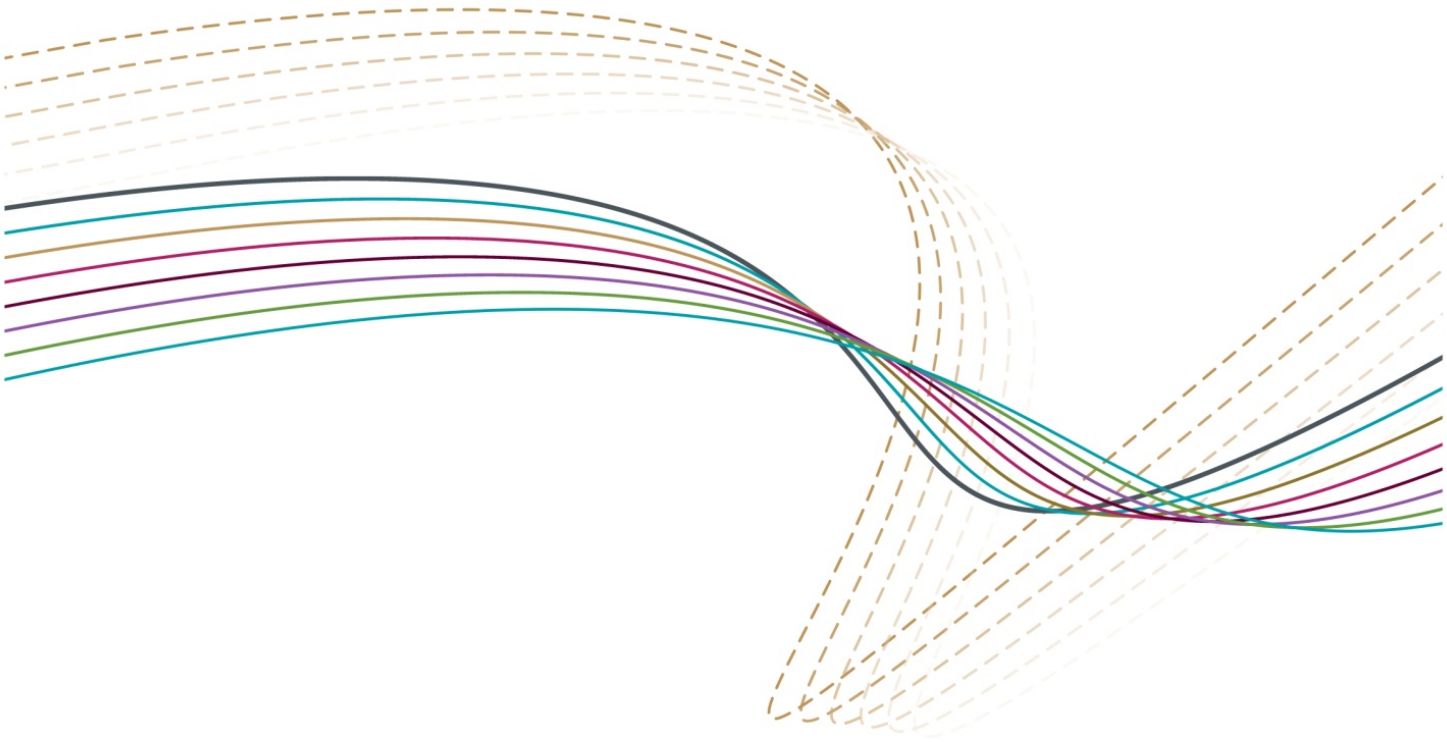
QUEENSLAND TREASURY

# Derivative Transactions Policy Guidelines

## Guidelines for agencies undertaking derivative transactions

**January 2016**



Queensland Government



Translating and interpreting assistance

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# 1.0 Introduction

These guidelines set out the policy framework for departments and statutory bodies undertaking derivative transactions.

The guidelines also apply to government owned corporations (GOCs) that do not have a Board approved financial policy for derivative transactions (as contemplated in the Code of Practice for Government Owned Corporations' Financial Arrangements).

# 2.0 What is a derivative?

A derivative transaction is a financial contract that derives its value from an underlying asset, commodity, liability or index. Examples of derivative transactions include:

- **Forward agreements** – forward bill agreements, forward commodity agreements, forward exchange agreements and forward rate agreements.
- **Futures** contracts for bills, bonds, commodities, shares and the share price index.
- **Options**, whether exchange traded or over-the-counter, including options on bonds, caps, collars, currencies, floors, interest rates, shares and swaps.
- **Swaps** – commodity, CPI linked, currency exchange, equity linked and interest rate swaps.

