
GUIDELINES FOR

The Management of Crown and Departmental Foreign-Exchange Exposure

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[Prepared by the Treasury]

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Preface

The Crown's policy on the management of Crown and departmental foreign-exchange exposure is outlined in Treasury Circular 1990/4 of 16 March 1990. This policy requires departments to cover all material foreign-exchange exposures on transactions related to their normal course of business in terms of guidelines approved by the Minister of Finance.

The 'Guidelines for the Management of Crown and Departmental Foreign-Exchange Exposure' were approved by the Minister of Finance in March 1990 and subsequently incorporated into Treasury Instructions.

During 2003, Treasury undertook a review of the guidelines, which highlighted a number of ways in which these could be improved. As a result, the guidelines have been updated and reissued, pursuant to section 80 of the Public Finance Act 1989 (Treasury Instructions).

The key changes from the 1990 version are:

- clarification that Chief Executives are responsible for the identification and management of Crown foreign-exchange exposure for receipts and payments that their department administers (in addition to departmental flows);
- the Transaction Exposure Limit is expressed on a currency basis instead of a transaction basis. The maximum uncovered individual currency exposure has been increased from NZ \$50,000 to NZ \$100,000. There is no maximum amount for aggregated uncovered exposure;
- the list of approved counterparties for foreign-exchange transactions and foreign-currency bank accounts has been replaced with generic credit criteria;
- confirmation that departments are prohibited under the Public Finance Act 1989 from rolling forward an existing foreign-exchange contract at a historic rate; and
- the role of the New Zealand Debt Management Office in foreign-exchange management is included in the supporting schedules.

Departments are requested to review their Foreign-Exchange Policy Document to ensure that their policies and practices comply with the 2003 Guidelines. In some cases, this may necessitate a revision of their policy document (the approval process for this is covered in paragraphs 12 and 13 of this document) and/or changes to their foreign-currency banking arrangements. Departments are asked to discuss any transitional issues with their Treasury Vote Team.

These guidelines replace the guidelines dated March 1990, which are hereby revoked.

Introduction

Background

1. These Guidelines have been drawn up in terms of the decision reached by the Cabinet State Agencies Committee on 24 January 1990 (SAS (90) M 1/3). This decision required each Ministry and Department to produce a 'Foreign-Exchange Policy Document' for the management of their department's transaction exposure, in terms of guidelines approved by the Minister of Finance (Treasury Circular 1990/4 of 16 March 1990).
2. Guidelines for the Management of Departmental Foreign-Exchange Exposure were first issued in March 1990. During 2003, Treasury undertook a review of the guidelines, which highlighted a number of ways in which these could be improved. As a result, the guidelines have been updated and reissued, pursuant to section 80 of the Public Finance Act 1989.

Objectives of the Guidelines

3. These guidelines are intended to assist departments in the preparation of their Foreign-Exchange Policy Document. They set the parameters within which departments are required to manage their Crown and departmental foreign-exchange exposure.

Underlying Principles

4. The guidelines are based on the underlying principles that government should:
 - be risk averse; and
 - minimise foreign-exchange exposure.
5. The Crown has an overall policy of adopting a conservative approach to risk. These guidelines have been developed with the intention of ensuring that the risk faced by the Crown due to transaction and counterparty exposure is minimised.

Application of Guidelines

6. These guidelines apply to the management of **transaction exposure only**, both Crown and departmental.
7. The guidelines are mandatory for all departments to follow unless changes to these guidelines have been agreed by joint ministers (refer to paragraph 12).

Transaction Exposure

8. Transaction exposure is the principal type of foreign-exchange exposure which departments face. It refers to the effect a change in foreign-exchange rates would have on the size of the cash flow in one currency necessary to settle a given cash flow in another currency. The cash flows may be direct or indirect. Direct exposures are identifiable cash flows which require a foreign-exchange transaction to be undertaken e.g. a purchase of goods from overseas. Indirect exposures reveal no explicit requirement but incorporate a hidden foreign-exchange component which may affect pricing and costs e.g. transportation costs associated with the purchase of goods from overseas.

Translation Exposure

9. Translation exposure refers to the effect on period-end financial statements for reports of fluctuations in exchange rates. This exposure arises from translating:
 - i transactions undertaken in a foreign currency into a base currency (New Zealand dollars); and
 - ii the financial statements of foreign sub-entity operation into the base currency of its parent.
10. The recording of transactions and changes in asset and liability values does not usually produce an economic impact on the parent entity, in that no direct cash effect arises. However, financial statements are used for a number of purposes, including performance measurement. In this context, the balance sheets of departments subject to translation exposure will require careful interpretation.
11. Translation exposure is not included within the scope of these guidelines. It is being addressed in the context of implementing the International Financial Reporting Standards in New Zealand.

