Inquiry into the Nation-Building Funds Bill 2008; Nation-Building Funds (Consequential Amendments) Bill 2008; COAG Reform Fund Bill 2008

ANAO Submission

Legislative provisions defining classes of financial assets for investment purposes

The specification of the types of instruments that are authorised to be purchased with public money is an important control for Commonwealth investment activities. In this respect, two different approaches have been applied, each of which offers different benefits and involves different risks.

The first approach has involved explicitly identification of authorised types of investments through legislation and/or disallowable regulations. A clear benefit of this approach is that it maximises the ability for the Parliament to exercise control over investment activities. An example of this approach involves the investment of public money by agencies subject to the *Financial Management and Accountability Act 1997* (FMA Act). Specifically, unless otherwise stipulated in legislation, the authority to invest for these agencies is controlled by section 39 of the FMA Act and FMA Regulation 22. The authorised investments under these provisions are, at present:

- securities of the Commonwealth or of a State or Territory;
- securities guaranteed by the Commonwealth, a State or a Territory;
- a deposit with a bank, including a deposit evidenced by a certificate of deposit;
- (for the Treasurer only), debt instruments issued or guaranteed by the government of a foreign country or a financial institution whose members consist of foreign countries, or of Australia and foreign countries;
- a bill of exchange accepted or endorsed only by a bank; and
- a professionally managed money market trust if the Finance Minister or the Treasurer is satisfied that:
    - o the only investments managed by the trust are securities of, or guaranteed by, the Commonwealth, a State or a Territory; or a bill of exchange accepted or endorsed only by a bank; and
    - o a charge over trust assets does not support any borrowings by the trust.

Similar to the approach that has been taken in the Commonwealth's financial framework legislation, the legislation that established the Communications Fund authorised the investment of money standing to the credit of the Fund Account to be invested in financial assets and defined, within the body of the legislation, those financial assets that were able to be purchased.

The second approach we are aware of involves the establishing legislation defining the types of authorised investments by reference to the *Australian System of Government Finance Statistics* (GFS).[1] For example, the establishing legislation for the Future Fund and the Higher Education Endowment Fund defines (in section 6 of each Act) a 'financial

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[1] GFS is an economic reporting standard developed by the Australian Bureau of Statistics. It provides government financial information consistent with international standards, including those of the International Monetary Fund, within the framework of the Australian System of National Accounts.

asset' for investment purposes as:

(a) *an asset that, in accordance with GFS Australia, is treated as a financial asset for the purpose of the GFS system in Australia; or*

(b) *an asset specified in regulations made for the purposes of this paragraph.*

The same approach has been adopted in the Nation-building Funds Bill 2008 (section 5). While the rationale for adopting this approach has not been explained, its benefits would include certainty in terms of Budget impact and presentation, as well as greater flexibility in the range of investments that are able to be purchased, particularly given the pace at which financial instruments can evolve. Nevertheless, the categories of authorised investments are not as clear to the Parliament under this latter approach as is the case where they are directly specified in legislation or regulations. In addition, earlier performance audits have raised matters worth considering in circumstances where key parameters or approaches are defined not within the legislation but by reference to other publications issued either by industry[2] or in economic reporting standards.[3]

Breadth of permissible investments

A key issue that arose in the development and Parliamentary consideration of the legislation establishing the Communications Fund was the breadth of the definition of financial asset for the purpose of Fund investments. Our performance audit of the establishment and management of the Communications Fund found that the broad range of investments represented a significant departure from the categories of conservative investments authorised by the FMA Act (section 39).

The Department of the Treasury raised issues about the breadth of the proposed categories of investments for the Communications Fund, but these issues were not addressed in the process of drafting the legislation.[4] Subsequently, through an Investment Authorisation signed by the two responsible Ministers, and the Investment Guidelines issued by the administering agency, the Communications Fund was restricted to investing in a portfolio of low risk, highly liquid, fixed interest assets. This approach closely aligns with the approach adopted for entities investing under the FMA Act and is also more consistent with the policy that that Fund be perpetual in nature. The audit concluded that there would be benefits from agencies having greater regard to the principles that underlie the existing financial framework before proposing significant departures from it.

