TE TAI ŌHANGA
THE TREASURY

Reference: 20210148

7 May 2021

[redacted]

Dear [redacted]

Thank you for your Official Information Act request, received on 8 April 2021. You requested the following:

- *Treasury Report T2020/3194: Debt Strategy in the Context of the LSAP Programme,*
- *Treasury Report T2020/3274: Presentation of Losses from the Large Scale Asset Purchases in the Financial Statements of the Government, and*
- *Aide Memoire T2020/3254: Risk-free discount rates for accounting valuations and negative yields on government bonds*

Information being released

Please find enclosed the following documents:

Item	Date	Document Description	Decision
1.	1 October 2020	Treasury Report T2020/3194: Debt Strategy in the Context of the LSAP Programme	Release in part
2.	16 October 2020	Treasury Report T2020/3274: Presentation of Losses from the Large-Scale Asset Purchases in the Financial Statements of the Government	Release in full
3.	2 October 2020	Aide Memoire T2020/3254: Risk-free discount rates for accounting valuations and negative yields on government bonds	Release in full

I have decided to release the documents listed above, subject to information being withheld under one or more of the following sections of the Official Information Act, as applicable:

- advice still under consideration, section 9(2)(f)(iv) – to maintain the current constitutional conventions protecting the confidentiality of advice tendered by Ministers and officials,
- names and contact details of officials, under section 9(2)(g)(ii) – to maintain the effective conduct of public affairs through protecting Ministers, members of

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government organisations, officers and employees from improper pressure or harassment,

- direct dial phone numbers of officials, under section 9(2)(k) – to prevent the disclosure of information for improper gain or improper advantage, and
- commercially information, under section 9(2)(i) – to enable … [the Crown] to carry out commercial activities without prejudice or disadvantage.

Direct dial phone numbers of officials have been redacted under section 9(2)(k) in order to reduce the possibility of staff being exposed to phishing and other scams. This is because information released under the OIA may end up in the public domain, for example, on websites including Treasury's website.

In making my decision, I have considered the public interest considerations in section 9(1) of the Official Information Act.

Please note that this letter (with your personal details removed) and enclosed documents may be published on the Treasury website.

This reply addresses the information you requested. You have the right to ask the Ombudsman to investigate and review my decision.

Yours sincerely

Reubhan Swann
Manager, Ministerial Advisory Services

20210148
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TE TAI ŌHANGA
THE TREASURY

Treasury Report: Debt Funding Strategy in the Context of the LSAP Programme

Date:	1 October 2020	**Report No:**	T2020/3194
		File Number:	DE-3-2-1-0 (Policy and General)

Action sought

	Action sought	**Deadline**
Hon Grant Robertson **Minister of Finance**	**Note** the content of this report	None

Contact for telephone discussion (if required)

Name	**Position**	**Telephone**		**1st Contact**
Emma Clarke	Senior Strategist, Funding Strategy and Engagement, Capital Markets	s9(2)(k)	N/A (mob)	✓
Matthew Collin	Head of Portfolio Management, Capital Markets		N/A (mob)	

Minister's Office actions (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report	

Enclosure:

Treasury Report: Debt Funding Strategy in the Context of the LSAP Programme

Executive Summary

The overarching objective of New Zealand Debt Management's (NZDM) debt funding strategy is to minimise the Crown's borrowing costs over the long-term with due consideration for risk, while ensuring ongoing access to debt funding markets.

To achieve this, our debt funding strategy involves smoothing New Zealand Government Bond (NZGB) issuance over time, issuing a range of products that appeal to a wide set of investors, ensuring a mutually beneficial relationship with intermediaries, and contributing to the ongoing development of New Zealand capital markets. In addition, our actions and communications are undertaken in a transparent, consistent and even-handed manner. Together, these support vibrant primary and secondary markets, which increases investor demand and reduces costs over the long-term.

In March, the Reserve Bank of New Zealand (RBNZ) began undertaking purchases of NZGBs from market participants, through the secondary market, as a form of alternative monetary policy. This is known as the Large Scale Asset Purchase (LSAP) programme.

In the short-term, the LSAP programme is beneficial to NZDM, with the LSAP programme ensuring there is a regular and reliable buyer for NZGBs in the market, indirectly supporting primary issuance, and lowering overall Crown borrowing costs. LSAP activity does present some long-term risks to the functioning of the NZGB market if NZGB purchases were such that there was not sufficient free-float of NZGBs in the secondary market to support market liquidity and price transparency. However, Treasury and the RBNZ are working closely at an operational level to ensure continuation of an efficient and well-functioning secondary market.

An alternative to secondary market purchases would be for the RBNZ to purchase all or part of the programme directly from NZDM (the primary market). Treasury do not recommend this approach as it would likely reduce price transparency, market efficiency and the incentive on intermediaries to support the secondary market, which risks increasing the Crown's borrowing costs over the long-term. In addition, primary market purchases could reduce the effectiveness of monetary policy, negatively impact NZGB market function, and compromise RBNZ operational independence.

The Pre-Election Economic and Fiscal Update (PREFU) 2020 reported 'losses' from LSAP purchases as approximately $11.1 billion over the forecast period. These 'losses' do not represent the transaction costs of the Treasury selling bonds to investors and the RBNZ subsequently repurchasing them. The $11.1 billion loss is due to valuation differences, and will unwind over time. Treasury will report back with further detail on the transaction costs, and the economic and accounting treatment of LSAP.

Recommended Action

We recommend that you **note** the contents of this report.

