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September 2006

Australian Government Foreign Exchange Risk Management Guidelines

Financial Management Guidance

FINANCIAL MANAGEMENT GROUP (FMG)

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Introduction

1 Introduction

Introduction

These Guidelines explain the Australian Government's policy on foreign exchange risk management and the framework under which it operates. The policy has been in place since 1 July 2002. The reporting requirements set out in chapter 5 of these guidelines apply from 1 July 2006.

This policy applies to *Financial Management and Accountability Act 1997* (FMA Act) agencies[1] and General Government Sector (GGS) *Commonwealth Authorities and Companies Act 1997* (CAC Act) bodies[2], and relates to both departmental and administered funding. Collectively, FMA Act agencies and GGS CAC Act bodies are referred to as GGS entities.

The Australian Government requires GGS entities to manage foreign exchange risk within the constraints set by the policy and consistent with these guidelines. These guidelines will also be used as a benchmark against which GGS entities' foreign exchange risk management practices will be measured.

Accordingly, these guidelines apply to all GGS entities and provide guidance regarding responsibilities under the financial framework. These guidelines have been reissued to add clarity to the operation of the policy, in the light of the experience gained since its introduction on 1 July 2002 and to reflect the revised reporting requirements.

These guidelines will provide you with practical guidance on:

- understanding the Foreign Exchange Risk Management policy and the overarching principle prohibiting hedging;
- determining what may be considered to be a hedge;
- calculating foreign exchange exposures, gains and losses, which need to be reported to the Department of Finance and Administration; and
- the implications the policy may have for GGS entities.

[1] The Australian Office of Financial Management is excluded from these arrangements.

[2] Sections 28 and 43 of the CAC Act set out consultation and notification requirements relevant to GGS CAC Act bodies.

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Overview

2 Overview

Overarching Principle

The overarching principle of the policy is that:

GGS entities are responsible for the management of their foreign exchange risks. However, they will not act to reduce the foreign exchange risk that they would otherwise face in the course of their business arrangements.

This means that GGS entities should not undertake any form of hedging. Under the framework, any arrangement that attempts to reduce foreign exchange risk is considered to be a hedge and is, therefore, contrary to the Australian Government's policy.

As GGS entities are prohibited from acting to reduce foreign exchange risks, for the purposes of this policy, 'managing' means identifying, measuring, monitoring and reporting foreign exchange exposures, as well as being able to identify whether an arrangement will constitute a hedge under the policy.

Rather than allowing GGS entities to enter into individual hedging arrangements, the Australian Government has taken a decision to self-insure foreign exchange exposures and not accept the additional costs associated with hedging. This is based on the view that, as a large organisation, the Commonwealth has a broad spread of assets and liabilities and a range of revenues and expenses, both geographically and across classes, which assists in the management of movements in exchange rates. This means that arrangements that mitigate foreign exchange risk are viewed as being unnecessary.

GGS entities should bear this overarching principle in mind in interpreting the policy.

Foreign exchange risk is the risk that an entity's financial performance or position will be affected as a result of fluctuations in the exchange rate between the Australian dollar and other currencies.

Under the Australian Government's financial framework, GGS entities are responsible for their financial management, including the foreign exchange risk of their entity.

For the purposes of this policy, 'hedging' includes any arrangement (contractual or otherwise) that mitigates foreign exchange risk. Hedging is not limited to definitions in accounting standards and is not necessarily linked to securities and other financial instruments. Other arrangements that may be viewed as mitigating foreign exchange risk are also prohibited under the policy, where that arrangement does not represent best Australian dollar value for money (such as those discussed in examples 1 and 2).

Example 1: An External Hedge

A GGS entity has entered into a contract to make a payment to a Swiss firm, in Swiss francs, in twelve months' time.

In order to gain certainty over the price to be paid in Australian dollars, the entity converts the Australian dollars to Swiss francs now, deposits the money in a Swiss bank account, and makes the payment in Swiss francs when the payment is due (in twelve months time).

This would be considered to be an external hedge and would not be allowed under the policy. This is because the entity mitigated its foreign exchange risk by purchasing the foreign currency now, rather than at the time payment is due.

Under the policy, GGS entities should strive to achieve the 'best Australian dollar value for money' when undertaking a transaction involving foreign exchange, whilst not entering into hedging arrangements.

Example 2: A Request for Tender

A GGS entity is conducting a request for tender, for a project in another country and in the documentation, asks that all tenders be priced in Australian dollars.

