However, the investment approach taken by ITSA had resulted in a low credit risk.
- 2.40 The ANAO recommended that entities investing public funds prepare, document and implement credit risk management policies and procedures.
- 2.41 The four audited agencies found not to have specific credit risk policies - SBS, ANSTO, ITSA and DVA - all agreed to this recommendation.
- 2.42 At the hearing, the Committee asked DVA about progress towards implementing a credit risk policy. DVA told the Committee that its investment manager (UBS Global Asset Management) had its own credit risk policy in place. DVA would 'reference that in terms of our internal investment strategy'.²⁵

25 DVA, *Transcript of Evidence*, 5 September 2005, p. 4.

Maximising returns

- 2.43 The ANAO outlined a number of ways in which government agencies can maximise investment returns, within a given level of risk. These include:
- quotes can be sought from a number of institutions;
 - when selecting an investment provider, agencies can consider rates and margins that will be offered on products; and
 - agencies can compare quoted rates with published market rates.²⁶
- 2.44 The ANAO found that the NMA and SBS displayed better practice in aiming to maximise returns, by obtaining quotes and validating quotes against published market figures.
- 2.45 However, the ANAO found that the other audited agencies displayed significant variability in their approach. While ANSTO had documented procedures, they were not being followed. ITSA and the Land Fund did not have procedures to maximise returns on individual investments. DVA was not included in this assessment because it invested in a managed money market trust.
- 2.46 The ANAO undertook an assessment of short-term investments against the Bank Bill Swap Rate (BBSW) as a benchmark. In this analysis, only the NMA and SBS, which were following better practice, achieved investment returns which were above the BBSW.²⁷ The ANAO estimated that the interest foregone during the period from 2000–01 to 2003–04 by the three entities obtaining rates of return lower than the BBSW rate was just over \$428 000.
- 2.47 Four of the six audited agencies did not have procedures in place to maximise risk-adjusted returns. The audit found that procedures to maximise for individual investments were not in place for the Land Fund. This was reflected in the ANAO's analysis of the returns being achieved.
- 2.48 As mentioned above, the ANAO did not include the DVA in its BBSW analysis because the majority of its funds were in a managed money market trust. The funds were placed in this account partly because it provided next-day access to funds, which DVA considered important as

26 Audit Report 22, 2004-05, p. 40.

27 The Bank Bill Swap Rate is an adjusted average of a range of bank bill rates at a specific time each day. An average of these rates, published by the Australian Financial Markets Association, can be used as an indicator that an entity has obtained a consistently higher, or lower, rate of return than the market over time. Audit Report 22, 2004-05, p. 41.

DSHIS, as an insurance provider, required ready access to funds to meet insurance claims and related expenses.

- 2.49 However, the ANAO noted that that the most DVA has required to access at any one time had been \$2 million. The return on the trust, from 1998 to August 2004, was reported at 5.15 per cent. This was below the benchmark of 5.25 per cent. The ANAO stated:

[The next day access], when funds are not so readily required, may be adversely impacting on the potential rate of return that could be paid to DVA for the amount of funds invested.²⁸

- 2.50 The Committee believes that DVA should investigate the possibility of splitting its investments, to allow a portion to be available in a next-day account to provide for emergencies, and the remainder to be invested in whatever vehicle (within statutory and credit risk limitations) will provide the best return. In the case of DVA requiring more cash than is immediately available in the next-day account, an overdraft or similar mechanism should be investigated. If, as the DVA and ANAO have suggested, the likelihood of the DSHIS requiring a large amount of cash on-call is very small, the risk of any penalty arising out of an overdraft would also be small.

Recommendation 1

- 2.51 **The Committee recommends that the Department of Veterans' Affairs calculate the likely amount required by the Defence Service Homes Insurance Scheme to be withdrawn from a next-day account, and invest that amount accordingly.**

To counter the possibility that a larger amount may need to be drawn in an emergency, the chosen next-day account should also have provision for an overdraft facility.

The remaining funds should be invested in institutions which may provide a higher rate of return than next-day accounts.

- 2.52 The Committee notes the ANAO's finding that between 2001-02 and 2003-04, fees of some \$325 680 were paid to the DVA fund manager. DVA

records did not enable the ANAO to identify the fees paid prior to 2001-02.