Against this background, we note that the Nation-building Funds Bill adopts, by reference to GFS Australia, a broad definition of financial assets, as follows:

Financial assets are assets that are in the form of financial claims on other economic units. In the system, financial assets are classified to the following instrument categories:

- **Cash and deposits** - this includes: (i) notes and coins on hand; (ii) cheques held but not yet deposited; (iii) cash and deposits in both Australian currency and foreign currency, which are recoverable or transferable on demand and are held at all banks, non-bank financiers and other deposit taking institutions; (iv) deposits placed in the Short Term

[2] See Audit Report No. 29 2006-07, *Implementation of the Sydney Airport Demand Management Act 1997*.

[3] See Audit Report No. 32 2007-08, *Preparation of the Tax Expenditures Statement*.

[4] ANAO Audit Report No.3 2008-09, *Establishment and Management of the Communications Fund*, Canberra, 23 September 2008, pp. 15 and 40.

Money Market (for example grants received from the Commonwealth and deposited overnight); and (v) units issued by cash management trusts and withdrawable share capital of building societies. The item excludes bank certificates of deposit and fixed deposits held with banks;

- **Investments, loans and placements** - this includes: (i) non-negotiable, non-transferable loans, other than advances; (ii) credit foncier loans; (iii) deferred payment schemes (re-purchase agreements); (iv) securities such as promissory notes; (v) bills of exchange; (vi) certificates of deposit; (vii) fixed term deposits; (viii) Treasury notes and bonds; (ix) redeemable preference shares; (x) debentures; (xi) long term notes; and (xii) net value of swaps and other derivatives that are in a net asset position;
- **Accounts receivable** - this includes short and long term trade credit and accounts receivable, accounts and interest receivable, and prepayments made;
- **Advances outstanding** - this category refers to loans and other non-equity financial assets acquired for policy rather than liquidity management purposes. As a general rule, all loans made by general government to other government bodies, except loans made by central borrowing authorities, are deemed to be for policy purposes. Included are long and short term loans, non-marketable debentures, and long and short term promissory agreements (bonds and bills) issued to public sector units for the purpose of achieving government policy objectives. Excluded are government equity in public corporations (see next item), grants and non-repayable funds, and investments for liquidity management and income generation purposes;
- **Equity** - this category refers to claims on other entities entitling the holder to a share of the income of the entity and a right to a share of the residual assets of the entity should it be wound up. The item includes the market value of shares on issue in listed corporations and preference shares and convertible notes after conversion. It excludes convertible notes before conversion. The item also includes the book value of assets (real and financial) less liabilities of unlisted public corporations.

Whilst the Bill proposes a broad definition of financial asset, it is also worth noting that, compared to the approach taken for the Communications Fund, the Nation-building Funds Bill proposes a more conservative approach to the use of financial derivatives. For the Communications Fund, the legislation permitted the purchase of derivatives for the purposes of enhancing or protecting the value of, or return on, an investment of the Communications Fund. This provision allowed for the purchase of a derivative not only to protect an existing investment (through hedging), but also to create new exposures, which carries with it an inherently higher level of risk than might otherwise be considered acceptable for a Commonwealth entity. By way of comparison, the Nation-building Funds Bill provides that derivatives must not be acquired for the purpose of speculation or leverage. This, in our view, is a sound approach.

Fund liquidity requirements and investment returns

The Nation-building Funds Bill requires the responsible Ministers to give the Future Fund Board written directions about the performance of the investments for each Fund, to be known as the Investment Mandate for each Fund.[5] The Bill further requires that the Future Fund Board must take all reasonable steps to ensure that the amount of money standing to the credit of each Fund Special Account is sufficient to cover the debit of amounts authorised, or proposed to be authorised, for payment. Against this background, an important issue to be addressed during the implementation of the Funds will be the specification of the liquidity requirements of the Funds, as this can have a significant impact on potential Fund returns.

[5] The Future Fund Board is to be consulted by the responsible Ministers before such directions are given.

Special Account arrangements

A Special Account is a mechanism used to record amounts in the Consolidated Revenue Fund (CRF) that are appropriated for specified purposes. Special Accounts can be created through a determination by the Finance Minister (which is a disallowable instrument), or through an Act of the Parliament. Special Accounts enable money to be earmarked within the CRF for the purposes for which the account has been established.