Approval of Policy Documents

12. The policies designed by each department and any changes to approved policies will require the approval of:
 - i the Secretary to the Treasury and the relevant department's own Chief Executive where they conform with the guidelines; or
 - ii the Minister of Finance and the Responsible Minister where they do not.
13. In both cases the department should seek approval via their Treasury Vote Team. Once a department's policy document has been approved, adherence to it by that department will be mandatory.

Amendments to the Guidelines and Policy Documents

14. The guidelines may be amended from time to time. Any changes will be communicated to all departments. This may necessitate revision of individual policy documents. Equally, departments may wish to alter their policies. The process for obtaining approval to amendments to the policy documents is the same as for new documents.

Contents of the Guidelines

15. The guidelines set out the issues that need to be considered in preparing a Foreign-Exchange Policy Document. They focus on specific policy areas with the intention of ensuring that the risk faced by the Crown due to transaction and counterparty exposure is minimised. In each case, the guideline appears first followed by the policy rationale. There are eight sections:
 - i. Foreign-Exchange Policy Objectives;
 - ii. Foreign-Exchange Exposure Faced by the Department;
 - iii. Accountabilities and Responsibilities;
 - iv. Identification and Timing of Cover;
 - v. Covering Transaction Exposure: Transaction Exposure Limit, Approved Instruments and Historic-Rate Rollovers;
 - vi. Counterparties: Approved Counterparties, Counterparty Exposure Limit and Monitoring Credit and Transaction Exposure Limits;
 - vii. Bank Accounts: Legislative Requirements; and
 - viii. Reporting: Internal and External Requirements.
16. Supporting these guidelines are four schedules:
 - Schedule I: Instruments for the Management of Foreign-Exchange Exposure.
 - Schedule II: The role of the New Zealand Debt Management Office (the NZDMO).
 - Schedule III: Procedure for opening a Foreign-Currency Bank Account.
 - Schedule IV: Outline for a Foreign-Exchange Policy Document.

1. Foreign-Exchange Policy Objectives

Guideline 1

The policy document must state the department's foreign-exchange policy objectives.

17. Each department is required to produce a policy document for the management of their transaction exposure so that this exposure is covered in a systematic way. Chief Executives are responsible for the development and implementation of their department's policies.
18. The policy document must contain the department's policy objectives. Consistent with the Crown's approach to risk, these objectives should include the following:
 - to minimise transaction exposure by covering all material foreign-exchange exposures as soon as they arise, with approved instruments and counterparties;
 - to minimise counterparty exposure by establishing the criteria for acceptable transaction and bank account counterparties and limiting the amount of exposure to any single counterparty; and
 - to ensure that the policies and practices comply with the Public Finance Act 1989 and the Guidelines for the Management of Crown and Departmental Foreign-Exchange Exposure.
19. Departments may also choose to include other objectives relating to how they specifically manage their foreign-currency transactions and/or banking arrangements.

2. Foreign-Exchange Exposure faced by the Department

Guideline 2

The policy document must describe the types of foreign-exchange exposure faced by the department.

20. Transaction exposure is the principal type of foreign-exchange exposure which departments face (refer to paragraph 8 for a definition of this).
21. The scale and type of the foreign-exchange exposure faced by a department will vary depending on the nature of the department's operations. Examples of departments with foreign-exchange exposures and foreign-currency bank accounts include those which:
 - have personnel based overseas;
 - are responsible for administering foreign-currency receipts or payments on behalf of the Crown e.g. pensions, child support; and
 - acquire capital assets from overseas.
22. The policy document must describe the types of foreign-exchange exposure faced by the department.

3. Accountabilities and Responsibilities

Guideline 3

The policy document must list the delegated authorities and key responsibilities for foreign-exchange exposure management within the department.

Policy

23. Chief Executives are accountable for their department's foreign-exchange exposure management. This includes:
- designing and implementing their department's foreign-exchange policy document;
 - identifying and covering their transaction exposure, with approved instruments and counterparties;
 - managing the funding and operation of their foreign-currency bank accounts;
 - monitoring credit and transaction exposure limits; and
 - reporting on all aspects of foreign-exchange exposure as part of their normal financial reporting.
24. Pursuant to section 41 of the State Sector Act 1988, the Chief Executive may delegate any combination of the above responsibilities without limiting his/her responsibility.
25. In the case of extraordinary exposures related to transactions which fall outside the normal course of business (eg, the acquisition of major capital assets), the Minister of Finance may recommend to Cabinet that the associated foreign-currency transaction(s) be managed by the NZDMO (refer to Schedule II for the role of the NZDMO).
26. Treasury is responsible for:
- issuing guidelines for the management of Crown and departmental foreign-exchange exposure;
 - approving departments' foreign-exchange policy documents;
 - approving the opening of Crown and departmental bank accounts and any changes to them thereafter;
 - issuing directions regarding the terms and conditions under which bank accounts may operate;
 - executing foreign-exchange transactions on behalf of departments, where requested by the department; and
 - providing advice to departments (typically at an operational level) on how to manage their transaction exposure.

