NSW GOVERNMENT | Treasury

June 2018

TPP

18-03

Policy and Guidelines Paper

NSW Government Foreign Exchange Risk Policy

Replaced by TPP21-14

1 Preface

NSW Treasury (Treasury) has prepared the NSW Government Foreign Exchange (FX) Risk Policy (the Policy) to assist General Government Sector Agencies and Government Businesses (together, known as "Government Entities") to manage their FX risk. FX risk can arise from exposure to foreign currencies when Government Entities purchase, sell, or intend to purchase or sell goods and services either directly from/to overseas, or indirectly through domestic providers.

The Policy sets out the core requirements and relevant guidance for Government Entities to manage FX risk exposures, including those exposures arising before or after committing to a sale, purchase, or certain other government transactions.

The Policy is designed to improve project cost certainty and provide a cost-efficient arrangement for managing FX risk. It also provides a level of flexibility when Government Entities determine appropriate strategies to manage the identified risk.

In supporting the State's focus on financial risk management, the Policy ensures that FX risk is managed transparently, consistently and at the lowest cost and/or risk to the State. This Policy is the first in a series of updates to Treasury's risk management framework, which will be developed to promote the consideration, identification and management of a broad range of financial risks that Government Entities and the State are subject to (e.g. commodity risk, interest rate risk).

The Policy applies to all Government Entities, other than where FX exposures are part of a Government Entity's approved investment strategy within the scope of its investment powers.

In 2013 Treasury committed to the Financial Management Transformation (FMT) program to improve financial governance across the NSW public sector. One pillar of the FMT program is the development of new financial legislation establishing a single framework for public sector financial management, namely the Government Sector Finance Bill 2018 (NSW) (the GSF Bill).

This Policy applies to Government Entities as at 1 July 2018, however, we note the intended introduction of the GSF Bill in the near future. In this regard, while it is intended that the objective and substance of the Policy will remain the same, Treasury will review the Policy to ensure consistency with the terminology used and relevant requirements set out in the GSF Bill if it is passed at Parliament and subsequently enacted.

This Policy replaces and supersedes the FX risk policy contained in the Treasury Management Policy (TPP07-7), taking effect from 1 July 2018.

Replaced by TPP21-14

Michael Pratt AM
NSW Treasury Secretary
June 2018

Note
General inquiries concerning this document should be initially directed to:
Strategic Balance Sheet Management, NSW Treasury sbsm@treasury.nsw.gov.au.
This publication can be accessed from the Treasury's website www.treasury.nsw.gov.au.

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3 Executive Summary

3.1 FX risk, if not identified and managed appropriately, can have significant financial impacts for Government Entities and the State as a whole. These impacts mostly flow from the sale or purchase of international goods or services due to the inherent volatility of FX markets.

3.2 Identifying FX risk will improve the whole-of-State visibility of FX risk and provide an ability to manage it appropriately. It will also help improve cost certainty for government spending.

3.3 In turn, managing FX risk helps reduce the risk that Government Entities may have to either reprioritise spending or forgo spending altogether driven by FX movements and costs being higher than budgeted. It also reduces the State's unmitigated FX risk and related cost.

3.4 The Policy sets out core requirements for Government Entities to manage their FX exposures in business-as-usual transactions, the procurement of major projects, and any other transactions. The Policy applies to all Government Entities, other than where FX exposures are part of a Government Entity's approved investment strategy within the scope of its investment powers.

3.5 The Policy is designed to promote Government Entities' consideration of FX risk, identification of FX risk, and to provide the information, contacts and advice to enable informed FX risk management decisions.

3.6 The Policy does not support speculative behaviour when considering FX risk. Likewise, it is not responsible financial management to leave an FX exposure unhedged in the expectation or hope of a favourable outcome or gain from an unhedged FX position.