This is likely to result in a hedge under the policy, as additional costs for accepting the foreign exchange risk may have been built into the tenders and, therefore, the GGS entity will not be able to determine what is the best Australian dollar value for money at the time it chooses a successful tender.

Other elements of the policy, explained in more detail in these guidelines, are:

- managing foreign exchange risk (chapter 3);
- consulting with the Department of Finance and Administration (Finance) prior to entering into expenditure commitments where the foreign exchange exposure exceeds AUD 100 million (chapter 3);
- Budget adjustments (chapter 4);
- reporting requirements (chapter 5); and
- obtaining an exemption from the prohibition on hedging (Appendix A).

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3

Management of Foreign Exchange Risk in Accordance with the Policy

3 Management of Foreign Exchange Risk in Accordance with the Policy

GGS entities are required to manage their foreign exchange exposures in accordance with the policy. As GGS entities are restricted from hedging their exposures, 'managing' involves being able to identify, measure, monitor and report the exposures that the GGS entity is exposed to, as well as being able to identify types of arrangements that will constitute a hedge under the policy.

3.1 Identifying and Measuring Exposures

Identification and measurement of exposures enables GGS entities to better understand their foreign currency exposures and report to the Australian Government. The streamlined reporting requirements from 1 July 2006 mean that only those GGS entities that have not opted out of the reporting requirements are still required to measure and monitor their foreign exchange exposures.

For a GGS entity that is subject to the reporting requirements, where the Australian dollar value of receipts and payments changes as a result of movements in exchange rates, the transaction should be classified as a foreign currency exposure to the extent that the exchange rate movement affects it. Where an Australian dollar amount is only partly affected by a foreign exchange rate, then only part of that exposure can be classified as a foreign currency exposure. The relationship between exchange rates and the Australian dollar value of the exposure should be able to be recorded and reported by the GGS entity.

These GGS entities should be able to forecast their payments and receipts in terms of:

- amounts payable or receivable in a foreign currency; and
- Australian dollar amounts payable or receivable that are calculated as the equivalent of a foreign currency amount.

When negotiating contracts, agreements or arrangements with suppliers, GGS entities should ensure that all foreign currency exposures relating to either operational or capital expenditure are correctly identified. These exposures should be monitored and reviewed periodically to ensure the GGS entity's reporting requirements can be met.

3.2 Identifying Hedging Arrangements

GGS entities need to be able to identify whether an arrangement will constitute a hedge under the policy. This is because GGS entities are prohibited from entering into contracts, agreements or arrangements that actively seek to mitigate foreign exchange risk. Such actions are hedges, given that they lock in an exchange rate prior to the payment becoming due.

GGS entities may be presented with contracts, agreements or arrangements that contain clauses (ie embedded structures) and methodologies that purport to mitigate foreign exchange risk. Refer to the box on the next page for further information on embedded structures.

Management of Foreign Exchange Risk in Accordance with the Policy

There are a number of ways to mitigate foreign exchange risk, which do not necessarily occur through traditional financial instruments. These are all prohibited under the policy. For example, pricing a contract, agreement or arrangement in Australian dollars may give rise to additional costs for the contractor accepting the foreign exchange risk. These additional costs, if passed on to the GGS entity, would ordinarily not represent best Australian dollar value for money. Where additional costs for accepting foreign exchange risk are identified as forming a component of an Australian dollar price, they must be excluded.[3]

Additionally, GGS entities must not seek to mitigate foreign exchange risk by:

- using foreign currency bank accounts to purchase foreign currency and place the money in a foreign bank account for a future payment; or
- pre-pay purchases with the intention of removing foreign exchange risk.[4]

Hedging Arrangements - Embedded Structures within Contracts, Arrangements or Agreements

The following are examples of embedded option structures where there is an impact on the foreign currency exposure.

It is important for entities to note that embedded structures will normally involve a cost (usually hidden) or additional risk and, therefore, entities must carefully consider the cost or risk involved before seeking an exemption allowing them to use such structures.