# 3.0 Why use derivatives?

Derivatives can play an active role in the management of financial risk. When used prudently, derivatives can offer agencies efficient and effective methods for reducing certain financial risks and achieving cash flow and budget certainty.

Derivative transactions may only be entered into for the purpose of hedging[1] underlying exposures (e.g. foreign currency, commodity price and interest rate risks). Agencies must not enter into derivative transactions purely for speculative purposes.

The use of derivatives within the public sector is essentially related to managing three areas of financial risk exposure: foreign exchange risk, commodity price risk and interest rate risk.

# 4.0 Foreign exchange risk

Foreign exchange risk is the risk that an agency's operations will be affected by changes in currency exchange rates.

Any agency dealing with offshore parties can be exposed to foreign exchange risk. For example, if goods are being purchased from overseas, and payment is being made in a foreign currency or indexed to a foreign currency, foreign exchange risk exists.

[1] Hedge: To make an offsetting commitment to minimise the impact of fluctuations in commodity, currency or financial transactions.

Essentially, there are two types of foreign exchange risk:

- **Translation risk** – this refers to the translation of the value of overseas assets and liabilities into domestic currency. Translation risk affects the balance sheet.
- **Transaction risk** – the risk that the value of revenue or expenses will change as a result of a change in the exchange rate. Transaction risk will impact upon the operating statement.

# 5.0 Commodity price risk

Any agency involved in the buying or selling of commodities is subject to commodity price risk.

Commodity price risk exists where changes in the price of a physical commodity (e.g. fuel, electricity) impact upon an agency's cost structure and cash flows.

# 6.0 Interest rate risk

Interest rate risk arises when either borrowing costs or investment returns are affected by changes to the underlying level of interest rates.

Interest rate risk occurs with floating rate loans/investments or the re-financing of fixed term debt/investment. For example, the interest cost on debt will increase as interest rates rise if a security has a floating interest rate.

For departments, interest rate risk associated with their borrowings is implicitly managed via the Government Debt Pool.

# 7.0 A framework for risk management

As stated above, derivative instruments may be used as risk management tools. Risk management involves taking deliberate action to reduce the amount of a given risk to an acceptable level and requires an entity to:

- identify its risks or exposures
- quantify the level of risk
- evaluate the exposures
- manage the risk, and
- monitor performance.

An agency should manage its exposures (as outlined below) even if the agency is not entering into derivative transactions.

## 7.1 Identify the risk

The agency will need to identify its exposure (including but not limited) to:

- foreign exchange movements
- commodity prices, and
- interest rate risk.

## 7.2 Quantify the level of risk

Once an exposure has been identified, it needs to be quantified where possible. This usually entails some form of sensitivity analysis, for example, “if the value of the A$ increases relative to the US$ or other denominated currency, what is the impact on revenues?”

## 7.3 Evaluate the risk

Once the quantum of potential exposures has been determined, the agency needs to evaluate the significance of this risk. The sensitivity of the agency to the exposure will drive the formulation of a management strategy.

An agency should also consider whether there are any natural hedges arising from opposing exposures. For example, depreciation of the A$ may increase the cost of imported purchases, but may also increase revenue from sales denominated in foreign currency.

## 7.4 Manage the risk

Once the exposure has been identified, quantified and evaluated, the agency can consider management alternatives.

- Will the exposure be hedged?
- How much should be hedged? When should the exposure be hedged?
- What sorts of products can be utilised?

### 7.4.1 Will the exposure be hedged?

This decision will depend on the evaluation of the exposure and the significance of this to the agency. It will also be based on the agency’s attitude towards risk. For example, a conservative agency may aim to hedge 100% of exposures as soon as they are identified, with a view to maintaining cash flow and budget certainty.

Alternatively a decision may be made to leave the exposure uncovered, providing capacity for the agency to gain from a positive change in the area of risk exposure.

The cost of hedging also needs to be considered. While a currency exposure may be identified for goods contracted for delivery in two years’ time, the cost of locking in an exchange rate so far in advance may prove prohibitive. The closer to maturity, the cheaper it is to hedge (all other things being equal).

### 7.4.2 How much should be hedged? And when?

A decision may be made to hedge 100%, 75%, 50% or less. This will depend on the factors outlined under section 7.4.1 above.

For example, assume a payment in foreign currency will be made in 12 months’ time, and the decision has been made to hedge it. Part may be hedged now and the remainder gradually hedged over time.

