

Department of Health

health

# Investment policy guidelines for Victorian public hospitals



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# 1 Acknowledgements

The department would like to acknowledge the work of the National Australia Bank Health Services team in the preparation of the investment policy guidelines.

## 2 Foreword

The Victorian Government continues to promote the prudent management of the financial assets and liabilities of all Victorian departments and agencies. While hospitals have a primary responsibility for the effective delivery of health care to the public, their boards have a fiduciary responsibility in managing the financial assets held by the hospital on behalf of taxpayers, donors, residents and employees.

These guidelines have been prepared for hospital boards with the assistance of an experienced consultant working with a broad sample of hospitals (metropolitan, large and small rural) and also in discussion with the Department of Treasury and Finance, Treasury Corporation of Victoria and Victorian Funds Management Corporation.

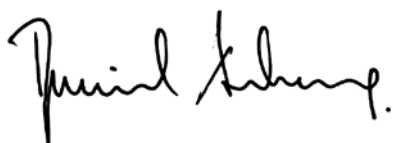
The guidelines set out the roles and responsibilities of the hospital board and management in:

- understanding the legislative framework and Victorian public hospital guidelines governing investments
- understanding the key stakeholder interests in managing a hospital's investment monies
- setting investment policies and objectives that align to the various stakeholder interests, and
- understanding the risk management approach adopted by management in managing these investments.

The guidelines also provide an illustrative set of authorised investments and risk limits that the board may adopt, including the prohibition of leverage, direct derivatives, hedge funds and structured investments.

They include a simplified investment approach for smaller hospitals as well as sample investment reporting that boards should be reviewing on a regular basis.

The government recommends that these Investment policy guidelines be adopted by each hospital, with the appropriate customisation where necessary.



**Hon. Daniel Andrews MP**  
**Minister for Health**

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# 4 Introduction

This report sets out advice to assist hospitals prepare investment policy guidelines.

The guidelines are consistent with best practice principles for the prudent management of investments. A key point of this paper is that a best practice approach needs to recognise the diverse stakeholder interests at play in the investment decisions facing many hospitals.

# 5 Policy context

## Organisational profile

5.1.1 The policy approach taken in Victoria for the delivery of health care to the public has been to establish hospitals as independent entities. The way these entities are governed and managed reflects their operational and financial profiles both of which are relevant to investment policy. Key areas of differentiation include:

- the size of the agency and number of financial managers on staff
- the financial expertise of board members and financial managers
- the mix of health services provided (in particular whether there are substantial aged care facilities or research programs)
- the mix of revenue sources and stakeholder interests (that is, government, private donations or bequests, bonuses attributable to the provision of specialist medical services, aged care residents)
- the extent to which separate investment portfolios are set up to match specific future expenditures or liabilities (for example, aged care bond funds, special purpose funds)
- the potential for a hospital to leverage its community or donor networks for financial support
- the significance of investment earnings in light of the total dollar amount of hospital health expenditures
- the time horizon of the expenditures for which funds are held and liquidity requirements
- the fact that some agencies outsource investment management to external managers and some do not.

## Governance

5.1.2 Investment policy is ultimately the responsibility of the hospital board. In managing investment assets held by the hospital, the board functions as the governing fiduciary body managing funds on behalf of government, donors, private practitioners or residents.

5.1.3 Good governance requires the governing fiduciary body within a hospital to:

- recognise their fiduciary position of trust in relation to the management of funds on behalf of key stakeholders (for example, government, donors, private practitioners or residents)
- establish clear policies regarding the management of investments and working capital
- carefully consider and approve the investment strategy adopted by the agency
- oversee the hospital's investing activities to ensure they are managed prudently in accordance with legislation, the right stakeholder interests and sound investment policies.

## Investment management framework

- 5.1.4 A structured investment management framework is widely employed by fiduciary bodies in the investment industry to achieve the dual goals of good governance and prudent investing. Explicit investment objectives are used as the basis for the development of investment strategy and for monitoring and reporting processes.
- 5.1.5 This approach is applied in the private and public sectors by boards and management (including the Department of Treasury and Finance's own Prudential Framework) and forms the basis of the policy guidelines in sections 6 to 9 of this document.

## Financial structures

- 5.1.6 Victorian hospitals' primary purpose is not to manage investments but to provide health-related services to the public. The principal focus of hospital financial controllers is the management of financial plans and to keep expenditures and revenues in line with budget.
- 5.1.7 Hospitals are not natural accumulators of financial assets, but they often manage financial assets from the following sources:
- working capital (funded by the department and allocated to operational expenses or self-funded)
  - capital grants (funded by the department)
  - funding of employee entitlements such as long-service leave (funded by the department)
  - special purpose funds (tied or unallocated)
  - research grants (funded by donors of various types: individuals, corporates, governments, endowments)
  - aged care bonds (funded by residents)
  - donations or bequests (for example, funded by corporate donors or the general public)
  - revenue from commercial activities (funded by the agency itself).
- 5.1.8 Though the financial assets held by hospitals may ultimately be applied to a number of funding purposes, the assets are often managed in a pooled form within the hospitals' accounts. In some cases, assets are matched to specific funding purposes (for example, tied donations, special purpose funds, aged care bond portfolios, et cetera). The matching may be done in different ways:
- legal separation (for example, money held in a separate trust or foundation)
  - physical separation (for example, separate bank account or physically distinct investment portfolio that holds the investment funds of a restricted private practice fund),
  - notional separation only (a reporting separation only such as that contained in investment or accounting reports).

# 6 Investment guidelines: general

## Purpose

6.1.1 The guidelines documented in sections 3 to 6 of this document are intended for the use of Victorian hospitals in developing their investment policies. Following the guidelines should help hospitals maintain investment programs that are consistent with the standards that generally apply to Victorian public sector enterprises and with the principals followed by best practice fiduciary bodies.

## Application

6.1.2 All health care service agencies should have documented policy guidelines covering the management of their investments.

## Applicable legislation and public sector guidelines

6.1.3 The activities of Victorian hospitals are governed by state and Commonwealth legislation.

6.1.4 Relevant state and Commonwealth legislation covering the investment policies of hospitals include:

- *Health Services Act 1988* (State)
- *Trustee Act 1958* (State)
- *Financial Management Act 1994* (State)
- *Aged Care Act 1997* (Commonwealth).

Relevant guidelines also include:

- Department of Treasury and Finance Prudential and Risk Management Framework (2001)
- Treasury Management Guidelines (2007)
- Accommodation Bond Liquidity Management Strategy (Commonwealth guidelines on aged care bond funds).

6.1.5 Appendix 2 outlines some key requirements. The most important requirement for investment policy is set out under the *Trustee Act (1958)* and requires hospitals to manage consistent with the prudent person test – the legal standard generally applied by common law or legislation to governing fiduciary bodies in the investment management industry.

## Accounting reporting standards and Department of Treasury and Finance financial reporting directives

6.1.6 All hospitals must prepare financial accounts in accordance with Australian accounting standards. Relevant accounting standards for investment assets include:

- AASB 132 *Financial instruments: disclosure and presentation*
- AASB 7 *Financial instruments: disclosures*
- AASB 139 *Financial instruments: recognition and measurement*
- AASB 136 *Impairment of assets*

Hospitals should also comply with the following Department of Treasury and Finance Financial Reporting Directives:

- FRD 114A *Financial instruments: general government entities and public non-financial corporations*
- FRD 106 *Impairment of assets*

## Investment policy statement

- 6.1.7 An investment policy statement should be prepared to document a hospital's investment policy and the approach taken in managing its investments. This statement should be reviewed by the board (or relevant sub-committee) and approved as an accurate statement of the hospital's investment policy (see Appendix 3 for a sample investment policy statement).
- 6.1.8 The investment policy statement can serve as a convenient way to inform stakeholders of the hospital's investment approach.

## Monitoring and reporting

- 6.1.9 The hospital should prepare regular investment reports to assist the board and management to be satisfied that its investment program is managed consistent with its objectives and investment policies.
- 6.1.10 Management should, at a minimum, provide the following investment reports to the board:
- monthly: copy of the internal summary investment report or bank account statement monitored by management
  - quarterly: total portfolio value; broad composition of the investment portfolio; comment on any significant investment issues arising; listing of any investments outside the authorised investments recommended in these guidelines (including a listing of any structured products or investments held).

