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# Executive Roundtable and Professional Placements

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## Session 2

### Current Assessment:

Impacts of Global Financial Turbulence on Victorian  
Government Financial Assets and Liabilities

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A major concern of State Governments resulting from the global financial turbulence is the direct impact on the value and returns of the financial assets of the State and the State's capacity to raise funds in financial markets.

The State Government of Victoria has a substantial balance sheet with total assets of approximately \$133 billion at 31 December 2007, of which over \$30 billion were financial assets. These financial assets are held against three key financial liabilities; debt of \$15 billion on a gross basis, superannuation liabilities of \$12 on a net basis and insurance claims liabilities of approximately \$16 billion. The main direct impact of the financial market turbulence is on these financial assets and liabilities although its implications for the Victorian and Australian economy will have important budget implications.

The State is organised around three key sectors, the general government sector, public financial corporations sector and public non-financial corporation sector. The general government sector largely comprises the government departments and is mostly centrally funded from the budget. The public corporation sectors comprise government owned authorities, established as separate bodies overseen by Government appointed boards. These corporations are predominantly commercial entities providing services on a user pays basis. These entities have broad powers to borrow and invest and are subject to a commercial corporate governance framework which provides for the payment of dividends and income tax equivalents to the government.

The State has established prudential frameworks and policies to manage its financial risks and exposures as well as establishing financial corporations to manage the State's financial market interactions on a centralised basis. The current financial market turbulence provides a test of the effectiveness of these polices, frameworks and institutions.

## **Treasury Corporation of Victoria (TCV)**

TCV is the State's centralised treasury and plays an important role as the States interface to financial markets. The State and its authorities are required to borrow through TCV and most government agencies deposit surplus funds with TCV.

By centralising its financial market operations through TCV, the State is able achieve the following benefits:

- a reduction the overall level of financial transactions with markets as debt and deposit balances can be netted before transacting in markets, reducing overall cost and risk to the State;
- better understanding and reporting of the State's financial exposures;
- better co-ordination of the State's approach to financial markets;
- reduced costs by achieving scale in its funding programs;
- reduced treasury administration costs and operating risks by eliminating the need to establish Treasury departments within individual government authorities.

As at 30 June 2008, TCV had advanced \$11 billion to the State and its authorities and accepted \$7 billion of deposits from government agencies.

To service the financial requirements of the State of Victoria, TCV maintains four key funding programs. TCV's Domestic Inscribed Stock program is the cornerstone of the Corporation's funding strategy. TCV seeks to maintain at least five lines of stock with a minimum of \$A1.5 - 2.0 billion per issue. TCV supplements its Domestic Inscribed Stock with three other programs: a \$US3 billion Euro Medium Term Note (EMTN) program, a \$A2 billion Euro Commercial Paper (ECP) program and a \$A2.5 billion Domestic Promissory Note program. Activity in each program is predominantly facilitated by a dealer panel. For 2008-09, TCV's funding program is expected to be \$4.4 billion, including client loan refinancing of approximately \$900 million.

In order to ensure that TCV's financial risks are effectively managed, the Treasurer has issued a prudential statement which TCV must comply with. This statement covers areas such as interest rate risk, credit risk and liquidity risk. Key features of the policy are that an adequate level of capital must be held against its financial risks which constrains the overall level of risk that TCV can maintain. These standards have resulted in TCV maintaining low levels of balance sheet risk which has minimised the impact of financial market turbulence on its capital position.

The main impact of the financial market turbulence on TCV's operations is through changes in credit spreads which have increased significantly since the credit crisis began. Tighter market conditions are also making it more difficult to source term funding. The TCV 10 year spread to bond has historically ranged between 20 and 40 basis points. At the end of July 2008, this had risen to 64 basis points. The State's AAA credit rating has

however been important in limiting the impact of the financial turbulence on the State's cost of funds and access to funding.

### **Victorian Funds Management Corporation (VFMC)**

VFMC is the State's centralised funds manager and had State funds under management of approximately \$34 billion as at 30 June 2008. In addition VFMC manages funds for non-State entities such as Melbourne and Swinburne Universities. VFMC accepts funds from State agencies that are long term investors while short term deposits and investments are largely placed with TCV.

VFMC's major clients are the State's insurance agencies; the Victorian Workcover Authority, the Transport Accident Commission and the Victorian Managed Insurance Authority and the Emergency Services and State Superannuation Scheme. These agencies hold 95 per cent of VFMC's funds under management (evenly divided between superannuation and insurance assets).

From 1 July 2006, the Government implemented changes to the centralised investment model and expanded VFMC's role with a vision of establishing a Centre of Investment Excellence at VFMC.

Under this vision, VFMC moved from being essentially a manager of fund managers to an expanded role where it took responsibility for determining the strategic asset allocation of its major clients. The investment process that operates under this model is that VFMC clients are responsible for setting their investment objective based on a consideration of the nature of their liabilities, capital policies, premium setting parameters etc. VFMC is responsible for determining an appropriate asset allocation to meet these objectives which is approved by the Treasurer. VFMC then implements the strategy.

The strategy will vary depending on the clients investment objective and liabilities and other policies. VFMC is moving toward an aggregate strategic asset allocation of approximately 56 per cent equities, 29 per cent inflation linked assets and 15 per cent debt and absolute return assets.

Other developments at VFMC include an expanded investment team to around 30 investment professionals and the development of greater in-house management capability.

Given the long term nature of the liabilities of VFMC's major insurance and superannuation clients, the State has adopted a growth strategy for its investment portfolio which is similar to that of a balanced superannuation fund. The current market downturn has therefore impacted the States investments that are managed by VFMC, particularly through falls in equity markets. This fall is reflected on the balance sheets of VFMC's clients.

VFMC advise that the aggregate return for all State clients portfolio's for the 12 months to 30 June 2008 was -8.06 per cent. However this result needs to be considered in context of the State's longer term investment performance. For the five years to 30 June 2008, the State portfolio averaged a return of 10.5 per cent and this investment performance has benefited the State significantly compared to a risk free investment approach.

The adoption of a growth investment strategy by the State does introduce volatility into the balance sheets of the State's insurers and the value of the unfunded superannuation liability. However the State has a capital, pricing and reserving policy for the insurers that requires a level of capital to be maintained which is commensurate with the risk of that entities balance sheet. The level of capital should therefore reflect the risk of the insurance liabilities and the investment strategy for the assets. Even after the negative investment performance this financial year, all three insurance entities maintain capital levels well within their target range and in the case of Workcover, above the maximum required level.

In relation to the unfunded superannuation, the Government is committed to a policy of fully funding the unfunded superannuation liability by 2035. While the market downturn has increased the reported value of that liability at 30 June 2008, the long term investment return is the key determinant of the cost of servicing this liability.