### 7.4.3 Which hedging products can be utilised?

A number of hedging products can be utilised, ranging from simple (e.g. forward contracts) to sophisticated (e.g. zero-cost collars).

It is recommended that particular caution be exercised when looking at more complex products, as they may not only prove more expensive but are less transparent. For example, overlaying complex hedging arrangements on top of a physical exposure may result in the agency losing sight of its real exposure.

## 7.5 Monitor performance

Once a risk management strategy is in place, the agency needs to measure and report on performance – with strategies revised if necessary. Exposures should be measured and monitored irrespective of whether the exposure is hedged or unhedged. All exposures should be reported on a mark-to-market[2] basis.

Hedging strategies should be re-evaluated where key terms and conditions of a hedge are varied during its exposure period.

## 7.6 Summary of risk management process

This table summarises the roles and responsibilities of individual agencies and Treasury in the risk management process. The table highlights that Treasury's role is to identify strategic exposures and to manage residual risks on behalf of the State.

| Risk Management Process | Individual Agency Responsibilities | Treasury Responsibilities |
|---|---|---|
| **Establish context** | • Establish agency financial risk management policy | • Establish whole-of-Government policy guidelines |
| **Identify the risk** | • Risk audit of contracts (e.g. foreign currency and commodity exposures)<br>• Estimate cash flows and internal offsets<br>• Determine time horizon of exposures | • Identify strategic exposures, such as those resulting from budget supplementation arrangements |
| **Quantify the level of risk** | • Sensitivity analysis | • Analyse net whole-of-Government position |
| **Evaluate the risk** | • Evaluate the size and type of exposure against available risk management options | • Assess the impact of whole-of-Government exposures |
| **Manage the risk** | • Consider management alternatives (accept, restructure or manage exposures) | • Develop policy guidelines |
| **Monitor performance** | • Monitor exposures against objectives<br>• Review effectiveness of management strategies and consider alternatives | • Monitor and report on the overall whole-of-Government exposure position |

[2] Mark to market: Revaluation of financial instruments to reflect their current market value.

# 8.0 The role of QTC and QIC

## 8.1 Role of QTC

Derivatives, by their nature, involve potential significant risk and require substantial expertise in their use. Agencies are not generally expected to have the necessary technical expertise in this area.

Accordingly, it is preferred that all transactions in derivatives by agencies are undertaken through Queensland Treasury Corporation (QTC), unless otherwise approved by the Treasurer. QTC will act as an interface with financial markets. This will:

- enable centralised management and control of related risk exposures
- ensure a professional approach to derivative transactions, and
- result in more effective management of whole-of-Government risk exposures.

QTC can also assist agencies in the following areas:

| Risk Management Process | Role of QTC |
|---|---|
| **Establish context** | • Advise agencies on appropriate strategies and instruments |
| **Identify risks or exposures** | • Identify underlying risk exposures |
| **Analysis** | • Advise/assist with agency analysis |
| **Manage the risk** | • Develop hedging strategies<br>• Advice regarding hedging of particular exposures<br>• Execution of transactions on behalf of agencies |
| **Monitor performance** | • Monitor and report on risk exposures |

## 8.2 Role of QIC

Queensland Investment Corporation (QIC) will undertake derivative transactions as part of its overall portfolio management on behalf of clients.

# 9.0 Developing a derivative policy

An agency should establish a risk management policy for derivative transactions if it intends to manage foreign exchange, commodity price or interest rate risk through the use of derivatives.

At a minimum, agencies should be aware of, and must comply with, the following principles in developing a derivative policy:

- agencies will not be permitted to take speculative positions in derivatives:
  - derivative transactions may only be entered into for the purpose of hedging exposures that arise in the normal course of an agency's business (e.g. foreign currency, commodity price and interest rate risks), and

  - the value of any derivative transactions entered into should not exceed the value of the underlying physical asset being hedged.
- a risk management committee should be established where derivative risks or the volume of transactions are material.

The policy should also consider other relevant issues including:

- the relationship of the policy to the agency's credit risk[3] policy
- the level of need to use derivatives
- the level of appropriate expertise held by employees of the agency
- the quality of appropriate management, control and accountability systems implemented by the agency
- how these risks may be managed
- the overall appropriateness of the agency undertaking derivative transactions, and
- the appropriate roles and responsibilities of agencies, senior management, Treasury and QTC in relation to derivative transactions.

# 10.0 Legislative requirements

## 10.1 Departments

Part 5, Division 6 of the *Financial Accountability Act 2009* (FA Act) outlines and regulates the power of departments to enter into derivative transactions.