Refer to Appendix 8 for a simple reporting template.

- 6.1.11 Other items that could be considered if a more comprehensive reporting approach is required include:
- a standard description of the investment strategy used, including:
    - brief description of the purpose of each portfolio (if separate portfolios are set up for different purposes)
    - portfolio composition across different asset types (for example, cash, bonds, term deposit)
    - listing of investment managers and products used
    - the implementation approach (for example, use of any physically segmented portfolios set aside to meet specific future expenditures, strategic asset allocation, actively managed sector portfolios, et cetera).

- summary of investment returns
- credit rating of investments
- comment by management on the use of any derivatives in the portfolio
- compliance status of the investment program (any breaches incurred during the quarter and the steps taken to remedy them).

## Reporting to the Department of Health

6.1.12 The Minister is ultimately responsible for the management of government funds and relies on the department for information regarding the investment activities of the hospitals.

Each hospital should, if requested, be in a position to promptly provide the department the following documents:

- copies of the hospital's investment policy guidelines
- quarterly investment reports
- names of external investment managers employed (if used)
- full schedule of investments, investment managers or products selected directly by management
- a full list of investments that sit outside the illustrative set of authorised investments specified in these guidelines
- list of any external trusts used and their dollar value.

## Simplified investment policy approach

6.1.13 A board of a hospital may adopt a simplified approach to the management of its investment assets in some circumstances. A simplified investment approach would hold only very simple traditional forms of low risk investments such as bank deposits and government bonds and rely on existing financial control policies to manage them (see Appendix 4 for a sample investment policy statement).

6.1.14 In order to justify the use of a simplified approach a board must satisfy itself that:

- All relevant funding stakeholders have been properly identified and their interests safeguarded consistent with the board's fiduciary responsibilities (funding stakeholders include residents in respect of the investment of aged care bonds, government in respect of working capital or capital grants, donors in respect of research grants and donations, et cetera).
- Existing documented delegations, monitoring, control and audit processes that apply to the financial operation of the hospital are sufficient to satisfy its prudential responsibilities with respect to the management of its investments.
- The liability, stakeholder and investment profile of the organisation is simple enough to justify a very simple investment strategy such as holding all investment assets in government securities, and bank deposits debt instruments.
- The investment strategy, investment portfolio and corresponding risk and liquidity profile is appropriate taking into account the purposes for which funds are used, risk profile of underlying funding stakeholders, the liquidity needs of the business and the skill set of staff with delegated responsibility for the management of the assets.

6.1.15 A valid approach in this circumstance may be as follows:

- The board would explicitly approve reliance on this section for the development of its investment policy guidelines.
- The agency may hold all its financial assets in simple Commonwealth or state guaranteed debt instruments, bank deposits or conventional bank debt instruments such as bank bills, floating rate notes or fixed rate notes.
- The hospital may rely on its existing finance-related operational, monitoring and control processes.

6.1.16 If requested by the department, the board of a hospital will need to provide justification for its reliance on a simplified investment policy approach (including why more detailed investment policy guidelines were not judged necessary).

A hospital following a simplified approach should be in a position to promptly provide the department a full listing of its deposits and investments when requested.

# 7 Investment guidelines: roles and responsibilities

## Structure of responsibilities and delegations

- 7.1.1 The hospital should document the structure of responsibilities of all parties involved in the management of investments including the board, Chief Executive Officer, Chief Financial Officer, other responsible staff officers and any external consultants.
- 7.1.2 Delegations of authority to officers responsible for making investment or investment-related decisions should be specifically identified in the hospital's delegations manual and approved by the board.

## Board responsibilities

- 7.1.3 The board is accountable for the investment of a hospital's funds. It has overriding authority to develop, implement and review its investment policies and to delegate investment-related activities to management.
- 7.1.4 The board must apply sound governance principles to the management of agency funds in line with its role as a fiduciary body managing funds provided by taxpayers, residents or donors. In doing so, the board must carefully consider the competing interests of different stakeholders and seek to protect the hospital's funds from the actions of different interest groups.
- 7.1.5 The board should allocate responsibilities between the board and management in a way that preserves the stewardship and independence of the board in relation to investment matters. It should also put in place reporting and compliance processes to allow it to ensure investments are managed consistent with policy goals.
- 7.1.6 Specifically, in relation to investment-related activities, the board must:
  - ensure that its investment policies are documented
  - formally adopt investment objectives
  - approve the investment strategy and implementation method used to manage investments
  - understand and approve the risk management approach adopted in the management of investments (including any use of derivatives)
  - approve delegations of authority with respect to the management of investments, authorised investments and risk limits for the agency
  - satisfy itself that the investment program is managed by those with the necessary skills and that managers are acting within the limits of their delegations and mandates
  - receive and consider investment reports supplied by management on a monthly and quarterly basis
  - review the hospital's investment strategy at least once a year
  - examine independently audited investment portfolio valuations as part of the preparation of their annual accounts.

## Management responsibilities

7.1.7 Management's general responsibility is to manage a health hospital's investment program consistent with the standard of conduct required under the prudent person test, the hospital's investment policies and the limits of its own delegated authorities.

7.1.8 Specific management responsibilities include:

- making investment management decisions (consistent with delegated authorities) including decisions about which investment products, external trusts or professional investment managers to use and the terms on which these managers are engaged
- communicating with external managers to ensure that investment portfolios are managed consistent with approved objectives and strategy
- monitoring the investment performance and compliance status of the strategy
- preparing investment reports for the hospital's board, keeping the board informed of any issues with the potential to materially impact the likelihood of achieving the hospital's investment objectives.

## Use of external managers and advisors

7.1.9 The board and management may consider the use of external specialist investment managers and consultants where they consider that the hospital's own staff do not have the necessary resources or expertise or are pursuing a long-term investment strategy.

7.1.10 Funds may be managed externally using third party investment products or managers (discrete accounts). Where external managers are used, they should operate under formal legal agreements that link to an agreed, well-specified investment mandate that articulates the investment objective, benchmark, authorised investments, diversification requirements, risk limits, derivatives management and compliance obligations.

7.1.11 When choosing an advisor or receiving advice from an investment advisor, the hospital must satisfy itself that the advisor has the necessary skills and experience and must consider the potential for conflicts of interest or other commercial incentives to bias the advice. Where investment advisors are employed by a financial services organisation, agencies should use advisors with institutional independence from investment promoters.

# 8 Investment guidelines: investment strategy

## Introduction

8.1.1 This section deals with each of the following aspects of investment management that are essential to best practice investment strategy design:

- stakeholder interests
- investment objectives
- investment strategy
- risk management approach.

8.1.2 Table 2 below provides a stylised representation of how the key considerations of funding purpose, stakeholder interests, financial situation and risk profile combine to influence investment strategy. Note that the strategies shown in the table should be read as illustrative only and are not necessarily appropriate for a particular hospital. It does, however, indicate how the source and purpose of the financial assets managed by a hospital are critical to determining the appropriate investment strategy.

**Table 2 – Aligning strategy to funding purpose: illustrative only**

Investment pool	Working capital*	Capital grants *Note 1	Employee entitlements * Note (1)	Aged care bonds	Specialist's bonuses	Donations, tied grants (short-term)	Research grants (long-term)
Key stakeholder	Government	Government	- Government - Employees	Residents	Specialists	Donors	Donors
Key funding purpose	Operational expenditure	Capital expenditure	Long service leave etc	Bond repayment	Specialists' operations	Equipment purchases	Research
Investment horizon:							
- wind up	< 1mth	< 1mth	1–3 yrs	1–3 yrs	< 2 yrs	<2 yrs	<2 yrs
- ongoing	n/a	n/a	n/a	5 yrs+	2–5 yrs	n/a	5–10 years+
Risk profile	Low	Low	Low	Low/medium	Medium	Low	Medium/high
Liquidity requirement (< 7 days)	100%	100%	50%	Can repay bond/entry contribution <14 days	30–50%	100%	10%
Typical funding level	100% of near-term expenditure	100% of near-term expenditure	10% of entitlements	100% of repayment liability	100% of equipment expenditure	100% of near term expenditure	Excess reserves are a multiple of expected annual expenditures
Core investments	Cash	Cash	Short and longer duration debt	Medium duration debt	Medium duration debt/equity	Short duration debt	Debt/equity
Equity allocation (% of total assets) * Note (2)	0%	0%	0%	0–15%	10–30%	0%	Depends on the level of excess reserves – say, 10–50%
Typical structure	Pooled in hospital funds	Pooled in hospital funds	Pooled in hospital funds	Separate account or trust	Separate account or trust	Separate account or trust	Separate account or charitable trust

Note:

(1) In practice, working capital, capital grants and employee entitlements tend to be pooled and managed as one investment portfolio.