The Nation-building Funds Bill 2008, together with the COAG Reform Fund Bill 2008, proposes the establishment of 12 Special Accounts for the administration of the three Nation-building Funds. The proposed arrangements are illustrated in Figure 1. The approach adopted, whilst complex, offers potential benefits in terms of separately identifying the amounts being disbursed for different portfolio responsibilities, and the balance of remaining funds. However, we note that, under the proposed arrangements, payments of the same type (for example, an infrastructure financial assistance grant to a State or Territory) are able to be either:

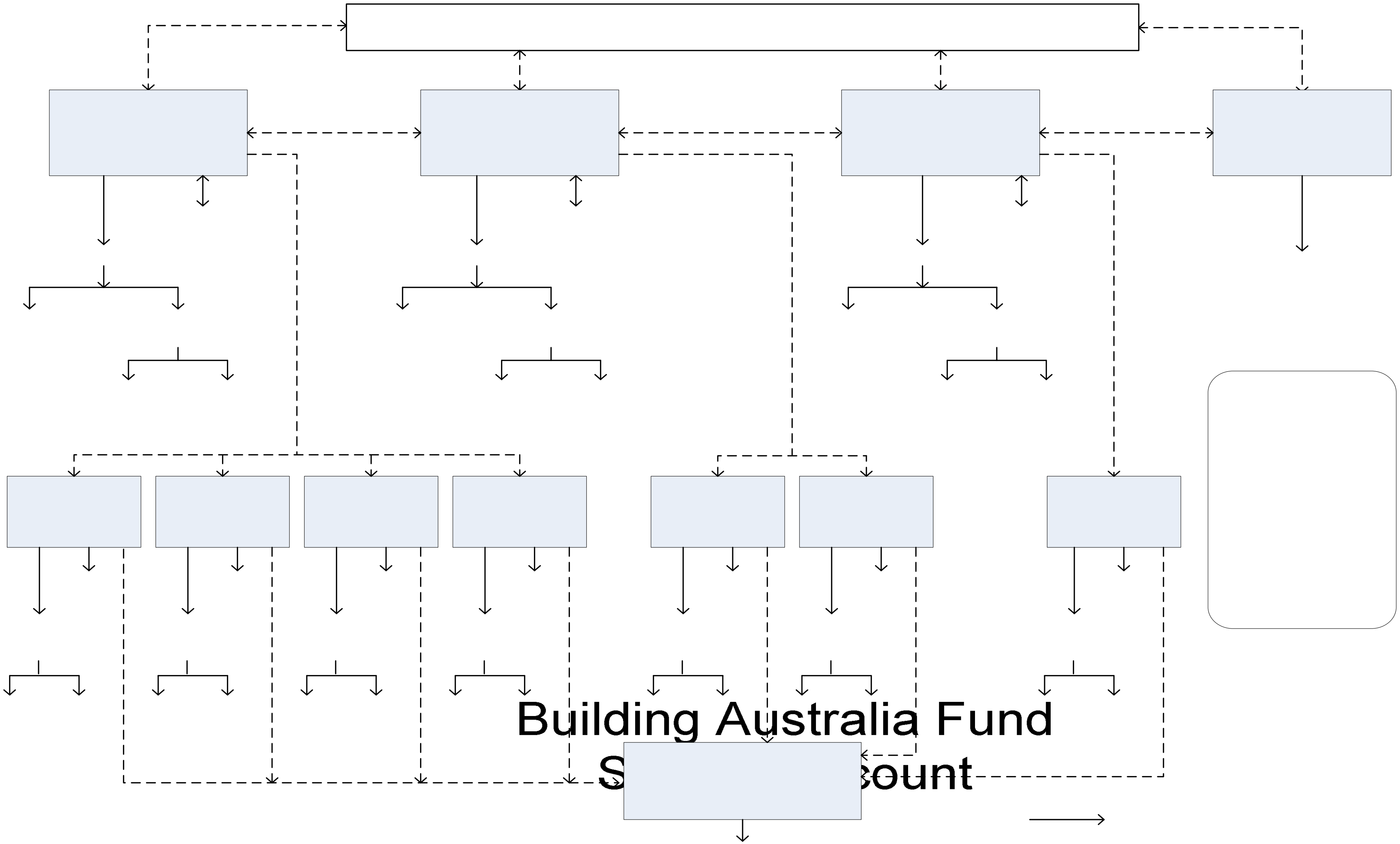
- made directly from the relevant Nation-building Fund Special Account; or
- channelled from the Nation-building Fund Special Account to a related Portfolio Special Account, form which the payment to the recipient is made; or
- channelled from the Nation-building Fund Special Account to a related Portfolio Special Account, and then channelled to the COAG Reform Fund Special Account, from which the payment to the recipient is made.

