Controller and Auditor-General
Tumuaki o te Mana Arotake

B.29 [16c]

A review of public sector financial assets and how they are managed and governed

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A review of public sector financial assets and how they are managed and governed

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Contents

Auditor-General's overview

For many years, the public sector has had a focus on managing debt. However, in the last couple of decades, the public sector's ownership of financial assets, such as cash, deposits, shares, and derivatives, has steadily increased. At 30 June 2014, the public sector's financial assets were worth about $132 billion.

The public sector's increased holdings of financial assets has coincided with increasing innovation and technological change in financial markets around the world. Unlike physical assets, many of the financial assets now in use are complex, interconnected, evolving quickly, traded often, and highly responsive to external circumstances. As a result, many of these financial assets offer new opportunities and challenges.

This report discusses the increasing significance of public sector financial assets and, using a sample of public entities, reviews how these assets are being managed and governed.

Value and use of financial assets expected to continue to increase

Historically, the holdings of financial assets in the public sector were relatively small and usually based around managing short-term cash needs and supporting debt requirements. Today, they are also being used to increase liquidity, flexibility, and risk management in the delivery of public services.

Central government entities hold by far the most financial assets in the public sector. Most of these assets are in the Accident Compensation Corporation (ACC) and the New Zealand Superannuation Fund (NZSF). Marketable securities (such as bonds and deposits) are the dominant financial asset class. However, the use of derivatives has increased significantly in recent years. Treasury projections suggest that financial assets will increasingly dominate the Crown's balance sheet.

In local government, share investments are the dominant financial asset class. They include partnering and joint ventures with other local authorities, central government, and private organisations. Auckland Council holds the largest value of financial assets in local government.

Good management and governance practices but with room to improve

We reviewed the financial assets of 14 public entities that, together, hold about 65% of all financial assets in the public sector. By and large, all 14 had reasonably good structures and systems in place for managing and governing those assets. As expected, ACC, the NZSF, and the Government Superannuation Fund have effective management and governance practices in place over financial assets. They are also leaders in promoting responsible investment practices.

Investment portfolios of financial assets can be complex. Those entities that use investment portfolios to support their core operational activities face a risk of such portfolios becoming isolated from the organisation's general management and governance. In these circumstances, governors could be supported by using independent expertise more or by public entities pooling financial assets for management purposes, as happens with the Local Government Funding Agency and the New Zealand Debt Management Office.

Public entities could also consider how to improve communication with stakeholders (including the public) about the objectives and performance of their financial assets. The NZSF does this well, and public entities with significant financial assets can learn from the way the NZSF's investment beliefs, policies, and approaches are written and communicated to stakeholders.

Future opportunities and challenges require careful thought

As the value and use of financial assets continue to increase, we expect to see a wider set of opportunities, challenges and risks. This is particularly so for central government, which holds a large (and changing) portfolio of financial assets.

The financial assets and associated liabilities of central government should be considered together, with a clear understanding of the risks being taken, how they are being managed, and the opportunities and challenges they create. Wider matters such as how public assets and liabilities interact with, and influence, each other, the Government, the investment industry, and the economy also need careful thought at a whole-of-government level.

The Treasury has started some of this work, with the Investment Statement published every year and its ongoing project on managing risk to the Crown's balance sheet. These are positive steps, but more is needed, including an overall strategic framework and plan, similar to the one the Treasury has for physical assets (the National Infrastructure Plan).

I thank Fidato Advisory Limited and the 14 public entities we reviewed. These were the NZSF, the Government Superannuation Fund, ACC, New Zealand Venture Investment Fund Limited, Housing New Zealand Corporation, the New Zealand Debt Management Office, Te Tumu Paeroa, the University of Otago, the University of Canterbury, Auckland Council, Dunedin City Council, New Plymouth District Council, Otago Regional Council, and Public Trust.

Lyn Provost
Controller and Auditor-General

2 March 2016

Our recommendations

1. We recommend that those public entities holding investment portfolios that support their core operational activities regularly assess how they can strengthen the skills and capabilities for governing their financial assets.
2. We recommend that public entities with significant financial assets regularly assess how well they are managing and governing their financial portfolios and reporting to stakeholders using the following questions:
   - Are the investment objectives clear and consistent with the purpose of holding the assets?
   - Are the designs of the management and governance processes appropriate?
   - Are responsibilities clearly assigned?
   - Are delegations used appropriately?
   - Are duties clearly separated?
   - Are incentives well-aligned?
   - Is there a clear and documented process?
   - Is monitoring effective?
   - Are communications clear and relevant to the needs of stakeholders?
3. We recommend that the Treasury prepare a strategic perspective on and vision for holding financial assets in the public sector.

1 Introduction

Why are we focusing on financial assets?

1.1 The holdings of financial assets within the public sector have increased since the liberalisation of financial institutions and markets in the mid-1980s, particularly over the last couple of decades. Since 1999,[1] the Financial Statements of the Government of New Zealand (FSG) show that the value of financial assets has increased, on average, by about 13.5% a year, to $123.2 billion at 30 June 2014. The Treasury's projections suggest that financial assets will increasingly dominate the Crown's balance sheet.

1.2 The value of the Government's financial assets has exceeded the value of its debt since 2005, and has exceeded the value of its physical assets since 2011.

1.3 Local authorities' projections show that physical assets are, and will continue to be, the dominant asset class. However, financial assets such as investment funds are becoming increasingly important in infrastructure planning, as are share investments in arrangements between local authorities, central government, and/or private sector entities. In 2014, the total value of local government financial assets was $7.1 billion.

1.4 We note that the 2015 FSG were released in October 2015. We did not fully incorporate this information but, where relevant, we have added further commentary in this report.

The objectives of this report

1.5 In the context of the increasing significance of financial assets to the public sector, this report:

- describes the extent of financial assets and how they are being used in the public sector;
- reviews how significant holdings of financial assets are being managed and governed in practice;
- provides some guidance for other public entities; and
- considers the implications for the public sector as a whole.

1.6 This report is not an in-depth analysis of all public sector financial assets or public entities' management and governance practices. Rather, it is intended to increase awareness of how financial assets are being used and encourage more discussion and debate.

1 The earliest Financial Statements of the Government on the Treasury's website were published in 1999. Tertiary education institutions' financial assets are excluded from the value of financial assets in the Financial Statements of the Government.

What we looked at

1.7 We looked at the financial assets held by both central and local government. The 2015 FSG define financial assets as:

> *Any asset that is cash, an equity instrument of another entity (shares), a contractual right to receive cash or shares (taxes receivable and ACC levies), or a right to exchange a financial asset or liability on favourable terms (derivatives in gain).*

The extent of financial assets and their use

1.8 For central government, we used the FSG data that consolidates financial information of all central government entities into one set of financial statements for the Crown. This includes, for example, all government departments, Crown entities such as district health boards, Crown financial institutions, and State-owned enterprises.[2]

1.9 The FSG include tertiary education institutions as equity-accounted investments. At 31 December 2014, the value of tertiary education institutions' financial assets was about $1.8 billion. Adding this value to the consolidated FSG financial assets gives a total of about $125 billion.

1.10 In this report, we use "central government" to mean all of the public entities included in the FSG as well as tertiary education institutions' financial assets.

1.11 For local government, we used the financial statements of all 78 local authorities. In this report, "local government" means the 78 regional and territorial authorities.

1.12 The Local Government Funding Agency (LGFA) was set up in 2011 to provide collective loan funding to local authorities. In 2014, the LGFA held $3.9 billion of financial assets. Although these financial assets need to be managed and governed by the LGFA on an arms-length and commercial basis, they should be eliminated when taking a consolidated view of the local government sector.

1.13 We also read relevant literature, spoke with relevant experts, and analysed long-term projections of central government (from 2013) and local government (from 2014). For our international comparison, we analysed the financial statements of the governments of Canada, the United Kingdom, and Australia.

1.14 To analyse the financial assets held by both central and local government, we used the categories used in the FSG to group financial assets. The categories include:

- cash and cash equivalents – cash and deposits of less than three months;
- receivables, such as taxes or fines that are owed to the Government but not yet paid;

2 See the Financial Statements of the Government, Note 2 for a description of the public entities that are included.

- marketable securities and deposits, such as cash invested by the Government in bonds (debt securities) and bank deposits (for more than three months) used to generate capital gains or interest revenue;
- derivatives – agreements between two parties whose features and value are derived from another investment or reference rate (such as an equity market index), with derivatives that are "in-gain" (currently profitable) being reported as financial assets (see Part 3);
- share investments – "non-controlling" or minority ownership interests in a company or venture used to generate capital gains or dividend revenue, including strategic share investments that support better governance and service delivery;[3] and
- advances and other assets, such as mortgages provided by Kiwibank Limited and student loans.

How financial assets are managed and governed in practice

1.15 The management and governance of financial assets depends on many factors, including legislative requirements, their investment features, and the reason for, and time frame involved in, holding them.

1.16 We asked Fidato Advisory Limited to review publicly available documents and talk in more detail with 14 selected public entities about how their financial assets were managed and governed. Together, these public entities hold 65% of all financial assets in the public sector. Fidato Advisory Limited did not analyse or review receivables, because receivables are managed differently from other types of financial asset.

1.17 Figure 1 lists the 14 entities that we reviewed.[4]

3 Some minority holdings of investments in physical assets are recorded in the Financial Statements of the Government as share investments.

4 The Guardians of New Zealand Superannuation maintain the New Zealand Superannuation Fund. The Government Superannuation Fund Authority maintains the Government Superannuation Fund. The New Zealand Debt Management Office is an operating unit of the Treasury. Although they are not separate entities, they hold and are responsible for almost all, by value, of the controlling entity's financial assets. In this report, we refer to them as public entities.

Figure 1
The 14 public entities that we reviewed

Central government		Tertiary education institutions	Local authorities
Crown financial institutions	**Special-purpose entities**		
New Zealand Superannuation Fund	New Zealand Venture Investment Fund Limited	University of Otago	Auckland Council
Accident Compensation Corporation	Housing New Zealand Corporation	University of Canterbury	Dunedin City Council
Government Superannuation Fund	New Zealand Debt Management Office		New Plymouth District Council
	Te Tumu Paeroa (the Maori Trustee)		Otago Regional Council
	Public Trust		

1.18 Interviews were carried out with at least one senior executive and one representative of the governing body of each public entity. Interviews were used as an opportunity to obtain information that was not publicly available through documents such as annual reports, financial statements, third-party reviews, and investment policies.

1.19 The public entities' financial statement data refers to 2013/14. Most public entities' balance dates are 30 June, but some balance dates are 31 March or 31 December.

What we did not look at

1.20 We did not look at the financial returns earned on financial assets or public reports about expected and actual returns that are available through the Treasury and from the public entities themselves. Rather, this report focuses on the management and governance involved in planning for and earning returns.

1.21 We did not look at controlling ownership interests held by public entities or investments in physical assets (such as the ownership of ports, utility companies, real estate, or investment-holding subsidiaries). However, because we used group financial statements, our analysis includes any financial assets held within controlled subsidiaries.

1.22 We did not focus on the regulation of financial assets. Since the global financial crisis in 2008, the regulatory framework for financial markets and financial market participants has been extensively overhauled. The Financial Markets Authority, a new regulator with enhanced powers and capabilities, has been set up.

