7.4 RISK MANAGEMENT

This chapter provides details of the Risk Management issues faced by the Territory, particularly in regard to Economic Risk, Commonwealth funding, Market Risk, Insurable Risk, and Operational Risk.

Economic Risk

The ACT economy tends to be somewhat insulated from the uncertainties faced by the domestic and global economies. This situation has both positive and negative ramifications. From a positive viewpoint, during times of global and national slowdown, the ACT economy tends to be protected due to its limited exposure to changing international trade patterns. From a negative viewpoint, the ACT's limited industrial structure means that it is unable to fully participate in a global economic expansion such as that expected to occur over the coming years.

These factors suggest that any uncertainties in the international and domestic economies are likely to have less influence on the ACT. This does not mean however that the ACT economy is immune to risk. Two areas where the ACT economy is particularly sensitive are movements in interest rates and changes in Commonwealth Government expenditure.

In 2000-01, public administration and defence, general government, education, and the health and community service sectors accounted for 42.4% of ACT Gross State Product (GSP) compared to 16.1% of national Gross Domestic Product (GDP). In the December quarter 2001, Government Final Consumption Expenditure (GFCE) comprised 51% of ACT State Final Demand (SFD) and only 18% of Australian Domestic Final Demand (DFD). These figures highlight the important role that public, mostly Commonwealth, expenditure plays in the overall health of the ACT economy. Small changes, positive or negative, in public expenditure will have large impacts on ACT demand and output.

Changes in interest rates impact on the ACT economy in a variety of ways. For instance, interest rate movements will impact on Household Final Consumption Expenditure (HFCE), a large component of SFD, by altering household spending patterns. With interest rates in Australia rising, households will be required to devote more of their income to mortgage repayments resulting in less disposable income for discretionary spending.

Rising interest rates are also likely to exert downward pressure on investment. In the ACT, investment accounts for approximately 12% of demand. Private non-dwelling investment accounts for about one half of this and dwelling investment approximately 2% of SFD. Despite its relatively small component size, dwelling investment can be highly volatile, therefore contributing disproportionately to economic growth. It also has relatively high multiplier effects on other parts of the economy. Dwelling investment has been a large component of the growth in private investment in the ACT over the current financial year but activity in this area has begun to slow down. Larger than forecast increases in interest rates will put further pressure on the housing industry which is likely to lead to larger than expected reductions in private investment and, consequently, slower growth in SFD.

Commonwealth Funding

While the ACT's immediate outlook for Commonwealth assistance continues to be favourable in the short term, there are a number of factors which may alter this position in the longer term.

Commonwealth funding accounts for approximately 46% of General Government Sector revenue. This stream of funding is unlikely to deteriorate over 2002-03 and 2003-04 given the likely continued adoption of the Commonwealth Grants Commission's (the Commission) 1999 Review methodology, with the ACT expected to continue to receive an above equal per capita share of the GST revenue, the major source of Commonwealth funding.

However, the Commission is currently reviewing the methodology with the results due in 2004 for application in the financial year 2004-05 and updated annually thereafter for a four-year period. It is too early to form a view as to the outcome of the review however, the ACT's current position is under threat from a number of quarters.

NSW, Victoria, and WA have commissioned an Independent Review (IR) of Commonwealth-State Funding. This is essentially an attempt to pressure the Commonwealth for a redistribution of GST funding towards these States who receive less than an equal per capita share of the GST pool. The IR has outlined a range of criticisms of the current distribution method, and particularly targets Queensland and the ACT.

The ACT Treasury has responded to the Commission's 2004 Review with a submission which comprehensively argues the ACT's claims for an enhanced share of the GST pool from 2004-05 onwards.

The other possible development concerns two unique specific purpose payments the ACT receives from the Commonwealth concerning the impact of National Capital Influences on municipal functions and for Water and Sewerage totalling approximately $30m per annum.

The Commonwealth has foreshadowed that these payments will be reviewed, with the timetable for such a review yet to be determined.