(2) Equity allocations depend critically on individual circumstances (for example, level of excess reserves).

## Stakeholder interests

- 8.1.3 A hospital should identify different stakeholder interests affected by its investment practices and ensure that its investment strategies will strike the right balance between competing stakeholder interests.
- 8.1.4 It is expected that a hospital can identify the different financial providers involved (for example, state government, federal government, donors, residents) and the extent to which its investment strategy is consistent with these stakeholders' expectations, risk tolerance and any funding conditions.

## Investment objectives

- 8.1.5 The hospital should set and document investment objectives that apply to its investment program. In setting and approving investment objectives, the board should take into account a range of factors including:
- applicable legislation and guidelines
  - the purpose to which the funds are to be applied and the timing of future cash flows
  - the risk profile of the funding stakeholders
  - income and liquidity requirements
  - tax credits and fees
  - the extent to which there may be benefits in establishing separate investment objectives for the development of different portfolio segments.
- 8.1.6 It is prudent for a board to take into account the hospital's investment capabilities when setting its risk profile. Hospitals generally do not have dedicated professional investment staff and are rarely in a position to employ full-time investment specialists. An additional measure of conservatism may therefore be appropriate for governing bodies with respect to risk. Investing in risky assets (for example, equities, low-rating bond instruments), structured investments (such as non-traditional debt structures using embedded options, swaps or third-party guarantees), complicated product structures (hedge funds, unlisted funds, et cetera) requires resources and expertise. In practice, the advice or expertise needed to invest in these instruments may not always be available to the agencies on commercial terms.

## Investment strategy

8.1.7 The investment strategy of a hospital should be clearly documented and formulated consistent with the investment policies approved by the board.

8.1.8 The documented investment strategy should describe:

- the general investment approach used (for example, internal or external managers, whether any assets are matched to specific funding purposes, existence of any external investment trusts, areas subject to advice)
- the target allocation between different types of investments (cash, bank deposits, government bonds, et cetera), including any allowable ranges around these targets
- the risk profile of the strategy (in particular market risk, credit risk, any reliance on guarantees, et cetera)
- its liquidity profile (taking account of any key redemption restrictions that may apply to certain complex investment or product structures)
- risk management approach.

8.1.9 The investment strategy should be consistent with the hospital's investment objectives and reflect consideration of the risk/return profile of the investment strategy, the extent to which the timing of asset receipts matches expected future expenditures. Consideration of the risk profile should take into account a range of risks such as market risk, investment and issuer-specific risks, inflation risk, interest rate risk, credit risk and liquidity risk.

## Illustrative investment strategy

A suitable investment strategy that may be appropriate for a hospital with significant capital grants and aged care bond money may be as follows:

- Short-term strategy: a suitable short-term strategy would generally be to invest in a portfolio comprised of liquid, low-risk, government guaranteed or senior ranking bank debt instruments or deposits. Small internally managed portfolios would be restricted to a small number of bank, state or Commonwealth government guaranteed investments. Larger professionally managed portfolios might hold a diversified range of liquid, low risk investments and make use of their expertise to invest in instruments with slightly higher credit risk on the back of their expertise in credit assessment and the interpretation of credit ratings. External professional investment managers would manage assets under separate legal contracts.
- Long-term strategy: a suitable longer-term strategy might comprise a diversified bond portfolio of bank, government or very high rating, traditional (plain vanilla) debt investments with average duration comparable to the average duration of the agency's medium to long-term liabilities. Diversified portfolios of growth assets (equity or property) may be included in investment accounts that are physically segregated, professionally managed and highly funded relative to the funding liability.

# 9 Investment guidelines: management of investments

## Introduction

9.1.1 This section deals with each of the following aspects of investment management:

- authorised investments
- equity and property holdings
- structured investments and hedge funds
- credit ratings
- risk management
- derivatives
- benchmarking
- compliance processes
- monitoring and reporting
- custody of assets
- securities lending.

## Authorised investments

9.1.2 The hospital board is responsible for deciding what types of investments it considers appropriate to invest in. Agencies must clearly state the investments authorised for inclusion in their investment programs.

9.1.3 Hospitals can legally invest in a wide range of investments if not used for speculative reasons. However, it is generally not appropriate to provide an unrestricted or very broad set of authorised investments to an internal manager who does not have the investment expertise or access to specialist investment management capability. In restricting sets of authorised investments, other factors can also be taken into account such as the legal requirement to exclude speculative investment activity and the complexity associated with structured investments and other types of non-traditional investments or investment products.

9.1.4 Appendix 5 contains a recommended list of authorised investments together with an illustrative approach for setting risk limits to impose minimum levels of diversification across issuers, securities or implementation vehicles such as managed funds.

9.1.5 It is important to note that the inclusion of an investment in Appendix 5 (or any set of authorised investments adopted by a hospital) does not release the hospital from its prudential obligation to make its own assessment of any investment, manager or fund. Nor does it imply that a certain investment type is suitable for any individual hospital.

## Equity and property investments: managed and direct holdings

9.1.6 Direct holdings of equities and property are not generally considered to be suitable investments for hospitals but will be appropriate to hold in some circumstances:

- Direct holdings of shares or property by hospitals may be held where they are provided to a hospital in kind as a result of donations, bequests, et cetera and the terms of the grant require them to be held in that form by the hospital.
- Direct holdings of property assets may also be held where they represent capital assets earmarked for use by the hospital for its own operations. In this instance these would be treated as capital assets and not investment assets for the purpose of these policy guidelines.

9.1.7 Diversified portfolios of equity or property investments managed by professional investment managers may be appropriate for a hospital to include in its authorised investments and investment portfolios. This would generally only be the case for long-term portfolios where the funding stakeholder can tolerate the higher volatility associated with investments in equity and property markets. In instances where large sums of money are involved, it may be worth considering holding the assets in a physically separate trust structure where an independent trustee is responsible for ensuring that the investment program is consistent with stakeholder expectations.

## Structured investments and hedge funds

9.1.8 Hospitals should exclude structured investments and hedge funds from their investment portfolios.

9.1.9 A structured investment refers to a broad range of investments with complex investment structures. These include asset-backed securities, collateralised debt obligations, structured notes with embedded options or guarantees, certain types of alternative debt products, and investments built around the use of special investment vehicles.

9.1.10 Many structured investments have proved extremely difficult to evaluate, even for professional investors, on account of their complexity and the difficulty of assessing the risk profile of the investment. Some are also significantly leveraged. Many can become very illiquid and difficult to value under certain market conditions. Complex fee structures and guarantees also complicate due diligence.

9.1.11 Hedge funds are products that make extensive use of derivatives, short selling and leverage, typically have performance-based fees and are offered outside the regulatory regime that applies to mainstream investment products. A number of difficulties exist for fiduciary bodies investing in hedge funds: the risk and liquidity profile is often hard to evaluate, the investment strategies are very specialised making it hard to assess their effectiveness, fees are often high and complicated to estimate, and transparency and regulatory oversight is very limited.