1.23 We did not look at the management and governance of the financial assets held by the Reserve Bank of New Zealand. The Bank holds significant financial assets worth more than $29 billion as at 30 June 2015. Its financial assets mainly comprise government and near-government securities, which are both liquid and of high-credit quality, allocated to six major currencies. The Bank also holds New Zealand Government bonds. Some of these assets are available to support the country's foreign currency market in a crisis. Under section 167 of the Reserve Bank Act 1989, the Minister of Finance may appoint one or more persons to assess the performance by the Bank of its functions and of the exercise of its powers. The Bank is not subject to the Auditor-General's general powers under the Public Audit Act 2001 to review an organisation's efficiency and effectiveness or to inquire into its use of resources.

Legislation about using financial assets

1.24 Several Acts deal with how public entities use financial assets.

1.25 For central government entities, the Public Finance Act 1989 and the Crown Entities Act 2004 place general controls on the acquisition of financial assets and, in particular, derivatives. As a general rule, departments cannot, in their own right, enter into derivative transactions. However, under delegations from the Minister of Finance and the Secretary to the Treasury, and subject to the Treasury's oversight,[5] departments can use derivatives to manage their foreign exchange risk.[6] A Crown entity's own Act can have further specific controls over the use of financial assets. The Education Act 1989 applies to the management of tertiary education institutions' financial assets.

1.26 For local government entities, the use of financial assets needs to be in keeping with the entity's financial strategy and investment policy, with risks considered and managed.[7]

5 See the *Guidelines for the Management of Crown and Departmental Foreign-Exchange Exposure*, available on the Treasury's website, www.treasury.govt.nz.

6 See Part 10 of our 2007 report, *Central government: Results of the 2005/06 audits*, for more on the use of derivatives in central government.

7 See the Local Government Act 2002, sections 14(1)(f) and (fa), 101A(3)(d), and 105.

The increasing role of financial assets in the public sector

2

2.1 In this Part, we highlight the use of financial assets in the public sector, compare the financial assets held by central and local government, and compare New Zealand with other countries.

Using financial assets effectively

2.2 Financial assets are not new to the public sector. For many years, cash, bank deposits, and accounts receivable (money owed to an entity but not yet received) have been used to manage the flow of cash through the entity. Also, targeted funds (cash deposits and shares) have been set aside to meet future liabilities. For example, the Earthquake and War Damage Commission (the original Earthquake Commission) was set up in 1945 with a fund of £4 million to cover earthquake risk.[8]

2.3 However, in the last couple of decades, the value and use of financial assets have increased significantly, particularly in central government. Today, financial assets are being used to fund or finance[9] various public sector services. For example:

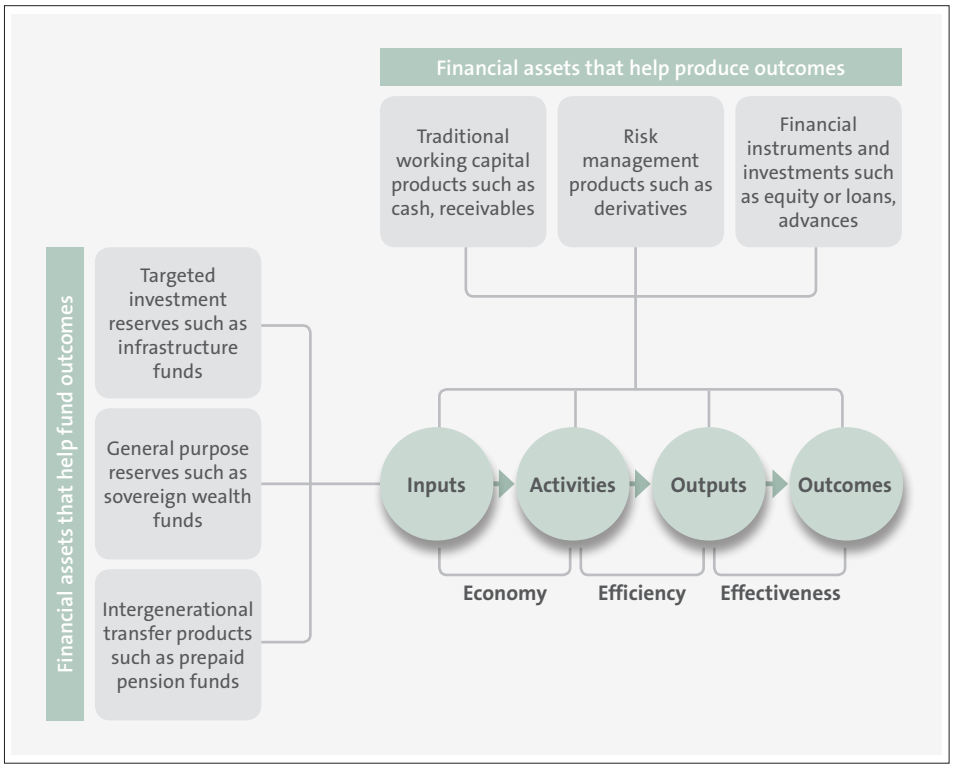
- The Earthquake Commission's considerable financial assets were used to help pay for claims associated with the Canterbury earthquakes.
- ACC uses financial assets to help pay the costs of providing accident cover to all New Zealanders.
- The financial assets of the New Zealand Superannuation Fund (NZSF) are designed to contribute to the country's superannuation costs in the future.
- The income from New Plymouth District Council's financial assets (held in its Perpetual Investment Fund) plays an important role in funding the local authority's services to ratepayers.

2.4 Figure 2 shows the different ways in which financial assets can help the delivery of public services.

8 See the history section of the Earthquake Commission's website, www.eqc.govt.nz.

9 Funding and financing can sometimes have different meanings, particularly in local government. Funding can refer to the different sources of money available to pay for a project or service. Financing can refer to the arrangements put in place to ensure that money is available when it is needed.

Figure 2
Using financial assets to help deliver public services



Source: Office of the Auditor-General.

Opportunities for public entities and the whole of government

2.5 For public entities, financial assets support traditional funding and delivery mechanisms. They are usually easier to buy, hold, and sell than physical assets, can be owned in small or divisible amounts, and have values that are more responsive to changing circumstances and market conditions. They can therefore introduce more liquidity and flexibility, which can be particularly important in times of change and uncertainty.

2.6 As the public sector's experience in using financial assets expands, the opportunities available to public entities and to the whole of government for funding and providing services will increase.

2.7 Public entities use financial assets in many ways.

Motivating entities or partners to act in certain ways

2.8 Crown Fibre Holdings Limited is using an innovative share-ownership transfer structure to co-invest with private sector partners to set up the ultra-fast broadband network throughout New Zealand.

Taking advantage of other ways of funding and delivering policy outcomes

2.9 New Zealand Venture Investment Fund Limited has venture capital and seed co-investment funds, and the Waitaki District Council is using loan funding to support a retirement village development in Oamaru.

Reallocating project or programme risks

2.10 Auckland Council reduces its exposure to changes in interest rates by various means, including using interest-rate derivatives. State-owned electricity generators also use derivatives to protect against the volatility in electricity prices.

Encouraging private sector providers to take part in public projects and programmes

2.11 Private sector equity providers enter into public-private partnerships through shareholdings in the contracting entity.

Promoting or influencing different investment or governance practices

2.12 ACC and the NZSF have signed up to the United Nations Principles for Responsible Investment. The NZSF is actively promoting, in New Zealand and abroad, long-term investment governance guidelines.

The sale of future revenue streams for use in other projects or to increase future debt capacity

2.13 In 2014, Hawke's Bay Regional Council repackaged 50 years of its future rental income from leasehold land it owns in Napier and sold the financial asset to ACC. In exchange, the Council received an upfront cash payment, which will be used to invest in infrastructure projects.

Other uses of financial assets

2.14 Financial assets are also being thought about and used at a whole-of-government level.

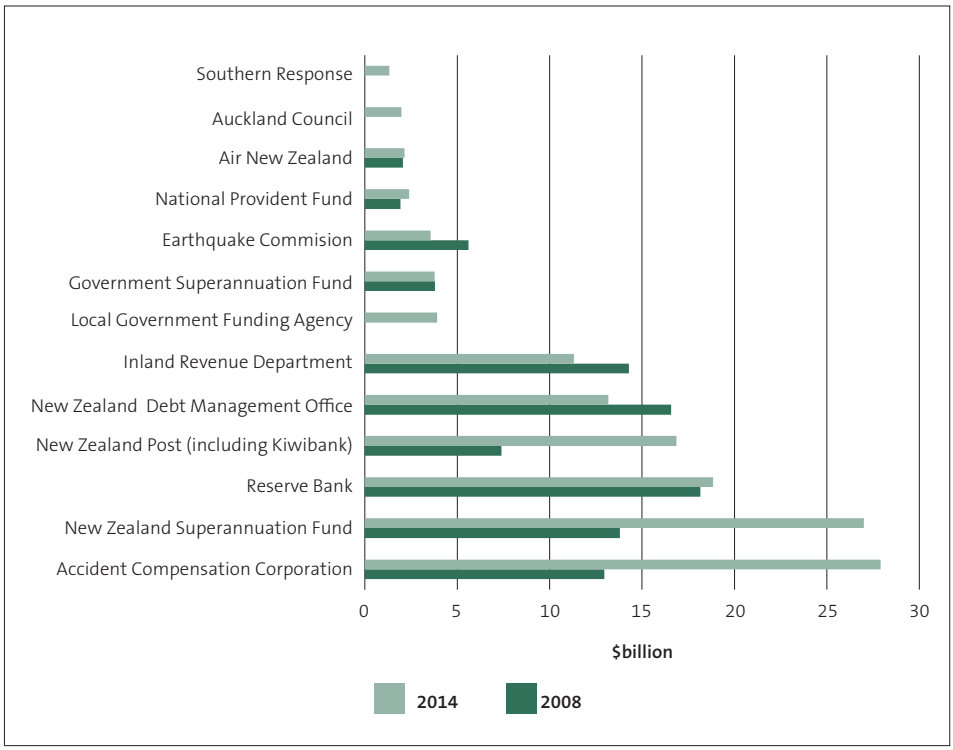
2.15 Financial assets are being used to provide independence in the management of assets while retaining a chosen level of control. For example, the Government's shareholding in Air New Zealand allowed it to progressively increase the company's commercial independence while retaining a meaningful ownership interest. Many local government entities hold strategic shareholdings in organisations that benefit a region's long-term prospects, such as airports or ports.

2.16 The Treasury is also considering the usefulness of a "stabilisation fund" to "act as a complement or alternative to using changes in debt as a buffer to manage volatility in revenues."[10]

The extent of financial assets in the public sector

2.17 The FSG and local government annual reports show that, in 2014, the public sector had total financial assets of about $132 billion. Figure 3 shows those public entities with the largest holdings of financial assets and how the value of those assets has changed since 2008.

Figure 3
Public entities with the largest financial assets by value



Source: Drawn from the Financial Statements of the Government and local government annual reports.

10 See The Treasury's Budget 2014 Information Release, July 2014, pages 2-3.

2.18 These 13 public entities hold about 87% of all public sector financial assets. The main increases since 2008 have been in New Zealand Post (mainly Kiwibank Limited's mortgage lending), ACC, and the NZSF. In 2008, Southern Response Earthquake Services Limited (Southern Response), the LGFA, and Auckland Council did not exist in their current form.