- **Embedded floor:** guarantees the supplier (or the purchaser) a minimum exchange rate, protecting them from decreases in an exchange rate.
- **Embedded cap:** guarantees the purchaser (or the supplier) a maximum exchange rate, protecting them from increases in an exchange rate.
- **Stop-loss clause:** similar to a cap or floor where a predetermined exchange rate, when triggered, will alter the terms of the contract.
- **Demand triggered contract:** alters the exchange rate mechanism, should there be a change in the underlying demand for the service or product.
- **Rise and fall clause:** uses changes in the exchange rate to alter the delivery price of goods or services. This clause may relate to the direct currency exposure or to a third currency exposure relating to input costs for the supplier. This clause may also include a multiplier effect on the exchange rate or have a non-linear impact

[3] This does not prohibit contracts, arrangements or agreements to be priced in Australian dollars, provided this represents best Australian dollar value for money, and has not been required by the GGS entity (ie. the GGS entity has not passed on the risk). The policy does not prohibit arrangements where a contractor may have assumed a foreign exchange risk, where this is not expressly recognised in the contract, arrangement or agreement and it represents the best Australian dollar value for money at the time tenders are being evaluated.

[4] Refer to the relevant Finance Circular regarding discounts for prepayment and early payment, available from www.finance.gov.au.

upon the underlying currency exposure. Rise and fall clauses may also use an average rate methodology for calculating the exchange rate, which may not align to the actual exchange rate transacted by the GGS entity. This could result in a cash flow mismatch for the GGS entity.

3.3 Standard Industry Practice

Contracts, agreements and arrangements are not considered to contain hedging arrangements where they are standard industry practice, meeting all of the following conditions:

- the intended transaction is similar to those transactions that would be entered into by other entities within the industry;
- those similar transactions entered into by other entities within the industry are not simply entered into with the intent of removing or mitigating foreign exchange risk; and
- it would be impractical, impossible or not value for money (for reasons other than foreign exchange risk) to enter into an arrangement different to the standard industry practice.

It is of particular importance to maintain adequate documentation to demonstrate that relevant issues have been taken into account when considering whether an arrangement is standard industry practice.

Where a GGS entity enters into arrangements considered to be standard industry practice, it must continue to ensure that any residual foreign exchange risk under the arrangements are in line with all other elements of the policy, such as relevant reporting and control requirements.

3.4 Dealing with Contracts, Agreements or Arrangements that include Hedges

Embedded structures in contracts, agreements or arrangements (or other arrangements which mitigate foreign exchange risk) can seem desirable to an entity. However, they normally involve a cost or an additional risk and operate outside of the policy.

In accordance with the policy, GGS entities are required to exclude embedded structures from contracts, agreements or arrangements that they enter into, and ensure that any actions they undertake are not viewed as hedging their risk. However, if the structures presented or the approaches contemplated are considered to be the best value for money, then GGS entities should, through their Minister, seek a project specific exemption. Refer to Appendix A, *Obtaining an Exemption* for more information.

A GGS entity may also consider it appropriate to seek external financial or legal advice, to assist in identifying and excluding requests for embedded structures in contracts, agreements and arrangements (or other arrangements which mitigate foreign exchange risk). Where appropriate, a GGS entity should also seek such advice to substantiate an application for an exemption from the hedging restriction of the policy.

3.5 Exposures Greater than AUD 100 Million

GGS entities are responsible for consulting with Finance, prior to entering into any expenditure commitment where the total foreign exchange exposure exceeds the equivalent of AUD 100 million. GGS entities considering entering into such an arrangement should consult Finance as soon as is practical.

This information allows for early recognition of significant foreign exchange exposures from a whole of government perspective and enables Finance to consider the impact that large foreign exchange exposures may have on the Budget.

Example 3: A Commitment Exceeding AUD 100 million

A GGS entity begins managing a construction project in another country, and engages local firms to complete the work and pays them in the local currency.

Three firms are engaged to perform contracts worth AUD 60 million, AUD 30 million and AUD 20 million in Australian dollar equivalent amounts at the time the contract is executed. While no single contract exceeded the AUD 100 million limit, the project would need to be considered as a whole. Therefore, the GGS entity would be required to consult with Finance before entering these contracts.

4

Budget Adjustments

4 Budget Adjustments

GGS entities that meet certain minimum thresholds and demonstrate proper foreign exchange risk management practices consistent with these guidelines will, subject to agreement in the Budget process, have their departmental appropriations adjusted on a "no win, no loss" basis, to offset realised foreign exchange losses or gains. Budget adjustments are only available for those GGS entities that have not opted out of the requirement to report to Finance (refer to chapter 5 for more information regarding reporting requirements).