Section 85(2) of the FA Act provides that a department may enter into derivatives only if:

- the department has received the Treasurer's approval to enter into derivative transactions, and
- the transactions are entered into for the purpose of hedging underlying exposures (i.e. not speculation).

Section 86 of the FA Act requires a department that enters into derivative transactions to provide reports to its Minister at prescribed times and containing prescribed information. The Minister is required to monitor the transactions. A copy of the report must also be given to the Treasurer or an appropriately qualified employee of the Treasury department.

Section 59(1) of the *Financial and Performance Management Standard 2009* (FPMS) prescribes that reports must be provided by the department on derivative transactions:

- for the duration of the transaction – the first day of each calendar month; and
- when the transaction is complete – the first day of the calendar month after completion.

Section 59(3) of the FPMS prescribes that a report about a derivative transaction must:

- identify the transaction
- state the underlying exposure which the department is hedging, and
- state details of:
  - the Treasurer's approval

[3] Credit risk: The risk of suffering loss due to another party defaulting on its financial obligations.

- compliance with any approved conditions, and
- realised or unrealised gains or losses from the transactions.

A pro forma derivative transaction report is provided as an attachment.

## 10.2 Statutory bodies

Part 7, division 1 of the *Statutory Bodies Financial Arrangements Act 1982* (SBFA Act) outlines and regulates the powers of statutory bodies to enter into derivative transactions.

Sections 53 and 54 of the SBFA Act provide that a statutory body may enter into derivatives only if:

- the statutory body is prescribed by regulation as a body that may enter into derivatives
- the Treasurer's approval has been given for the statutory body to enter into derivative transactions, and
- the transactions are entered into for the purpose of hedging underlying exposures (i.e. not speculation).

Section 55 of the SBFA Act requires a statutory body that enters into derivative transactions to provide reports to the Treasurer, at the times prescribed under a regulation, containing:

- details sufficient to identify the transaction
- a statement about the underlying exposure the statutory body is hedging
- the stated purpose of the derivative transaction, including details of the Treasurer's approval and compliance with any approved conditions, and
- details of any realised or unrealised gains or losses from transactions.

The *Statutory Bodies Financial Arrangements Regulation 2007* prescribes that reports must be provided by statutory bodies on their derivative transactions on a quarterly basis unless a more frequent reporting requirement is determined by the Treasurer.

A pro forma derivative transaction report is provided as an attachment.

Section 56 of the SBFA Act requires a statutory body to provide the Minister who administers the authorising Act of the statutory body with a report about each derivative transaction. Section 57 of the SBFA Act requires the Minister to monitor the transactions.

## 10.3 Government owned corporations

GOCs must comply with the requirements of the *Government Owned Corporations Act 1993* and their individual Statements of Corporate Intent.

# 11.0 Administrative procedures

QTC (or an external consultant engaged by QTC) will perform a competency review of any agency seeking the Treasurer's approval to enter into derivative transactions under the FA Act or the SBFA Act.

QTC will review:

- the agency's risk management policy for derivative transactions
- the level of appropriate expertise held by employees of the agency, and
- the quality of appropriate management, control and accountability systems implemented by the agency.

## 11.1 Departments

A department wishing to enter into a derivative transaction should approach Treasury with complete details of its proposal and a request for approval under the FA Act.

Treasury is responsible for considering and assessing the proposal, and for determining (having regard to the requirements of prudent financial management) whether it is appropriate for the Treasurer's approval to be given.

## 11.2 Statutory bodies

If a statutory body intends to enter into a derivative transaction it should:

- Check whether it is prescribed by regulation as a body that may enter into derivative transactions.

  *If a statutory body is not prescribed by regulation as a body that may enter into derivatives, its administering department will need to request an amendment to the Statutory Bodies Financial Arrangements Regulation 2007 for it to be allocated power to enter into derivative transactions under the SBFA Act.*

- Approach its administering department with complete details of the proposal and a request that the department seek any necessary approvals on behalf of the body.

The administering department is responsible for considering and assessing the proposal, and for determining (having regard to the requirements of prudent financial management) whether it is appropriate for approval to be given. This determination will form the basis of a recommendation by the department to Treasury regarding the application.

## 11.3 Government owned corporations

A GOC with a Board approved financial policy for derivatives will enter into derivative transactions in accordance with that policy. GOCs without a Board approved financial policy for derivatives must comply with these guidelines.