Matthew Collin
Head of Portfolio Management

Hon Grant Robertson
Minister of Finance

Treasury Report: Debt Funding Strategy in the Context of the LSAP Programme

Purpose of Report

1. The purpose of this report is to outline the New Zealand Debt Management (NZDM) debt funding strategy, particularly in the context of the Reserve Bank of New Zealand's (RBNZ) Large Scale Asset Purchase (LSAP) programme following your request for a briefing at the Pre-Election Fiscal and Economic Update (PREFU) 2020.

Background

2. New Zealand Debt Management (NZDM) is a function within the Treasury responsible for managing the core Crown borrowing programme, and the Crown's net cash flows and liquidity position. The overarching objective of NZDM is to minimise the Crown's borrowing costs over the long-term with due consideration for risk, while ensuring ongoing access to debt funding markets and continued development of New Zealand capital markets.

3. To achieve this objective, NZDM balances three goals (Figure 1):

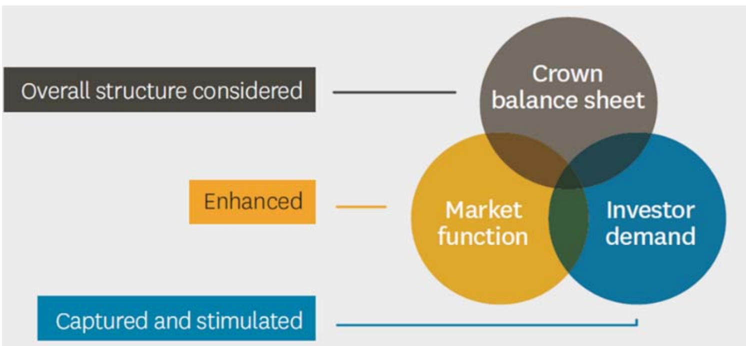
   i consideration of the overall structure of the Crown balance sheet – which ensures fiscal risks resulting from the borrowing programme are considered and managed

   ii enhancing the efficiency and functioning of New Zealand Government Bond (NZGB) markets, and

   iii capturing and stimulating investor demand.

   The first goal attempts to minimise the balance sheet risks associated with our debt portfolio, whilst the last two goals seek to minimise costs associated with borrowing by maximising investor demand and reducing any risk premias associated with issuing NZGBs.

Figure 1: Goals to guide NZDM debt funding strategy



4. All actions of NZDM are guided by the three core principles, to be: transparent, consistent and even-handed.

5. Strategy work on the core Crown borrowing programme is continuous and formally updated at each Economic and Fiscal Update. We are currently refreshing analytical work on the optimal debt funding strategy to mitigate overall Crown balance sheet risks and reduce volatility in OBEGAL outcomes over time. This is important given the significant forecast increase in the borrowing programme resulting from the economic implications of, and fiscal response to, the COVID-19 pandemic.

6. Separately, we continually seek feedback from NZGB investors, intermediaries and international peers on how to best capture investor demand and enhance NZGB market function to inform our debt funding strategy.

7. In March 2020, the RBNZ implemented a LSAP programme, as an alternative monetary policy tool, to lower interest rates in response to the COVID-19 pandemic. The LSAP programme impacts on all three of the NZDM's goals (Figure 1). The RBNZ and the Treasury work closely together to ensure that impacts are considered, and that the right balance is achieved between implementing monetary policy efficiently and effectively, whilst still achieving our long-term debt management goals and objectives.

Debt Funding Strategy

The borrowing programme is set periodically and allows for smoothing of the profile of issuance over time

8. NZGB borrowing programmes are set at each Economic and Fiscal Update. In August 2020, you approved the FY2021 core Crown borrowing programme of $50 billion (Table 1, T2020/2723 refers).

Table 1: Forecast Core Crown Borrowing Programme

Year ending 30 June (face value)	2020	2021	2022	2023	2024	Total
Gross NZGB issuance (NZ$ billion)	29	50	35	35	35	184
Forecast T-Bills on issue (NZ$ billion)	12	10	10	10	10	n/a
Change in NZGB issuance (relative to BEFU)	+4	-10	-5	0	+5	+10
Change in T-Bills on issue (relative to BEFU)	+2	0	0	0	0	n/a

9. Rather than mechanically setting borrowing programmes equal to the Crown's forecast cash deficit (and zero in the case of a surplus) we aim to ensure some smoothing of the profile of NZGB issuance over the forecast period. This reduces volatility that would occur if funding intentions were frequently updated to exactly match cash requirements. We also place value on providing market participants with as much consistency as possible. We avoid unnecessarily changing borrowing programme forecasts, particularly given the uncertainty associated with some of these forecasts in the outer years of the forecast period.

10. Our approach aims to ensure there are not periods of excessive NZGB issuance followed by periods of insufficient NZGB issuance, relative to established demand. Ultimately this will help reduce unnecessary volatility in prices, minimises risk premia over the long-term, and ensures investors and intermediaries remain engaged in the NZGB market through time.

11. When cash proceeds from NZGB issuance is higher than required, financial assets will build up over and above our minimum liquidity requirements. This has no impact on net debt or fiscal strategy. This does provide additional financial resilience for the Crown, as these assets can be liquidated to provide additional funds in the presence of unforeseen shocks (such as the impact from COVID-19). This 'liquidity buffer' helps to minimise the need to immediately adjust the borrowing programme, and further supports its predictability and consistency.