## Credit ratings

- 9.1.12 Hospitals must carefully consider their ability to assess the credit risk attached to different types of investments.
- 9.1.13 Credit ratings are widely used as a measure of creditworthiness but are subject to variation over time and differences between rating firms. They are also subject to some limitations principally due to the existence of various sources of uncertainty in assessing risk. Investors cannot rely solely on credit ratings for their due diligence of an investment or issuer.
- 9.1.14 Approaches to managing the difficulties that arise in the use of credit ratings include:
- diversification – do not have a large proportion of your investments with one deposit-taking institution, issuer, security type or security
  - confine your investments or deposits to very highly rated debt instruments that are simple in structure and backed by strong guarantors (for example, state and Commonwealth government)
  - avoiding the use of structured investments
  - make use of professional investment managers of debt securities (who have expertise in assessing credit risk and the interpretation of credit ratings).
- 9.1.15 Appendix 6 sets out the key credit ratings produced by private sector firms such as Standard & Poor's, Moody's and Fitch. These ratings are a measure of the creditworthiness and debt repayment ability of firms and debt instruments.

## Risk management

- 9.1.16 A hospital's risk management approach must reflect consideration of the relative materiality of different types of risk and their potential to jeopardise the achievement of its investment goals. The hospital's risk management approach should be documented and approved by the board.
- 9.1.17 The process of formulating an investment strategy will give some guidance on risk management. For example, a hospital mostly holding financial assets to back aged care bond liabilities is less concerned about liquidity risk than a hospital holding only short-term working capital. On the other hand, interest rate risk matters more to the aged care bond portfolios on account of their longer term.
- 9.1.18 Key investment risks include the following :
- liquidity risk: the risk that funds potentially required for short-term needs are not able to be redeemed or sold quickly enough
  - credit risk: the risk that issuers may fail to repay some or all of an investment
  - inflation risk: the value of investments in long-term portfolios do not keep pace with increases in wages, research or equipment costs for portfolios earmarked for these purposes
  - interest rate risk: that rises in interest rates reduce the value of long-term investments (or that falling rates prevent earnings on cash holdings being sufficient to fund planned future expenditure)
  - mismatch risk: generally, the risk that investment portfolio values fall due to market factors that do not cause a commensurate fall in the value of liabilities

- market risk: the risk that market prices and projected future yields across a broad range of markets fall in response to expectations of deteriorating economic or market conditions
- strategy and security selection risk: the risk that poor portfolio structures or investment selection leads to investment losses that jeopardise the achievement of investment objectives
- concentration risk: the risk that insufficient diversification across investment types, issuers, managers or securities, creates significant portfolio exposure from a single risk event.

## Diversification, asset allocation targets and other risk limits

- 9.1.19 Diversification is a core part of any risk management policy. Diversification across both issuer and investment categories acts to limit exposure to various security-specific risks, event risks and liquidity risks.
- 9.1.20 Agencies should set portfolio risk limits on investments with different investment characteristics (for example, risk level, credit risk or liquidity level). This may be expressed as a target asset allocation (equities, bonds, property or cash) together with allowable departures from target or risk limits applied to sub-asset class allocations such as those applied to debt sub-sectors in the table in Appendix 5.

## Derivatives

- 9.1.21 Hospitals must document their risk management strategy with respect to derivatives and must not invest directly in derivatives contracts.
- 9.1.22 Derivatives contracts are specialist instruments that have a number of legitimate uses. However, they also have the potential to create considerable risk by substantially increasing a portfolio's effective exposure to market movements or changing the effective risk exposure of the portfolio to higher risk assets.
- 9.1.23 Hospitals may only invest in derivatives via professional investment managers who have derivatives management expertise and under the following conditions:
- The derivatives are managed under formal investment management contracts which specify the types of derivatives used, the purpose for which they will be used and which have audited derivatives compliance processes in place.
  - The investment manager entering into derivatives contracts has policies in place that prevent: gearing of the portfolio through the use of derivatives, their use for speculative purposes or uses that may create significant additional risk compared to what would be the case without them.
  - The investment managers fall under and comply with the regulatory requirements of an appropriate Commonwealth or state regulatory body (such as APRA) that has responsibility for regulating the use of derivatives by financial institutions or superannuation funds.

## Benchmarking

- 9.1.24 Suitable benchmarks should be nominated to assist in monitoring the performance of investment portfolios.
- 9.1.25 The use of a benchmark does not necessarily imply a strong need to outperform it. A core purpose of comparing returns to a benchmark is to help check that portfolio returns are in line with returns on a standard portfolio of similar investments. Targeting excessive levels of outperformance can create pressures to take on unwanted levels of investment risk.
- 9.1.26 Appendix 7 contains a list of standard benchmarks applied to different types of investment portfolios.

## Custody of assets

- 9.1.27 Evidence of legal title to all investment assets must be recorded in a register either by the hospital administration or an external custodian. This should be reconciled back to the records held by any investment managers at the end of the hospital financial year.
- 9.1.28 Investments of Victorian hospitals should not be pledged, lent or used as security without the express approval of the board and the department.

## Leverage

- 9.1.29 Hospitals should establish policies that prevent leverage of their investment portfolios. Leverage should be prohibited regardless of whether it arises directly by investing borrowed funds or indirectly as a result of the use of derivatives or by investing in structured investments.

## Securities lending

- 9.1.30 Hospitals should not engage in securities lending. Securities lending is an arrangement that allows institutional investors to lend their securities to borrowers in return for a fee and collateral in some form such as a cash deposit or letter of guarantee. Engaging in securities lending creates risks to the lending institution and requires special skills and market knowledge to evaluate.

# Appendix 1 Policy checklist

The following checklist has been prepared to assist hospitals check whether their investment approach is consistent with departmental investment guidelines.

**Table 3 – Investment policy checklist**

Item	Policy guideline	Yes/no <sup>3</sup>
<b>Simplified investment approach</b>		
Are you following a simplified investment approach as per section 6.1.13 of the guidelines? (If yes, you may not need to answer all of the questions in the checklist)	6.1.13	
Does the hospital's investment portfolio only comprise very simple assets such as government securities and conventional bank deposits and debt instruments?	6.1.14	
If following a simplified investment approach, has the board satisfied itself that: <ul style="list-style-type: none"> <li>• all providers of funds to the agency have been identified and their interests safeguarded</li> <li>• existing financial control processes are sufficient to direct the prudent management of its investment portfolios</li> <li>• the hospital's liability, stakeholder and investment profile is simple enough to justify a simplified investment approach</li> <li>• the investment strategy and portfolio structure is appropriate for the risk profile of stakeholders and the liquidity requirements of the agency</li> <li>• the scope of the hospital's investment program is consistent with the skills and experience of those responsible for managing the investment portfolio?</li> </ul>	6.1.14	
<b>Documentation</b>		
Have you documented your investment policies and had them approved by the board?	6.1.2	
<b>Scope of investment guidelines</b>		
Do your documented investment policy guidelines refer to: <ul style="list-style-type: none"> <li>• key stakeholder interests</li> <li>• relevant legislation</li> <li>• investment objectives</li> <li>• investment strategy</li> <li>• authorised investments</li> <li>• risk management approach</li> <li>• derivatives policy</li> <li>• benchmarks</li> <li>• delegations of authority</li> <li>• compliance approach</li> <li>• reporting requirements?</li> </ul>	Various	

<sup>3</sup> If you have answered 'No' to any of these questions you may wish to revisit your investment policies.

Legislation, prudential framework and reporting		
Is your investment program managed in all respects in accordance with the prudent person test <sup>4</sup> incorporated into the <i>Trustee Act 1958</i> ?	6.1.5	
Does your investment program comply with requirements and regulations under the following pieces of legislation: <ul style="list-style-type: none"> <li>• <i>Health Service Act 1988</i></li> <li>• <i>Trustee Act 1958</i></li> <li>• <i>Financial Management Act 1988</i></li> <li>• <i>Aged Care Act 1997</i>?</li> </ul>	6.1.4	
Do you comply with: <ul style="list-style-type: none"> <li>• Australian Accounting Standards AASB 132, AASB 7, AASB 139, AASB 136</li> <li>• DTF Financial Reporting Directives 114 and 106?</li> </ul>	6.1.6	
Do you consider your investment program consistent with the spirit of the DTF Prudential Framework, treasury management guidelines and the conservative risk profile generally expected with respect to the investment of government-sourced funds?	5.1.5	
Reporting		
Does the board receive and review regular investment reports containing up-to-date portfolio values, investment returns and comment on significant investment or compliance issues?	6.1.9-10	
Delegation of authority		
Is the division of responsibility between the board and management clear with respect to the management of investments? Are delegations documented and approved by the board?	7.1.1-2	
Does the board approve investment guidelines, investment objectives, investment strategy and the risk management approach?	7.1.6	
Are the board and management aware of their responsibilities with respect to the management of investments on behalf of different stakeholders?	7.1.8	
Does management regularly report back to the board in a way that allows the board to satisfy itself that the investments of the hospital are being managed consistent with investment objectives and policy guidelines?	7.1.8	
Are breaches of investment policy guidelines reported back to the board?	7.1.8	
Use of external managers and advisors		
Do you seek advice in areas where you consider that your own internal teams do not have the necessary expertise?	7.1.9	
Do you take into account any conflicts of interest when receiving advice from advisors?	7.1.11	
Does your advisor or advisory firm have the experience, skill and knowledge required to advise you in the areas where you seek their advice?	7.1.11	

<sup>4</sup> This test requires that a trustee must exercise the care, diligence, and skill that a prudent person engaged in the profession of managing the affairs of other persons would employ.