- 2.53 The Committee is most concerned to note that the ANAO has estimated that, based on the fees paid in that three year period, and the amount of money invested, fees exceeding \$1 million had been paid to the DVA fund manager since the investment commenced in 1995. This is almost double what the Land Fund paid its professional investment adviser for a fund 23 times larger.²⁹
- 2.54 The Committee also notes the updated Defence Service Homes Insurance Scheme's Investment Management Policy, and the model under development, which will enable the Scheme to 'perform internal investment performance benchmarking and market testing on a regular basis to ensure consistent strong returns and value for money for investment management services'.³⁰

The Legislative Framework

- 2.55 As outlined at the start of this chapter, government agencies fall under either the FMA Act or the CAC Act. A limited number of FMA Act agencies have been granted the right to invest public funds. Authorised investments can be expanded for FMA Act agencies through legislative change or changes to the regulations made under the FMA Act (FMA Regulations). Under subsection 18(3)(d) of the CAC Act, the Minister for Finance and Administration has the authority to approve CAC Act authorities (other than GBEs or SMAs) to invest surplus moneys in a manner other than that specified in the Act. Such approvals could previously be provided under subsection 63E(1)(c) of the *Audit Act 1901* as well as some entities' enabling legislation. There are still a number of instances where entities' enabling legislation provides the Finance Minister with the power to approve investment activities not specifically provided for in their legislation.³¹ As a Finance representative explained to the Committee:

The big difference between CAC Act agencies and FMA Act agencies is that the class of investments in which the FMA Act agencies may invest is not open to the minister to expand: it is

29 ANAO Audit Report no. 22, 2004-05, p. 43.

30 DVA, submission no. 6.

31 ANAO Audit Report no. 22, 2004-05, p. 51.

fixed by parliament – quite appropriately in terms of dealing with public money.³²

- 2.56 At the time of the audit, the Minister responsible for approving CAC Act investments outside those prescribed in the Act was the Treasurer. The *Financial Framework Legislation Amendment Act 2005* switched the responsibility from the Treasurer to the Minister for Finance and Administration. Finance explained the move:

The general thought was that it was sensible, given the development of the financial framework, that all of those things should be centralised. The role of the Treasurer in many cases was historical. In some cases it predated the creation of the Department of Finance and Administration.³³

- 2.57 The ANAO concluded that, at the time of audit fieldwork, Treasury did not have a comprehensive and accurate record of all current investment approvals provided by the Treasurer and his delegates for the purposes of investing public funds. The ANAO found that documentation of such approvals was also not always readily available from the entities that originally sought the approval. The ANAO recommended that the Department of the Treasury prepare and maintain a comprehensive and accurate record of all investment approvals provided by the Treasurer, and their current status.³⁴

- 2.58 At the hearing, the Committee asked Finance about their implementation of this recommendation, since the function had been transferred to Finance. Finance responded that they had fixed the problem of inaccurate or incomplete records of the approvals for investment under section 18 (3)(d) of the CAC Act.³⁵ Finance has developed a register for all current approvals. A submission from Finance noted that,

While CAC directors are responsible for investments they manage, Finance requires entities to submit a robust business case that explains why the approvals are needed and why the existing authority is insufficient. Finance will subsequently assess each case on its merits.³⁶

- 2.59 The ANAO noted that, in addition to the 25 Acts included in the *Financial Framework Legislation Amendment Act 2005*, there were a further three Acts
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32 Finance, *Transcript of Evidence*, 5 September 2005, p. 11.

33 Finance, *Transcript of Evidence*, 5 September 2005, pp. 15-16.

34 ANAO Audit Report no. 22, 2004-05, p. 56.

35 Finance, *Transcript of Evidence*, 5 September 2005, p. 16.

36 Finance, submission no. 1, p. 2.

that also currently provide the Treasurer with the power to approve additional types of investments. While two of the entities that were empowered to invest are no longer in existence, the investment activities continue to occur under the *Native Title Act 1993* (Native Title Act). The Native Title Act was not included in the *Financial Framework Legislation Amendment Act 2005*. Therefore at this stage, approval for investment outside the CAC Act remains with the Treasurer, for entities which are covered by the Native Title Act. The ANAO considered that there would be merit in Finance seeking to have all relevant investment approval powers transferred to the Finance Minister.