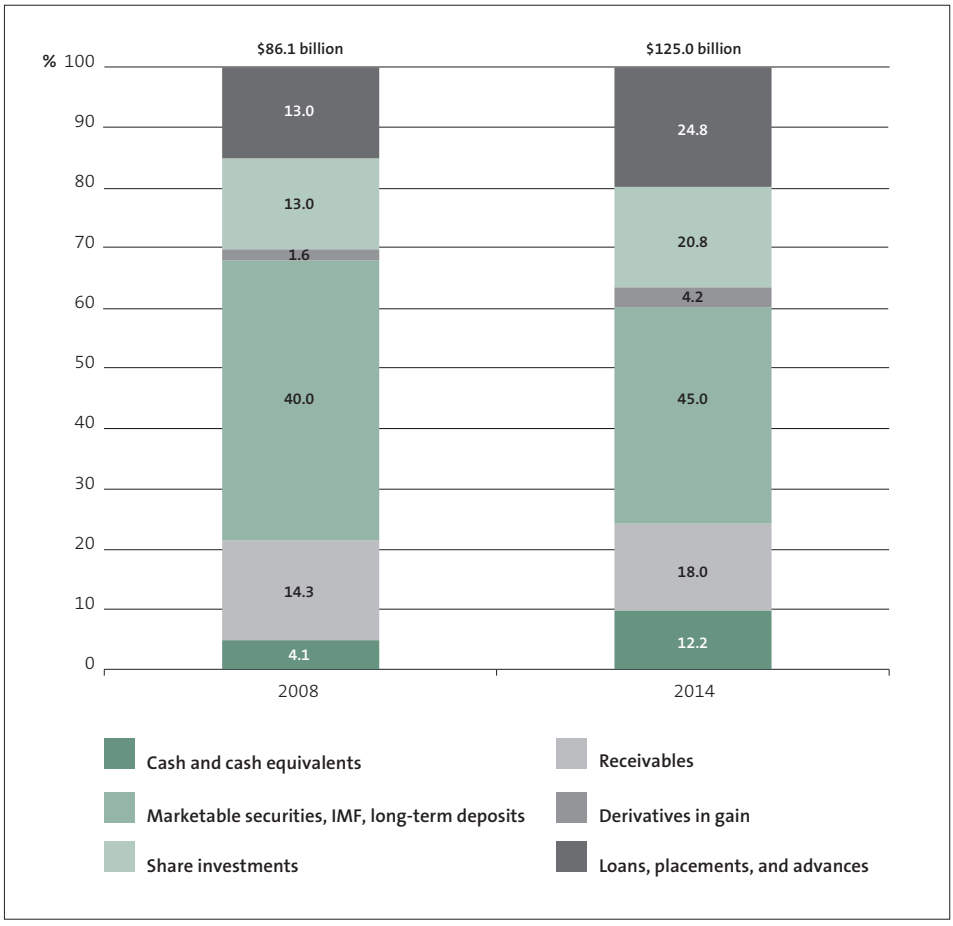
2.19 The financial assets of the Earthquake Commission and Southern Response have declined significantly since 2014, because they have been used to meet claims in support of Canterbury's recovery from the 2010 and 2011 earthquakes.[11] These financial assets were an important contribution to the recovery in Canterbury.

2.20 At 30 June 2014, the total value of financial assets in central government entities was about $125 billion, including tertiary educational institutions' financial assets. For local government, the total value of financial assets in all entities in 2014 was about $7.1 billion.

2.21 Figure 4 shows the composition of financial assets in central government and how the composition has changed since 2008.

11 See Southern Response Earthquake Services Limited's 2015 financial statements, page 8, and the 2015 Financial Statements of the Government, page 20.

Figure 4
Composition of financial assets in central government

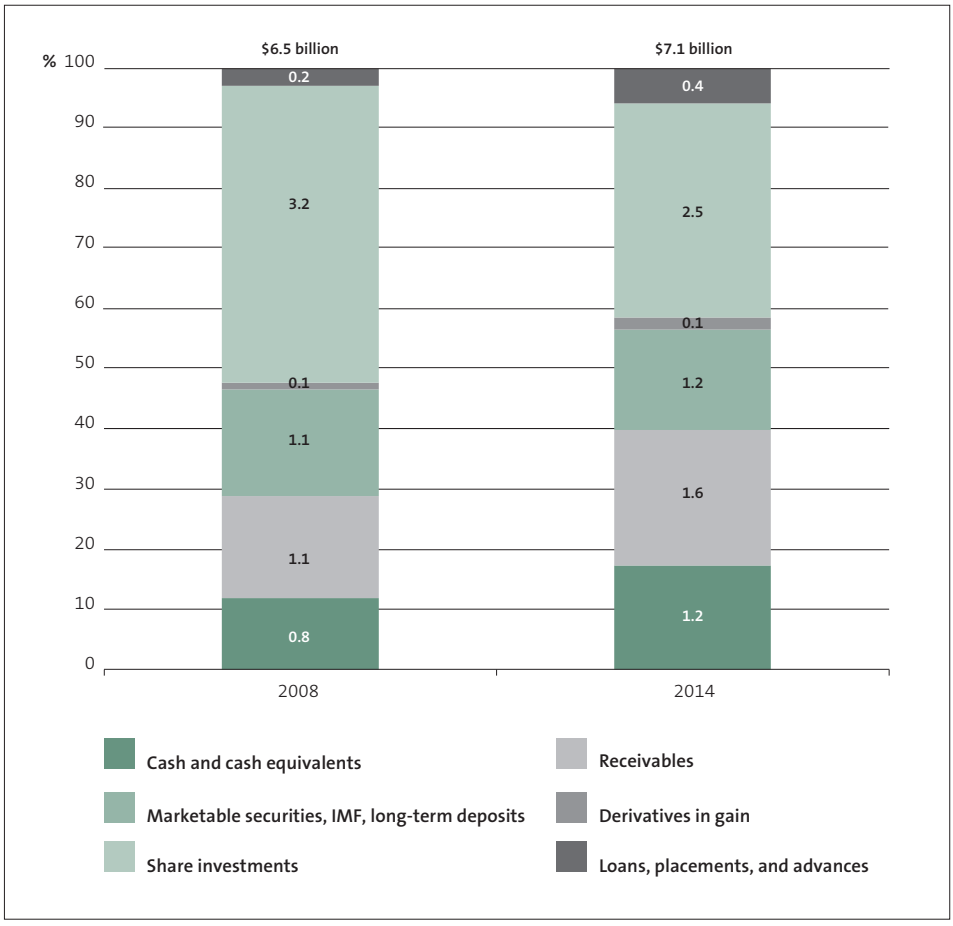


Source: Financial Statements of the Government, adjusted to incorporate the financial assets of tertiary education institutions.

2.22 In central government, the proportions of financial assets have moved slightly, with the small reduction in marketable securities offset by increases in the proportion of cash and derivatives. Marketable securities remain the dominant type of financial asset.

2.23 Figure 5 shows the composition of financial assets in local government and how the composition has changed since 2008.

Figure 5
Composition of financial assets in local government



Source: Local government annual reports.

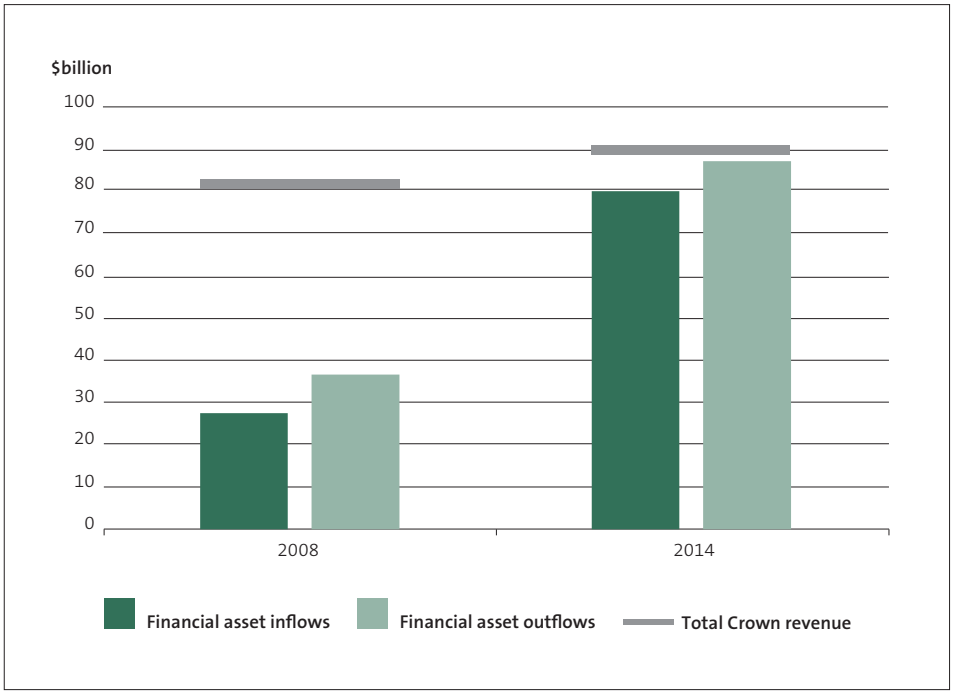
2.24 In local government, share investments have reduced in value but remain the dominant asset class. One reason for this reduction was the creation, in 2010, of Auckland Council, which took control of various large organisations that were then consolidated into Auckland Council's financial statements. For example, before the formation of Auckland Council, many of the previous local authorities held minority shareholdings in Watercare Services Limited, a large company with significant physical assets. These minority shareholdings were reported as financial assets (share investments). On amalgamation, Auckland Council took control of Watercare, and the company's underlying assets and liabilities were all reported as separate line items in Auckland Council's financial statements.

2.25 The value of in-gain derivatives in local government has increased from $70 million in 2008 to $143 million in 2014.[12]

2.26 Comparing the total value of financial assets to total liabilities shows that, for both sectors, financial assets are a material part of overall financial capacity. For central government, financial assets are about 70% of total liabilities and, for local government, financial assets are about 38% of total liabilities.

2.27 Although the proportions of central government financial assets have not changed significantly since 2008, the transaction activity in those financial assets has. Figure 6 shows the increase in annual transactions involving financial assets. To highlight their significance relative to the total activities of the Government, we also show total Crown revenue in 2008 and 2014.

Figure 6
Increase in central government transactions involving financial assets



Source: Financial Statements of the Government.