NZDM actions, issuance and communications aim to maximise investor demand and minimise borrowing costs

12. We issue a mix of bond tenors (maturities) and funding instruments (nominal bonds or inflation-indexed bonds (IIBs)) to appeal to as broad an array of investors as possible and to help diversify our investor base. For example, short tenor (circa 1yr – 5yr maturity) nominal bonds are most appealing to the bank market, IIBs appeal to longer-term investors such as pension funds or insurers, while longer maturity nominal bonds appeal to longer-term buy and hold investors such as asset managers. A large and diverse set of investors and market participants ensures deep and liquid NZGB markets, as well as ensuring flexibility and resilience in the borrowing programme.

13. NZDM communications and actions aim to maximise certainty and transparency for investors. NZDM release NZGB tender schedules monthly to advise the market in advance of the coming month’s specific issuances. This ensures our approach to NZGB issuance is strategic and predictable, rather than tactical or reactive. We also announce our upcoming syndications well in advance (for example at Economic and Fiscal Updates). We regularly arrange investor engagements to discuss New Zealand’s Economic, Fiscal and Funding Strategy.

14. Consistent and transparent communication relating to the Government’s funding intentions is vital to minimise unnecessary NZGB market price volatility and to create an environment which allows as many investors and intermediaries as possible to participate and actively support both primary issuance and secondary market liquidity.

15. This approach, in conjunction with a transparent and strong fiscal strategy, supports investor confidence and, therefore, demand for NZGBs. This helps promote well-functioning secondary markets, NZGB market liquidity, reduces risk premia and, ultimately, minimises Crown borrowing costs over the long-term.

16. The breadth and liquidity of the NZGB market also influences private sector debt market development, with a well-developed and liquid NZGB curve able to assist in pricing private sector debt and more accurately determine the cost of capital for firms. We are cognisant of supporting capital market development in New Zealand. In recent years, in addition to helping promote a well-functioning liquid secondary market, we have extended the NZGB curve out to 20 years and reinvigorated the inflation-indexed bond market.

17. s9(2)(f)(iv) [redacted]

Intermediaries play a key role in supporting us to meet our goals

18. NZDM issues NZGBs through syndications and tenders (the “primary market”). From there we are reliant on intermediaries (usually domestic and international banks) to buy and sell NZGBs from investors (the “secondary market”) in a way that supports both investor confidence and helps facilitate the efficient functioning of NZGB markets. In this regard we rely on our intermediaries to support the achievement of our objectives.

19. To help ensure a strong partnership between NZDM and our intermediaries, we limit who can become Registered Tender Counterparties (RTC) to those who meet certain criteria around performance, including supporting secondary market liquidity for NZGBs and demonstrating that they are active in intermediating bonds to end investors.

20. In return for their support of the primary and secondary market, the benefits of becoming an RTC include, but are not limited to:

    a being part of an exclusive ‘dealer panel’ able to access NZGBs through primary markets

    b being invited to participate on syndication panels

    c conducting engagement with investors, supported by NZDM officials and/or yourself as Minister of Finance, and

    d having the opportunity to facilitate other transactional activity managed by the Treasury.

Debt Funding Strategy in the Context of the RBNZ’s LSAP Activity

The RBNZ have deployed quantitative easing in response to COVID-19

21. In response to COVID-19, in March 2020 the Reserve Bank of New Zealand (RBNZ) implemented a LSAP programme as an alternative monetary policy tool[1]. The LSAP programme was initially for purchases of only nominal NZGBs up to a limit of $30 billion over the next 12 months. This was subsequently expanded by $3 billion to include Local Government Funding Agency (LGFA) bonds[2] and Inflation-Indexed NZGBs. In August 2020, the MPC increased the LSAP programme limit to $100 billion of eligible purchases by June 2022[3]. LSAP purchases are undertaken via an RBNZ tender with the secondary market (i.e. not purchased directly from NZDM).

22. LSAP aims to support employment and inflation through reducing benchmark interest rates on NZGBs (and LGFA) bonds. Indirectly, it also reduces Crown borrowing costs. Lowering of key benchmark rates transmits through the economy directly (where interest rates are linked to government bond rates) and indirectly as investors rebalance toward riskier investments in the face of lower returns. Whilst it is difficult to be definitive, on balance, in New Zealand LSAP has likely contributed to looser monetary conditions and supported growth.

LSAP purchases represent a significant portion of the NZGB market

23. The purchase of up to $97 billion of NZGBs by June 2022 (assuming $3 billion of LSAPs are for LGFA bonds) would represent a significant portion of the NZGB market. As a part of PREFU 2020, NZDM forecast $168 billion of NZGBs on issue by 30 June 2022 (T2020/2723 refers). If LSAP purchases of NZGBs were to reach $97 billion this would leave about $70 billion of free-float NZGBs (approximately 21% of forecast GDP), which is around the same volume of NZGBs on issue prior to the onset of COVID-19, and considered to be the approximate lower bound of the amount of bonds required to be available to support a deep and liquid market.