However, any criteria that are to be applied in determining the appropriate Special Account from which particular payments should be made are not clear from the Bill.

In addition, the complexity of the Special Account arrangements proposed under the Nation-building Funds Bill 2008 will require careful management to ensure each Special Account is administered in accordance with the legislation; transactions made through each Special Account are accurately recorded; and there is a consistent approach taken to the making of payments of a similar nature so as to assist in the reporting of the payments made for particular purposes.

In respect to the creation of new Special Accounts, we are aware that, in its inquiry into transparency and accountability of Commonwealth public funding and expenditure, the Senate Standing Committee on Finance and Public Administration canvassed issues relating to the proliferation of Special Accounts and for improving the capacity of the Parliament to scrutinise the establishment of new Special Accounts. There is now greater disclosure of the existence of Special Accounts and their transactions and balances (such as through a list of Accounts now being included in the Budget Papers together with each Account, its opening and closing balances and receipts and payments being reported in the Consolidated Financial Statements).

Figure 1 Special Account arrangements proposed under the *Nation-building Funds Bill 2008* and *COAG Reform Bill 2008*



Source: ANAO analysis of *Nation-building Funds Bill 2008* and *COAG Reform Fund Bill 2008*.

Payments other than grants of financial assistance

The Nation-building Funds Bill provides that payments made in relation to the creation or development of relevant infrastructure from each of the Building Australia Fund Special Account, the Education Investment Fund Special Account and the Health and Hospitals Fund Special Account, and each of the subsidiary Portfolio Special Accounts, may be made:

a) by way of a grant of financial assistance; or

b) otherwise than by way of a grant of financial assistance.[6]

Other payments (that is, payments that are not grants) include payments for the acquisition, in the name of the Commonwealth, of financial assets in a company or business entity involved in the creation or development of relevant infrastructure. For example, a purpose of the Building Australia Fund Special Account (and of the BAF Infrastructure Portfolio Special Account) is to make authorised payments in relation to '*the creation or development of transport infrastructure'*. For the purposes of the Bill, that term is given an extended meaning to include payments made in relation to the acquisition of:

a) shares in a company that is, or will be, involved in the creation or development of transport infrastructure;

b) debentures of a company that is, or will be, involved in the creation or development of transport infrastructure[7];

c) units in a unit trust that is, or will be, involved in the creation or development of transport infrastructure; or

d) financial assets in a business entity that is, or will be, involved in the creation or development of transport infrastructure.[8]

The purpose(s) set out in the Bill for each of the Fund Special Accounts and Portfolio Special Accounts similarly provide for payments to be made from the Special Account for the acquisition of financial assets in entities involved in the creation or development of relevant infrastructure. These provisions allow for investment at the time a relevant company is formed, as well as investment in relevant existing companies, and similarly in relation to business entities.[9]

The Explanatory Memorandum to the Nation-building Funds Bill advises that the inclusion of the extended definition of payments under the Funds is intended to provide flexibility in how the Government invests in the creation or development of relevant infrastructure.[10] There are, however, two noteworthy aspects of these provisions.

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6 Any payments that are to be channelled through the COAG Reform Fund Special Account must be a grant of financial assistance.

7 The provisions relation to the acquisition of debentures covers the provision of financial assistance to a company by way of loan, consistent with the definition of 'debentures' in the Bill, which provides that the term has the same meaning as in the Corporations Act (Source: The Parliament of the Commonwealth of Australia, House of Representatives, *Nation-Building Funds Bill 2008, Explanatory Memorandum*, Circulated by authority of the Minister for Finance and Deregulation, The Honourable Lindsay Tanner MP, p. 19).