2.28 Financial asset transactions in central government (incorporating both inflows and outflows) have increased at a faster rate than increases in the value of financial assets. In 2014, the value of these transactions was about the same as the total revenue of the Crown. One of the main reasons for these significant

12 Figures rounded to the nearest $1 million.

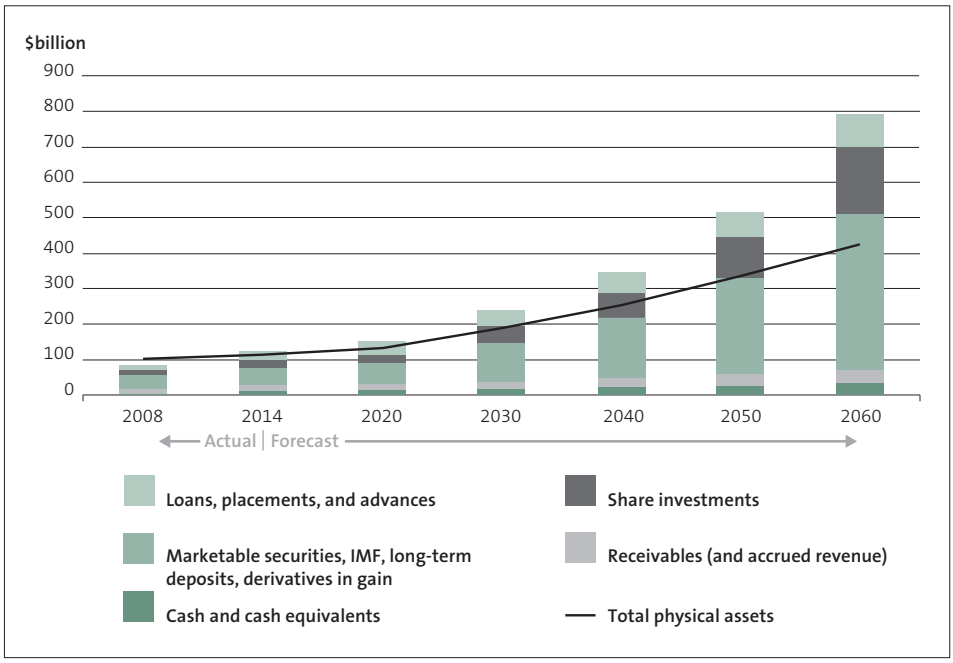
increases is the increase in, and trading of, the NZSF's and ACC's financial assets. For example, ACC's purchases of investments increased from $14.7 billion in 2008 to $47.6 billion in 2014. ACC's proceeds from the sale of investments increased by a similar amount over the same period.

2.29 The relative significance of annual financial asset transactions to local government entities is small, at only about 5%-6% of local government revenue in 2014. The value of these transactions is also considerably smaller than those of central government and fell in value from 2008 to 2014. One of the reasons for the decline was a large decrease in financial asset-related transactions between the previous individual local authorities after Auckland Council was formed in 2010.

What could the future look like?

2.30 The Treasury, in its 2013 long-term fiscal statement projections, modelled the projected growth in financial assets to 2060. These financial asset projections do not include tertiary educational institutions' individual financial assets. In Figure 7, we have summarised these projections in 10-year periods from 2020.[13] For comparison, we have also included the projected value of all physical assets.

Figure 7
Forecast growth in financial assets across central government



Source: Drawn from the Financial Statements of the Government and the Treasury's 2013 long-term fiscal model.

13 In its projections, the Treasury includes marketable securities and share investments together. For consistency, we have separated this group into marketable securities and share investments based on the 2014 proportions.

2.31 According to these projections, the bulk of the financial assets growth to 2060 is expected to be in marketable securities and shares. At 30 June 2014, about 48% of all government assets were financial assets. By 2060, this is projected to increase to 55%-65%, with the NZSF holding 30%-35% of those financial assets.[14]

2.32 Although significant variability in these central government projections is to be expected, the potential extent of the shift from physical to financial assets is clearly apparent.

2.33 Looking at the data from local authorities' 2015-25 long-term plans shows that local authorities expect cash, financial investments, and monetary assets to increase by just over 3% each year during the next 10 years.

How does New Zealand compare with other countries?

2.34 Figure 8 shows the value of central government financial assets compared with total liabilities in selected other countries – Australia, Canada, and the United Kingdom.

Figure 8
Public sector financial assets and total liabilities in New Zealand, Australia, Canada, and the United Kingdom

	2008[a]			2014		
	Financial assets	Total liabilities	Financial assets/ Total liabilities	Financial assets	Total liabilities	Financial assets/ Total liabilities
New Zealand NZ$billion	85	95	90%	123	175	70%
Australia A$billion	245	272	90%	352	754	47%
Canada Can$billion	176[b]	692	25%	318[b]	1,001	32%
United Kingdom £billion	421	2,419	17%	516	3,189	16%

Notes:
a. The figures for the United Kingdom are from 2010, when whole-of-government accounts were first published.
b. The assets of the Canadian Pension Plan fund are not consolidated into the financial statements of the Government of Canada.
Source: The Financial Statements of the Government and the financial statements of the governments of Canada, Australia, and the United Kingdom.

14 Based on the two future scenarios that the Treasury modelled in its 2013 long-term fiscal model.

2.35 Points to note about the comparison include:

- Since 2008, the governments of New Zealand, Australia, and the United Kingdom have been less able to cover existing obligations by using their financial assets, possibly as a result of the global financial crisis reducing the value of financial assets and/or increasing total liabilities. Also, in the case of New Zealand, the financial assets held by the Earthquake Commission have been used to pay claims following the Canterbury earthquakes.
- New Zealand's and Australia's financial assets have grown by 45% and 44% respectively from 2008 to 2014. The largest increases were in (the usually less liquid) loans and advances (for example, student loans and Kiwibank mortgages).
- Of the four governments, New Zealand's continues to be relatively well placed to cover its liabilities.

The 2015 Financial Statements of the Government

2.36 The 2015 FSG support what we have said in this Part. For example, the 2015 FSG state that:

- The total value of financial assets in central government has increased further to $135.8 billion (excluding financial assets held by tertiary education institutions).
- The value of the Crown's financial sector assets (held in the Government Superannuation Fund, the New Zealand Debt Management Office, the Earthquake Commission, ACC, the Reserve Bank of New Zealand, and the NZSF) increased by about 17% during 2014/15.
- Marketable securities and share investments have increased more quickly than the other financial asset classes during the last year.
- Cash flows arising from financial asset transactions have increased further and are now well above (about 15%-20% higher) the total revenue of the Crown.

3 How public entities manage and govern financial assets

3.1 In this Part, we summarise the main management, governance, and reporting practices of public entities that hold portfolios of financial assets. We also discuss the use of derivatives in the public sector.

Financial assets of 14 selected public entities

3.2 We reviewed 14 selected public entities that together hold about 65% of all financial assets in the public sector.

3.3 So that we could summarise their management and governance practices, we grouped the entities into four groups:

- Crown financial institutions (CFIs);
- special-purpose entities (SPEs);
- universities; and
- local authorities.

3.4 We reviewed:

- publicly available materials such as annual reports, financial statements, investment policies, public meeting agenda, statutory reviews, organisation charts, investment management agreements, long-term plans, and performance reports;
- public entities' internal documents such as meeting minutes, investment policies, remuneration structures, lists of holdings, memoranda, role descriptions, term sheets, and committee terms of reference; and
- other information supplied in interviews and by email.

3.5 Because receivables are managed and governed differently from other financial asset classes, these were not included in our review of the 14 entities.

Crown financial institutions

3.6 ACC, the Government Superannuation Fund, and the NZSF are CFIs that hold large portfolios of financial assets.[15] CFIs tend to be long-term investors with small cash holdings.

3.7 Figure 9 shows the value of these CFIs' financial assets in 2014, the allocations in the various financial asset classes, and the CFIs' main reasons for holding the assets.

15 "Crown financial institutions" is a term used to describe five public entities with specific responsibilities for managing and investing large financial assets – the NZSF, the Government Superannuation Fund Authority, the Earthquake Commission, ACC, and the National Provident Fund (a statutory board).

Figure 9
Amount, type, and reasons for holding financial assets – Crown financial institutions

	New Zealand Superannuation Fund	Accident Compensation Corporation	Government Superannuation Fund
Total financial assets, excluding receivables	$27.6 billion	$28.0 billion	$3.8 billion
Financial asset allocations			
Cash and cash equivalents	14%	2%	7%
Debt securities	26%	64%	17%
Listed equity	41%	31%	59%
Unlisted equity/private equity or other	19%	3%	17%
Main reasons for owning financial assets			
Working capital needs	√	√	√
Funding capital expenditure projects			
Backing specific current or future liabilities	√	√	√
Supporting economic development projects			
Subsidy of revenue, including rates			

3.8 In these CFIs, the largest asset classes are debt securities and listed equity shares. ACC is also a substantial holder of domestic debt securities. The main reason for holding financial assets is to help pay for a specific set of current or future liabilities – pensions, superannuation, or accident compensation costs.

Special-purpose entities

3.9 Special-purpose entities (SPEs) include New Zealand Venture Investment Fund Limited, Public Trust, Te Tumu Paeroa, the New Zealand Debt Management Office, and Housing New Zealand Corporation. The value of the SPEs' financial assets is far less than the CFIs' financial assets. SPEs also have different financial asset allocations, reflecting the different objectives for their financial asset portfolios.

3.10 Figure 10 shows the value of the financial assets held by SPEs in 2014, the allocations in the various financial asset classes, and the SPEs' main reasons for holding the assets.

Figure 10
Amount, type, and reasons for holding financial assets – special-purpose entities

	New Zealand Venture Investment Fund Limited	Public Trust	Te Tumu Paeroa	New Zealand Debt Management Office	Housing New Zealand Corporation
Total financial assets, excluding receivables	$0.12 billion	$0.54 billion	$0.10 billion	$18.0 billion	$0.70 billion
Financial asset allocations					
Cash and cash equivalents	9%	69%	39%	25%	89%
Debt securities	0%	31%	29%	21%	8%
Listed equity	0%	0%	2%	0%	0%
Unlisted equity/ private equity or other	91%	0%	30%	54%	3%
Main reasons for owning financial assets					
Working capital needs	√	√	√	√	√
Funding capital expenditure projects					√
Backing specific current or future liabilities		√		√	
Supporting economic development projects	√		√		
Subsidy of revenue, including rates					

3.11 The largest asset classes the SPEs held were cash and unlisted shares and private equity.

3.12 Most of New Zealand Venture Investment Fund Limited's financial assets were unlisted shares and private equity investments designed to help New Zealand companies with start-up funding. The greater part of Housing New Zealand's financial assets comprised short-term cash and money-market investments to help fund day-to-day maintenance and housing development projects (particularly in Christchurch). Public Trust's cash assets mostly reflected short-term deposits from its trust or estate clients. For Te Tumu Paeroa, social returns are as important as financial returns, reflecting an economic development perspective.

3.13 The New Zealand Debt Management Office's other financial assets include significant advances to other public entities, such as the Reserve Bank of New Zealand and the Ministry of Health.

Universities

3.14 The tertiary education institutions we looked at were the University of Canterbury and University of Otago.

3.15 Figure 11 shows the value of the two universities' financial assets held in 2014, the allocations in the various financial asset classes, and their main reasons for holding the assets.

Figure 11
Amount, type, and reasons for holding financial assets – universities

	University of Canterbury	University of Otago
Total financial assets, excluding receivables	$0.21 billion	$0.33 billion
Financial asset allocations		
Cash and cash equivalents	100%	43%
Debt securities	0%	17%
Listed equity	0%	40%
Unlisted equity/private equity or other	0%	0%
Main reasons for owning financial assets		
Working capital needs	√	√
Funding capital expenditure projects	√	√
Backing specific current or future liabilities		
Supporting economic development projects		
Subsidy of revenue, including rates		√

3.16 The two universities' asset classes are clearly defined by their needs. A large proportion of the University of Otago's financial assets are held in a foundation trust, used for funding scholarships and research. In contrast, the University of Canterbury's financial assets are used mainly for working capital and funding capital expenditure. The University of Canterbury also holds some unlisted equity but in the context of this analysis it is immaterial.