3.7 This Policy replaces and supersedes the FX risk policy contained in the Treasury Management Policy (TPP07/7).

Scope of application

3.8 The Policy applies to all Government Entities when they:

a. buy or sell goods or services in foreign currency

b. buy or sell goods that are ultimately sourced from overseas or foreign companies

c. have other income, expenses, assets or liabilities that are in, or affected by, foreign currencies

3.9 Policy requirements do not apply to a Government Entity's approved investment strategy within the scope of its investment powers.

3.10 The Policy has been structured in two (2) parts. Part 1 outlines two core requirements:

Core requirement 1:	Government Entities are required to manage their FX risks in accordance with this Policy, and/or in consultation with Treasury and the New South Wales Treasury Corporation (TCorp) as appropriate.
Core requirement 2:	Government Entities are required to manage their FX risks once identified. This may include hedging the identified risk exposure, and/or presenting a risk management plan if seeking Government's approval for procurement proposals.

3.11 These two core requirements improve upon the previous policy through:

a. providing specialist support to Government Entities

b. improving policy clarity

c. introducing new requirements for managing contingent FX risk (e.g. an FX risk may occur prior to making a commitment to complete a purchase or sale but where a spending approval is obtained)

d. addressing embedded FX risk (i.e. an FX risk may arise from making a commitment denominated in A$ where goods and services are sourced outside of Australia)

e. promoting Government's centralised FX exposure oversight.

3.12 Part 2 provides guidance to Government Entities on managing their FX exposures with TCorp's support.

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4 Definitions

A$ means Australian Dollars.

Commitment refers to when a Government Entity completes a sale, purchase, or other government transaction (through contract or otherwise), either denominated in a foreign currency or A$, where goods and services are sourced outside of Australia.

Contingent Risk means the FX risk arising prior to making a Commitment but where a spending approval is obtained.

Contracted Risk means the FX risk arising from known exposure amount after making a Commitment.

Embedded Risk means the FX risk arising from making a Commitment denominated in A$, and/or spending expected to continue to occur over future years, where goods and services are sourced outside of Australia.

Foreign Exchange Risk (also known as FX risk) is the financial risk of a change in value due to changes in currency exchange rates.

Government Entity is a General Government Sector agency or a government business. Government businesses consist of, but are not limited to:

- State Owned Corporations
- Government entities within the Total State Sector Accounts classified as public financial corporations
- Corporations Act 2001 companies where the Treasurer is a designated shareholder.

Hedging is a form of risk management strategy used to limit or offset the probability of loss from fluctuations in prices (e.g. currencies or commodities).

Natural Hedge is a reduction of risk that may be identified through matching opposite risk exposures against each other. For example, Treasury may be able to identify that an exposure to US$ sales in one Government Entity is offset by an exposure to US$ expenses in another Government Entity within a similar timeframe.

Substantial Risk is a risk considered to be substantial by Treasury and TCorp based on a range of factors, namely, size and nature of the exposure, duration and size of the procurement, frequency of the risk occurrence, timing and level of volatility of the foreign currency/ies to A$.

TCorp Execution Framework is the framework which provides guidance to Government Entities in relation to identifying and hedging FX risk in accordance with the Policy.

Translation Risk is the balance sheet exchange rate risk which is measured by the exposure of underlying goods or services to exchange rate movements.

Threshold is the face value of A$500,000 equivalent, or as otherwise agreed by Treasury.

Transactional Banking Platform is part of NSW State Government's Corporate Online banking system. It is used by Government Entities to access online banking services and provides a platform for the Crown to make payments to Government Entities.