The Government may adjust the departmental appropriations of a GGS entity that has made foreign exchange losses or gains, where:

- the GGS entity is the:
  - Department of Defence;
  - Department of Foreign Affairs and Trade; or
  - Australian Trade Commission; or
- the GGS entity has not opted out of the reporting requirements; and:
  - has actual or expected net foreign exchange gains or losses of greater than AUD 5 million; or
  - has actual or expected net foreign exchange gains or losses of greater than 1 per cent of the GGS entity's departmental appropriations (for FMA Act agencies) or total cash expenditure (for GGS CAC Act bodies). [5]

4.1 Application of Budget Adjustments

Where a GGS entity realises (or expects to realise) a foreign exchange loss that meets the threshold, it will be eligible to be considered for Budget supplementation. To be eligible for supplementation, the GGS entity must be able to demonstrate that it has followed proper foreign exchange risk management practices consistent with these guidelines. GGS entities must also maintain sufficient documentation and audit trails to support the case for Budget supplementation.

Where a GGS entity realises (or expects to realise) a foreign exchange gain that meets the threshold, it will be required to return any gain through the Budget process.

Adjustments for foreign exchange gains and losses occur as a part of the Budget process. During the Additional Estimates process, a reconciliation of the previous year's foreign exchange gains or losses will be undertaken to compare an agency's realised gains and losses against the budget estimated gains and losses for that year.[6]

[5] For GGS CAC Act bodies, total cash expenditure includes all cash expenditure, including capital expenditure.

[6] Current year and future year estimates may also be adjusted additionally to the Policy to take into account foreign exchange rate updates at each estimates update.

Finance advises the Government on Budget adjustments based on GGS entities' reporting, Chief Executive or Director certification and other information it is aware of or obtains.

The policy does not deal with the process for Budget adjustments to GGS entities' administered appropriations, which are subject to consideration during the Budget process.

4.2 Measurement of Gains and Losses

A reconciliation of foreign exchange gains and losses involves comparing the Australian dollar amounts of a transaction, as converted at both the settlement rate and the Budget Exchange Rate (BER). The BER is the exchange rate used for calculating the Australian dollar equivalent of Budgeted foreign currency exposures as supplied by Treasury. For expected realised gains and losses, the reconciliation involves comparing the estimated Australian dollar amount of the transaction.

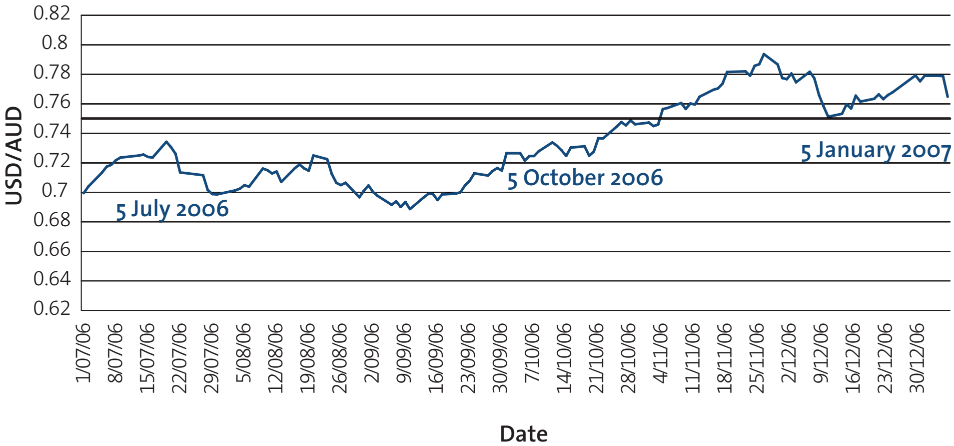
Where a GGS entity expends foreign currency, the calculation requires a reconciliation of the Australian dollar amount that the GGS entity was budgeted for to make the expenditure in foreign currency, against the Australian dollar amount that the GGS entity requires to make the payment.

Where a GGS entity receives amounts in foreign currency that are available for expenditure by the GGS entity (that is, for FMA Act agencies, the amounts are subsequently appropriated either through a Special Account or a net appropriation agreement), the calculation requires a reconciliation of the Australian dollar amount that the GGS entity was budgeted to receive in Australian dollars, against the Australian dollar amount that the GGS entity actually receives.