- 2.60 At the time of the audit, Finance advised the ANAO that it was liaising with DIMIA regarding an amendment to the Native Title Act being included in a future bill to transfer the approval power from the Treasurer to the Finance Minister. Finance stated that consultation with Treasury would also be required.³⁷ The Committee asked Finance about progress on the bill. Finance advised that a bill is being developed which, if passed by Parliament, would include the transfer of the investment approval power contained in the *Native Title Act 1993* from the Treasurer to the Finance Minister.³⁸

Unauthorised investments

- 2.61 During the course of the performance audit, the ANAO identified that at least 11 entities, and up to 13 entities, had purchased and reported holding investments not authorised by the relevant legislation. In total, more than \$566 million in unauthorised investments were identified.³⁹
- 2.62 DVA and ATSIC were found to have breached both Section 83 of the Constitution⁴⁰, and Section 48 of the FMA Act in relation to the purchase of unauthorised investments. Further breaches of Section 48 of the FMA Act also existed in each entity due to deficiencies in the accounts and records held in respect to their investment transactions.⁴¹
- 2.63 The ANAO found that the failure to obtain and retain sufficient information to properly inform investment decisions, combined with the development of investment strategies that permitted the purchase of unauthorised investments, led to at least \$415.5 million of the Land Fund's

37 ANAO Audit Report no. 22, 2004-05, p. 56.

38 Correspondence between Finance and the Committee secretariat, 24 November 2005.

39 ANAO Audit Report no. 22, 2004-05, p. 13.

40 Section 83 of the Constitution states that "No money shall be drawn from the Treasury of the Commonwealth except under appropriation made by law."

41 ANAO Audit Report no. 22, 2004-05, p. 62.

30 June 2004 investments being noncompliant with Section 39 of the FMA Act. In addition, due to the absence of proper accounts and records in respect of many investments, there were doubts about the compliance of a further \$70.5 million of Land Fund investments.⁴²

- 2.64 At the time of the audit, ATSIC agreed with the ANAO that there were a number of investments that were not authorised by the FMA Act. ATSIC had agreed to trade out of those holdings.
- 2.65 The Committee asked DIMIA and DVA if they had now traded out of all unauthorised investments. Both agencies responded that they had done so.⁴³ DVA also told the Committee that it now monitors the UBS investments on a monthly basis to ensure that they are compliant with relevant legislation.⁴⁴

Guidance from central agencies

- 2.66 In its Audit Report, the ANAO argued that there is a role for relevant central agencies to promote a shared understanding of limits in the financial framework legislation on Commonwealth entities' investment activities. The ANAO recommended that compliance be promoted by central agencies issuing guidance to investing entities to explain the legislative framework for investing public funds. The Treasury replied to the ANAO in November 2004:

Treasury is strongly of the view that compliance with Section 18 of the CAC Act lies firmly with the directors of CAC Boards and that the Treasury does not perform a compliance audit function.⁴⁵

- 2.67 Similarly, Finance noted that the responsibility for compliance with statutory obligations lies with investing agencies. However, Finance did agree that, where there was a lack of clarity, central agencies could assist by issuing guidance, where required.⁴⁶

42 ANAO Audit Report no. 22, 2004-05, p. 65.

43 DVA and DIMIA, *Transcript of Evidence*, 5 September 2005, pp. 17 and 30.

44 DVA, *Transcript of Evidence*, 5 September 2005, p. 17.

45 ANAO Audit Report no. 22, p. 70.

46 ANAO Audit Report no. 22, p. 70.

- 2.68 A submission from Finance outlined their response to the ANAO recommendations, including a number of Finance Circulars that have been developed since the audit.⁴⁷
- 2.69 The Committee is pleased to note the development of guidance from Finance to agencies, regarding investment of public monies. Finance also indicated that it has a training program on the FMA Act for departments, and that a number of other strategies are in train.⁴⁸
- 2.70 The Committee believes there may be some use in a central register of information about the investments being undertaken by FMA Act agencies and CAC Act agencies. This information could include the amount being invested, each entity's investment and credit risk strategy, the investment vehicles being used, and the management process – whether outsourced to an investment firm (and if so, what management fees are being charged), or if investments are managed in-house.
- 2.71 As there are only a small number of FMA Act agencies who invest public monies, it would not seem an onerous task to collect such information. There are a larger number of CAC Act agencies with investments, however, reporting such information to Finance once a year would not seem a large task for each agency to perform.
- 2.72 The development of such a register would allow this Committee, and other interested parties, to keep track of investment of public monies. It may also facilitate further information-sharing between agencies, if they notice that other departments have investment practices different to their own.