To enable the Treasurer to monitor the State's overall derivative exposure, the quarterly reporting process, required under the *Government Owned Corporations Act 1993*, must be used to inform shareholding Ministers of:

- the level of new and outstanding transactions undertaken, including details of any realised or unrealised gains or losses, and
- the corporation's exposure to individual counterparties.

# 12.0 Attachment – pro forma derivative transaction report

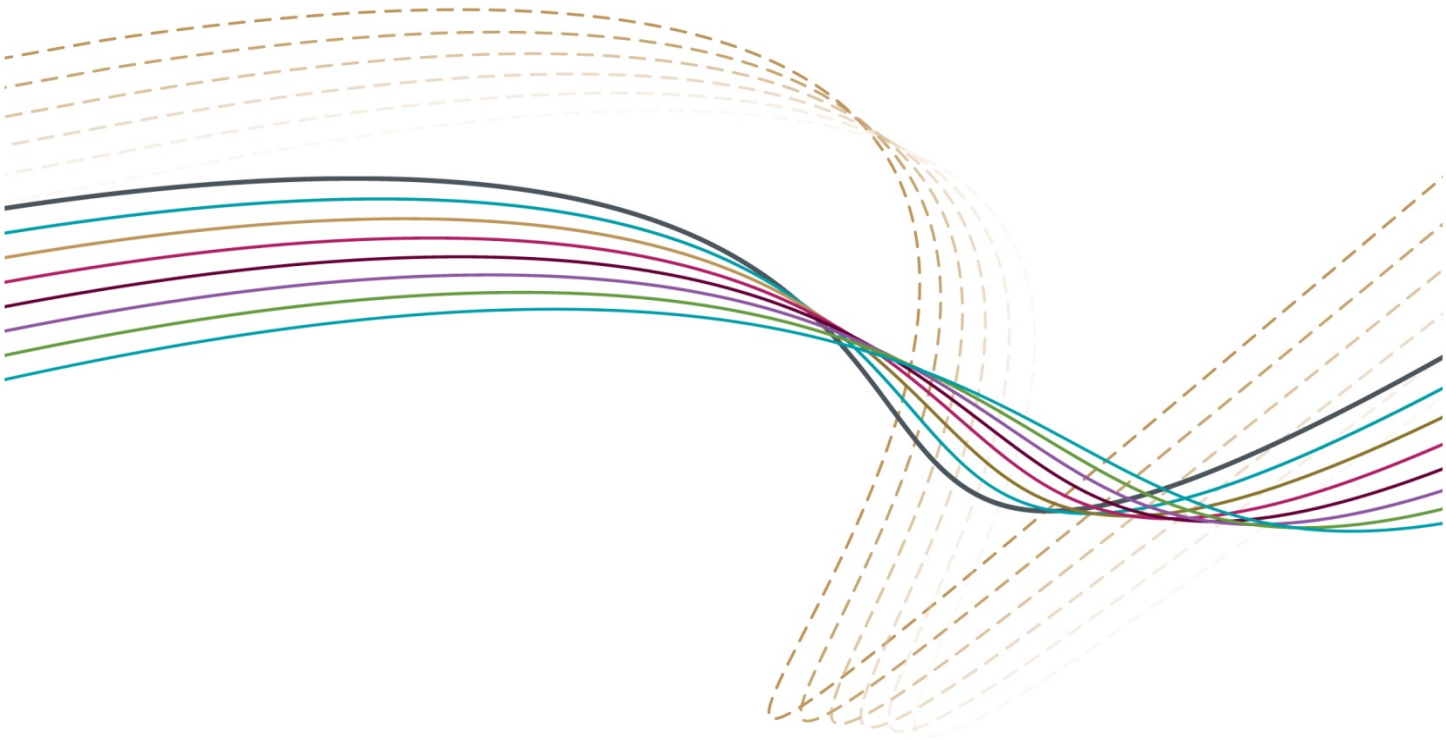
| Brief description of underlying exposure | Maturity date of underlying exposure | Value of underlying exposure | Amount of underlying exposure being hedged | Type of hedging instrument (e.g. future, forward agreement, option, swap) | Date derivative transaction is entered into (trade date) | Mark to market amount (unrealised gains or losses) | Maturity date of derivative transaction | Gains or loses realised at maturity or derivative transaction close out date |
|---|---|---|---|---|---|---|---|---|
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |

The derivative transactions outlined above have complied with the conditions as set out in the Treasurer's approval.

Signed: _____ Position: _____ Date: _____

Notes:

1. This template may be used for all types of derivative transactions (i.e. foreign exchange, commodity and interest rate).
2. Each derivative transaction entered into by the agency is to be listed separately.



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