Stakeholder interests		
Have you considered the interests and risk profile of stakeholders such as taxpayers, residents and donors in the formulation of your investment program?	8.1.3	
Have you taken into account the different underlying stakeholder interests and risk profiles that apply in respect of: <ul style="list-style-type: none"> <li>state government funded financial surpluses used as working capital or earmarked for capital investment</li> <li>aged care bond money managed in a fiduciary capacity on behalf of residents</li> <li>long service leave funds other sources of funds such as donations and research grants?</li> </ul>	8.1.4	
Investment objectives		
Have you documented board-approved investment objectives that: <ul style="list-style-type: none"> <li>are consistent with the risk tolerance and expectations of key stakeholders such as government, residents and donors</li> <li>set realistic return expectations</li> <li>specify the investment horizon applicable to the investment of different sources of investment funds managed by the hospital?</li> </ul>	8.1.5	
Investment strategy		
Has your investment strategy been documented and approved by the board?	8.1.7	
Does the documented investment strategy set out: <ul style="list-style-type: none"> <li>target asset allocation and rebalancing ranges</li> <li>the risk profile of the strategy</li> <li>liquidity profile</li> <li>approach to managing risk</li> <li>the extent of any use of derivatives (only permitted for use by qualifying professional investment managers for non-speculative purposes)?</li> </ul>	8.1.8	
Have you considered physically or notionally segregating financial assets held to fund different types of expenditures or liabilities (short-term expenses repayment of aged care bonds, research, equipment purchases, et cetera)?	8.1.2	
Have you set clear authorised investment guidelines for the type of assets that may be included in your investment program?	9.1.2	
Have these been approved by the board?	9.1.2	
Are the investments made by internal financial officers of the hospitals consistent with the expertise of internal staff and their consultants?	9.1.3	
Equity and property: managed and direct holdings		
Are equities and property investments consistent with your investment objectives, stakeholder expectations and managed by professional investment managers?	9.1.6	
Are any direct equities and property investments reported to the department?		

Structured investments and hedge funds		
Are structured investments and hedge funds excluded from your lists of authorised investments?	9.1.8	
Can your investment officers describe with respect to any structured investments considered: <ul style="list-style-type: none"> <li>the financial structures engineered to produce the risk/return profile of the funds</li> <li>the broad risk, return and liquidity characteristics of any underlying assets that generate the returns from the investment</li> <li>who exactly provides any guarantees, how creditworthy are they and what is their exposure to adverse systematic events</li> <li>the extent of any leverage applied within the structure of the note as well as any embedded options used</li> <li>any withdrawal restrictions that may apply on redemptions</li> <li>the cost of any guarantees or option-linked protection provided under the note?</li> </ul>	9.1.8	
Are your staff conscious of the fact that products distributed by a bank may not be guaranteed by that bank but by a third-party insurer?	9.1.8	
If you do invest in structured investments or hedge funds, do your financial officers have access to independent, expert advice required to make prudent assessments of these investments?		
Credit ratings		
Does your investment decision-making process recognise the limitations of credit ratings?	9.1.14	
Do your investment decisions avoid relying solely on credit ratings and require a broader investment assessment before investing in investments subject to significant credit risk?	9.1.13	
Risk management approach		
Does your investment decision-making process recognise the limitations of credit ratings?	9.1.14	
Have you documented and gained board approval for the approach you use to manage risk?	9.1.16	
Do you make use of or consider the following sources of risk and risk management approaches in managing the hospital's investments: <ul style="list-style-type: none"> <li>limiting authorities and investments (for example, to government- or bank-guaranteed deposits or debt)</li> <li>seeking liquid investments</li> <li>requiring diversification across the different deposit taking institutions, issuers, types of investments and types of investments</li> <li>managing liquidity risk</li> <li>evaluating and limiting credit risk</li> <li>mismatch risk (between investments and the liability or expense that they fund)</li> <li>inflation risk</li> <li>interest rate risk</li> <li>market risk</li> <li>strategy design risk</li> <li>security selection risk?</li> </ul>	9.1.18	

<b>Derivatives</b>		
Have you documented your policy with respect to the use of derivatives?	9.1.21	
Do your investment policies prevent financial officers entering into derivatives contracts directly on the hospital's behalf?	9.1.23	
Do your investment policies prevent financial officers entering into derivatives contracts directly on the hospital's behalf? If external investment professionals manage funds on behalf of the agency, do they: <ul style="list-style-type: none"> <li>• do so under formal contracts with the agency that specify how derivatives may be used</li> <li>• comply with APRA or equivalent state government guidelines with respect to derivatives use</li> <li>• contract with the agency not to use derivatives to leverage the portfolio</li> <li>• specify the purposes for which they will be used</li> <li>• commit not to use derivatives for speculative purposes?</li> </ul>	9.1.23	
<b>Benchmarks</b>		
Have you established clear benchmarks for monitoring the performance of investments?	9.1.24	
Are these benchmarks reported to the board alongside the returns on the hospital's investment programs?	9.1.24	
<b>Leverage</b>		
Do your investment policies prevent the gearing of investment portfolios via borrowing or derivatives exposures?	9.1.29	
<b>Securities lending</b>		
Do your investment policies exclude securities lending from your investment portfolios?	9.1.30	

# Appendix 2 Legislation

This appendix discusses sources of legislation governing the operation of hospitals and summarises some key requirements.

## State legislation

The Victorian public hospitals are registered agencies constituted as independent body corporates under the *Health Services Act 1988* which is administered by the Department of Health. The department does not have formal responsibility for the investment programs of the hospitals.

## Commonwealth legislation

Many Victorian hospitals receive accommodation bonds from residents entering their residential care facilities. The terms and conditions under which bond money is received stem from the Commonwealth *Aged Care Act 1997*. A key requirement is that the bond money must be held in trust by the hospitals in recognition that this money will ultimately largely be returned to the resident or their estate.

The key provisions relating to investment policy are contained in the *Trustee Act 1958*. Table 1 below sets out some of the key requirements.

**Table 1 Summary of relevant legislation and key requirements**

Issue	Legislation	Requirement
Investment powers	<i>Health Services Act 1988, s29</i>	Section 29 allows 'registered funded agencies ... to invest money in any manner authorised by law ... for trust funds.'
Authorised investments	<i>Trustee Act 1958, s5, s7</i>	In effect, gives the hospitals broad investment powers. A trustee may invest 'in any form of investment', though section 7 sets out a duty not to invest in speculative investments.
Investment duties	<i>Trustee Act 1958, s6 (1a)</i>	Prudent person test – trustees must 'exercise the care, diligence, and skill that a prudent person engaged in the profession of managing the affairs of other persons' would employ.
Review	<i>Trustee Act 1958, s6 (3)</i>	Annual review – 'Trustee must, at least once a year, review the performance (individually and as a whole) of trust investments'
Advice	<i>Trustee Act 1958, s7, s8 (2)</i>	Trustees have 'a duty to take advice' subject to certain conditions. This is reinforced in respect of investment advice in s8 (2).
Investment Considerations	<i>Trustee Act 1958, s8</i>	A range of matters are mentioned that should be taken into account, including trust purpose, beneficiary needs, diversification, risk, maintaining real value, term of investment, capital gains and losses, liquidity, term of trust, tax, costs, inflation.
Borrowing	<i>Health Services Act 1988, s30</i>	Hospitals can borrow as a state government-guaranteed borrower if both the hospital and the loan are approved by the Minister or Treasurer. Though, in practice, health care agencies do not typically borrow funds.
Reporting	<i>Financial Management Act 1988</i>	Hospitals must report borrowings and investments to the Department of Treasury and Finance.