47 In particular, Finance Circulars no. 2005/05 and 2005/11 outline the statutory obligations under the CAC Act and the FMA Act for investment of public monies. The Finance Circulars can be found at: http://www.dofa.gov.au/finframework/finance_circulars.html, accessed November 2005.

48 Finance, *Transcript of Evidence*, 5 September 2005, p. 26.

Recommendation 2

2.73 The Committee recommends that the Department of Finance and Administration develop a register of information about the investment of public monies by FMA Act and CAC Act entities. The register should include:

- the dollar value of investments by each agency;
- the rate of return on investments in the previous 12 months;
- a copy of each agency's investment strategy and credit risk strategy;
- an outline of the investments made; and
- an outline of the management of investments – via an external management agent (and any applicable fees), or in-house.

This register should be updated annually, at the conclusion of the financial year.

Audit Report No. 42, 2004–05

Background

2.74 The Australian Office of Financial Management (AOFM) was established on 1 July 1999. The AOFM is responsible for the administration, financial and operational risk management, and financial reporting of the Australian Government's portfolio of Commonwealth Government Securities and associated financial assets. The AOFM issues Treasury bonds and Treasury notes, invests in term deposits with the Reserve Bank of Australia, manages the Government's cash and conducts interest rate swaps.

- 2.75 ANAO Audit Report No.14 of 1999–2000, tabled in October 1999, examined Commonwealth Debt Management. The report made six recommendations, all of which were agreed to by the AOFM and the Department of the Treasury (Treasury).
- 2.76 The JCPAA conducted an inquiry into Commonwealth Debt Management during 2000, and released its report in November 2000. The JCPAA noted the AOFM's progress to date and made three recommendations. One of these was that the AOFM move as quickly as possible to implement all of the recommendations made in the ANAO's 1999 audit report.
- 2.77 A number of other reviews in relation to the management of the Commonwealth debt have also been undertaken since the 1999 audit. In September 2001, the Treasurer agreed to the gradual elimination of all foreign currency exposure from the Commonwealth debt portfolio following an internal AOFM review. Around February 2002, there was considerable media and Parliamentary attention, particularly in Senate Estimates hearings, surrounding the performance of the cross currency swaps component of the Commonwealth debt portfolio. In addition, in 2002–03, the Government reviewed the future of the Commonwealth Government Securities market. In the 2003–04 Budget, the Government announced its decision that, in the future, it would issue sufficient Treasury bonds to support the bond futures market.

Audit objectives

- 2.78 The objective of this follow-up audit was to assess the extent to which the recommendations and major findings of the ANAO's 1999 audit of Commonwealth Debt Management had been addressed, and the impact of any changes.

Overall conclusion

- 2.79 Overall, the ANAO found that the majority of the recommendations from the ANAO's 1999 audit report had been implemented or satisfactory progress has been made on their implementation.

ANAO recommendations

Table 2.2 ANAO recommendations, Audit report no. 42, 2004-05

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1. The ANAO *recommends* that the AOFM establish a reporting trigger to inform the Treasurer and Treasury Secretary when the swap portfolio has significant unrealised losses.
- AOFM Response: Agreed with qualification.*
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2. The ANAO *recommends* that, to improve transparency and accountability, the AOFM report more comprehensively and consistently on the efficiency of its swap dealings in future Annual Reports.

AOFM Response: Agreed.

The Committee's review

- 2.80 The Committee undertook this review to assess the AOFM's implementation of the ANAO recommendations. The Committee also had some interest in the cost of maintaining the bond market, versus retiring government debt.
- 2.81 Witnesses from the Australian Office of Financial Management, and the Department of the Treasury, gave evidence at a public hearing held on 5 September 2005.