Figure 1 on the next page demonstrates the gains and losses made on a hypothetical contract, under which a GGS entity has agreed to make three payments of USD 200,000 at three monthly intervals. It demonstrates how gains/losses are made on individual payments. The net result of these payments would be a loss of AUD 19,054. A BER of AUD 1= USD 0.75 applied at the time of the 2006-07 Budget and throughout the period.

4 Budget Adjustments

Figure 1 Gains/losses for three payments of USD 200,000



5 July 2006	**Budgeted Payment** **Actual payment**	USD 200,000 @ BER 0.75 = AUD 266,667 USD 200,000 @ Spot Rate 0.7134 = AUD 280,348 Loss = AUD 13,681
5 October 2006	**Budgeted Payment** **Actual payment**	USD 200,000 @ BER 0.75 = AUD 266,667 USD 200,000 @ Spot Rate 0.7215 = AUD 277,200 Loss = AUD 10,533
5 January 2007	**Budgeted Payment** **Actual payment**	USD 200,000 @ BER 0.75 = AUD 266,667 USD 200,000 @ Spot Rate 0.7648 = AUD 261,506 Gain = AUD 5,160

Example 4: Calculation of Gains and Losses

A Gain

A GGS entity made a payment of USD 150,000 to a supplier from the United States during the financial year. The payment was made when the spot rate was 1 AUD = USD 0.80, while the BER was 1 AUD = USD 0.75.

Accordingly, the GGS entity was budget funded AUD 200,000 for this transaction, but the GGS entity spent AUD 187,500. Therefore, a foreign exchange gain of AUD 12,500 was made on this transaction. The GGS entity will generally be required to return this gain to the budget (assuming the budget adjustment thresholds are met).

A Loss

A GGS entity made a payment of 300,000 euros to purchase scientific equipment during the financial year. The payment was made when the spot rate was 1 AUD = 0.62 euro, while the BER was 1 AUD = 0.68 euro.

Accordingly, the GGS entity was budget funded AUD 441,176 for this transaction, but the GGS entity spent AUD 483,871. Therefore, a foreign exchange loss of AUD 42,695 was incurred on this transaction. The GGS entity will generally be supplemented for this loss, providing the budget adjustment thresholds are met, the GGS entity can demonstrate proper foreign exchange risk management practices and the GGS entity can produce sufficient documentation if required.

Calculating the Net Gain/Loss for Budget Adjustment Purposes

The table below shows the foreign exchange transactions for a GGS entity during the financial year. Payments are shown as positive figures, and receipts are shown as negative figures. From the calculations below, it can be seen that the GGS entity has made a net loss of AUD 1,164,346.

Foreign currency payment (receipt)	Settlement exchange rate	BER	Australian dollar equivalent of payment (receipt)	Budgeted payments (receipts) in Australian dollars	Gain (Loss) in Australian Dollars
1,500,000 USD	0.78	0.72	1,923,077	2,083,333	160,256
£4,300,000	0.41	0.45	10,487,804	9,555,556	(932,249)
(1,110,000)USD	0.82	0.72	(1,353,659)	(1,541,667)	(188,008)
¥10,000,000	83	90	120,482	111,111	(9,371)
2,500,000 NZD	1.05	1.15	2,380,952	2,173,913	(207,039)
¥(23,540,000)	86	90	(273,721)	(261,556)	12,165
Net Loss					(1,164,246)

5

Reporting Requirements

5 Reporting Requirements

The reporting requirements of the policy are designed so that the Government is provided with information regarding the Government's realised foreign exchange gains and losses as calculated using the methodology outlined in Chapter 4. GGS entities are required to report to Finance, so that this information can be provided to the Government. However, in recognition of the administrative burden that these requirements may place on GGS entities, those GGS entities with exposures that are not material to the GGS entity or the Budget, may be permitted to opt out of these reporting requirements.

5.1 Finance Reporting to Government

Finance is responsible for providing advice to the Government on:

- the foreign exchange gains and losses reported to it by GGS entities in respect of the previous financial year;
- an estimate of funding adjustments for the current financial year and future years;
- estimated foreign exchange exposures for the current financial year and future years;
- factors driving material changes since the last report;
- the entities that have opted-out of the reporting requirements; and
- GGS entities' compliance, or otherwise, with the policy and these guidelines, as reported to Finance by GGS entities and taking into account any additional relevant information that Finance may obtain.