# Appendix 3 Sample investment policy statement: general case

## **Version date: 1 Jan 20XX**

This document summarises key investment policies of the XYZ health service as at 1 Jan 20XX. The investment policies were approved by the board on 1 July 20XX.

## **Approach**

The board has taken into consideration a range of matters in developing its investment policies including:

- the interests, risk profile and expectations of the funding stakeholders
- legislative requirements – in particular, the need for prudent management of investments
- relevant regulations issued under the Health Services Act and Aged Care Act
- the financial profile and policy goals of the hospital's operations
- the resources and investment expertise available to the hospital
- the materiality of investment earnings to the achievement of the hospital's health-related policy goals.

## **Prudent person standard**

The board recognises that the hospital receives and manages funds from government, donors and residents and looks to invest those funds with the care, diligence and skill that a prudent person would exercise in the management of others' money.

## **Governance**

Responsibility for the management of hospital assets has been delegated by the board to the Chief Executive Officer. All delegations are documented in appendix X. Management must manage all aspects of the investment program prudently and in a manner that complies with the hospital's investment guidelines.

## **Reporting**

Management must provide an investment report to the board on at least a quarterly basis setting out, at minimum, portfolio valuation, allocation report, summary of investment returns and a concise management briefing on any significant developments that materially impact the likelihood of the hospital achieving its investment objectives.

All breaches of policy guidelines must be reported as soon as practicable to the Chair of the Finance/Audit Committee and the board advised at its next scheduled meeting in the quarterly report together with a description of any corrective action taken or planned. Material breaches of the policy guidelines are to be reported to the department.

## **Code of conduct and conflicts of interest**

Staff involved in the management of the hospital's investments and board members must disclose any conflicts of interest to the Chief Executive Officer. No staff member or director of the hospital board is to accept any commission, personal financial or material non-financial benefit from an investment provider or distributor.

## Stakeholder interests

XYZ hospital looks to manage investments consistent with the reasonable express and implied expectations of the following stakeholders:

- the community it provides health services to
- residents on whose behalf bond money is held
- donors (present and past)
- state and federal governments.

Bond money held in respect of aged-care residents is considered to be funds held in trust for the beneficiaries of this money (the residents and their estates). It is managed consistent with the investment horizon and liquidity requirement of this asset pool and the risk profile of the beneficiaries.

Donations and research grants are pooled and invested consistent with the purpose, risk profile and investment horizon of the pool as determined by the relevant governing fiduciary body (board, trustee, et cetera).

## Investment objectives

The investment objective for XYZ hospital is to:

- earn market-like returns<sup>5</sup> on surplus short-term funds by putting the funds to work in low risk investments in such a way that sufficient liquidity is expected to be available for projected operating expenses over the next six months
- earn market-like returns or better on funds earmarked for the payment of medium to long-term outgoings by investing in a portfolio of low risk investments taking into account the timing of projected future cash flows and liquidity requirements.

## Investment strategy

The investment strategy adopted by the hospital is approved by the board and is reviewed on an annual basis. The initial strategy together with any subsequent changes to the investment strategy must be reported to the board in the quarterly investment report.

## Authorised investments

Approved hospital investments are limited to:

- Commonwealth or state government guaranteed investments
- Australian registered bank deposits, senior bank debt or bank accepted/endorsed bills
- deposits with state government pooling agencies (TCV et cetera).

Explicit board approval is required to invest in other types of assets such as corporate debt, equities or property. The agency does not invest in structured investments.

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<sup>5</sup> The term 'market-like returns' is not a very precise term for an investment objective but might be used as a conservative term to indicate that more assertive return-seeking investments may not be desirable given the tendency for this incentive to encourage unwanted risks. Various indices exist to help judge what might be a market-like return for a given investment sector or asset class (ASX200 for Australian equities for example) .

## **Use of derivatives**

A derivative is a financial asset or liability whose value depends on (or is derived from) other assets, liabilities or indices. Derivatives exist in a wide range of instruments including forwards, futures, options, swaps, and other composites.

Direct investment in derivatives by hospital management is prohibited.

Where an external professional investment manager manages money for the agency they operate under investment guidelines specified in a legally binding contract. The guidelines under which an external investment manager operates must:

- prohibit the use of derivatives for any purpose other than the hedging of market or security-specific risks
- only permit the use of derivatives if it does not introduce additional risk to the investment programs that would not be permitted without their use
- prohibit the use of derivatives to leverage the portfolio
- require all breaches of guidelines with respect to derivatives to be notified to the hospital within 24 hours.

## **Benchmarks**

Benchmarks are to be established that provide a sound basis for evaluating the performance of the hospital's investment portfolio. A list of standard market indices frequently used for benchmarking different types of portfolios is contained in Appendix 6.

## **Prohibition against leverage**

Leverage of investment portfolios is prohibited in any form (for example, such as may arise as a result of the use of borrowed funds, leverage or investment in leveraged products or investment instruments).

## **Custody of assets**

Evidence of legal title to all investment assets must be recorded in a register either by the hospital administration or an external custodian.

This should be reconciled back to the records held by any investment managers at the end of the hospital financial year.

## **Investment advice**

The hospital makes use of investment advisors from time to time on a range of matters related to its investment portfolios. Investment advisors are chosen based on their expertise and ability to provide advice free of bias arising out of commercial incentives or conflicts of interest.

# Appendix 4 Sample investment policy statement: simplified investment approach

**Version date: 1 Jan 20XX**

This document describes key investment policies of the XYZ health service as at 1 Jan 20XX. The investment policies were approved by the board on 1 July 20XX.

## **Policy approach**

The board has taken into consideration a range of matters in developing its investment policies including:

- the interests, risk profile and expectations of the funding stakeholders
- legislative requirements – in particular, the need for prudent management of investments
- relevant regulations issued under the Health Services Act and Aged Care Act
- the financial profile and liquidity requirements of the hospital's operations
- the resources and investment expertise available to the hospital
- the ability of existing financial control processes, delegations and compliance processes to adequately govern the management of its investment portfolios
- the scope of the hospital's investment program and the skills and experience of those responsible for managing the investment portfolio
- the materiality of investment earnings to the achievement of the hospital's health-related policy goals.

After taking into account the above factors, the board has decided that adopting a simplified investment approach is appropriate for the management of the XYZ health service's investment assets.

## **Simplified investment approach**

The simplified investment approach adopted by the XYZ hospital has the following key characteristics:

- investment portfolios comprising only investments to Commonwealth and state government debt, and highly rated bank deposits and debt instruments
- assets are managed in accordance with the hospital's existing financial control policies and processes
- delegations and authorised investments specified in its financial policies fully restrict the investment of assets to the above-mentioned low risk investments
- the board reviews its investment approach and auditors verify compliance with its financial policies and authorised investments on an annual basis.

## **Governance and delegations**

The board recognises that the agency receives and manages funds from government, donors and residents and invests those funds with the care, diligence and skill that a prudent person would exercise in the management of others' money.

Responsibility for the management of hospital assets has been delegated by the board to the Chief Executive Officer. All delegations are documented in appendix X. Management must manage all aspects of the investment program prudently and in a manner that complies with hospital's financial control guidelines.

### **Board reporting**

Management must provide an investment report to the board on a quarterly basis setting out, at minimum, the value of the portfolio and schedule of investments.

All breaches of policy guidelines must be reported to the board in the next scheduled meeting together with a description of any corrective action taken or planned.

### **Code of conduct and conflicts of interest**

Staff involved in the management of the hospital's investments and board members must disclose any conflicts of interest to the Chief Executive Officer. No staff member or director of the hospital board is to accept any commission, personal financial or material non-financial benefit from an investment provider or distributor.

### **Stakeholder interests**

XYZ hospital looks to manage investments consistent with the reasonable express and implied expectations of the following stakeholders:

- the community it provides health services to
- donors (present and past)
- state and federal governments.