There are some short-term benefits and long-term risks to the NZGB market that are created by LSAP activity

24. By design, the LSAP programme increases demand for NZGBs with the objective of decreasing interest rates. The LSAP programme undertaken in the secondary market

1 https://www.rbnz.govt.nz/news/2020/03/rbnz-to-implement-30bn-large-scale-asset-purchase-programme-of-nz-govt-bonds

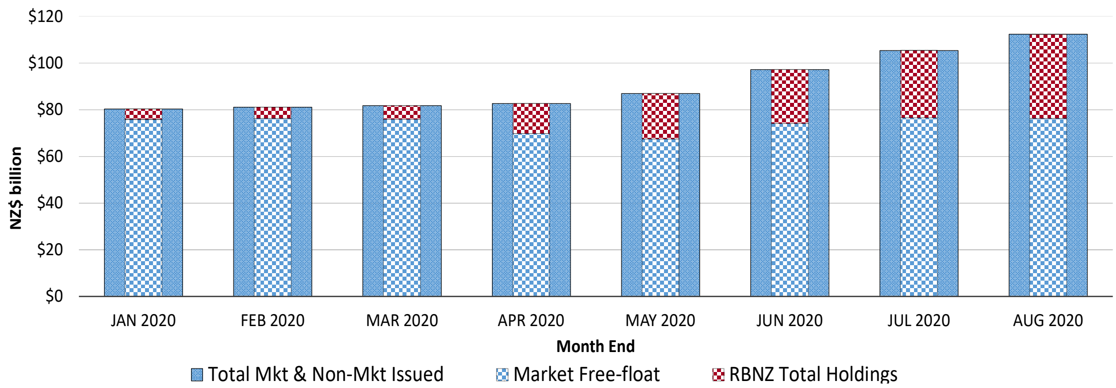
2 https://www.rbnz.govt.nz/news/2020/04/expanded-large-scale-asset-purchases

3 https://www.rbnz.govt.nz/news/2020/08/the-reserve-banks-balance-sheet-set-to-expand-further-in-response-to-covid-19

ensures there is a regular and reliable buyer for NZGBs in the market, supporting primary issuance and lowering overall Crown borrowing costs. LSAP can also support market function in the short-term. In May, investors commented that the RBNZ buying NZGBs helped with market liquidity in the secondary market at a time of relatively disrupted markets.

25. At the same time, the LSAP programme reduces the amount of NZGBs (free-float) held by and available in the secondary market, effectively reducing the size of the market (Figure 2). With this, the Crown's interest rate risk profile also changes, with the longer dated fixed rate NZGB's (those now owned by the RBNZ through LSAP purchases) being replaced by overnight funding at the Official Cash Rate (OCR).

Figure 2: NZGBs on issue and NZGBs held by RBNZ



26. Previous work on an optimal debt strategy has indicated that there can be benefits of including debt with a floating rate component (OCR in this instance), and that benefits are realised when interests costs associated with this debt are highly correlated to economic activity. However, when short-term interest rates are near zero, and expected to be low for a long period of time, the benefits associated with floating rate funding may reduce somewhat due to the limited ability for short-term interest rates to decline further.

27. Generally, there is an equal likelihood that short term interest rates could be higher or lower in the future. However, as you approach the zero-lower bound, the likelihood of short-term interest rates declining further is reduced, thereby limiting the benefits associated with having debt linked to these short-term rates. As indicated in paragraph 5, we are in the process of updating our analytical work around these dynamics in light of the higher funding requirement and economic developments following the COVID-19 pandemic.

28. As at the end of August 2020 the NZGB purchases within the LSAP have reduced the NZGB portfolio's weighted average maturity (WAM) from 8.1 years, down to an equivalent of 6.1 years. s9(2)(i)

29. If the RBNZ were to purchase a level of NZGBs such that there is not sufficient free-float in the secondary market (i.e. demand for NZGBs far surpasses supply) liquidity would be negatively impacted. Lower liquidity and fewer NZGBs available for purchase could ultimately increase liquidity risk premia, thereby increasing overall Crown borrowing costs, as well as resulting in investors and intermediaries exiting the NZGB market.

30. This would have enduring negative impacts on the long-term sustainability of the NZGB market and reduce our funding capability, which would largely be felt after the RBNZ ceases its LSAP purchases. Consequently, following an RBNZ LSAP exit, NZGB issuance would likely be more challenging and there may be an uncomfortable adjustment period, with associated elevated Crown borrowing costs. The investor and intermediary base would need to be rebuilt, with associated lag times (e.g. for investors to secure credit approvals for NZGBs that may have lapsed, or for intermediaries to reinvest in a ‘redundant’ business).

31. Treasury have previously advised, that in this manner, LSAP could pose a risk to the functioning of the NZGB market. If managed, we see this risk outweighed by the overall benefits of the LSAP programme (T2020/2364 refers).

The RBNZ and the Treasury continue to work closely together to minimise these risks

32. The Treasury and RBNZ have been working closely at an operational level over the past months to ensure the continuation of an efficient and functioning NZGB market. The indemnity limits on NZGBs that you have approved also help reduce the likelihood of negative impacts from LSAP activity on the NZGB market.

33. To date, NZDM consider that NZGB market function remains sound, as indicated through qualitative investor feedback, as well as strong demand in primary activity across both tenders and syndications. This suggests that, to date, the current LSAP programme has not negatively impacted market functioning.