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5 Core Requirements

Key points

- The Policy sets out requirements for managing Contingent Risk for major procurements, and refines the process for selling or procuring international goods and services and receiving government income.
- Government Entities are required to manage their FX risks in consultation with Treasury and TCorp. This consultation requirement ensures that Government Entities obtain specialist support for managing their FX exposures, and achieve the best value for them and the State. It also provides visibility of FX risk across the State.
- Government Entities are required to manage their FX risks once identified. Meeting this requirement provides opportunities to minimise unexpected changes to cash flows and achieve project cost certainty, before or after making a commitment to complete a sale, purchase, or other government transaction (through contract or otherwise), either denominated in a foreign currency or A$, where goods and services are sourced outside of Australia.
- Government Entities should refer to the TCorp Execution Framework for further detail on the FX execution process.
- The Policy applies to all Government Entities, other than where FX exposures are part of a Government Entity's approved investment strategy within the scope of its investment powers.

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Core requirement 1 – Government Entities are required to manage their FX risks in accordance with this Policy, and/or in consultation with Treasury and TCorp as appropriate.

5.1 Government Entities should consult with Treasury and TCorp when they are directly and/or indirectly affected by foreign currency movements. For example, a Government Entity may have an indirect FX exposure arising from having an A$ priced contract with an overseas supplier (**Embedded Risk**). The cost of such contracts may include an embedded or hidden premium from the supplier.

5.2 Where an FX exposure may occur prior to making a Commitment (**Contingent Risk**), Government Entities should consult with Treasury and TCorp to determine whether it is a **Substantial Risk**, based on the following factors:

a. size and nature of the exposure (e.g. which currencies are involved)

b. duration and size of the procurement

c. frequency of the risk occurrence (e.g. monthly, annually or one-off)

d. timing

e. level of volatility of the foreign currency/ies to A$.

5.3 Government Entities may wish to develop, or should revise, their own internal policies and procedures to align with the core requirements of the Policy. It will assist them in identifying FX risks on a timely basis as they emerge.

Core requirement 2 – Government Entities are required to manage their FX risks once identified. This may include hedging the identified risk exposure, and/or presenting a risk management plan if seeking Government's approval for procurement proposals.

5.4 For a **Contracted Risk above the Threshold (currently A$500,000 equivalent or as otherwise agreed by Treasury),** Government Entities must hedge the identified Contracted Risk (unless advised otherwise by Treasury), no later than three (3) business days after making a Commitment. Treasury may review and update the specified level of the Threshold periodically.

5.5 For a **Contracted Risk below the Threshold**, Government Entities should transact through the Transactional Banking Platform, or State Owned Corporations through their approved banking platform.

5.6 For **Contingent Risk** deemed to be a **Substantial Risk** (in consultation with Treasury and TCorp) and certain **Translation Risks** above the Threshold, a 'FX risk management plan' will be required (see Box 1) as soon as the risk is identified. Government Entities must develop and update (where needed) an FX risk management plan through consultation with TCorp and Treasury.

a. If seeking Government's approval for procurement proposals, Government Entities are required to present and update (where needed) this FX risk management plan as part of the government submission with supporting sign-off from TCorp and Treasury.

5.7 For **Contingent Risk** not deemed to be a **Substantial Risk**, there is no requirement to develop an FX risk management plan or undertake FX hedging (noting this should be re-assessed where certain changes occur, e.g. increased probability, increased size, or it becomes a **Contracted Risk** greater than the Threshold).

5.8 For expected **Embedded Risk above the Threshold**, Government Entities should obtain different quotes (if possible) to achieve the most cost competitive outcome. This involves obtaining two different quotes with one in A$ from the supplier, and one in foreign currency from the supplier coupled with an FX hedge quote from TCorp.

5.9 For **Translation Risk above the Threshold**, Government Entities are required to develop an FX risk management plan in consultation with TCorp and Treasury as soon as they become aware of this risk.