### **Investment objectives**

The investment objective for XYZ hospital is to:

- earn market-like returns<sup>6</sup> on surplus short-term funds by putting the funds to work in low risk investments in such a way that sufficient liquidity is expected to be available for projected operating expenses over the next six months
- earn market-like returns or better on funds earmarked for the payment of medium to long-term outgoings by investing in a portfolio of low risk investments taking into the timing of projected future cash flows and liquidity requirements.

### **Investment strategy**

The investment strategy adopted by the hospital is approved by the board and is reviewed on an annual basis.

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<sup>6</sup> The term 'market-like returns' is not a very precise term for an investment objective but might be used as a conservative term to indicate that more assertive return-seeking investments may not be desirable given the tendency for this incentive to encourage unwanted risks. Various indices exist to help judge what might be a market-like return for a given investment sector or asset class (ASX200 for Australian equities for example).

## **Authorised investments**

Approved hospital investments are limited to:

- Commonwealth or state government-guaranteed investments.
- Australian registered bank deposits, senior bank debt or bank accepted/endorsed bills.
- deposits with state government pooling agencies (TCV, et cetera).

Leverage, derivatives, hedge funds and structured investments

The hospital has no exposure to derivatives, hedge funds or structured investments.

Leverage of investment portfolios is prohibited in any form (for example, such as may arise as a result of the use of borrowed funds, leverage or investment in leveraged products or investment instruments).

## **Custody of assets**

Legal title to all investment assets is recorded in a register maintained by the XYZ health service and audited on an annual basis.

## **Department guidelines and reporting**

The board has verified its compliance with the requirements of section 6.1.14 of the investment policy guidelines issued by the Department of Health which indicates that a simplified investment approach may be approved by agency boards in some circumstances.

A full schedule of its investments is reported to the department as requested.

# Appendix 5 Authorised investments and risk limits

Under the Trustee Act, hospitals are permitted to invest in a broad range of investments. Nonetheless, it is prudent for hospitals to restrict the range of investments that it judges appropriate for it to invest in.

This appendix contains an illustrative set of authorised investments and set of risk limits that we believe might be appropriate for a typical hospital to apply to diversified portfolios.

The following points should be noted about this illustrative set of authorised investments:

- Agencies may justifiably allow broader sets of authorised investments in respect of certain portfolios managed by APRA-regulated investment management firms that employ skilled investment professionals operating under legally binding investment contracts. The legal contract would contain investment guidelines specifying a broader set of authorised investments together with the investment objectives, benchmarks, risk limits and diversification requirements that apply to the managed fund or investment mandate. Specialist investment managers may broaden the investment opportunity set and include a more diverse range of debt instruments such as foreign debt instruments but would need to do so under portfolio risk control processes designed to limit total portfolio risk to agreed levels.
- Greater concentration of risk arising from deposits of investments with hospitals' primary banks may be another justifiable departure from the risk limits implied by the table. In many instances, hospital boards may be able to justify departures from the authorised investments and risk limits on broader policy grounds. For example, small rural hospitals may find it in their interests to support those banks that provide strong support for their hospital fund raising programs.

The table combines authorised investments and risk limits. The cumulative risk limits are illustrative and apply within each investment category (for example, debt or cash) and add up in a bottom-up manner. For example, for debt securities, a total of 50 per cent of portfolio market value may be held in sub-category e below (major Australian bank debt) under a professionally managed portfolio. If 20 per cent is held in sub-category f below (corporate debt), then only 30 per cent can be held in major trading bank debt.

**Table 4 Illustrative set of authorised investments and risk limits – cash and short-term debt portfolios**

Investment category	Limits					
	Internally managed (% of category market value)			Professionally managed (% of category market value)		
	Issuer	Sub-category	Cumulative	Issuer	Sub-category	Cumulative
<b>Debt securities (structured investments and hedge funds excluded)</b>						
<b>Commonwealth Government debt</b>						
a Commonwealth Government debt securities	100	100	100	100	100	100
b Commonwealth Government guaranteed debt securities	20	40	100	20	40	100
<b>State Government debt</b>						
c Semi-government explicitly guaranteed debt securities	50	100	100	50	100	100
<b>Managed funds</b>						
d Investments in broadly diversified, professionally managed investment trusts or funds that have a bond fund rating of AAF or higher (or an equivalent rating as assigned by Moody's)	50	50	100	n/a	n/a	n/a
<b>Corporate debt</b>						
e Corporate debt (excluding securities covered by categories a, b, and c above) with a term to maturity between one year and 10 years, issued by: <ul style="list-style-type: none"> <li>major Australian banks: NAB, WBC, CBA, ANZ.</li> </ul>	50	100	100	50	50	50
f Corporate debt (excluding securities covered by categories a, b, c and e above) with a term to maturity between one year and 10 years, issued by: <ul style="list-style-type: none"> <li>corporates or other borrowers (rated AA or higher by Standard &amp; Poor's or Aa3 or higher by Moody's (long-term rating).</li> </ul>	n/a	n/a	0	20	50	20
<b>Derivatives (not in most hospitals' investment portfolios)</b>						
Derivatives (includes futures, options, swaps) – used for qualifying purposes such as hedging and employing idle cash balances.	Not permitted			Permitted (APRA regulated/ compliant)		
Derivatives (includes futures, options, swaps) – used for non-allowable purposes such as for speculative purposes or for leveraging the portfolio	Not permitted			Not permitted		
<b>Hedge funds, structured investments and securities lending</b>	<b>Not permitted</b>			<b>Not permitted</b>		

Notes:

- 1 Issuer – refers to the entity (for example, corporation, government, government authority, et cetera) that is contractually liable for the repayment of capital and interest under a debt instrument (bond, deposit, debt contract, et cetera).
- 2 Sub-category – refers to the sub-category of investment to which specific risk limits are identified in the table. This includes, for example, rows a, b, c, et cetera for the table setting out authorised investments and risk limits for the debt instruments. Similarly, rows j, k and l in Table 5 for the diversified portfolios of equity, property-related securities or unlisted property trusts are also investment sub-categories.

Investment category	Limits					
	Internally managed (% of category market value)			Professionally managed (% of category market value)		
	Issuer	Sub- category	Cumulative	Issuer	Sub- category	Cumulative
<b>Cash equivalents</b>						
<b>Short-term cash equivalents from highly rated licensed banks</b>						
g Cash, bank deposits, notes and bank-accepted bills, which have terms to maturity of less than twelve months and which can be converted into cash within one business day – issued by or guaranteed by an entity rated A1 (or higher) by Standard & Poor's or P1 (or higher) by Moody's.		100	100		100	100
<ul style="list-style-type: none"> <li>major Australian banks: NAB, WBC, CBA, ANZ</li> <li>other licenced banks (rated A1+)</li> <li>other licenced banks (rated A1).</li> </ul>	100			100		
	50			50		
	20			20		
<b>Managed cash funds</b>						
h Investments in broadly diversified, professionally managed investment trusts or funds that have a money market fund rating of AAm or higher, as assigned by Standard & Poor's (or an equivalent rating as assigned by Moody's).	50	50	50	n/a	n/a	n/a
<b>Cash Equivalents from other highly rated entities</b>						
i Non-licensed bank, or non bank deposit products issued by or guaranteed by an entity rated A1 (or higher) by Standard & Poor's or P1 (or higher) by Moody's. Note: excludes mortgage-backed securities, asset-backed securities, structured products or floating rate notes.	20	50	20	20	50	20
<b>Derivatives (not in most hospitals' investment portfolios)</b>						
Derivatives (includes futures, options, swaps) – used for qualifying purposes such as hedging and employing idle cash balances.	Not permitted			Permitted (APRA regulated/ compliant)		
Derivatives (includes futures, options, swaps) – used for non-allowable purposes such as for speculative purposes or for leveraging the portfolio	Not permitted			Not permitted		
<b>Hedge funds, structured investments and securities lending</b>	<b>Not permitted</b>			<b>Not permitted</b>		