5.2 Entity Reporting to Finance

Reporting requirements under the foreign exchange risk management policy have been simplified from 1 July 2006. The reporting requirements apply to all GGS entities that do not opt out, including GGS entities that have been granted an exemption from the hedging restrictions of the policy.

GGS entities are to provide reports to Finance in the required format, to enable Finance to meet its own reporting requirements to Government.[7] Reports are only required from those entities that meet the budget adjustments thresholds and will generally be required on an annual basis, coinciding with Finance's report to the Government. Finance advises GGS entities when reports are required.

Generally, the reports that Finance will request from relevant GGS entities are:

- a reconciliation of previous year's realised gains and losses against the budget estimated gains and losses, including explanations of the factors driving any variations;

[7] FMA agencies, under section 50 of the FMA Act, are required to provide to the Finance Minister any information in relation of the financial affairs of the agency that the Finance Minister requires. CAC Act bodies, under sections 16 and 41 of the CAC Act, are required to provide to the Finance Minister reports of the operations of the body that the Finance Minister requires.

- estimated foreign exchange gains and losses for the current financial year and future years, including explanations of the factors driving any variations; and
- a statement of estimated foreign exchange exposures (revenue and expenditure) for the current financial year and future years. These estimated exposures should be calculated, and updated from prior reports, using the latest applicable BER.

5.3 Applications for Opting out of Reporting Requirements

Under the revised reporting requirements, most GGS entities are able to request to opt out of the policy's reporting requirements. The revised arrangements involve:

- the Department of Defence, the Department of Foreign Affairs and Trade and the Australian Trade Commission, continuing to be required to report to Finance;
- the entities that have had the largest foreign exchange exposures (Tourism Australia, AusAID, the Commonwealth Scientific and Industrial Research Organisation, the Australian Nuclear Science and Technology Organisation and the Bureau of Meteorology) being able to opt out of the reporting requirements after advising their Minister and subject to obtaining the written agreement of the Minister for Finance and Administration (Finance Minister) that they have a strong case that their exposures are not a material risk to the agency or the budget; and
- the remaining GGS entities being able to opt out of the reporting requirements after advising their Minister and the relevant Chief Executive Officer obtaining the written agreement of the Secretary of the Department of Finance and Administration that they have a strong case that their exposures are not a material risk to the agency or the budget.

A GGS entity wishing to opt out should initially contact Finance, and provide information regarding the size of its exposures in foreign currency terms (regardless of duration) for assessment.

5.4 Applications for Opting into the Reporting Requirements

A GGS entity that has opted out of the reporting requirements is able to seek approval from the Finance Minister to opt back into the reporting and budget adjustment arrangements, only with respect to future foreign exchange commitments. That is, the exposures of the GGS entity at the time of opting back in will not be considered for budget adjustments purposes.

For this reason, the GGS entity should consult with Finance as soon as practical when it becomes aware that a substantial change to its foreign exchange exposures may occur.

5.5 Certification

Chief Executives of FMA Act agencies, and the directors of GGS CAC Act bodies, are required to provide Finance with an annual certification stating whether their GGS entity has complied with the policy as set out in these Guidelines, explaining and quantifying any non-compliance. For GGS CAC Act bodies, a certification stating that they have complied with the provisions of the CAC Act includes certifying compliance with the policy, and meets this certification requirement. [8]

For those GGS entities that have an exemption from the policy, certifying compliance with the policy also requires certifying that the GGS entity has complied with the terms of any exemption (or explaining and quantifying any non-compliance).

[8] Where the GGS CAC Act body has been notified of the policy under section 28 or 43 of the CAC Act (as applicable), the directors are required to ensure that the policy is carried out in relation to the CAC Act body.

6

Foreign Exchange Controls

6 Foreign Exchange Controls

6.1 Procedures and Controls

Management of the operational risk surrounding foreign exchange exposures forms a part of a GGS entity's overall foreign exchange risk management obligations. Consequently, it is recommended that each GGS entity develop and document a distinct set of procedures for the management of foreign currency and foreign exchange exposures. Any internal procedures developed should take into account these guidelines and the GGS entity's particular business practices. Each FMA Act agency may wish to consider developing a Chief Executive's Instruction that sets out its agency's policy governing foreign exchange operations.[9]

It would be prudent for any GGS entity-specific foreign exchange policy or procedure documents to:

- clearly state that hedging is prohibited;
- incorporate a set of controls that efficiently and effectively manage the risks associated with transacting and recording foreign exchange contracts, agreements or arrangements; and
- ensure the effective segregation of the transaction, authorisation, confirmation and recording functions.