Box 1:

An FX risk management plan should contain the following key elements:

- identification of FX exposure (e.g. size and nature) impacting Government Entities and/or the State, based on the information available
- where an FX risk is identified and Treasury/TCorp are consulted, outline of the resulting FX Risk Management Strategy covering:
  - objective: fully or partially hedge or identify a rationale for no hedging (e.g. where a Natural Hedge exists)
  - hedging instruments (if applicable): limits and controls on size of exposures
  - execution process: internal/external expertise and costs
  - monitoring measures: benchmarks of measuring the performance; assessing the appropriateness of hedging instruments; monitoring the amount of risk exposures; and hedge accounting effectiveness if applicable
  - ownership: identification of the appropriate entity for responsibility and ownership of risk, and entering into a hedging transaction
  - accounting impacts: any accounting impact of FX transactions
- whether Government Entity has appropriate approval for undertaking FX risk management activities under the *Public Authorities (Financial Arrangements) Act 1987*
- whether the resulting FX Risk Management Strategy is endorsed by Treasury and TCorp, with a list of Treasury and TCorp stakeholders that have been consulted.

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6 Guidance on FX Risk Management

Key points

- Government Entities should engage with TCorp when an FX exposure may arise from business-as-usual transactions, the procurement of major projects, and any other transactions. TCorp Execution Framework provides step-by-step guidance on identification and management of FX exposures.
- Government Entities are required to comply with the Policy when managing their FX exposures. Any FX policy established at the entity level should be consistent with the Policy.
- Government Entities are required to provide an FX Attestation Statement for the prior financial year to Treasury, indicating whether the Entity was 'compliant', 'non-compliant' or 'in transition'. As the effective date of this Policy is 1 July 2018, the first FX Attestation Statement will be for the 2018-2019 financial year.
- Government Entities have a transitional period of twelve (12) months to comply with the two core requirements under the Policy. Government Entities should engage with Treasury while they take steps to achieve their compliance with these requirements.

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TCorp Foreign Exchange Execution Framework

6.1 TCorp provides specialist support to Government Entities in identifying and managing FX risks. The TCorp Execution Framework provides step-by-step guidance to Government Entities in accordance with the Policy (Appendix A provides a process summary).

6.2 Implementing the TCorp Execution Framework provides opportunities for cost savings and obtaining the best value through:

a. accessing preferential pricing based on State's credit rating, and TCorp's relationships with multiple service providers and its collateral management procedures

b. executing FX transactions directly with TCorp's panel of service providers

c. supporting and executing (where appropriate) FX transactions below the Threshold

d. TCorp not charging fees for executing FX transactions.

6.3 Government Entities may undertake hedging activities or other FX risk management activities with their funds managers, in accordance with the written approval of the Treasurer per section 16 or section 25 of the *Public Authorities (Financial Arrangements) Act 1987* (PAFA Act).

Reporting and Compliance

6.4 Government Entities are required to comply with the Policy when managing their FX exposures. Any FX risk policy established at the entity level should be consistent with the Policy. Any policy breaches are to be reported to the Government Entity's management and Treasury as soon as identified, along with an explanation on the basis of "if not, why not" and proposed remedial actions.

6.5 This Policy requires each Government Entity to produce to Treasury an FX Attestation Statement for the prior financial year indicating whether the Entity was 'compliant', 'non-compliant' or 'in transition' by 31 October each year. A copy of the FX Attestation Statement template is provided in Appendix B. The FX Attestation Statement will form part of Government Entities' annual internal audit and risk management attestation process.

6.6 Government Entities need to monitor and report on their exposures and any hedges in place to Treasury on an annual basis. Government Entities may authorise either TCorp or service provider(s) on TCorp's panel to provide requested information to Treasury to meet their reporting obligations.

6.7 Treasury and TCorp will report to Treasury's Asset and Liability Committee on FX exposures and hedging in place, whether they remain within acceptable limits, and on potential budget and balance sheet implications.

6.8 Government Entities have a transitional period of twelve (12) months to comply with the core requirements under the Policy. Government Entities should engage with Treasury while they take steps to achieve their compliance with these requirements.

6.9 During the transitional period, Government Entities are required to report cases of non-compliance based on their best knowledge (refer Appendix B). These will not be considered as a breach of the Policy, rather identification of an issue or transitional arrangement for future address.