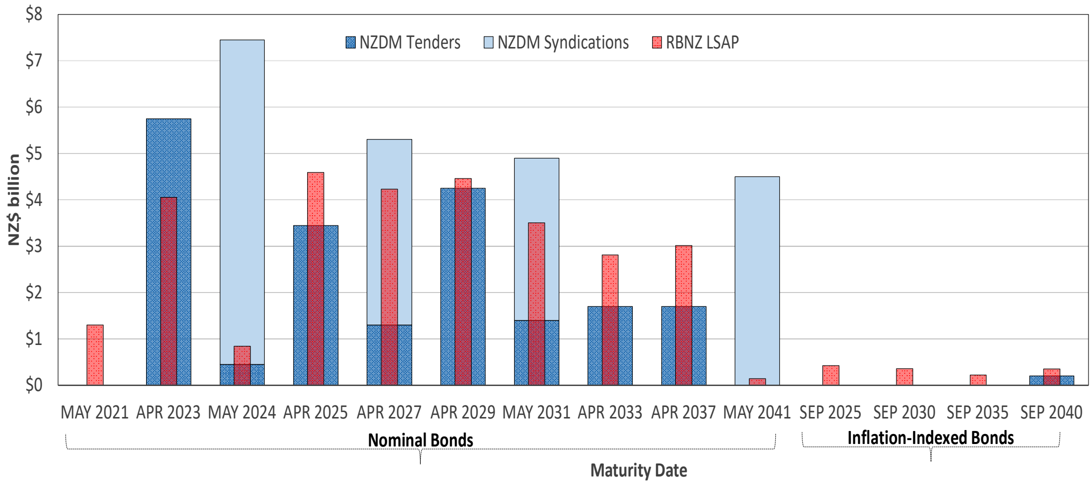
LSAP activity conducted through the secondary market, rather than the primary market[4], is a key way to reduce long-term risks to the efficient functioning of NZGB markets

34. Under the LSAP programme, the RBNZ conduct independent regular weekly auctions to purchase a specific amount of eligible bonds from the secondary market. On Fridays, the RBNZ announce its indicative schedule of the bond maturity dates and the volume of purchases for the following week. Typically, the RBNZ will hold three NZGB and one LGFA purchase auctions a week, each comprising of four bonds. The RBNZ has a list of approved legal entities able to participate in the weekly auctions, which are comprised of both domestic and international banks; the majority of these banks are also RTCs.

35. While NZDM typically issues 3 or 4 different NZGBs weekly through tenders, as well as undertaking syndications of new bonds, and syndicated taps of existing bonds, it is a common misconception that we are issuing the very bonds that the RBNZ is buying back the next week. In practice, the timing and mix of issuance and repurchases is more complicated (Figure 3).

4 In this paper, primary market LSAP purchases specifically refers to LSAP activity where the RBNZ purchases NZGBs directly from the Treasury by participating in auctions of NZGBs to the market

Figure 3: LSAP NZGB purchases compared to NZGB issuance by bond (since LSAP inception)



36. Treasury have previously advised (T2020/1309 refers) that there are a number of debt management benefits to LSAP activity occurring in secondary markets. In particular, secondary market LSAP activity increases price transparency, market efficiency and the incentive on intermediaries to support the secondary market, which in turn supports a deep and liquid market and, ultimately, minimises borrowing costs. The primary market for NZGBs acts as a key pricing benchmark for the broader secondary market, which is of critical importance to investor confidence.

There are more benefits from secondary market LSAPs to the overall effectiveness of achieving monetary policy objectives, and from an institutional perspective, than a programme undertaken strictly in the primary markets

37. LSAP activity conducted through the secondary market is more effective at achieving monetary policy objectives than through the primary market. If purchases were undertaken solely through the primary market this would limit the quantity, and specific bond lines, the RBNZ is able to buy to those being issued by the Treasury at the time, constraining monetary policy's ability to lower NZGB yields, and interest rates more generally.

38. LSAP occurring only through primary market purchases could also limit the ability of the RBNZ to use their LSAP programme to reduce volatility in the secondary market during periods of market dysfunction, which may increase risk premia and, as a result, increase interest rates.

39. LSAP activity conducted solely in the primary market could also lead to concerns around the RBNZ's operational independence. If the Government was seen to be limiting monetary policy, by restricting what the RBNZ is able to buy, perceived independence of the RBNZ may be impacted. This would undermine New Zealand's strong institutional framework, negatively impacting investors' and credit rating agencies' views of New Zealand, likely increasing borrowing costs (amongst other things). Treasury have previously provided advice on this (T2020/1309 refers).

40. It may be possible to minimise some of the above risks if a flexible LSAP programme was established whereby a portion could be purchased in the primary market (and the remainder in the secondary market) at the RBNZ's discretion, within pre-agreed levels. This may mitigate some risks related to institutional frameworks and monetary policy effectiveness. However, it is unlikely to resolve concerns related to efficient market functioning.

This option has not been examined in detail, and more analysis of the costs, risk and any potential benefits would need to be undertaken in order to evaluate this option further.

Financial Implications of LSAP Purchases

41. At PREFU 2020, ‘losses’ from initial LSAP repurchases were reported as $3.3 billion in 2019/20 and were forecast to be $6.1 billion in 2020/21 and $1.7 billion in 2021/22 – a total of $11.1 billion.

42. In some instances, it has been assumed or implied (incorrectly) that the upfront accounting ‘losses’ recorded against LSAP purchases are the cost of banks ‘clipping the ticket’ when LSAP is conducted in the secondary market. This is not the case. The $11.1 billion loss is due to valuation differences, and will unwind over time.

43. Treasury have previously advised you that there may be some costs to transacting in the secondary market (versus primary), and that these are difficult to quantify (T2020/1309 refers). The transaction costs arise to the extent that there may be a marginal price difference to purchase a bond away from ‘fair value’. Treasury are in the process of estimating this cost, noting it depends on timing, composition and market conditions when LSAP purchases take place. It is not a directly observable cost and is therefore difficult to quantify exactly. We estimate it would be minimal, with bank research suggesting that any early ability to generate profits have eroded over time.