A GGS entity may also consider it appropriate to seek external financial or legal advice to assist in developing procedures.

6.2 Foreign Exchange Control Responsibilities

Set out below are suggested best practice internal control procedures for the management of foreign exchange exposures. These may be considered for inclusion in the individual procedures of each GGS entity.

- There should be a complete segregation of duties between responsibility for executing foreign exchange transactions and responsibility for reconciling, settling, reporting, verifying and accounting for those transactions. Ideally, the person responsible for reconciling and accounting for foreign exchange transactions should not also be responsible for settling (ie making the payment for) that transaction.
- A system should be in place that controls access to counterparty payment details, or requires independent verification of counterparty payment details. This will provide a reasonable assurance that every payment is made to the correct counterparty and to the correct bank account.
- A process should be in place to ensure that counterparties to foreign exchange transactions are approved by the GGS entity prior to executing the transaction.
- A process should be in place to ensure all foreign exchange transactions are effectively reconciled.

[9] Refer to the relevant Finance Circular regarding CEIs on the Finance website – www.finance.gov.au

- A process should be in place to ensure all foreign exchange transactions are appropriately authorised.
- A system should be in place to record and allow review, audit and reporting of foreign currency transactions, including details such as:
  – foreign exchange amount;
  – currency paid;
  – Australian dollar equivalent amount;
  – relevant Budget Exchange Rate;
  – counterparty;
  – payment date;
  – foreign exchange rate;
  – settlement date;
  – cost of the transaction (if any);
  – current spot rate (if different to rate at which the transaction is dealt);
  – the reason for the difference between the spot rate and the rate at which the transaction is dealt;
  – reason for the transaction;
  – person dealing the transaction;
  – person authorising the transactions; and
  – counterparty payment details.

This system should also ensure that a record is kept of any foreign exchange transaction that is modified (eg changes to dates, amounts, or rates) or cancelled (eg as part of the foreign exchange register or foreign exchange system). This should include the cost of, and reasons for, any such modification or cancellation.

A process should be in place to ensure that any exceptions or variations to the authorised procedure for foreign exchange transactions is reported to an appropriate senior manager, who can review and provide guidance on any remedial action that should be undertaken.

7

Appendices

7 Appendices

Appendix A: Obtaining an Exemption from the Policy

A GGS entity may make a request to the Finance Minister (through its own Portfolio Minister) for an exemption from the policy's requirement that the GGS entity is not to enter into hedging arrangements. The Finance Minister will consult with the Treasurer prior to granting an exemption from the hedging restrictions contained in the policy. The GGS entity should liase with Finance prior to initiating ministerial correspondence.

All exemptions must be supported by a robust argument, which demonstrates the business need for the exemption. When a GGS entity obtains an exemption from the hedging restrictions contained within the policy, it does not exempt it from other aspects of the policy, such as reporting. However, the Budget adjustment arrangements do not apply for GGS entities or projects that have received an exemption from the policy.

The policy provides for two different types of exemptions—case-by-case exemptions and general exemptions.

Case-by-case Exemptions

In cases where a GGS entity intends to undertake an activity that will require some form of hedging arrangement, for example where it is unable to exclude a request for an embedded structure from a proposed contract, the GGS entity may apply to the Finance Minister for a case-by-case exemption. Where an exemption relates only to a specific activity, it is only that activity that would not be subject to the Budget adjustment arrangements.

General Exemptions

CAC Act bodies that are subject to the policy are also able to apply to the Finance Minister for a general exemption. General exemptions will only be granted in special circumstances, such as where the policy would unduly restrict the GGS entity from carrying out its core business. FMA Act agencies are generally not able to apply for a general exemption from the hedging restriction of the policy.

Appendix B: Unwinding Existing Hedging Arrangements

There may be instances where a GGS entity has hedging arrangements in place at the time that the policy comes into full effect for the individual GGS entity. The correct treatment of these arrangements is as follows:

- the GGS entity must not renew, extend or replace any hedging arrangements;
- the GGS entity must review any existing hedging arrangements and, where it is considered cost effective, these arrangements should be terminated; and
- where hedging arrangements are not terminated, they must be allowed to run their course, but not be extended or replaced.