4. Identification and Timing of Cover

Guideline 4

The policy document must state the point or points at which identification and covering of transaction exposure will occur. Where more than one identification point is stated, the policy should define the circumstances under which each is applicable.

Definition

27. The identification of transaction exposure entails highlighting those cash flows, the New Zealand-dollar value of which could be affected by movements in exchange rates. The cash flows may be direct or indirect (as explained in paragraph 8 of these guidelines).
28. The timing of cover appropriate to each department is dependent on the nature of the department's activities. Departments will prepare budgets based on assumed exchange rates. As there is a delay between the preparation of budgets, the approval of appropriations and the conclusion of contracts, departments could potentially face a material transaction exposure before the contract date.

Policy

29. The point at which a transaction exposure is considered certain to arise is the point at which the exposure should be covered. The latest point at which an exposure may be covered is at the contract stage, when an agreement with a supplier or purchaser has been concluded.
30. In certain circumstances it may be appropriate to cover transaction exposure prior to the contract stage. This may be undertaken at the following points:
 - i. at the budget stage where:
 - a department's budget has been prepared and signed by the Responsible Minister for inclusion in the budget cycle;
 - a financial authority exists; or
 - the Chief Executive has reasonable grounds for believing that the budget (or the relevant portion thereof) will be approved and can specify the currencies, amounts and timing of the foreign-exchange flows involved;
 - ii. or at the appropriation stage where:
 - a department's appropriation and the associated imprest supply has been approved by Cabinet or a Cabinet Committee; and
 - the Chief Executive can specify the currencies, amounts and timing of the foreign-exchange flows required to produce the agreed outputs.

5. Covering Transaction Exposure

A. Transaction Exposure Limit

Guideline 5

The policy document must state the Transaction Exposure Limit for each individual currency. The Transaction Exposure Limit for an individual currency must not exceed NZ \$100,000.

Definition

31. The Transaction Exposure Limit refers to the maximum level of uncovered exposure a department can have to an individual currency expressed as a New Zealand-dollar equivalent. A department's level of net transaction exposure should be checked against this limit daily where transactions occur frequently and at least once a month where transactions are infrequent.
32. A department's net transaction exposure to a currency includes all current (e.g. bank accounts) and future cash inflows and outflows for that currency discounted to a present day equivalent and then aggregated. The New Zealand-dollar equivalent may be obtained by applying the spot exchange rate between the relevant currency and the New Zealand dollar. It is important that only identified cash inflows and outflows are included in the calculation of net transaction exposure (refer to section 4 of this document).

Policy

33. The Transaction Exposure Limit for an individual currency is NZ \$100,000.
34. If the total net transaction exposure for an individual currency is above the Transaction Exposure Limit, it is the responsibility of the department to cover this risk fully using approved instruments and counterparties.

Example

Date	USD Cash Outflow	USD Cash Inflow	Net Exposure (USD)	Present Value (USD)
Bank Account		\$1,200,000	\$1,200,000	\$1,200,000
17-Sep-03	-\$500,000		-\$500,000	-\$499,384
14-Oct-03	-\$3,000,000	\$2,000,000	-\$1,000,000	-\$997,883
17-Nov-03	-\$250,000		-\$250,000	-\$249,203
12-Feb-04		\$300,000	\$300,000	\$298,132
14-Apr-04	-\$100,000		-\$100,000	-\$99,126
15-Jun-04	-\$200,000	\$100,000	-\$100,000	-\$98,844
				Net Transaction Exposure
				NZD Equivalent
				-\$446,307
				-\$769,496

In this example the department has exceeded the Transaction Exposure Limit and therefore needs to buy USD. This could be done by undertaking a forward FX transaction to sell NZD and buy USD 500,000 on the 14th October 2003.

The table below shows the calculation after this transaction has been completed.

Date	USD Cash Outflow	USD Cash Inflow	Net Exposure (USD)	Present Value (USD)
Bank Account		\$1,200,000	\$1,200,000	\$1,200,000
17-Sep-03	-\$500,000		-\$500,000	-\$499,384
14-Oct-03	-\$3,000,000	\$2,500,000	-\$500,000	-\$498,941
17-Nov-03	-\$250,000		-\$250,000	-\$249,203
12-Feb-04		\$300,000	\$300,000	\$298,132
14-Apr-04	-\$100,000		-\$100,000	-\$99,126
15-Jun-04	-\$200,000	\$100,000	-\$100,000	-\$98,844
				Net Transaction Exposure
				\$52,634
				NZD Equivalent
				\$90,748

B. Approved Instruments

Guideline 6

The policy document must identify the instruments which the department may use to cover its transaction exposure, together with any limitations on their use. Such limitations should include:

- i. maximum utilisation of a particular instrument without reference to the Chief Executive;
- ii. specific approval from the Chief Executive required to use a particular instrument; and
- iii. use of particular instruments to cover specified types of transactions.

