

## 7.4 RISK MANAGEMENT

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### Economic Risk

The ACT economy, because of its reliance on public sector activities, tends to be insulated from the uncertainties faced by the national and international economies. This circumstance can have both positive and negative implications for the performance of the local economy. As a positive implication, during times of global and national slowdown, the ACT economy tends to be protected because of its limited exposure to changing international trade patterns. As a negative implication, 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 post the war in Iraq.

While these factors suggest that any uncertainties in the international and domestic economies are likely to have less impact on the ACT, it does not mean that the ACT economy is immune to risk. Two key areas where the ACT economy is particularly exposed relate to changes in public sector expenditure and movements in interest rates.

During 2001-02, public sector consumption and capital expenditure accounted for 51% of ACT State Final Demand (SFD) – 47.1% and 3.9% respectively. This is significantly higher than that for Australia where public sector expenditure accounted for only 21.6% of Australian Domestic Final Demand (DFD). Public sector activities (such as *public administration and defence, general government, education, and health and community services*) accounted for 43% of ACT Gross State Product (GSP) at factor cost during 2001-02. By comparison, these activities at the national level accounted for 17% of Australia's GDP. These estimates highlight the significance of public sector activities, mostly those of the Commonwealth Government, and their influence on the ACT economy. They do not take account of the flow-on effects of public consumption expenditure on other areas of the economy. For example, the *tourism and hospitality* sector is heavily dependent on the business related tourism associated with Federal Government activities.

Interest rate changes can impact on consumption and investment in the ACT economy. Such changes will impact on private consumption expenditure, which accounts for about 38% of SFD, by altering household spending patterns. If interest rates rise, households will need to devote more of their income to mortgage repayments resulting in less disposable income for discretionary spending.

A rise in interest rates is also likely to have a negative impact on capital investment, which accounts for just over 11% of SFD. In particular, private sector investment, which accounts for about 7% of SFD, is likely to decrease. Despite its relatively small contribution to SFD, dwelling investment can be highly volatile and can disproportionately affect economic growth. Dwelling investment has been a large component of the growth in private investment in the ACT during the current financial year, and notwithstanding a hold on increases in interest rates this sector is showing signs of contracting. As this sector has relatively high multiplier effects it will therefore have a negative impact on SFD. The potential contractionary impact of an interest rate increase is likely to be more acute, given the recent growth in household debt.

While the level of public expenditure and changes in interest rates are the most serious threats to the performance of the local economy, there are other factors, outlined below, that may impact on the ACT's economic performance over the short-term.

- *The War in Iraq* – Australia's commitment to involvement in the war in Iraq is difficult to quantify at both the national and local levels. Increased national outlays will cause DFD and consequently SFD to increase. It may, however, lead to a redirection of public consumption by the Federal Government, which potentially could see a reduction for the ACT.
- *Drought* – Adverse seasonal conditions across Australia have resulted in one of the worst droughts for the past 20 years. The impact of this has been to greatly reduce the level of agricultural production, which is impacting on both domestic and export markets. In the context of domestic markets, agricultural prices are likely to have an inflationary effect and some upward movement in the CPI is expected. In addition Canberra, as a regional hub, is likely to be affected through a reduction in incomes and spending of agricultural producers.

### **Commonwealth Funding**

Overall it is reasonable for the ACT to expect some degree of certainty in its dealings with the current and foreseeable Federal Governments. There is always, however, the possibility of unforeseen circumstances impacting on the ACT's outlook. As outlined earlier in Chapter 4.2, a number of possibilities exist leading to some degree of risk to future Commonwealth grant funding to the ACT particularly in the medium to longer term.

While the Intergovernmental Agreement underpinning national tax reform and the GST provides a safety net in the shorter term for all jurisdictions so that States' budgets will be no worse off following the implementation of the GST, the longer term prospects for a continuation of the guarantee are uncertain as States and Territories embark on further tax reform.

Similarly, any change of government at the Federal level could provide the States receiving less than an equal per capita share of the GST (donor States) an opportunity to pursue a change to current distribution arrangements through a major overhaul of fiscal equalisation as currently administered by the Commonwealth Grants Commission. The ACT does not support this call.

Of more immediate concern to the ACT is the outcome of the Commonwealth Grants Commission's 2004 Report on State Revenue Sharing Relativities due to be released in February 2004. This report will establish the underlying fiscal equalisation methodology for the next five years commencing 2004-05.

State and Territory Treasurers are also concerned about the increasing Commonwealth and shrinking State-Territory share of national tax revenues and have called on the Commonwealth to maintain Specific Purpose Payments (SPPs) in real terms as well as providing for growth where relevant. This will need to be closely monitored by the States.