Review of the Policy

6.10 Treasury may review and update the Policy on a periodic basis to ensure the appropriateness of this Policy.

6.11 Separately, Treasury will review the Policy to ensure consistency with the terminology used and relevant requirements if new legislation may require.

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7 Further information and contacts

For further Information or clarification on issues raised in the TPP, please contact:

- NSW Treasury relationship leads, NSW Treasury's Strategic Balance Sheet Management division sbsm@treasury.nsw.gov.au

For accounting related queries, please contact accpol@treasury.nsw.gov.au

For assistance in managing FX exposures, please contact:

- NSW Treasury Corporation relationship leads, NSW Treasury relationship leads, NSW Treasury's Strategic Balance Sheet Management division sbsm@treasury.nsw.gov.au

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8 Appendices

Appendix A – Process Summary Table

Type of FX risk / action required:	Contracted Risk	Contingent Risk	Embedded Risk	Translation Risk
Definition	FX risk arising from known exposure after making a Commitment	FX risk arising prior to making a Commitment but where a spending approval is obtained	FX risk arising from making a Commitment denominated in A$, and/or spending expected to continue over future years, where goods and services are sourced outside of Australia	FX risk arising from balance sheet exchange rate risk which is measured by the exposure of underlying assets and liabilities to exchange rate movements
Is the exposure greater than the Threshold or a Contingent Risk that is deemed to be a Substantial Risk?	**Yes** – Execute hedge pending your PAFA approval limits unless advised otherwise by Treasury **No** – No requirement to hedge	**Call or email TCorp** TCorp will work with you and Treasury to determine whether it is a Substantial Risk. **If deemed a Substantial Risk** – Develop an FX risk management plan through consultation with TCorp and Treasury **If not deemed a Substantial Risk** – No requirement to hedge (noting this will be re-assessed where certain changes occur, e.g. increased probability, increased size, or it becomes a **Contracted Risk** greater than the Threshold)	**Yes** – Obtain different quotes (i.e. in A$ and in foreign currency coupled with an FX hedge quote from TCorp) (where possible) **No** – No requirement to obtain different quotes	**Yes** – Develop an FX risk management plan through consultation with TCorp and Treasury **No** – No requirement to hedge
Without PAFA approval	Contact TCorp	Contact TCorp	Contact TCorp	Contact TCorp
With PAFA approval	Execute through TCorp or TCorp's panel of service providers	Contact TCorp	Execute through TCorp or TCorp's panel of service providers	No further action required

Appendix B – Statement of FX Attestation Template

The Government Entity must use these templates to attest that, for the relevant reporting period, the Entity was either 'compliant', 'non-compliant' or 'in transition' in relation to the core requirements of TPP18-03.

A Government Entity may mark 'in transition' where it is in the process of transitioning its arrangements to meet new or changed requirements of this Policy providing details of such transitional arrangements below. It does not constitute a breach of the core requirements under the Policy if an Entity is making transitional arrangements.

Core requirement 1: Government Entities are required to manage their FX risks in accordance with this Policy, and/or in consultation with Treasury and the New South Wales Treasury Corporation as appropriate.

I, [ ] attest that [Government Entity] is compliant/non-compliant/in transition (delete as appropriate) with Core Requirement 1.

Core requirement 2: Government Entities are required to manage their FX risks once identified. This may include hedging the identified risk exposure, and/or presenting a risk management plan if seeking Government's approval for procurement proposals.

I, [ ] attest that [Government Entity] is compliant/non-compliant/in transition (delete as appropriate) with Core Requirement 2.

Where a Government Entity is non-compliant or in transition to compliance with the Policy TPP18-03, further detail is to be provided below.

	Detail of non-compliance or transitional arrangements
Core requirement 1	
Core requirement 2	

Sign and date

Chief Financial Officer or delegate

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