Definition

35. There are two types of instruments that may be used to cover foreign-exchange exposure:
 - i. Spot Foreign-Exchange Contract – for not more than two-business-day settlement. This is used where a department needs to buy or sell currencies immediately (eg, to pay an invoice).
 - ii. Forward Foreign-Exchange Contract – for settlement at a future date. This is used when a department has identified a foreign-exchange transaction exposure but does not need to buy or sell the cash until a future date (eg, a contract is agreed to purchase goods in six months time in US dollars).
36. An example of each instrument is contained in Schedule I.
37. Note that both instruments will cover the foreign-exchange exposure but differ in the timing of the cash flows. Irrespective of the instrument, the department must ensure that the term of cover entered into matches the term of the related exposure.

Policy

38. Departments may transact only in spot and forward-exchange contracts. Spot and forward-exchange contracts may be executed with the NZDMO or any counterparty that meets the minimum credit rating criteria outlined under Guideline 8.

Term Deposits

39. Pursuant to sections 23 and 65 of the Public Finance Act 1989, departments can place foreign-currency funds on deposit with the NZDMO. This may be appropriate when a department wishes to delay the delivery date of their foreign-currency funds e.g. the department purchases USD 5 million for a given settlement date, but does not require the funds until a future date.
40. The department does not earn interest on the funds that are deposited with the NZDMO. Instead the Crown earns interest from the onward investment of those funds by the NZDMO.
41. The procedures for placing a deposit with the NZDMO are covered under Schedule II of this document.

C. Historic-Rate Rollovers

Guideline 7

The policy document should state that the department is prohibited under the Public Finance Act 1989 from rolling forward an existing foreign-exchange contract at a historic rate.

Definition

42. A historic-rate rollover refers to a situation where an existing foreign-exchange contract is rolled forward using the rate applicable when the original contract was entered into, rather than at the current market rate. The situation generally arises when a department needs to roll out the delivery date because the timing of its foreign-currency requirement has changed. Furthermore, a department may want to roll forward the historic rate because;
- the exchange rate has moved favourably and, therefore, renegotiating at the historic rate means that the department might avoid having to realise a profit for return to the Crown, thereby retaining purchasing ability; or
 - the exchange rate has moved unfavourably and, therefore, renegotiating at the historic rate means that the department may be able to postpone realising a loss.

Policy

43. Departments are prohibited under the Public Finance Act 1989 from rolling over a foreign-exchange contract at an historic rate as, under certain circumstances, it could be equivalent to borrowing from the counterparty.

6. Counterparties

A. Approved Counterparties

Guideline 8

The policy document must identify the counterparties with whom the department may undertake foreign-exchange transactions and/or hold foreign-currency bank accounts. The minimum credit rating for a counterparty is A- / A3 (subject to the exceptions outlined in paragraph 48 of this document). Counterparties that do not meet the criteria may be included only with the prior approval of joint ministers.

Definition

44. A counterparty is a bank with which departments may undertake foreign-exchange transactions and/or hold foreign-currency bank accounts (domiciled in New Zealand or overseas).
45. The NZDMO is also a counterparty for foreign-exchange transactions, including term deposits (refer to Schedule II for dealing with the NZDMO).
46. Credit risk refers to the risk of loss due to the failure of a counterparty to fulfil its financial obligations.

Policy

47. Departments are required to transact and hold bank accounts only with those counterparties whose long-term debt credit rating is A – (as assigned by the Standard and Poor's), or A3 (as assigned by the Moody's Investors Service) or higher. When the counterparty is rated differently by the two agencies, the lower rating prevails. If the counterparty does not have a long-term rating, a minimum short-term rating of A -1 /Prime-1 is required (refer to paragraph 57 of these guidelines on how to check the credit rating of an institution).
48. The two exceptions for foreign-currency bank accounts are:
 - where there are no banks in the country that meet the credit criteria; and
 - where, by government regulation in the host country, the department has to bank with a specific (usually government) bank.
49. The counterparties with which departments may transact or hold foreign-currency bank accounts must be documented in an appendix to their Foreign-Exchange Policy Document. It is important to note that inclusion of a counterparty in a department's policy document does not constitute authority to open a foreign-currency bank account (refer section 7 for further information).
50. Departments are responsible for managing their transaction and banking relationships. In the case of foreign-currency bank accounts, departments should exercise judgement and caution and their own regional knowledge in dealing with overseas banks.