Reporting on the swap portfolio

- 2.82 At the time of the audit, the AOFM had not established any boundaries regarding the extent that it remains comfortable when the swap portfolio goes significantly 'out of the money' (that is, the maximum level of unrealised losses that the AOFM deems to be an acceptable risk). The ANAO observed that the Treasurer was consulted about significant matters and, in particular, was regularly briefed by the AOFM on progress following the decision to wind-up the cross currency swaps program. However, the ANAO considered that there was scope for improving advice to the Treasurer about the level of unrealised losses when the interest rate swaps portfolio was significantly 'out of the money'.⁴⁹
- 2.83 The ANAO recommended that the AOFM establish a reporting trigger to inform the Treasurer and Treasury Secretary when the swap portfolio has significant unrealised losses. The AOFM agreed, with qualification, stating that reporting should apply to the physical net debt portfolio as well as to swaps, since both generate interest rate risk exposures and should be considered together. At the time the Audit Report was published, the AOFM was considering whether reporting should be done on a regular basis or using a trigger.
- 2.84 At the hearing, the Committee questioned AOFM about its implementation of this recommendation. AOFM told the Committee that it now reports to the Treasurer and to Treasury on the market value of the

49 ANAO Audit Report no. 42, 2004-05, p. 37.

total portfolio and the swaps, on a two-monthly basis. These reports are made via reporting to the AOFM board, which meets every two months. The Secretary of the Treasury is a member of the AOFM board. The AOFM also noted that its annual financial statements include a report on the market value of the portfolio, including the market value of the swap component of the portfolio.⁵⁰

- 2.85 The Committee also asked Treasury and the ANAO if they were happy with these arrangements. Treasury responded that they were happy with the current arrangements.⁵¹ The ANAO noted that in spite of the regular reporting requirements:

...one would still expect that, if there was a sudden untoward very large adverse movement, advice would come forward more quickly – rather than just the specified regular [meeting].⁵²

- 2.86 The Committee is pleased to note that there are now regular reports to Treasury, via the AOFM board meetings, on the market value of the total portfolio and the swaps. However, the Committee agrees with the ANAO that there should remain a trigger mechanism for a separate report, in the event of a sudden large movement within the portfolio.

Recommendation 3

- 2.87 **The Committee recommends that the Australian Office of Financial Management and the Department of the Treasury draw up a formal agreement which states that in the event of a large movement within the AOFM investment portfolio, AOFM will provide formal advice to the Treasury as soon as possible.**

Conduct of swap tenders

- 2.88 The second ANAO recommendation was that the AOFM report more comprehensively and consistently on the efficiency of its swap dealings in future Annual Reports. At the time the Audit Report was published, the

50 Australian Office of Financial Management (AOFM), *Transcript of Evidence*, 5 September 2005, pp. 41-43.

51 Treasury, *Transcript of Evidence*, 5 September 2005, p. 41.

52 ANAO, *Transcript of Evidence*, 5 September 2005, p. 42.

AOFM was considering how, in practical terms, reporting on the efficiency of swap transactions might best be developed.

- 2.89 The Committee asked the AOFM about progress against this recommendation. The AOFM responded that for the forthcoming annual report (2004-05), it was intending to make a number of changes in light of the audit findings. The AOFM indicated that it was looking to include an efficiency measure on the swap, bearing in mind the need to provide information that is comprehensible to the reader.⁵³
- 2.90 The Committee notes that the AOFM annual report was tabled in October 2005. The Committee is pleased to see that the AOFM has provided further information in this annual report, including an efficiency measure for the swap.⁵⁴

Maintenance of the bond market

- 2.91 While outside the parameters of Audit Report no. 42, at the public hearing the Committee also discussed with AOFM the cost of maintaining the bond market on an interest basis, and the total returns on term deposits and swap books. This discussion can be read in the Transcript of Evidence for the public hearing.⁵⁵

53 AOFM, *Transcript of Evidence*, 5 September 2005, p. 43.

54 AOFM, *Annual Report 2004-05*, p. 25. See Figure 2 regarding an efficiency measure for the swap. Available at:
http://www.aofm.gov.au/content/publications/reports/AnnualReports/2004-2005/download/04_Part_2.pdf, accessed November 2005.

55 AOFM, *Transcript of Evidence*, 5 September 2005, pp. 34 – 40.