44. Treasury will report back to you on any transactions costs associated with secondary market LSAP, as well as a more complete overview of the economic and accounting treatment of LSAP in the near term.

s9(2)(f)(iv)

TE TAI ŌHANGA
THE TREASURY

Treasury Report: Presentation of Losses from the Large Scale Asset Purchases in the Financial Statements of the Government

Date:	16 October 2020	**Report No:**	T2020/3274
		File Number:	BM-1-2-1-2020-12 (June)

Action sought

	Action sought	Deadline
Minister of Finance (Hon Grant Robertson)	**Note** the recommendations. **Indicate** whether you agree with the Treasury's preferred option for disclosing the losses from the Large Scale Asset Purchases in the Financial Statements of the Government. **Indicate** whether you would like to discuss this report with Treasury Officials.	5pm, Monday 19 October 2020

Contact for telephone discussion (if required)

Name	Position	Telephone		1st Contact
Kamlesh Patel	Team Leader, Fiscal Reporting	s9(2)(k)	s9(2)(g)(ii)	✓
Jayne Winfield	Manager, Fiscal Reporting			

Minister's Office actions (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report

Enclosure: No

Treasury Report: Presentation of Losses from the Large Scale Asset Purchases in the Financial Statements of the Government

Executive Summary

The 30 June 2020 Financial Statements of the Government (FSG) are due to be finalised on 30 October 2020. We are currently working with the Office of the Auditor-General (OAG) on matters raised through their audit process.

This report is being provided on a no surprises basis to the incoming Minister of Finance to inform signing off on the integrity and compliance of the FSG. The only significant outstanding matter we are currently working to resolve relates to the presentation of losses arising from the Large Scale Asset Purchases (LSAP) programme. At this point, the Treasury and the OAG have different views on the reporting of these losses within the operating balance before gains and losses (OBEGAL). This report outlines the reasons for the different views and options to progress this issue going forward. Our preferred option involves removing the presentation of OBEGAL in the audited section of the FSG and reducing the prominence of OBEGAL in the commentary accompanying the FSG.

Both the Treasury and the OAG agree on the accounting treatment and the value of the losses from the LSAP programme, so the issue is purely around how the losses are being presented in calculating OBEGAL in the financial statements. The difference in professional opinion comes about from a different interpretation of the underlying policy in an untested area.

Continuing with our current presentation of losses from the LSAP programme being excluded from the calculation of OBEGAL, risks the OAG issuing a qualified audit opinion. The FSG have not had a qualified audit opinion since the early 1990's. As OBEGAL is not prescribed by accounting standards, there are judgements by the Treasury being made around the presentation; however, we do not believe this should lead to a qualification. At this point we believe the OAG has not yet provided a compelling argument for us to include losses from the LSAP programme in the calculation of OBEGAL.

The Treasury's view is that the LSAP programme has been implemented for monetary policy purposes and the decision was independently taken by the Reserve Bank of New Zealand's Monetary Policy Committee. The indemnity provided by the Crown reinforces that the decision was taken independently from the Crown. In addition, the Treasury believes the LSAP losses arise due to a valuation difference as a result of market changes in interest rates and therefore should be excluded from OBEGAL. This presentation approach has been applied in the fiscal forecasts presented in *the 2020 Pre-election Economic and Fiscal Update* (Pre-election Update) and the *2020 Budget Economic and Fiscal Update*. Our approach to LSAP losses is consistent with the presentation of other valuation changes on financial instruments due to market movements.

We have received formal advice from the OAG on Thursday 8 October 2020, that in their view, the losses should be part of "total expenses (excluding losses)" and included in the calculation of OBEGAL. It is their view that the losses are a direct result from a fiscal policy decision by the Government and therefore should be reflected in the fiscal performance of the Government as measured by the OBEGAL.

The OAG are of the view that OBEGAL is a key measure and communications tool used by the Treasury and Minister of Finance to communicate the Government's performance. Given its prominence, the current presentation of OBEGAL excluding the LSAP losses does not fairly present the performance of the Government for the year. As a result, they have signalled they intend to issue a qualified audit opinion that the OBEGAL result is not fairly stated in the Financial Statements of the Government.

We are concerned with the OAG's position, and in particular that their view (that OBEGAL should reflect the fiscal impacts of all decisions the Government has control over) is contrary to the purpose of OBEGAL, which is primarily used to communicate performance against the Government's fiscal strategy. In addition, we believe the OAG's view would create an inconsistency in the treatment with other gains and losses on financial instruments due to market movements (e.g. investment gains from increases in share prices).

It is highly probable that we will not be able to reach a common view with the OAG. We see three possible options/outcomes:

- Presentation remains unchanged with LSAP losses in gains and losses reported below OBEGAL **(Option 1)** – likely results in a qualified audit opinion; or

- OBEGAL is removed from the audited section of the FSG and is given reduced prominence in the commentary **(Option 2)** – OAG have signalled this removes the risk of a qualified audit opinion (subject to seeing the final presentation), but as the losses would still be part of "gains and losses" and not "total expenses", this option does not remove the qualification risk entirely; or

- Presentation changes where LSAP losses are reported in the calculation of OBEGAL **(Option 3)** – likely results in an unqualified audit opinion, but it is a different presentation to the Pre-election Update.

Overall, our assessment is that all the options pose minimal risk to the Government's credit rating and investor confidence because it is a presentational issue and our understanding is that credit rating agencies do not focus on only one fiscal indicator, but look at a wide range of metrics in making assessments.

Also, given that currently there are no specific point targets for government fiscal objectives, we believe there is limited risk to the Government in achieving their fiscal strategy and the need to change fiscal policy if LSAP losses were reclassified as expenses and included in OBEGAL.