Local authorities

3.17 The local authorities we looked at were Auckland Council, Dunedin City Council, New Plymouth District Council, and Otago Regional Council.

3.18 Figure 12 shows the value of their financial assets held in 2014, the allocations in the various financial asset classes, and their main reasons for holding the assets.

Figure 12
Amount, type, and reasons for holding financial assets – local authorities

	Auckland Council	Dunedin City Council	New Plymouth District Council	Otago Regional Council
Total financial assets, excluding receivables	$1.66 billion	$0.15 billion	$0.12 billion*	$0.11 billion
Financial asset allocations				
Cash and cash equivalents	17%	30%	37%	46%
Debt securities	7%	11%	3%	3%
Listed equity	66%	23%	27%	51%
Unlisted equity/ private equity or other	10%	36%	33%	0%
Main reasons for owning financial assets				
Working capital needs	√	√	√	√
Funding capital expenditure projects				√
Backing specific current or future liabilities				
Supporting economic development projects	√	√		
Subsidy of revenue, including rates	√	√	√	√

* The total for New Plymouth District Council excludes a farming investment with a 2014 value of about $0.13 billion.

3.19 For these public entities, the largest asset classes are listed and unlisted equity. Auckland Council stands out as having large holdings of listed shares (including significant investments in Auckland International Airport Limited held by its investment subsidiary Auckland Council Investments Limited).

3.20 New Plymouth District Council, as part of its Perpetual Investment Fund, also owns a Tasmanian dairy and pastoral farming investment with a 2014 value of about $0.13 billion. The Council is currently in the process of selling this investment.

3.21 In 2014, Otago Regional Council, through its subsidiary Port Otago Limited, owned listed shares in Lyttelton Port Company Limited with a value of $50.6 million. In September 2014, these shares were sold to Christchurch City Holdings Limited.

3.22 Apart from working capital needs, the main use of financial assets is to subsidise local authority rates.

Responsible investment practices

3.23 Responsible investment practice looks at more than financial risks and value drivers. Public entities with investment portfolios that practise responsible investment also take into account environmental, social, and/or ethical considerations when researching, analysing, selecting, and monitoring investments.

3.24 All three CFIs, Public Trust, and the University of Otago have responsible investment policies. ACC, the Government Superannuation Fund, and the NZSF have signed the United Nations' Principles for Responsible Investment.[16]

3.25 As an example, ACC's Ethical Investment Policies mean that ACC:

- does not invest in companies that carry out activities that "are repugnant to the laws of New Zealand or exhibit corporate behaviour that seriously breaches ethical/responsible investment standards"; and
- will engage with companies that have serious environmental, social, or governance problems to modify corporate behaviour and improve performance in relation to ethical matters.[17]

3.26 A 2015 report by the Responsible Investment Association Australasia showed that ACC, the Government Superannuation Fund, and the NZSF were leaders in responsible investment in New Zealand. The report noted that, in 2014, $63.5 billion of assets was managed under responsible investment policies in New Zealand. ACC and the NZSF held about 86% of these assets.[18]

16 See the United Nations Principles for Responsible Investment website, www.unpri.org.

17 See ACC's 2014 annual report, page 124.

18 See the Responsible Investment *Benchmark Report 2015 New Zealand*, pages 4-5 and 14, available at the Responsible Investment Australasia website, www.responsibleinvestment.org.

Three stages of managing and governing financial assets

3.27 The process of managing a portfolio of financial assets is an iterative one that involves three stages – design, implement, and monitor.

3.28 In the **design** stage, the public entity selects a portfolio to meet its objectives after considering the range of investments available and the way these investments can be combined. Investment principles (or beliefs) that underlie the portfolio management approach are agreed and investment policies (such as the Statement of Investment Policies and Objectives) are written and adopted.

3.29 In the **implement** stage, assets are bought or sold to put the design decisions into effect.

3.30 When a portfolio is in place, activities in the **monitor** stage include periodically assessing how well the portfolio is performing versus the objectives of the entity. If the performance of the portfolio is not in line with expectations, the investment environment changes, or objectives change, it might be appropriate to revisit the design or implement stages.

3.31 Alongside these three stages, the process of allocating governance responsibilities, authorities and accountabilities across an organisation holding financial assets also needs to be designed, implemented and monitored. The optimal governance structure will depend on the size and complexity of a portfolio, the purpose for which the assets are being held, the range of management services that can be internally resourced or outsourced, as well as the costs of those services.

3.32 When a governance structure is in place, it might be appropriate to revisit the structure periodically or in response to material changes in the size of the portfolio, the purpose for which it is being held, or the range of alternative models available.

What is good practice?

3.33 There is no set standard for judging whether management and governance processes are good practice or not, because practices vary with the scale, complexity, and purpose of the portfolio.

3.34 Consistent with the principle that "prudence is process", we looked at the design and operation of entities' processes for managing and governing their portfolios of financial assets. We did not look at the decisions that management or governors made about their portfolio, nor the details about the specific assets held.

3.35 Figure 13 sets out the attributes that we consider should be looked at to determine how well a portfolio management process supports responsible and transparent decisions.

Figure 13
Attributes of good practice for managing and governing financial assets

The three stages	Category	Attributes
Design	Objectives and planning	Consistency of investment objective with portfolio purpose
		Consistency of the strategic asset allocation with the investment objective
		Alignment of governors' tenures with the objectives and complexity of the fund
		Consistency of skills and experience (in conjunction with any advisor) with the duties and authorities
		Completeness and apparent justification for the set of beliefs
		Apparent rigour of any performance self-assessment processes
	Legislation	Awareness of relevant legislation and regulations
		Appropriateness of systems in place for maintaining compliance
	Governing bodies	Governors' familiarity with duties and authorities
		Appropriateness of the size of the membership
		Alignment of governors' tenures with the complexity of the process
		Consistency of skills and experience (in conjunction with any advisor) with the tasks and authorities
		Completeness and justification for the set of investment beliefs
		Apparent rigour of any performance self-assessment processes
Implement	Internal management	Internal managers' cognisance of duties and authorities
		Appropriateness of the sizes of committees (if any)
		Independence (potential for bias in decision-making)
		Consistency of skills and experience (in conjunction with any advisor) with the duties and authorities
		Extent to which accountabilities, performance measures, and remuneration reinforce alignment of interests
	External management	Formality and completeness of contracts, objectives, and guidelines
		Rigour of manager selection processes
		Extent to which accountabilities, performance measures, and remuneration reinforce alignment of interests
	Process	Sufficient frequency of face-to-face meetings
		Use of a rolling look-ahead work agenda
		Consistency of governors' and internal managers' actions with their roles

The three stages	Category	Attributes
Monitor	Reporting	Capture and assessment of performance relative to standards
		Little potential for bias in reported returns
		Extent to which frequency and content of reporting meets the needs of governors and stakeholders
		Consistency of performance data/measures with original objectives
		Consistency of investment horizon with that adopted by governors
		Appropriate investment knowledge and skills
	Transparency	Comprehensiveness of published information on financial assets and the investment management process
		Frequency, ease, and accessibility of the information

Source: Fidato Advisory Limited.

3.36 The three portfolio management and governance stages are interrelated. Although many of the categories and attributes apply to one particular stage, they will influence the other stages. Some attributes will also apply to one or more stages – for example, the alignment and consistency of skills and experience with responsibilities.

Reviewing practices in the 14 public entities

3.37 To assess the extent to which the 14 public entities achieved good practice in the three stages of managing and governing financial assets, we used interviews and other information. Taking into account the size, complexity, and purpose of the entity's financial asset portfolio, we applied the following scale to each of the eight categories shown in Figure 13:

- **Falls short** of achieving good practice – where material shortcomings were found in the attributes we reviewed;
- **Just achieves** good practice – where shortcomings were found in the attributes we reviewed but were not considered material to the management and governance of the portfolio; and
- **Clearly achieves** good practice – where few shortcomings were found in the attributes we reviewed.

3.38 Figure 14 shows the proportion of the categories of management and governance that were found to fall short of, just achieve, or clearly achieve good practice.

Figure 14
How well the 14 public entities practised good management and governance of financial assets

	Overall percentage achieved in the eight categories
Clearly achieves good practice	67%
Just achieves good practice	28%
Falls short of achieving good practice	5%

Source: Fidato Advisory Limited.

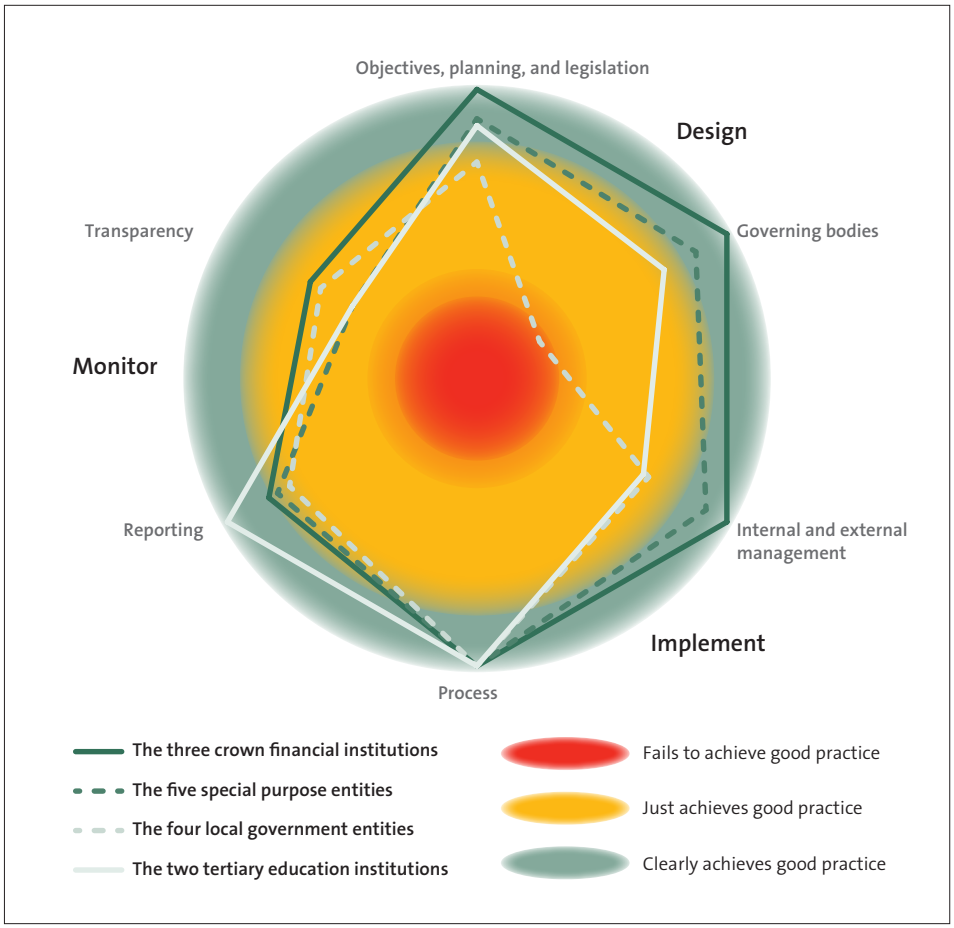
3.39 As Figure 14 shows, most of the entities either clearly achieved or just achieved good practice within the eight categories reviewed.

