Treasury Circular 1990/4

Chief Executives
Directors of Finance/Chief Accountants

CC: All Treasury Managers, and Vote Analysts

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MANAGEMENT OF DEPARTMENTAL FOREIGN EXCHANGE EXPOSURE

Introduction

1 The purpose of this circular is to set out the background to recent Government decisions on the management of departmental foreign exchange exposure, and to foreshadow events planned to help implement this policy. These decisions reflect the Crown's policy on risk aversion, under which departments will be required to cover all material foreign exchange exposures on transactions related to their normal course of business.

2 In particular, at its meetings on 24 January and 14 March 1990, the Cabinet State Agencies Committee:

a agreed that Chief Executives be responsible for:

- i identifying their transaction exposure;
- ii designing policies to cover their transaction exposure, within a set of guidelines, the resulting policy documents to be approved by:
    - the Secretary to the Treasury and relevant Chief Executive where the policies conform with the guidelines; or
    - the Minister of Finance and Responsible Minister where the policies do not conform with the guidelines;

iii covering their transaction exposure with approved financial institutions as specified in the guidelines, within the agreed policy; and

iv designing and executing their foreign currency banking arrangements and associated banking functions;

b authorised departmental officials to proceed with implementing the recommendation on departmental transaction exposure management;

c agreed that departments receiving Mode B or C appropriations as at 1 July 1990 be required to have approved exposure-covering policies by 1 October 1990;

d agreed that departments receiving Mode A appropriations at 1 July 1990 be required to have approved exposure-covering policies before they may receive Mode B or C appropriations; and

e noted that departments face translation exposure and that this must be taken into account when assessing the performance of departments and Chief Executives.

3 The remainder of this circular discusses the types of foreign exchange exposure that departments face; describes the system of foreign currency payments and receipts operating until recently; explains why this system is no longer appropriate; provides an overview of the Government's new policy on foreign exchange exposure; and outlines the associated implementation process.

Types of Exposure

4 There are three types of foreign exchange exposure:

- transaction exposure;
- translation exposure; and
- competitive exposure.

The policy approved by the Cabinet State Agencies Committee relates to the management of transaction exposure only.

5 Transaction exposure is the principal type of foreign exchange exposure which departments experience. It arises from future direct or indirect payments or receipts which require actual conversion in foreign exchange markets. For example, a

department purchasing supplies from the United States may have agreed a price in US dollars. If payment is not due for three months, the New Zealand-dollar cost could change due to fluctuations in the exchange rate. Because appropriations are set in New Zealand dollars, departments may face an unexpected loss or gain.

6 Foreign exchange movements also have an impact on financial statements - for example, where a department owns assets denominated in foreign currencies. This impact is referred to as translation exposure. While translation exposure would not normally require active management, it must be taken into account when using financial statements for the purposes performance measurement. The annex to this circular contains further comments on this category of exposure.

7 The third type of foreign exchange exposure is competitive exposure. This is the risk of a business losing competitiveness due to exchange rate movements favouring competitors. This exposure is difficult to quantify and is not discussed further.

The Current System

8 Although a number of departments make payments and collect receipts denominated in foreign currencies, most have not managed their foreign exchange exposure. In fact, departments must currently obtain the Treasury's approval to do so. The majority of overseas payments and receipts have been handled by the overseas imprest system operated by the Ministry of External Relations and Trade (MERT). This system is being withdrawn.

9 A brief summary of the overseas imprest system follows:

- departments authorise MERT to make foreign currency payments on their behalf and forward invoices to the Ministry;

- MERT pays the invoices and requests reimbursement, in foreign currency, from the Treasury;

- the Treasury reviews reconciliations of imprest accounts, and forwards foreign currency (usually via the Reserve Bank) to reimburse the MERT post at which payment was made;

- MERT allocates the payment to the originating department. This is done through the SIGMA system in the case of Mode A departments, while other departments and organisations are invoiced. This allocation or invoice is expressed in New

Zealand dollars and calculated at the exchange rate prevailing on the day the purchaser's foreign exchange invoice was paid by MERT. Departments become aware of the impact of exchange rate movements on the New Zealand-dollar cost only at this point.

10 There are a number of problems with the current policy and in particular with the overseas imprest system. The main shortcomings are that no one is directly responsible for managing transaction exposures and that, in any event, no information is available for this purpose. The arrangements are also administratively cumbersome. All these problems are linked. The overseas imprest system was designed at a time when exchange rates were fixed. Its purpose was to make foreign exchange payments and to collect overseas receipts. It was not designed to provide details on transaction exposure as there was no demand for this information when the system was established.

11 The overseas imprest system is also costly, particularly for small payments, and involves unnecessary duplication and delay. Departments have no influence over the timing of their payments and therefore over the exchange rate they receive. Nor do they have the ability to negotiate favourable rates for large transactions. Some departments do, however, elect on occasion to pay invoices early or late in the expectation of more favourable rates. By assuming that the exchange rate will move in a certain direction, these departments are effectively speculating on the currency.