8 Other payments could also include public-private partnership payments (Source: ibid., p. 17).

9 See, for example, ibid., p. 19.

10 See, for example, ibid., p. 19.

Investment-management parameters not identified

These financial assets (to be held in the name of the Commonwealth and managed by the Commonwealth) will not be part of the relevant Fund once acquired.[11] This is in contrast to the investments made by the Future Fund Board (held in the name of the Future Fund Board and managed by the Board), which will constitute part of the balance of the relevant Fund.[12] The acquisition of these financial assets will not be subject to the provisions governing the investment of amounts standing to the credit of the Nation-building Fund Special Accounts by the Future Fund Board.[13] Nor are they subject to the provisions of section 39 of the FMA Act. In this respect, the Explanatory Memorandum for the Nation-building Fund Bill states:

> …Section 39 of the FMA Act authorises the Finance Minister to invest public money in only a limited range of investments, such as government bonds and bank deposits. Therefore, it is appropriate that Commonwealth investment in the creation or development of [*relevant*] infrastructure through the acquisition of shares, debentures, trust units or other financial assets are exempted from the application of section 39 of that Act.[14]

The Explanatory Memorandum further advises that it is intended that the relevant portfolio Minister will manage the Commonwealth's ownership obligations as well as exposures and risks associated with the assets, on behalf of the Commonwealth.[15] However, the Bill does not otherwise address the governance and investment-management parameters that will apply to the investment of public money in shares, debentures, trust units and other financial assets under transactions of this nature. Our previous audit work on the monitoring of Government Business Enterprises has drawn attention to the risks that can exist where individual portfolio departments oversight these types of investments unless there is adequate central agency coordination and a way of sharing knowledge and expertise.[16]

Crediting investment proceeds to the relevant Fund Special Account

The Bill includes provisions stipulating that, in relation to investments in financial assets made by the Future Fund Board, the following amounts must be credited to the relevant Fund Special Account:

- income derived from an investment of the Fund;
- a return of capital, or any other financial distribution, relating to an investment of the Fund; and

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[11] In this context, the Explanatory Memorandum for the Nation-building Funds Bill 2008 (p. 19) advises: 'As these financial assets will not be part of the BAF, the Future Fund Board will not be involved in the acquisition or management of these assets. See also Clause 121 of the Bill which provides that investment provisions do not apply to these assets.' Similar comments are provided at p. 76 and p. 115 in respect to financial assets acquired through payments from the EIF and HHF Special Accounts, or related Portfolio Special Accounts, in relation to the creation or development of relevant infrastructure.

[12] The clauses in the Nation-building Fund Bill establishing each of the Building Australia Fund, the Education Investment Fund and the Health and Hospitals Fund provide that the relevant Fund will consist of the relevant Fund Special Account and the investments of the relevant Fund (see clauses 12, 131 and 214).

[13] Investments by the Future Fund Board are to made with the objective of enhancing the Commonwealth's ability to make payments in relation to the creation or development of infrastructure. Clauses 121, 206 and 274 of the Bill stipulate that the investment provisions set out in the Bill for the relevant Fund do not apply to financial assets acquired through payments made for the creation or development of infrastructure under the extended meaning given to the relevant terms for each Fund.

[14] See, for example, op. cit., p. 65.

[15] See, for example, ibid., p. 19.

[16] Audit Report No. 2 1997-98, *Government Business Enterprise Monitoring Practices*, Canberra, 24 September 1997 and ANAO Audit Report No. 15 2000-2001, *Agencies' Performance Monitoring of Commonwealth Government Business Enterprises*, Canberra, 9 November 2000.

- the proceeds of an investment of the Fund upon realisation of the investment.

Our analysis to date suggests that the Bill does not include any similar provisions in relation to proceeds from financial assets acquired through payments made from a Fund Special Account or Portfolio Special Account in relation to the creation or development of the relevant infrastructure type. In the absence of specific provisions in the establishing legislation relating to the crediting of amounts received from those investments (including in relation to debentures) to the balance of the Special Account from which the original payment was made, they could only be credited to the balance of the relevant Fund through a written determination of the responsible Ministers (see, for example, clause 15 Subsequent credits of amounts to the Building Australia Fund Special Account—determination by the responsible Ministers).