Market Risk

The Territory is exposed to market risk from changes in interest rates and foreign currency exchange rates since it denominates a proportion of its financial investment transactions in a variety of foreign currencies and has a debt portfolio of long-term and short-term borrowings. As a result, future operating results, cash flows and fair values of assets and liabilities are subject to uncertainty.

The Territory has established limited market risk management policies in the past, however there will be an adoption of a more pro-active policy from 2002-03. A major factor that has limited the Territory's ability to manage its exposure to market risk more actively, has been a legislated prohibition on the use of financial derivative instruments. Derivative transactions are financial contracts and include a wide assortment of instruments such as forwards, futures, options, warrants, swaps, share ratios and other composites, which are most commonly used as a risk management tool, within an investment or debt portfolio. Common uses of derivatives are to:

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

The prohibition on the use of financial derivatives was removed when the provisions of the *Financial Management Legislation Amendment Act 2001* became effective from 12 January 2001. These will provide the Territory with the opportunity to more actively manage its market risk exposures.

Interest Rate Risk

Interest rate risk is the exposure of the Territory's financial position to adverse movements in interest rates. Accepting this risk is a normal part of financial operations, however, excessive interest rate risk can pose a significant threat to the Territory's earnings and capital base. Changes in interest rates affect the Territory's operating result by changing its net interest income and the level of other income and operating expenses sensitive to interest rates. Changes in interest rates also affect the underlying value of the Territory's assets, liabilities and off-balance sheet instruments as the present value of future cash flows, and in some cases, the cash flows themselves change when interest rates change.

The Territory is exposed to changes in interest rates, primarily due to its financing, investing and cash management activities, which include long and short-term borrowings.

In regard to the general government investment portfolio, a 1% increase or decrease against the estimated interest rate returns assumed in the Budget estimates for interest revenue would affect income by approximately $5.3m in 2002-03, $4.3m in 2003-04, $4.0m in 2004-05, and $4.5m in 2005-06.

Territory borrowings comprise approximately 42% funded on a fixed rate basis and 58% on a floating rate basis. Presently, the floating rate borrowings are exposed to interest rate movements. An increase or decrease in market interest rates applicable to Territory's floating rate borrowings, above or below the interest rates used in the development of the budget estimates, will have a direct impact on the interest costs of these borrowings. The falling interest rate environment over the past few years has been advantageous to the Territory, in respect of its floating rate borrowings, however, as it is becoming increasingly likely that there will be a period of increasing interest rates, more active interest rate exposure management will be considered.

A 1% increase or decrease in the assumptions used to calculate the interest costs on the floating rate borrowing would affect interest expenses by approximately $4.0m in 2002-03, $4.3m in 2003-04, $5.0m in 2004-05, and $5.4m in 2005-06.

A targeted outcome of the risk management review to be undertaken during 2002-03 will be to clearly establish an appropriate interest rate risk management policy, including the development of performance benchmarks.

Foreign Exchange Rate Risk

The Territory's exposure to currency risk in respect of its financial investments only relates to a portion of the Superannuation Provision Account (SPA) investment portfolio. The SPA's investments are diversified among a number of asset classes that include international equities. This proportion of investments in non-Australian denominated currency is currently fully unhedged.

During 2002-03 a revised investment strategy for the SPA investment portfolio will be implemented. The new strategy will require a proportion of any investments exposed to foreign currency movements to be hedged. This hedging will be possible due to the removal of the prohibition on the use of financial derivatives for such purposes, and subject to the passage of the financial guidelines through the Assembly.

The Territory does not have any financial borrowings in non-Australian denominated currency and therefore is not exposed to any foreign exchange risk.

The Territory does not have a significant exposure to foreign exchange, in relation to goods and services purchases.

Governance, Advisory and Consultancy Arrangements

An important aspect of the Territory's investment and borrowing arrangements, particularly due to their significance as a proportion of the total Territory balance sheet, is the established governance, advisory and consultancy arrangements.