B. Counterparty Exposure Limit

Guideline 9

The policy document must state the Counterparty Exposure Limit for each individual counterparty. The Counterparty Exposure Limit for an individual counterparty must not exceed NZ \$5 million.

Definition

51. The Counterparty Exposure Limit refers to the maximum transaction exposure a department can have to a counterparty, expressed as a New Zealand-dollar equivalent. It is considered an overnight limit and should be checked daily where transactions occur frequently and at least once a month where transactions are infrequent.
52. A department's total net transaction exposure to an individual counterparty includes; foreign-currency bank account balances plus spot transactions plus forward-exchange contracts calculated across all currencies and converted to New Zealand-dollars.

Policy

53. The Counterparty Exposure Limit for an individual counterparty is NZ \$5 million. This limit does not apply when the counterparty is the NZDMO or the Reserve Bank of New Zealand. In these instances, departments may have unlimited exposures.
54. The Counterparty Exposure Limit is set so that credit risk can be managed prudently and credit exposures can be diversified across counterparties where necessary.
55. If the total net transaction exposure to an individual counterparty is above the Counterparty Exposure Limit, it is the responsibility of the department to cover this risk either by reducing the bank account balance or, where possible, negotiating out of an existing arrangement.

C. Monitoring Credit and Exposure Limits

Guideline 10

The policy document must specify how frequently counterparty credit ratings and exposure levels are to be checked. It must state that, where an approved counterparty is subsequently downgraded to a rating that is below the minimum level (A- / A3), the department will be required to cease trading and/or close their bank account with that counterparty, unless joint ministerial approval has been granted to keep the account open.

Policy

56. Departments are responsible for monitoring their counterparty credit ratings and exposure levels and for ensuring compliance with these guidelines and their policy document.
57. Counterparty credit ratings should be checked regularly (i.e. quarterly). This is particularly important where departments have exposures to counterparties at the lower end of the rating scale, i.e. A- / A3. Information on credit ratings can be obtained from the respective rating agencies' websites: www2.standardandpoors.com and www.moodys.com (departments can register with them online, free of charge). Other sources of information include the Reserve Bank of New Zealand's website www.rbnz.govt.nz, which provides credit ratings for registered banks in New Zealand. The NZDMO can also provide assistance where required.
58. Where an approved counterparty is subsequently downgraded to a rating that is below the minimum level (A- / A3), the department will be required to cease trading and/or close their bank account with the counterparty as soon as practicable. Any exceptions to this will require joint ministerial approval and should be sought in writing via the department's Treasury Vote Team.

7. Bank Accounts

Guideline 11

The policy document must comply with the requirements of the banking and investment provisions contained in the Public Finance Act 1989. These include:

- Treasury approval is required to open/ amend or close a bank account;
- a foreign-currency bank account cannot be operated until a Direction for Foreign-Currency Bank Accounts or a Notice of Delegation Regarding Crown Bank Accounts has been received from the Treasury;
- a foreign-currency bank account cannot be overdrawn;
- interest received on a foreign-currency bank account must be returned to the Crown; and
- departments cannot invest any money held in a Crown or departmental bank account.

Legislative Requirements

59. Pursuant to sections 18 and 19 of the PFA 1989, a department must obtain Treasury approval prior to opening a foreign-currency bank account. Approval should not be sought unless the bank account is essential to the efficient conduct of that business and the department has an approved Foreign-Exchange Policy Document in place.
60. Pursuant to section 21 of the PFA 1989, a department cannot operate a bank account until a Direction for Foreign-Currency Bank Account or Notice of Delegation Regarding Crown Bank Account has been received from the Treasury. These documents govern the terms and conditions under which the bank accounts must be operated.
61. Pursuant to section 47 of the PFA 1989, a foreign-currency bank account must not be overdrawn. Any interest earned on a foreign-currency bank account must be returned to the Crown by year-end.
62. Subject to the above, the department is responsible for managing its own banking facilities and establishing appropriate mechanisms for the transfer of funds required to operate its accounts.
63. The procedure for opening a foreign-currency bank account is covered in Schedule III of this document.

8. Reporting

Guideline 12

The policy document must identify the types and frequency of foreign-exchange exposure reports to be produced for internal and external use, and to whom they are to be distributed.