3.40 Where an entity had a category that fell short of achieving good practice we intend to follow up these matters with the entity.

3.41 Figure 15 shows how the four entity groups performed in each of the categories.[19]

19 For clarity, we combined the legislation and objectives and planning categories, and the internal and external management categories.

Figure 15
Review of financial asset management and governance practices in the four groups of entities



Source: Fidato Advisory Limited.

3.42 All four groups had strengths in preparing objectives, understanding legislation, and procedures for buying and selling financial assets. The entities in the CFI group were assessed as demonstrating the highest standards overall.

3.43 Some examples of the strengths in the 14 public entities include clear and well-defined:

- processes for selecting and monitoring managers;
- documentation and processes for trading and monitoring credit and liquidity risk;

- processes for engaging with external managers, external advisors, and independent service providers; and
- policies with clear objectives and a focus on risks and their management.

3.44 We also found examples of CFIs co-operating and sharing information well. For example, ACC, the Government Superannuation Fund, and the NZSF met regularly and have agreed to share responsible investment information and resources. ACC has developed a new investment database in collaboration with the NZSF.

3.45 However, we also found room for some improvement in the four groups. For example:

- Although there is normally considerable reporting about management activities, portfolio composition, and performance of financial assets, the clarity and usefulness of that information in many of the entities could be improved.
- The quality and completeness of investment policies varied considerably. Some entities could benefit from giving more thought to the connection between their operational objectives and their financial asset objectives. The entity's tolerance for risk was also often not documented.
- Some knowledge and skills gaps were observed in the governing bodies of those local authorities and universities where, for example, whole-of-council committees are used to oversee their investment portfolios. These investment portfolios are used to support the entities' core activities.

3.46 Improving transparency through better reporting and communication with stakeholders (including the public) about the objectives and performance of an entity's financial assets is about improving the relevance, rather than the amount, of information. For example, generally accepted accounting practice requires entities to report a lot of information about financial assets in their audited financial statements – all of it relevant but also, at times, highly technical. The challenge for entities is to make financial asset information more accessible, understandable, and useful to stakeholders.

3.47 Two of the three CFIs we reviewed noted that having a better relationship with the Treasury could help to improve the Treasury's capability to monitor these entities' activities. This was particularly important with the increasing sophistication of CFIs' activities in areas such as the use of derivatives. CFIs suggested more face-to-face contact to better understand the CFI's activities and steps to reduce staff turnover in the monitoring team. The Treasury believes that it has good working relationships with all of the CFIs, which include an appropriate amount of contact. It remains committed to rebuilding its CFI monitoring skills and expertise after some turnover of staff in early 2015.

3.48 A common theme in the 14 entities was the difficulty of attracting and retaining suitably skilled and experienced management and governors and the associated problem of "key person risk". We accept that this is a difficult area in practice. However, robust succession planning, realistic retention strategies, and sharing information between entities can all help to reduce these risks.

Financial asset governance of investment portfolios used to support core service delivery needs

3.49 Public entities with investment portfolios that support operational activities face a risk that these assets can become isolated from the entities' general management and governance. Local authorities, in particular, also need to balance the tension between involving their communities in governance and decision-making, and having the right investment skills and experience to manage financial assets.

3.50 We found that, where investment portfolios were being used to support other core activities, expertise in investment and capital markets and oversight structures for governing portfolios of financial assets were sometimes limited.

3.51 For example, two of the four local authorities with investment portfolios fell short of good practice in their governing bodies. The one tertiary education institution that clearly achieved good practice holds mostly cash assets.

3.52 Further work to support governors in these circumstances could include improving reporting and communication with stakeholders and making more use of independent expertise.

3.53 More innovative thinking about how best to gain the necessary expertise and structures to govern financial assets might also be required. For example, in the United States, "Local Government Investment Pools" combine the financial assets of various local governments to obtain greater efficiencies and expertise and better structures.

3.54 The pooling of financial assets is similar to the collective provision of debt financing that already takes place among local authorities.

Recommendation 1

We recommend that those public entities holding investment portfolios that support their core operational activities regularly assess how they can strengthen the skills and capabilities for governing their financial assets.

The use of derivatives in the public sector

3.55 All financial assets and liabilities have investment features that determine the set of benefits or costs that are expected to arise in the future. For example, the interest rate, the currency, the volatility, the financial strength of the parties, the timing, and/or the value of payments.

3.56 Derivatives are contractual agreements between two parties under which cash payments are made, depending on how one or more of these investment features (or some other market-based reference rate) moves over time.

3.57 Because the amount of the cash paid depends on the amount of the movement, derivatives can be used as:

- protection from unexpected movements in the investment features of an asset or liability ("hedging");
- a proxy for investing in the actual asset or liability –"investing synthetically", "increasing (or decreasing) exposure" or "tilting"; and
- a bet for, or against, future movements in an investment feature or reference rate ("speculation").

3.58 In explaining how derivatives can both protect and increase risk, *The Economist* quoted an eminent (unnamed) economist as saying:

> *Derivatives are like a car with four wheel drive. Four wheel drive makes driving safer, but it also means people will be more likely to drive in the snow.*[20]

3.59 The value of derivative contracts can vary with changes in the underlying investment feature or reference rate. If the contract's payments currently benefit the holder, the derivative is termed "in-gain" and reported in the financial statements as a financial asset. If the contract's payments do not currently benefit the holder, the derivative is termed "in-loss" and reported in the financial statements as a financial liability.

3.60 Where derivatives are used to protect against unexpected movements in the value or investment features of an asset or liability, the value of the derivative will usually rise as the value of the investment feature falls (and the other way around). Therefore, understanding the value of these derivatives also requires an understanding of how the underlying investment features move.

3.61 In all of central government, a little more than half of all derivatives in 2014 were in-gain and recorded as financial assets.[21] The market value of these in-gain derivatives changes regularly but has increased from about $1.6 billion in 2008 to about $4.2 billion as at 30 June 2014. The 2015 FSG show that the value of

20 See the 2008 blog post *Wither the derivative?* at www.economist.com/blogs.

21 Those in-loss derivatives, recorded as financial liabilities, are not included in this analysis.

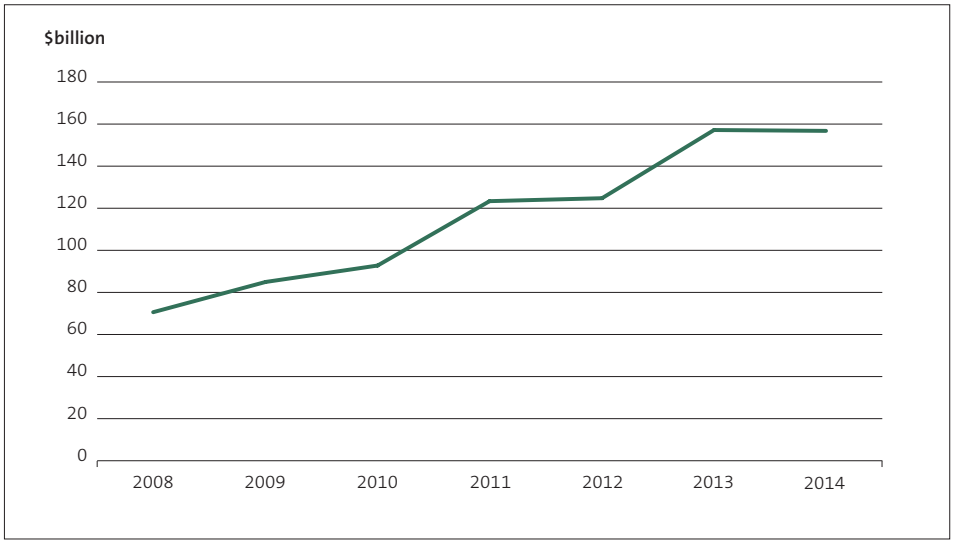
in-gain derivatives declined during 2014/15 to about $3.0 billion, highlighting the potential volatility that surrounds their use and market value.

3.62 In local government, the value of in-gain derivatives has increased, on average, by about 13% a year from 2008 to $143 million in 2014.

The use of derivatives in the public sector is increasing

3.63 Figure 16 shows the changes in the notional value[22] of all central government derivatives since 2008.

Figure 16
Changes in the notional value of central government derivatives



Source: Drawn from the Financial Statements of the Government.

3.64 The notional value of all of central government's derivatives has significantly increased, by an average of 14.2% each year from 2008 to 2014. The greatest level of activity is in foreign exchange and interest-rate swaps. The 2015 FSG show that the notional value of derivatives has increased significantly during the last year, to about $206 billion.

3.65 Although local government entities reported the fair (or carrying) value of their derivatives, we could not see a complete picture of the notional value of derivatives. This is because notional value is required to be reported only in certain circumstances. Based on the number of entities reporting fair values in 2014,

22 Notional value refers to the principal or contract amount on which the derivative contract is based, including both in-gain and in-loss derivatives. It is a better indicator of derivative activity than the carrying value in the financial statements.

42% of all local government entities held in-gain derivatives, slightly down from 44% in 2008.

3.66 Most of the increase in the use of derivatives by central government entities has arisen from the investment practices of the NZSF, ACC, and the Reserve Bank of New Zealand, which use derivatives as a cost-effective way to protect investments or carry out asset allocation strategies. For example:

- In the last few years, the NZSF has substantially increased its use of credit default swaps to manage the risks of counterparties defaulting on debt obligations held by the fund. The NZSF also uses total return swaps as an alternative to investing directly in actual assets (such as shares) to meet its asset allocation needs.
- ACC has used interest-rate swaps to protect its Reserves Portfolio assets from adverse changes in interest rates.
- The Reserve Bank of New Zealand uses cross-currency swaps to protect against foreign exchange movements associated with funding most of the assets held for foreign reserves management. The Bank also uses foreign exchange swaps as an integral part of its dollar liquidity management operations.[23]

3.67 Figure 17 shows the increasing use of different types of derivatives by ACC and the NZSF, taken from their annual reports in 2008 and in 2014.

23 For more information, see the Reserve Bank of New Zealand's 2015 annual report, pages 81-82.

Figure 17
Types of derivatives used by the Accident Compensation Corporation and the New Zealand Superannuation Fund

Accident Compensation Corporation		New Zealand Superannuation Fund	
2008	2014	2008	2014
Interest-rate swaps Forward foreign currency contracts	Interest-rate swaps Forward foreign currency contracts Credit default swaps Cross-currency interest-rate swaps Futures contracts – long Futures contracts – short Options	Forward foreign exchange contracts Futures contracts Equity swaps Commodity swaps Options	Forward foreign exchange contracts Cross-currency swaps Volatility swaps Longevity contingent swaps Futures contracts Total return swaps – equity Total return swaps – bonds Credit default swaps Insurance linked swaps Interest-rate swaps Other OTC swaps Options

Source: Annual reports of ACC and the NZSF.

Some of the challenges in using derivatives

3.68 Although derivatives can be cost-effective and easy to convert into cash, the greater range and complexity of contracts can increase the risk of default by either party, errors in processing and reporting, and intentional misuse.