In 2000 a Finance and Investment Advisory Board was established to provide advice to Treasury on all financial investment and borrowing related issues. The essential purpose of the Finance and Investment Advisory Board is to contribute to better outcomes in the ACT Government's financial dealings by enhancing financial returns and improved governance.

During 2001 the Territory appointed Frontier Investment Consulting Limited as its investment consultant. The consultant provides advice on portfolio optimisation and strategic asset allocation, fund manager and portfolio monitoring.

In November 2001 Commonwealth Custodial Services (CCS) was appointed by the Territory to provide master custodian services to the Territory, including,: safekeeping, settlement, derivatives clearing, valuation of investments, accounting reconciliations, accounting reporting, mandate compliance reporting, performance measurement, performance reporting, audit, performance attribution, transition of assets and taxation equivalent reporting.

During 2002-03 a risk management adviser will be engaged to provide assistance with the risk management policies and practices, identification of financial exposures, reporting and benchmarking and performance management.

The established governance, advisory and consultancy arrangements provide the Territory with a very solid platform from which it is able to implement best practice management of the Territory's financial assets and liabilities.

Insurable Risk

The ACT Insurance Authority (ACTIA) was established as a statutory authority under the *Insurance Authority Act 2000*. The Authority commenced operation on 1 April 2001.

ACTIA manages a fund, which was established to finance the cost of insurable risk for ACT Government agencies, excluding workers' compensation risks. The objectives of the ACTIA are to:

- enable the Territory to meet the cost of its claims and losses in an orderly, timely and cost effective manner;
- ensure the costs are fully reflected in the Territory's accounts in accordance with accrual accounting principles;
- protect the budget from the risk of very large claims; and
- aid and improve risk management practices in agencies.

ACTIA is financed through risk-based levies that reflect the asset holdings and liability risks faced by each agency. The levies are set to generate sufficient funds to ensure that ACTIA's internal funds and its overlying insurances will be able to meet all claims incurred during the current year, even if those claims are not paid until a later year.

The agency levies are set at a level sufficient to meet most claims or losses experienced through the normal operations of government agencies. Each agency meets the cost of claims below the level of an agreed deductible or excess. ACTIA purchases insurance to protect the Territory against large claims or losses, or a series of such events, which would threaten the viability of ACTIA's internal funds. This protection is becoming both increasingly difficult and expensive to purchase and ACTIA's self-insured retentions are being increased, where viable, to offset this increase in expense.

It is the responsibility of agencies to develop appropriate risk management strategies. During 2002-03 ACTIA will also provide a number of risk management strategies as set out below. In addition, once sufficient data is gathered, ACTIA will adjust agency premiums to provide economic incentives for the agencies, which adopt best practice risk management strategies.

Issues that will be pursued in 2002-03 include:

- the roll out of the Comcover Risk Management Benchmarking system which measures and compares the risk management process;
- provision of focused risk management training of agency managers and staff; and
- regular review of existing major claims to ensure appropriate management is being applied to claims, and that realistic estimates of costs are included in ACTIA's accounts.

Operational Risk

In addition to good risk management practices, a procurement strategy has been developed with the aim of reducing risks associated with the procurement of goods and services on behalf of the Government.

Procurement Policy

The *Government Procurement Act 2001* established the Government Procurement Board (the Board) to develop, implement and review policies and practices for the procurement of goods, services and works by Territory entities.

The Board has established a procurement framework within the Territory supported by:

- legislation issued as Disallowable Instruments and circulars issued for guidance purposes;
- a planning regime that requires the preparation of procurement plans, including full risk management plans, for all proposals in excess of $50,000 for examination by Approved Procurement Units (APUs) and endorsement of the Board if over $1 million;
- training arrangements to ensure that staff have the necessary competencies to undertake procurement projects in accordance with the requirements of the Board; and
- performance monitoring through audit and review.

Specific guidance is provided for procurement activity both under and over $50,000 that addresses the risks associated with purchasing goods, services or works, within a value for money framework.