**Table 5 Illustrative set of authorised investments and risk limits – equity and property portfolios**

Investment category	Concentration limits					
	Internally managed (% of category market value)			Professionally managed (% of category market value)		
	Issuer	Sub- category	Cumulative	Issuer	Sub- category	Cumulative
<b>Equity (not in most hospitals' investment portfolios)</b>						
<b>Short-term cash equivalents from highly rated licensed banks</b>						
j Broadly diversified portfolios of equity securities (common stock or preferred stock) that are listed on a regulated stock exchange.	Index weight +10%	100	100	Index weight +10%	100	100
<b>Property (not in most hospitals' investment portfolios)</b>						
k Broadly diversified portfolios of property-related securities listed on a regulated stock exchange or units in public unlisted property trusts.		100	100		100	100
l Unlisted property trusts holding broadly diversified property portfolios.		20	20		20	20
<b>Derivatives (not in most hospitals' investment portfolios)</b>						
Derivatives (includes futures, options, swaps) – used for qualifying purposes such as hedging and employing idle cash balances.	Not permitted			Permitted (APRA regulated/ compliant)		
Derivatives (includes futures, options, swaps) – used for non-allowable purposes such as for speculative purposes or for leveraging the portfolio	Not permitted			Not permitted		
<b>Hedge funds, structured investments and securities lending</b>	<b>Not permitted</b>			<b>Not permitted</b>		

# Appendix 6 Credit ratings

Table 6 below shows the classification for short and long-term investment credit ratings used by the three main credit rating agencies. The shaded area indicates those credit ratings for rated investments generally considered to be of insufficient quality for direct investment by hospitals.

**Table 6 – Classification of the major credit rating agencies**

Short-term debt / commercial paper ratings			
Grade	Moody's	S&P	Fitch
Superior	P-1	A1+	F1+
		A1	F1
Strong	P-2	A2	F2
Acceptance	P-3	A3	F3
Long-term debt and individual security ratings			
Grade	Moody's	S&P	Fitch
Highest quality	Aaa	AAA	AAA
High quality	Aa1	AA+	AA+
	Aa2	AA	AA
	Aa3	AA-	AA-
Above average quality	A1	A+	A+
	A2	A	A
	A3	A-	A-
Average quality	Baa1	BBB+	BBB+
	Baa2	BBB	BBB
	Baa3	BBB-	BBB-
Sub-investment grade			
Grade	Moody's	S&P	Fitch
Speculative	B1	BB+	BB+
	B2	BB	BB
	B3	BB-	BB-
Poor	Caa	CCC+	CCC
	Ca	CCC-	
	C	CC	CC
Default		D	DDD
			DD
			D

Links:

- Moody's <[www.moody.com](http://www.moody.com)>
- Standard & Poor's <[www.standardandpoors.com](http://www.standardandpoors.com)>
- Fitch <[www.fitchratings.com](http://www.fitchratings.com)>

# Appendix 7 Standard market indices

Table 7 below contains a list of standard market indices commonly used in the investment industry to benchmark the performance of different types of professionally managed investment portfolios.

**Table 7 Standard market indices – Australian and global**

Asset class	Market index
Cash	UBS Warburg Bank Bill Index
Australian debt securities – all maturities	UBS Warburg Composite Bond Index (All Maturities)
Australian debt securities – short duration	UBS Warburg Composite Bond Index (0-3 Years)
Australian inflation-linked bonds	UBS Warburg Inflation Linked Bond Index (All Maturities)
Australian equity	S&P ASX 200
Australian listed property	S&P/ASX 200 Property Accumulation Index
Global listed property	Global Property Trust Index
Global equity	MSCI World Gross Index
Global equity (inc emerging mkts)	MSCI All Countries Index (4A)
Emerging market equities	MSCI Emerging Markets Index
Global debt securities	Lehman Brother's Global Aggregate Index
Global inflation-linked securities	Lehman Brother's Global Real Yield Index
US high-yield debt	Lehman Brother's US High Yield Index
Emerging market debt	J.P.Morgan Emerging Markets Bond Index

# Appendix 8 Reporting template

We consider it good practice to state the investment objectives and investment strategy approved by the board in all investment reports and to tailored reports to the hospitals own situation. Nonetheless, the following very basic report may be useful as a starting point in summarising the asset composition of a portfolio.

XYZ Health Service – Investments report (Period ending 30 June 2008)							
1. Debt							
Institution	Rating	Face value	Purchase price	Current market value	Maturity date	Coupen rate (%p.a)	Current yield (%)
<b>Term deposits</b>							
Bank A	A+						
Bank B							
Bank C							
<b>Cash</b>							
Bank A	AA						
Bank B							
Bank C							
<b>Debt instruments</b>							
ABC Issue No. 1	AA						
DEF Issue No. 23							
GBF Bond No. 315							
<b>Total debt</b>							

2. Equity and property				
	Rating	Return (% p.a.) Period ending 30 June 2008		
		Market value (\$m)	5 years	3 years
<b>Term deposits</b>				
<b>Equities:</b>				
Manager A				
Manager B				
<b>Property:</b>				
Australian				
Offshore				
<b>Total equity</b>				

Total portfolio value \$xm

3. Debt exposures by financial institutions				
Institution	Rating	Value	Limit	
Bank A	AA			
Bank B				
Bank C				
Bank D				
	<b>Total</b>			

4. Income and dividends	
	\$m
Current month	–
YTD current year	–
YTD previous year	–

5. Commentary by management	
Key issues arising during the quarter	
Breaches / non-authorised investments	
Current action items	

# Appendix 9 The Victorian centralised financial management system

The Australian investment management industry is a mature one with both private and public sector organisations offering funds management and outsourcing options to institutional investors. There are many institutional-grade, broad capability investment management organisations servicing institutional investors in Australia (for example, MLC, AMP, CFS, et cetera). A small number of public sector organisations also offer some of the same services.

A centralised public sector financial management system exists in Victoria. Under this system, Treasury Corporation of Victoria (TCV) is available to accept short-term deposits and Victorian Funds Management Corporation (VFMC) may be able to provide investment services with respect to the investment of longer-term funds. TCV and VFMC operate under the supervision of the Department of Treasury and Finance (DTF) but are not compulsory for hospitals under the current system.

It is our understanding that DTF guidelines do not strictly extend in their application to hospitals. Nonetheless, we consider it appropriate that the general prudential standards described in DTF guidelines be taken as an indicator of the government's expectations regarding the financial management of public sector entities and the (conservative) risk profile to assume in respect of the management of taxpayer funds.

# Appendix 10 Consulting brief

The consulting contract under which this advice has been provided was made between National Australia Bank Limited and the Department of Health.

The contract states that ‘the purpose of the project is to develop investment policy guidelines and template that will be provided to public hospital Boards to assist with their short-term investments and investment strategies where longer-term investments are concerned’ and makes reference to the Request for Quotation (RFQ) for more details.

The Request for Quotation document sets the scope of the project to be ‘the development of a comprehensive investment policy and user manual (guidelines and template).

‘The user manual instructions should include, but not be limited to:

- legislative and regulatory requirements
- appropriate authorities, delegations and authority/approval protocols
- investment monitoring and reporting frameworks.

‘Treasury management policy including:

- approved investments
- rate-of-return and risk targets
- portfolio diversification
- credit risk management.’

Project steps were referred to on page two of the RFQ as:

- ‘drafting of comprehensive investment policy guidelines and user manual for use by public hospitals
- user-acceptance testing at four hospitals and amend as appropriate.’

The project approach has been as follows:

- reconfirm project scope with the help of an early draft of this paper and adjust where necessary
- consult with a diverse sample of eleven hospitals and incorporate the key findings into the report
- take into account best practice investment policy approaches evolving in other states in the aftermath of the 2007 sub-prime crisis
- retain flexibility in the guidelines so they can be applied to a diverse range of hospitals
- apply a best practice investment policy approach to the specific financial and organisational profile of the Victorian hospitals
- refine the draft guidelines after taking into account feedback received from a working committee of four hospital Chief Financial Officer’s and representatives of the department.

The proposed policy guidelines are covered in sections 6–9 of the report, legislative requirements in section 6 and appendix 2 of the report, authorities and delegations in section 7, and approved investments and diversification requirements are discussed in various parts of the report as well as in appendix 5. Credit risk management is covered in section 8 and appendix 5 of the report.