Internal Reporting

64. Departments should produce reports which enable them to manage their transaction exposure consistent with their Foreign-Exchange Policy Document and for periods appropriate to the volume of transactions and/or size of exposure. This is likely to include reports such as:
- i. future cash profile by currency (showing total inflows and outflows and the net flow) together with the opening and projected bank account balance;
 - ii. New Zealand-dollar equivalent exposure by currency and in aggregate compared with the maximum exposure allowed;
 - iii. analysis of transactions (by day and currency) into those recognised at the contract stage, budget stage and the appropriation stage;
 - iv. limits and utilisation by counterparty; and
 - v. exception reports detailing all situations where limits and authorities set out in their policy document were exceeded.

External Reporting

65. In accounting for foreign-exchange transactions, departments should follow the "Accounting Policy Parameters for External Financial Reporting by Departments" (section 4 of the Treasury Instructions) and other relevant standards issued by the Institute of Chartered Accountants of New Zealand, including the principle of hedge accounting to match benefits with costs. In the case of Crown activity managed by the department, reports are to be prepared in accordance with the "Crown Accounting Policies for External Financial Reporting" (section 3 of the Treasury Instructions).
66. Beyond meeting normal external reporting requirements (half-year and annual financial statements), departments are required to provide the Treasury with any other information it may seek from time to time pursuant to section 79 of the PFA 1989.

SCHEDULE I: Instruments for the Management of Foreign-Exchange Exposure

Spot Foreign-Exchange Contract

- An exchange rate is the value of one currency expressed in terms of another currency.
- The spot value refers to the exchange rate where settlement will be made not more than two business days from the contract date (today).

Quoting Spots

- An example of a spot quote is NZD / USD 0.5650.
- This means that 1 NZD = 0.5650 USD.

Forward Foreign-Exchange Contract

- A forward exchange rate (FWD) is a rate agreed today at which one currency is sold/bought against another for delivery on a specified future date.

Calculating Forwards

- The forward price of a currency is not a forecast of where the value of that currency will be, or is expected to be, at a given future date.
- Instead, it is a reflection of interest-rate differentials between countries/currencies.

Example:

A hypothetical example of the calculation of a forward exchange rate follows:

- Assumptions
- US \$600,000 payment to be made in six months' time
 - Spot exchange rate is NZ \$1 = US \$0.55
 - NZ interest rate is 6% per annum
 - US interest rate is 1.5% per annum

The forward rate would be calculated as follows:

$$0.55 \times \frac{(1 + \frac{0.015}{2})}{(1 + \frac{0.06}{2})} = 0.5380$$

Suppose a department needs to pay US \$600,000 for computer equipment in six months' time. The department has two options:

- i. It can borrow NZ \$1,082,758.88 now and sell that amount now at the spot rate of 0.55 to buy US \$595,533.50. The USD can then be invested at 1.5% for six months to give US \$600,000 on the payment date. The company would then have to pay back NZ \$1,115,241.65 (NZ \$1,082,758.88 borrowed @ 6% for six months); or
- ii. The department can transact now at a FX forward rate of 0.538 to sell NZ \$1,115,241.65 to buy US \$600,000 in six months time.

The economics of both options are the same. The benefit of option 2 is that it is a simpler solution because there are fewer transactions involved.

SCHEDULE II: The Role of the New Zealand Debt Management Office

The NZDMO is responsible for managing substantial financial risks in the Crown's balance sheet, including foreign-exchange exposures. The NZDMO is active in the foreign-exchange market on a daily basis and has staff experienced in dealing with foreign-exchange exposures. This expertise can be used by departments in the following ways:

- i. Departments can deal directly with the NZDMO for their foreign-exchange requirements. The advantages of using NZDMO vis-a-vis another counterparty are:
 - a) *Competitive Pricing for the Crown* - because the NZDMO is very active in the financial markets, it is able to achieve wholesale pricing when hedging small and large exposures.
 - b) *Cost savings from netting off exposures amongst departments* - by netting off some exposures, the NZDMO can efficiently manage the Crown's foreign-exchange risk without the need to hedge with an external counterparty.
 - c) *Better management of credit and operational risk* - this is achieved by minimising the number of transactions that occur with counterparties outside the Crown.
- ii. The NZDMO is available to provide advice to departments (typically at an operational level) on how best to cover their transaction exposure.

Procedure for foreign-exchange transactions

1. Transactions may be executed by phoning authorised NZDMO personnel. The following details will be required:
 - purchase currency and amount;
 - sale currency;
 - required settlement date; and
 - bank account details for paying and receiving funds.
2. The NZDMO will give the department a foreign-exchange rate for the transaction and, if this is acceptable, the deal will be completed over the phone.

3. The transaction will then be confirmed in writing to the department. The confirmation will include:
 - trade date;
 - currency and amount purchased;
 - currency and amount sold;
 - exchange rate;
 - settlement date; and
 - bank account details for both payment and receipt of funds.
4. Departments are required to return a separate confirmation to the NZDMO.