In this context, the ACT continues to receive a range of unique SPPs totalling some \$62m per annum, and although they are not under immediate threat it could be expected that they may be reviewed within the next 3-5 year period.

Finally, the Federal Treasurer's recent statements linking the continuation of National Competition Payments to issues such as water reform, if applied, could severely disadvantage the Territory.

## Market Risk

Market risk is the exposure to an adverse variation in costs or returns resulting from a change in a market price or rate. The Territory is exposed to market risk mainly through its financial investments. The Territory's financial investments are diversified across a number of asset classes including equities, fixed interest and property, each of which has its own unique risk/return characteristics. The broad diversification between these asset classes, both domestically and internationally is designed to minimise the impact of market risk. Changes in the fair market valuations of investments will have a direct impact on the current and future operating results of the Territory.

For 2003-04, the target rate of return for superannuation investments is 3% above inflation. A 1% variation from this target results in a \$10.7m variation to the budget.

Territory borrowings are presently accounted for on an historic cost basis and are typically held to maturity, or repaid on an amortising basis. Additionally, a large proportion of borrowings are held on a fixed interest rate basis. Accordingly, there is little if any significant market risk attributable to Territory borrowings.

## 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', the impact of a 1% increase or decrease against the estimated interest rate returns assumed in the Budget estimates for interest revenue is shown in the following table:

**Table 7.4.1**  
**Impact of interest rate change on general government investment portfolio**

	2003-04 \$'000	2004-05 \$'000	2005-06 \$'000	2006-07 \$'000
<b>Budget</b>	43 562	44 303	46 276	50 472
<b>+1% / -1%</b>	+/- 8 228	+/- 7 955	+/- 7 957	+/- 8 695

The Territory borrowings comprise approximately 56% on a fixed rate basis, and 44% 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.

The impact of a 1% increase or decrease in the assumptions used to calculate the interest costs on the 'floating rate borrowings' is shown in the following table:

**Table 7.4.2**  
**Impact of interest rate change on borrowing costs**

	2003-04 \$'000	2004-05 \$'000	2005-06 \$'000	2006-07 \$'000
<b>Budget</b>	26 077	26 118	26 110	25 652
<b>+1%<sup>a</sup></b>	2 874	3 368	3 500	3 749
<b>-1%<sup>a</sup></b>	-3 599	-3 571	-3 530	-3 473

<sup>a</sup> A 1% increase in interest rates will lead to increased expense and, accordingly, a corresponding reduction in the budgeted operating result and vice versa.

Overall, rising interest rates will have a net positive effect on the budgeted outcome, due mainly to the low proportion of debt exposed to interest rate movements, and comparatively higher level of investments.

### *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.

A new strategy developed during 2002-03 for the SPA investment portfolio will require any international equity exposure greater than 20% of the total portfolio to be fully hedged and any exposure to international fixed interest to be fully hedged. The ability to undertake this hedging strategy has been made possible by the removal of the prohibition on the use of financial derivatives for such purposes through the passage of financial guidelines by the Legislative 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 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, Macquarie Risk Advisory Services Limited was appointed as the Territory's risk management adviser to provide assistance with the development of appropriate financial risk management policies and practices, identification of financial exposures, reporting and benchmarking and performance management, in respect of the Territory's borrowing liabilities.

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 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. Because of worldwide insurance events and the bushfires in January 2003, this protection is becoming increasingly difficult and expensive to purchase. As a result, ACTIA's self-insured retentions are being reviewed to ensure an appropriate balance between risk transferred and risk retained.

While it is the responsibility of agencies to develop appropriate risk management practices and procedures, ACTIA is developing a discussion paper on integrated risk management in the ACT Public Service. This is a strategic model which will provide an agreed risk management policy for the whole of government, and a set of principles to guide agencies in developing their practices and procedures.

ACTIA is implementing processes where premiums will be adjusted to provide economic incentives for agencies which adopt best practice risk management strategies and demonstrate improvement in risk management performance over time.

During 2003-04, risk management issues to be promoted include:

- continuing the promotion of agency participation in the Risk Management Benchmarking programme which measures and compares the standard of risk management within an organisation;
- provision of focused risk management training of agency managers and staff to enable progress towards development of risk management plans;
- provision of risk management tools and guidebooks to enable best practice risk management to be introduced to all business processes, and not just insurable risk; 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 \$1m;
- training arrangements to ensure that staff have the necessary competencies to undertake procurement projects in accordance with the requirements set by 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.