A GGS entity that has a demonstrable business need to renew, extend or replace any existing hedging arrangements may, on a case-by-case basis, seek an exemption from the hedging prohibition.

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Appendix C: Glossary of Terms

AUD – Australian Dollar.

Budget Exchange Rate – The exchange rate used for calculating the Australian dollar equivalent of Budgeted foreign currency exposures as supplied by Treasury.

CAC Act bodies – entities that are subject to the *Commonwealth Authorities and Companies Act 1997*. These are:

- Commonwealth authorities - a statutory authority (ie a body created by legislation) that is a separate legal entity from the Commonwealth and which has the power to hold money on its own account
- Commonwealth companies - companies under the *Corporations Act 2001* in which the Commonwealth has a controlling interest.

Cap – an option contract whereby the seller agrees to pay the purchaser, in return for an upfront premium, the difference between a reference rate and a strike rate when the reference exceeds the strike.

Counterparty – the other party with whom an entity enters into any form of currency transaction.

Embedded structures – options or other structures, included within a contract agreement or arrangement, that alter or transfer the foreign exchange risks faced by the parties. (Refer to examples at page 7)

External Hedge – in assessing the nature of foreign exchange transactions, GGS entities should have regard to the whole-of-Government self-insurance principle that takes advantage of foreign exchange gains and accepts foreign exchange losses.

For the purposes of the Government's foreign exchange risk management policy an external hedge is a transaction/s with a party external to the general government sector, which give the effect of altering or transferring the foreign exchange risk faced by the general government sector. External hedges include, but are not limited to:

- structures embedded within contracts, agreements or arrangements that reduce or alter the exposure to exchange rate fluctuations; and
- financial instruments such as forward exchange contracts, swaps and options.

Floor – an option contract whereby the seller agrees to pay the purchaser, in return for an upfront premium, the difference between a reference rate and a strike rate, should the strike rate exceed the reference rate.

FMA Act agencies – agencies that are financially part of the legal entity of the Commonwealth and are subject to the *Financial Management and Accountability Act 1997*. FMA Act agencies include:

- Departments of State;
- Departments of the Parliament; and
- Agencies prescribed by the FMA Regulations.

Foreign exchange exposure – an entity's exposure to loss (or profit) due to movement in the exchange rate between the Australian dollar and a foreign currency.

Foreign exchange risk – the potential profit (loss) due to movements in exchange rates given the level of exposure.

Foreign exchange, foreign currency – commitments to pay obligations in a currency other than Australian dollars.

Forward exchange contract – an agreement to exchange a specified amount of one currency for another at a future date.

General Government Sector – the General Government Sector (GGS) comprises those entities that fulfil the functions of government as their primary activity. The primary function of this sector is to provide public services, which are mainly non-market in nature, and for the collective consumption of the community, or involve the transfer or redistribution of income. These services are largely financed through taxes and other compulsory levies.

GGS entities – collectively FMA Act agencies and CAC Act bodies that are classified as being within the general government sector are referred to as 'GGS entities' throughout these guidelines.

Hedge – an offset of risks. Creating or having a situation where a risk (eg: an exposure to pay five million US dollars) is offset by another risk (eg: having the right to receive five million US dollars from another party). Hedges are generally either natural hedges, or created using derivative instruments.

Managing – identifying, measuring, monitoring and reporting foreign exchange exposures, as well as being able to identify whether an arrangement will constitute a hedge under the policy.

May – options in these guidelines that are denoted by the use of the term 'may' are to be considered by GGS entities and followed when deemed relevant.

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Must – obligations in these guidelines that are denoted by the use of the term 'must' are to be complied with in all circumstances.

Natural hedge – a hedge that occurs naturally as a result of the entities normal operations, without the use of derivatives. For example, revenue received in a foreign currency and used to pay known commitments in the same foreign currency would comprise a natural hedge.

Operational risk – the risk that an entity's internal practices, policies and systems are not rigorous enough to cope with adverse market conditions or human or technological errors.

Options – an agreement that gives the purchaser the right but not the obligation to buy or sell foreign currency at a certain level on or before an agreed date.

Segregation of duties – the separation of the transacting, settlement and accounting functions with regard to foreign exchange activities.

Settlement Rate – the exchange rate applying at the time the foreign currency is purchased by the GGS entity.

Should – obligations in these guidelines that are denoted by the use of the term 'should' are to be complied with as a matter of sound practice.

USD – United States Dollar.

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