On balance, the Treasury's preference would be **Option 2** because it removes the risk of a qualified audit opinion and can be transparently explained and communication of OBEGAL can still be achieved. There will need to be a careful communication strategy to help mitigate any adverse reaction.

As mentioned the Minister of Finance is required to sign a Statement of Responsibility on the Financial Statements of the Government that attest to their integrity, compliance with the Public Finance Act (PFA) and that they fairly reflect the financial position and performance of the Government. In order to sign the Statement of Responsibility the Minister of Finance will need to form a view on the appropriate presentation of losses from LSAP.

We seek the Minister of Finance's comments on the issue and confirmation of the Treasury's preferred option as we work to finalise the FSG. Treasury officials are available to discuss the content of this report and the Minister of Finance may also want to discuss the issue with the Controller and Auditor-General directly.

Recommended Action

We recommend that you:

a **note** that the 30 June 2020 Financial Statements of the Government (FSG) are due to be finalised on Friday 30 October 2020;

b **note** that the Controller and Auditor-General will issue his audit opinion on the 30 June 2020 FSG on the same day as the finalisation date of the FSG;

c **note** that through the audit process the OAG has concluded that losses from the Large Scale Asset Purchase (LSAP) programme should be included in the calculation of OBEGAL;

d **note** that at this point in time the Treasury disagrees with the OAG's position and believe the losses from the LSAP programme should be excluded from the calculation of OBEGAL;

e **note** that the OAG has signalled they intend to issue a qualified audit opinion if no changes are made to the presentation of the OBEGAL amount to include LSAP losses;

f **note** that if a common view is not reached the Treasury see three possible options/outcomes;

- Presentation of LSAP remains unchanged with LSAP losses in gains and losses reported below OBEGAL **(Option 1)** – likely qualified opinion.
- Remove the OBEGAL calculation from the audited section of the FSG and reduce its prominence in the commentary from the FSG **(Option 2)** – reduces risk of a qualified opinion.
- Presentation changes where LSAP losses are reported in the calculation of OBEGAL **(Option 3)** – likely results in an unqualified opinion, but presentation is different to the Pre-election Update.

g **note** that the Treasury preferred option/outcome from recommendation (f) is Option 2;

h **indicate** whether the Minister of Finance agrees with the Treasury's preferred option in recommendation (g);

Agree/disagree.

i **note** the Treasury will report back to the Minister of Finance on the final presentation of the losses from the LSAP programme;

j **note** that the Minister of Finance is required to sign a Statement of Responsibility on the FSG that attest to their integrity, compliance with the PFA and that they fairly reflect the financial position and performance of the Government; and k **indicate** whether the Minister of Finance would like an opportunity to discuss this report with Officials.

Yes/no.

Jayne Winfield
Manager, Fiscal Reporting

Hon Grant Robertson
Minister of Finance

Treasury Report: Presentation of Losses from the Large Scale Asset Purchases in the Financial Statements of the Government

Purpose of Report

1. The purpose of this report is to advise you of the different views that the OAG and the Treasury have on the presentation of losses from the LSAP programme in the FSG, the possible consequences on the audit opinion for the 2019/20 FSG and to seek the Minister of Finance's comment on the presentation options to progress this issue.

2. The OAG believe losses from the LSAP programme should be part of the government's "total expenses" and included within the OBEGAL rather than their current presentation as gains and losses below OBEGAL. The OAG has signalled they will issue a qualified audit opinion over the FSG for 30 June 2020, if OBEGAL does not include the impact of losses from LSAP.

3. The Treasury are of the view that these losses should not be included in the OBEGAL, but reported below-the-line as losses. This report covers:

    - background on OBEGAL as a fiscal indicator;
    - explanation of how the losses from the LSAP programme arise;
    - views on the presentation of the losses from LSAP; and
    - the possible options and outcomes (including our recommendation).

Background on OBEGAL as a Fiscal Indicator

4. The Public Finance Act 1989 requires the Government to set a fiscal strategy in accordance with the principle of responsible fiscal management. A government makes choices about fiscal indicators to use to measure progress towards its fiscal strategy. Fiscal indicators can be drawn directly from the FSG, prepared in accordance with generally accepted accounting practice (GAAP) or they may be constructed from some elements of financial information used to prepare the FSG.

5. Since 2001 New Zealand governments have used a complementary indicator to the GAAP based operating balance to measure performance against their fiscal strategy. From 2008, OBEGAL has been the indicator used by governments to measure performance against their fiscal objective. OBEGAL is a non-GAAP measure therefore is not prescribed by accounting standards; however, it is constructed from financial information in the FSG, which has been prepared in accordance with accounting standards.

6. In 2008, when moving the preparation of the FSG to a new suite of accounting standards based on IFRS (International Financial Reporting Standards), we took the opportunity to present the OBEGAL sub-total on the face of the Statement of Financial Performance. This provided additional transparency around how both the OBEGAL indicator and the bottom-line operating balance were calculated.

7. The main purpose of OBEGAL (and previous complementary operating balance indicators) is as a communications device, designed with the objective of improving the feedback quality of information as to how the Government is performing against its fiscal strategy through fiscal policy choices. Complementary operating balance indicators were introduced to deal with concerns around the accountability to the government's fiscal strategy when using the operating balance which is subject to market fluctuations in asset and liability valuations. These items are highly variable and not within the direct control of the Government in the short-term. As a result, they are not helpful to readers of the financial statements in assessing or communicating the Government's fiscal management performance against its stated strategy.