3.69 To better understand these challenges, we spoke with the NZSF about the risks it faces and how it manages those risks. Because derivatives are settled regularly in cash, the main risk that the NZSF faces using derivatives is not having enough money to pay another party when required – liquidity risk.

3.70 The NZSF manages liquidity risk through robust processes, systems, and controls but also by ensuring that enough money is available (termed a Minimum Liquidity Requirement) to pay other parties in the event of a two-day "crisis".

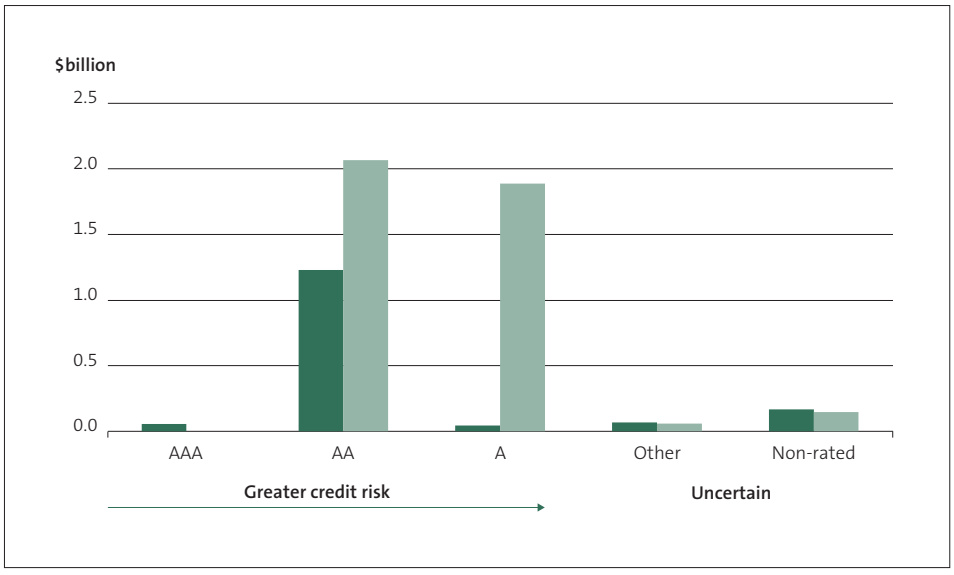
3.71 For larger and longer crises (such as another global financial crisis), the NZSF has plans to ensure that more of its assets can be converted into cash as required (known as the "liquidity replenishment system"). The NZSF expects the potential

loss in fund value during a global financial crisis to be largely the same, regardless of whether it uses derivatives. However, the way derivative gains or losses are paid in cash could expose the fund to more liquidity risk than if the investment was limited to only shares or bonds (where a reduction in values would not immediately lead to a demand for cash).

3.72 Although derivatives are used to protect against day-to-day risks, such as currency movements, the NZSF does not use derivatives to help protect the fund from a catastrophic or global financial crisis. The NZSF believes that the opportunity cost (in lost returns) to the fund outweighs the benefit of this type of insurance.

3.73 Counterparty risk, or the risk that the other party to the contract fails to pay money owed to the NZSF (for example) is also important in derivatives. Figure 18 shows that, at a whole-of-government level, the credit risk of the other parties that central government is dealing with in in-gain derivatives from 2008 to 2014 has increased.

Figure 18
Changing credit exposure of central government's "in-gain" derivatives



Note: Standard & Poor's uses the AA, AA, and A ratings when assessing credit risk. Some derivatives have other credit ratings, and some do not need to be rated.
Source: Financial Statements of the Government.

3.74 Figure 18 shows that, for all of central government's in-gain derivatives, the risk of a counterparty not paying the Government when required has increased. The 2015 FSG show that this risk has reduced since 2014, but remains greater than in 2008. One possible reason for this increase is the re-rating of some of the larger financial institutions after the global financial crisis, many of which are counterparties in central government derivative contracts.

3.75 Figure 18 and the increased value of derivatives in central and local government suggest an increasing exposure to risk. However, credit exposure is only one aspect of derivative risk, and increasing activity does not necessarily mean increased exposure to risk. For example, one derivative contract might be entered into to offset another derivative contract or an asset, so the net exposure could be neutral.

3.76 Because of the number and variety of derivatives in the public sector, assessing the current and future exposure to risk is beyond the scope of this report.

Challenges in managing and governing financial assets

4

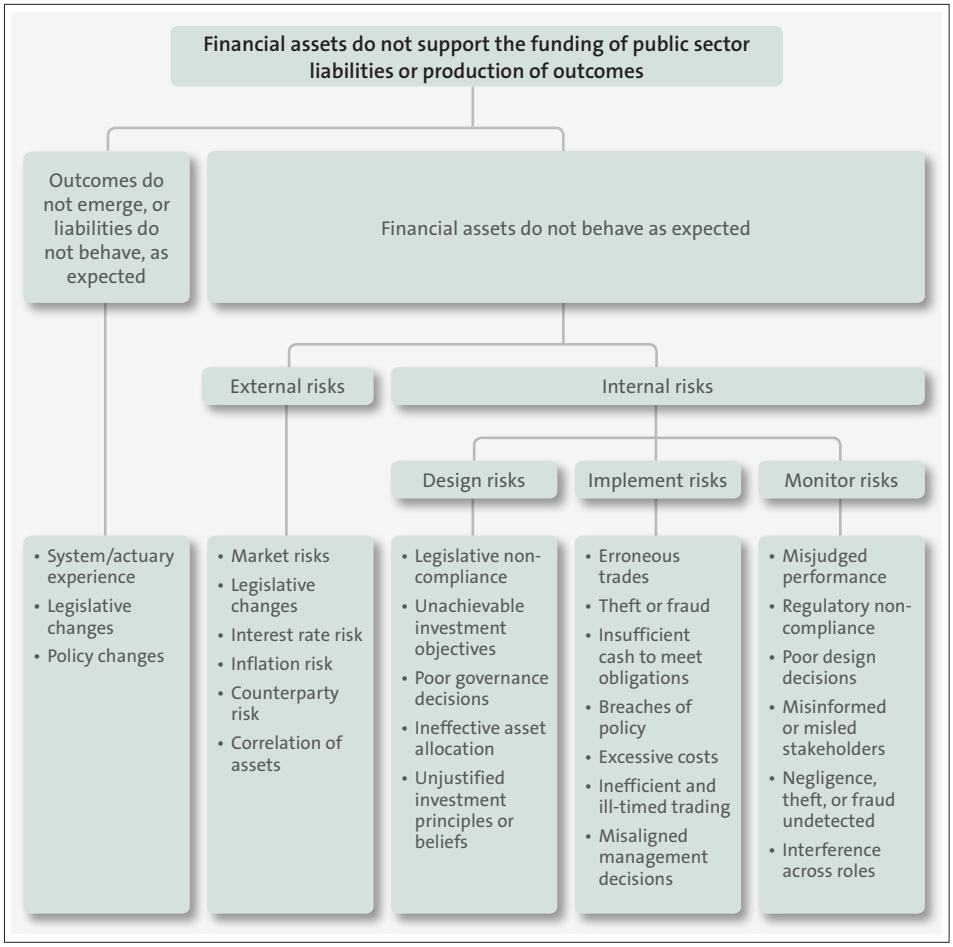
4.1 In this Part, we review the challenges that individual public entities and the whole of government face in managing and governing financial assets. We also provide some guidance for public entities that hold, or are looking to hold, financial assets.

Challenges and risks for public entities

4.2 Although there are clear opportunities for using financial assets, the global financial crisis in 2008 highlighted how financial assets can also create sizeable risks when their use is not transparent, or they are not understood, or they are not adequately managed or monitored.

4.3 Figure 19 summarises the main risks for public entities in holding financial assets.

Figure 19
Key risks in holding financial assets



Source: Adapted from Chief Investment Officers and the Association of Public Pension Fund Auditors (2000), *Public Pension Systems: Statements of Key Risks and Common Practices to Address Those Risks*, Columbus, Ohio.

4.4 Figure 19 covers the spectrum of risks involved in holding a diversified pool of financial assets for the purposes of meeting some future liability (such as pension obligations). Many of the risks would also apply to a single financial instrument used for a single policy objective (such as using derivatives to mitigate interest-rate risk).

Taking on additional external risks might be necessary

4.5 External risks are particularly important in an investment context. They affect not only how financial assets are managed and governed, but also the potential return expected on those assets.

4.6 Any financial asset will have some market risk. Where higher returns are sought to fulfil a particular objective, taking on additional market risks may be necessary.

4.7 How much additional market risk an entity is willing to take on (its risk tolerance) depends on many factors, including the purpose for which the assets are being held, the investment horizon, the financial strength of the entity, and the expectations of stakeholders.

4.8 Understanding the investment context is important in determining what market risks are important, how they are measured, and how they are evaluated. Specialist advice might be needed.

Nine guiding principles for managing internal and external risks

4.9 The following principles should be helpful for public entities managing the various internal and external risks highlighted in Figure 19.

Clear and relevant objectives

4.10 Be clear about the reasons for holding financial assets. Financial assets can be held for several reasons, including funding future liabilities, managing risks, and motivating commercial behaviours. Ensuring that these objectives are clear, justified and remain relevant to the entity is fundamental to ensuring that the financial assets do what they are supposed to do. For example, a portfolio with a long-term investment objective should be designed around long-term investment strategies with long-term performance measures.

Get the design of the management and governance processes right

4.11 Designing the portfolio's management and governance correctly means matching the entity's objectives, legislation, and tolerance for risk with the right set of financial assets and the skills necessary to manage and govern them. The right processes ensure that stakeholders, governors, and managers have common,

clear investment expectations and are appropriately resourced and organised. Depending on the size and complexity of the entity's objectives, independent specialist advice might also be needed.

Clearly assign responsibilities

4.12 As a principle of good governance, responsibility for different tasks should be clearly assigned to the party or parties best placed to carry them out. For example, usually, internal accounting and finance staff members should not choose which shares to invest in.

Use delegations appropriately

4.13 Delegation can be an effective way to bridge expertise and capacity gaps. It can also reduce costs and improve efficiency. For example, it would be unusual for a board to delegate strategic asset allocation responsibilities, but understandable for day-to-day portfolio management to be delegated to external professional fund managers. However, with delegation comes the need to monitor effectively.

Clearly separate duties

4.14 The risks of fraud or falsifying information increases when complementary functions are not kept separate. For example, an investment management firm should not be made accountable for assessing its own performance. A clear separation of duties is the first line of defence against risks of fraud.

Have effective, well-aligned incentives

4.15 Staff-related risks and operational risks can be reduced by ensuring that effective incentives are in place. For example, governors should be aware of creating "free options" within performance fee structures, because they can encourage investment managers to take on risk with impunity. Similarly, those tasked with assessing performance should not have incentives to show that the performance has been favourable, nor be punished for finding that it has been unfavourable.

Have a clear process

4.16 "Prudence is process" is a simple and easily remembered principle in financial management. Although it is possible to suffer failures or losses with the best laid plans, such failures are more likely to be tolerated and understood if good processes were in place. Processes must be recorded clearly.

Monitor effectively

4.17 Monitoring is an integral part of a healthy process. Continual reviews can help to create a culture of continual improvement and refining of processes over time. They should also be effective in identifying why outcomes are favourable or unfavourable. Continual reviews also inform the planning for corrections or policy changes, when necessary, or reinforce the current approach.