Procedure for foreign-currency deposits

1. Transactions may be executed by phoning authorised NZDMO personnel. The following details will be required:
 - currency and amount;
 - settlement date i.e. deposit date; and
 - maturity date.
2. The transaction will be recorded @ 0% deposit rate. The NZDMO will invest the funds in the market place to ensure the Crown generates a return.
3. The transaction will be confirmed in writing to the department. The confirmation will include:
 - trade date;
 - currency and amount deposited;
 - @ 0% deposit rate;
 - settlement date;
 - maturity date; and
 - NZDMO's bank account details.
4. Departments are required to return a separate confirmation to the NZDMO.

SCHEDULE III: Procedure for Opening a Foreign-Currency Bank Account

1. Pursuant to sections 18 and 19 of the PFA 1989, the Manager of the Budget and Macroeconomic Branch (BMB) of Treasury has delegated authority to approve the opening of Crown and departmental bank accounts.
2. Pursuant to section 21 of the PFA 1989, foreign-currency bank accounts may only be operated under the terms of a Direction for Foreign-Currency Departmental Bank Accounts or a Notice of Delegation Regarding Crown Bank Accounts issued by the Treasury.
3. The department must apply in writing to their Treasury Vote Team to open a foreign-currency bank account. The application should include:
 - whether a Crown or departmental account is required;
 - the business justification for the bank account;
 - the currency and required exposure limit;
 - the bank and location at which the account is to be opened;
 - the credit rating of the bank;
 - whether the account is to be interest-bearing; and
 - the names or job titles of the authorised signatories.
4. The Vote Team will consider the application in terms of the business justification and Treasury's minimum credit criteria (A- / A3)¹ [subject to the exceptions outlined in paragraph 48 of these guidelines]. They will advise BMB whether or not they are in support of the department's application.
5. If the Vote Team is in support of the application, BMB will process the request and issue a Direction or Delegation to the department to operate the bank account. In the event that the Vote Team declines the application e.g where the bank does not meet Treasury's credit criteria and there is an alternative bank available which does, the department will require joint ministerial approval should they wish to proceed with their application.
6. Once a bank account has been approved by Treasury and the appropriate Direction or Delegation issued, the department will need to update their list of approved counterparties in their Foreign-Exchange Policy Document.

¹ Credit rating assigned by Standard and Poor's and Moody's respectively. When the institution is rated differently by the two agencies, the lower rating prevails.

7. Any proposed changes to a department's banking arrangements must also be approved by their Treasury Vote Team. The application must be made in writing and state:

- what the required change is;
- the reason for the change, including any supporting documentation; and
- where the request is to close a bank account, confirmation that the account has been reconciled to a zero balance and that no transactions are outstanding.

SCHEDULE IV: Outline for a Foreign-Exchange Policy Document

Introduction

1. In preparing a policy document for the management of foreign-exchange transaction exposure, departments may wish to use the following outline of contents:

Standing of this policy

2. This policy document has been drawn up in terms of the decision reached by the Cabinet State Agencies Committee on 24 January 1990. This decision required each Ministry and Department to produce a Foreign-Exchange Policy Document for the management of their department's transaction exposure (both Crown and departmental cashflows).
3. These policies have been agreed between the Secretary to the Treasury and the Chief Executive (or where applicable joint Ministers) and are binding on the department. The Chief Executive is charged with the responsibility of ensuring that the department operates within the provisions of these policies. Changes to, or deviations from, these policies may only be made by agreement between the Secretary to the Treasury and the Chief Executive, where they conform with the 'Guidelines for the Management of Departmental Foreign-Exchange Exposure (November 2003); or the Minister of Finance and the Responsible Minister where they do not. This policy document is subject to the provisions of the Public Finance Act 1989 and Treasury Instructions.

Foreign-Exchange Objectives

<p>Guideline 1</p>

<p>The policy document must state the department's foreign-exchange policy objectives.</p>

4. The objective is to ensure that the risk faced by the department due to transaction and counterparty exposure is minimised. The department will act to minimise this risk by entering into transactions to cover all material foreign-exchange transaction exposures created in the normal course of their business. This will be achieved by identifying and covering transaction exposures on a timely basis and limiting exposure to any single financial institution (refer to page 6 of the guidelines for examples).

Foreign-Exchange Exposure Faced by the Department

Guideline 2

The policy document must describe the types of foreign-exchange exposure faced by the department.

Accountabilities and Responsibilities

Guideline 3

The policy document must list the delegated authorities and key responsibilities for foreign-exchange exposure management within the department.