12 In his annual reports to Parliament in 1985 and 1988, the Auditor-General stated that departments, and hence the taxpayer, were exposed to direct and indirect foreign exchange risks that were not being managed effectively. The Foreign Affairs and Defence Select Committee expressed interest in what action the former Ministry of Foreign Affairs was taking to manage these risks, and the Resource Management Review of Defence suggested the need for better management of the currency exposure of the Ministry of Defence.

13 Recent financial management reforms have also highlighted the need to revise current policies and practices in respect of foreign exchange. The Public Finance Act 1989 made Chief Executives responsible for the financial management of their department. Departments receiving Mode B or C appropriations operate their own bank accounts and are obliged to forecast domestic cash flows. These departments have already commented upon the inconsistency between the treatment of domestic and foreign cash flows.

New Policy on Foreign Exchange Exposure

14 This section discusses the implications of the Crown's overall policy of risk aversion, which requires that departmental transaction exposure be minimised.

15 As mentioned earlier, most departments do not manage their foreign exchange exposure at present. Henceforth, Chief Executives will be responsible for all aspects of the identification and management of transaction exposure. Each department will be required to prepare a policy document. The guidelines approved by the Minister of Finance are intended to assist departments in this process. Since Chief Executives are being held accountable for their performance, they have an incentive to both control costs and reduce the risks to which they are exposed.

16 Transaction exposure is usually minimised by purchasing forward exchange cover. Guidance will be provided, however, to help determine whether an exchange risk is sufficiently material to require this action. Thus, within the general policy of covering transaction exposures, a specific policy of transacting at the spot rate may be approved for particular transactions. Chief Executives have the best information to apply these parameters to their own departments. Moreover, they will be permitted to choose those banks from amongst an approved list of counterparties (subject to individual counterparty exposure limits) which best meet their needs. This will encourage departments to seek out competitive prices.

17 In summary, the guidelines will - among other things - specify that departments:

a must identify their foreign exchange transaction exposure, at the latest, at the contract stage in purchasing goods or services;

b must detail in their policy documents the approach adopted to the management of this exposure and the timing of execution of cover;

c will have no authority to deviate from the policies approved in their documents;

d will receive delegated authority (as required), to enter into spot and forward exchange contracts and must transact with the New Zealand Debt Management Office for all other instruments (such as swaps);

e may deal only with approved counterparties, viz financial institutions scheduled in the guidelines or additional institutions approved by the Treasury; and

f must establish appropriate foreign currency banking arrangements and internal controls.

The guidelines will thus seek to ensure that departments operate in a prudent manner, consistent with the Crown's overall policy.

18 The specific policies developed by a department will be agreed between the Secretary to the Treasury and relevant Chief Executive where they conform with the guidelines, or by the Minister of Finance and the Responsible Minister if they exceed the scope of the guidelines. Furthermore, the Minister of Finance may recommend to Cabinet that an extraordinary foreign currency transaction, such as the purchase of frigates, be managed by the Treasury.

19 Cabinet approval of departmental budgets, and of expenditure on specific projects and assets, will continue to be expressed in New Zealand dollars. Departments should allow in their budgets for the cost of covering material transaction exposures, ie the premium. This cost is seen as an appropriate offset to the risk of not taking cover.

20 Departments should account for their foreign exchange transactions in accordance with the departmental accounting policies and with SSAP-21, issued by the New Zealand Society of Accountants.

Implementation

21 The key steps for departments in implementing the decentralised approach to transaction exposure management are to:

a design exposure-covering policies;

b specify system requirements; and

c complete the set-up phase.

22 The key steps for the Treasury are to:

a obtain the approval of the Minister of Finance to the guidelines;

b brief departments on their role and the implementation timetable;

c provide support, where needed by departments, in the policy design and implementation phases; and

d review both:

- departmental policy documents prior to their approval; and

- departmental operating systems to be put into place.

23 It is expected that the guidelines will soon be approved by the Minister of Finance. They will be distributed at a briefing session for departments at which the Treasury will elaborate on the implications of the Government's new policy and the assistance available to aid its implementation. The briefing is tentatively scheduled for 30 March. Directors of Finance will be advised of details as soon as possible. A further forum to discuss banking arrangements will be offered shortly thereafter.

24 We hope that the information in this circular will provide useful background for the departmental briefing.

R Beckett
for Secretary to the Treasury

ANNEX

TRANSLATION EXPOSURE

1 Foreign exchange movements may result in gains or losses on transactions or in changes in the value of assets and liabilities denominated in foreign currencies. The impact of such movements on financial statements is referred to as translation exposure. This may arise, for example, in translating the financial statements of a foreign sub-entity into the base currency of the parent.

2 The act of recording the transactions or changes in the value of assets, etc does not usually have a direct cash effect. There is usually no need to cover projected translation exposures. Doing so could actually produce adverse consequences.

3 However, financial statements are used for a number of purposes, including performance assessment. The balance sheets of departments subject to translation exposure will require careful interpretation in this context. The relevant accounting policies are set out in SSAP-21, which has been issued by the New Zealand Society of Accountants.

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