Communicate clearly

4.18 Clarity and transparency about the design, management, and governance of financial assets is important to all stakeholders during the lifetime of a portfolio of such assets. The reasons the portfolio was set up and whether the financial assets are meeting the entity's objectives can be complicated to explain. However, if these matters are not well understood by all stakeholders, it can lead to misunderstandings, relationship problems and, at worst, financial assets that become detached from the operational objectives of the entity.

Recommendation 2

We recommend that public entities with significant financial assets regularly assess how well they are managing and governing their financial portfolios and reporting to stakeholders using the following questions:

- Are the objectives clear and consistent with the purpose of holding the assets?
- Are the designs of the management and governance processes appropriate?
- Are responsibilities clearly assigned?
- Are delegations used appropriately?
- Are duties clearly separated?
- Are incentives well-aligned?
- Is there a clear and documented process?
- Is monitoring effective?
- Are communications clear and relevant to the needs of stakeholders?

Challenges at a whole-of-government level

4.19 As the value and use of financial assets continue to grow, challenges will emerge at a whole-of-government level. We discuss some of these potential challenges in paragraphs 4.20-4.35.

Governance and agency relationships

4.20 In 1998 and 2001, Treasury working papers[24] raised various matters about the relationships between taxpayers, the government, and financial asset investment managers. The matters included the potential for:

- the Government to directly or indirectly affect the performance of the financial asset, such as through unexpected withdrawals or enforcing excessive prudence, "short-termism", or other government perspectives on investment decisions;
- adverse effects on private sector behaviour through the Government exercising its ownership rights in a way that conflicts with private sector goals; or
- insufficient stewardship, particularly where governors are not independent enough from fund managers.

4.21 The governance structure of the NZSF was designed to address these matters. The NZSF is "double arms-length" away from the Government. The Government does not decide on the pool of candidates for appointment to the board that governs the NZSF. The board and management make investment policies and decisions.

Effects on financial stability and sustainability

4.22 As financial assets become a larger part of the Crown's balance sheet, investment decisions will affect not only the public entity holding the assets but also the financial position of the Government and, possibly, the whole economy. Collectively, these assets could materially affect the Government's financial risk exposure through:

- the way in which the value of the financial assets change relative to the value of key industries or the economy – financial asset portfolios can be designed to exploit or mitigate the effects of such movements;
- the potential for increasing cross-holdings of financial assets by public entities, which create financial interdependencies[25] that could affect how financial risks flow through the public sector – the FSG show that, in 2014, about 14% of the financial assets held by three segments in central government[26] were securities issued by other central government entities, up from 11% in 2008; or
- the potential exposure to global systemic risks – for example, the more foreign-owned and/or foreign-denominated financial assets, the more the Government is exposed to movements in global financial markets.

24 Much of this discussion is based on Grimes, A. (2001) *Crown Financial Asset Management: Objectives and Practice* and Davis, N. (1998) *Governance of Crown Financial Assets*.

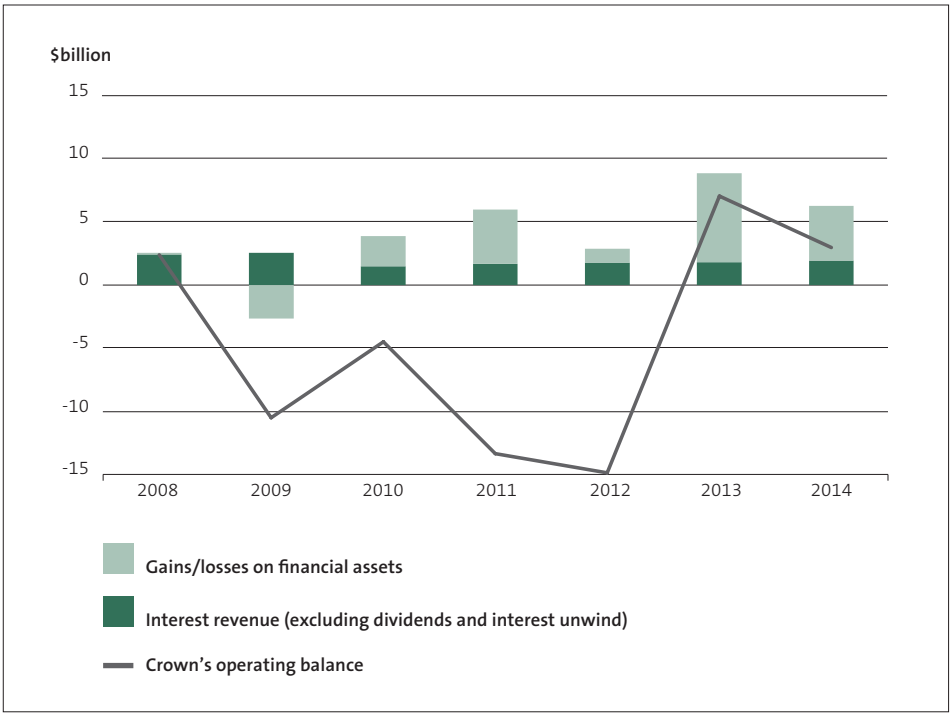
25 Where one entity's financial performance depends, to some extent, on another entity.

26 The three segments in the FSG are the core Crown, Crown entities, and State-owned enterprises.

4.23 Changing returns on financial assets affect important government indicators, such as the operating balance, net debt, and/or net assets. For example, the 2015 FSG show that core Crown net debt (excluding the NZSF) changed little during the past year because the increase in sovereign debt (about $4.6 billion) was offset by a similar increase in the value of financial assets.

4.24 Figure 20 shows how central government financial asset gains and losses, and interest earned, has affected the Crown's operating balance from 2008 to 2014.

Figure 20
Effect of financial asset gains, losses (including derivatives), and interest on the Crown's operating balance, 2008-14



Source: Financial Statements of the Government.

4.25 Figure 20 shows the historical variability in the value of financial asset gains and losses and their effect on the Crown's operating balance. Without the large and positive returns in 2013 and 2014, the operating balance would have been negative.

4.26 Indicators such as the operating balance focus mainly on the short-term financial stability of the Government. However, many of the Government's reasons for holding financial assets relate to longer-term responsibilities. Measures are also needed that reflect how financial assets affect the longer-term financial sustainability of the Government.

Effects on the tolerance for risk

4.27 As with individual entities, understanding the whole-of-government's willingness for taking on financial risk is a fundamental part of planning, managing, and governing a portfolio of entities that holds many financial assets.

4.28 For example, the NZSF does not insure the fund from a catastrophic or global financial crisis because it believes the opportunity cost (in lost returns) outweighs the benefit of lower risk. This is consistent with the NZSF's long-term investment approach, higher risk tolerance and return expectations.

4.29 However, this might also be inconsistent from a whole-of-government perspective, where such a crisis could mean widespread challenges for government entities, potentially leading to increased debt (and other obligations) at a time when financial asset values are also declining. In this situation, important financial indicators such as net worth and net debt could take a short-term to medium-term double hit – as debt needs to increase while the value of financial assets decline.

4.30 Appreciating the relationship between higher (lower) returns and higher (lower) risk is fundamental to understanding how much risk is acceptable at all levels of government. Preparing a formal Risk Appetite Framework that includes policies, processes, controls, and systems through which risk appetite is established, communicated, and monitored, is one way to gain a whole-of-government perspective on the level of tolerance for risk with financial assets.[27]

Effects on effectiveness and efficiency

4.31 Although the CFIs are co-operating and sharing information, the issues identified in the Government's 2013 ICT Strategy and Action Plan about the use of different technology platforms by entities might become more relevant (such as duplication and fragmentation, and a lack of co-ordinated investment creating cost inefficiencies).

4.32 In our review of the 14 public entities, we found little commonality in the technology platforms and systems used to manage and track financial assets.

27 For example, see the Financial Stability Board (2013), *Principles for An Effective Risk Appetite Framework*.

Effects on domestic capital markets

4.33 In its 2015 annual report, ACC noted that it "... is one of the largest investors in New Zealand companies, owning about 3% of the market capitalisation of the New Zealand share market".[28] As well as this significant share ownership,

> *ACC owns 40% of the inflation-indexed bonds that have been issued by the New Zealand Government, and 6% of the regular (not inflation indexed) New Zealand Government bonds.*[29]

4.34 In total, the NZSF, the Government Superannuation Fund, and ACC own close to 5% of all New Zealand Stock Exchange-listed securities. As the value and use of government-owned financial assets increase, this could have implications for domestic markets. Although greater public sector participation in financial markets can have benefits, such as improving liquidity and encouraging a greater range of investments, it can also:

- "crowd out" private investors;
- limit private shareholder power;
- influence company behaviour; and
- cause instability through political changes and time frames.

4.35 Independent governance frameworks and clear objectives can manage most of these concerns at the entity level. However, at a whole-of-government level, these issues could remain.

Planning for future opportunities and challenges in managing public sector financial assets

4.36 The increasing, complexity, and materiality of public sector financial assets will offer new opportunities and challenges for public sector entities, New Zealand's capital markets, and the economy. Careful thought about how best to manage these changes is now needed at a whole-of-government level.

4.37 In a recent report on how best to manage the numerous financial institutions that the Government of the United Kingdom has ownership interests in, the National Audit Office concluded:

> *We consider that government should adopt a portfolio management approach alongside the traditional departmental oversight model to provide heightened assurance over the portfolio.*[30]

4.38 The Treasury already has a strategic plan for physical assets. The National Infrastructure Plan provides a long-term framework with a vision that "New

28 ACC's *Annual Report 2015*, page 35.

29 ACC's *Annual Report 2015*, page 35.

30 National Audit Office (2015), *Financial institutions landscape*, page 13.

Zealand's infrastructure will be resilient and co-ordinated, and contribute to a strong economy and high living standards".

4.39 The Treasury has also recently released a consultation document about a proposed framework to "increase the Treasury's ability to advise the Government on risk in the Crown's balance sheet".[31] An important part of this work will be ensuring that there are enough financial assets to provide resilience against major risks, such as another global financial crisis. Related to this are questions about clearly defining and measuring risk across short-term and long-term investment horizons.

4.40 Preparing such a strategic vision (and plan) for financial assets could help:

- show the future direction and profile of financial assets;
- provide more alignment between entities and sectors;
- increase public awareness of the role that financial assets play in public sector service delivery and the challenges that emerge; and
- complement and reinforce the Treasury's National Infrastructure Plan, Debt Management Strategy, and current work on managing the Crown's balance sheet risk.

4.41 All these strands of work are interrelated. Brought together, they provide the foundation for an integrated asset strategy for the Government.

Recommendation 3

We recommend that the Treasury prepare a strategic perspective on and vision for holding financial assets in the public sector.

31 See the Treasury's 5 October 2015 consultation document, *Crown Asset and Liability Management*, pages 2 and 4.

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Other publications issued by the Auditor-General recently have been:

- Improving financial reporting in the public sector
- Principles for effectively co-governing natural resources
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- Reviewing aspects of the Auckland Manukau Eastern Transport Initiative
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- Inquiry into Health Benefits Limited
- Service performance reporting: Results of the annual audits of TEIs for the year ended 31 December 2014
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