5. Organisation Chart – departments should include an outline of the department's structure with an emphasis on the reporting lines between the foreign-exchange function and the rest of the department.
6. Key Responsibilities - departments should include here a list of responsibilities and the hierarchy of authorities, which will apply within the department.
7. Segregation of Duties – departments should demonstrate there is an appropriate standard of controls and segregation of duties.

Identification and Timing of Cover

Guideline 4

The policy document must state the point or points at which identification and covering of transaction exposure will occur. Where more than one identification point is stated, the policy should define the circumstances under which each is applicable.

Covering Transaction Exposure

A. *Transaction Exposure Limit*

Guideline 5

The policy document must state the Transaction Exposure Limit for each individual currency. The Transaction Exposure Limit for an individual currency must not exceed NZ \$100,000.

B. Approved Instruments

Guideline 6

The policy document must identify the instruments which the department may use to cover its transaction exposure, together with any limitations on their use. Such limitations should include:

- i. maximum utilisation of a particular instrument without reference to the Chief Executive;
- ii. specific approval from the Chief Executive required to use a particular instrument; and
- iii. use of particular instruments to cover specified types of transactions.

C. Historic-Rate Rollovers

Guideline 7

The policy document should state that the department is prohibited under the Public Finance Act 1989 from rolling forward an existing foreign-exchange contract at a historic rate.

Counterparties

A. Approved Counterparties

Guideline 8

The policy document must identify the counterparties with whom the department may undertake foreign-exchange transactions and/or hold foreign-currency bank accounts. The minimum credit rating for a counterparty is A- / A3 (subject to the exceptions outlined in paragraph 48 of this document). Counterparties that do not meet the criteria may be included only with the prior approval of joint ministers.

8. It should be stated that departments are required to transact and hold bank accounts only with those counterparties whose long-term debt credit rating is A – (as assigned by the Standard and Poor's), or A3 (as assigned by the Moody's Investor's service) or higher. When the counterparty is rated differently by the two agencies, the lower rating prevails. If the counterparty does not have a long-term rating, a minimum short-term rating of A -1 / Prime-1 is required.
9. The counterparties with which departments may transact or hold foreign-currency bank accounts should be documented in an appendix to their Foreign-Exchange Policy Document, together with any conditions of use.

B. Counterparty Exposure Limit

Guideline 9

The policy document must state the Counterparty Exposure Limit for each individual counterparty. The Counterparty Exposure Limit for an individual counterparty must not exceed NZ \$5 million.

C. Monitoring Credit and Exposure Limits

Guideline 10

The policy document must specify how frequently counterparty credit ratings and exposure levels are to be checked. It must state that, where an approved counterparty is subsequently downgraded to a rating that is below the minimum level (A- / A3), the department will be required to cease trading and/or close their bank account with that counterparty, unless joint ministerial approval has been granted to keep the account open.

Bank Accounts

Guideline 11

The policy document must comply with the requirements of the banking and investment provisions contained in the Public Finance Act 1989. These include:

- Treasury approval is required to open/ amend or close a bank account;**
- a foreign-currency bank account cannot be operated until a Direction for Foreign-Currency Bank Accounts or a Notice of Delegation Regarding Crown Bank Accounts has been received from the Treasury;**
- a foreign-currency bank account cannot be overdrawn;**
- interest received on a foreign-currency bank account must be returned to the Crown; and**
- departments cannot invest any money held in a Crown or a departmental bank account.**

External Delegations

10. Foreign-currency bank accounts may be opened under the terms of a Direction for Foreign-currency Departmental Bank Accounts or a Notice of Delegation Regarding Crown Bank Accounts (section 21 PFA 1989) issued by the Treasury.
11. The department will comply with any terms and conditions set by the Treasury or the Minister of Finance for the operation of these bank accounts.

Internal Authorities

12. Subject to any terms and conditions set by the Treasury, the department's procedures for domestic bank accounts shall also apply to foreign-currency bank accounts. Two signatories are required to authorise a payment from a bank account.
13. The department may not overdraw any of its bank accounts nor may the department invest surplus funds (including an interest-bearing account) except in accordance with a specific delegation given by the Treasury. Any interest received constitutes Crown money and must be remitted to the Crown by year end.
14. The department will limit the funding of its foreign-currency bank accounts to the level necessary to settle transactions in the normal course of business.

Monitoring of Relationships

15. The department will monitor the operation of its bank accounts and banking relationships in general to ensure their satisfactory operation.

Reporting

Guideline 12

The policy document must identify the types and frequency of foreign-exchange exposure reports to be produced for internal and external use, and to whom they are to be distributed.

Procedure for Amending Policy Document

16. The department may apply for approval to amend its policy document at any time. In general, approval by joint Chief Executives will be required to make amendments to the policy document. However, if the proposed amendment is outside the parameters set out in the guidelines, approval from the Minister of Finance and the Responsible Minister will be required.