8. It is important to note that the purpose of OBEGAL is not to remove all the volatility in the Government's operating performance or measure only the controllable portion of the operating balance. In addition, OBEGAL is not a substitute indicator for the operating balance but rather complementary to it. The operating balance remains the best measure to assess the overall financial performance of the Government, particularly over longer time horizons.

9. As OBEGAL is a non-GAAP indicator there is some judgement involved in determining the valuation changes that should be extracted from the operating balance to form the calculation of OBEGAL. In most cases judgements are straightforward, however when there is some uncertainty around the presentation of matters there are some key principles the Treasury apply to guide our judgement. These include:

- limiting the number of items reported below OBEGAL, both to maintain credibility of the indicator, and to maintain its simplicity and therefore its understandability;
- seek to separately report, below OBEGAL, items that are impacted by changing views about the time value of money affecting present valuations;
- seek to separately report, below OBEGAL, revaluation changes that impact the operating balance caused by changing economic prices and conditions;
- seek consistency with System of National Accounts (SNA) and Government Finance Statistics (GFS) accounting by ensuring that there are no items that are considered "transactions" in those frameworks, as opposed to "other economic events" which are reported below OBEGAL; and
- seek to minimise compliance costs by not requiring difficult or arbitrary allocations of single items between revenues and expenses (above OBEGAL) and gains and losses (below OBEGAL).

10. While the operating balance remains the best measure of overall financial performance in our view, we acknowledge both the Government and the media often focus on OBEGAL as a better measure of the implementation of fiscal policy and fiscal responsibility. This leads to a greater prominence of OBEGAL compared to the GAAP operating balance measure.

Losses on the LSAP Programme

11. The primary aim of the LSAP programme is to support the economy by lowering borrowing costs to households and businesses and depreciating the New Zealand dollar. Under this programme, the Reserve Bank of New Zealand (Reserve Bank) intends to buy up to $100 billion of New Zealand Government Bonds (NZGBs) and Local Government Funding Agency (LGFA) Bonds in the secondary market.

12. As at 30 June 2020 the Reserve Bank had purchased $22.0 billion of assets under the programme, comprising $21.0 billion in NZGBs and $1.0 billion in LGFA bonds. As well as the economic impacts from the LSAP programme there are a number of fiscal consequences for the FSG.

13. To acquire the financial assets under the LSAP programme on the secondary market, the Reserve Bank must pay current bondholders the market price for those bonds. The market price in the current environment will generally be higher than the bond prices that bondholders paid when the bonds were first issued by the Government (as interest rates have fallen) and therefore the NZGBs liability on the Crown's books.

14. As a consequence, a valuation difference arises on consolidation between the current market value, paid by the RBNZ for the NZGBs, and the historical value of the NZGB liability as recorded by the Crown. Broadly speaking, the valuation difference reflects the change in the value of bonds since they were issued owing to movements in interest rates in the market. This valuation movement on the repurchased bonds has been presented as a loss of $3.3 billion that comes about on consolidation when eliminating the Reserve Bank bonds and the NZGB liability.

15. As the NZGBs purchased by the Reserve Bank move closer to their maturity, the valuation difference on consolidation narrows, meaning that the initial losses on consolidation reported reverse over time, through a reduction in future finance costs. The reason the valuation difference gets smaller is because as bonds get closer to their maturity it is expected that the market price of the bonds and the cash that will be paid out on those bonds will converge.

Views on the Presentation of Losses from LSAP

The Treasury's View

16. As noted above, the inclusion or exclusion of items from OBEGAL in some cases are a matter of judgement. When it became clear that LSAP losses on the purchase of NZGBs would be material and that the fiscal impacts of the Reserve Bank's interventions in the markets should be clearly explained in the FSG, the Treasury worked to determine the most appropriate disclosure of these losses. This included assessing the presentation of the losses against the key principles of OBEGAL, considering the approach in other jurisdictions, and discussing the issue with the OAG and the FSG Audit Committee.

17. The Treasury considers there is a balanced judgement to be made in determining whether losses on LSAP should be included in OBEGAL. On one hand, the LSAP programme has been implemented for monetary policy purposes and the decision was independently taken by the Monetary Policy Committee and the losses are due to movements in interest rates and the different valuation approaches for NZGB assets held by the Reserve Bank and the Crown's NZGB liability. On the other hand, the losses are directly due to a decision by the Reserve Bank to intervene in the market for monetary policy purposes. On balance, the Treasury's position has been to report the losses from LSAP below the OBEGAL line, in gains and losses and therefore, only included in the operating balance. The key factors leading to that view were:

    - Consistency with the overarching purpose of OBEGAL of providing accountability against the Government's fiscal strategy, which looks through LSAP losses and therefore provides a more relevant ex-ante and ex-post comparison.

- Consistency with previous repurchases of NZGBs, notably by the Reserve Bank who repurchase in advance of the final maturity of a bond, to smooth operations and promote market liquidity, but also trading in Government stock by Crown financial institutions such as New Zealand Superannuation Fund (NZS Fund) and ACC.

- Consistency with the SNA and GFS accounting frameworks which report all financial instruments at fair value, that has the consequence of reporting unrealised losses as “other economic events” when they occur, and consequently no loss when a repurchase occurs.

- Consistency with the treatment of other gains and losses on financial instruments owing to market changes (e.g. changes in share prices), which are not included in OBEGAL.

- Greater understandability for users of the FSG, as OBEGAL stands for Operating Balance **before** Gains and Losses and the losses from LSAP are more easily understood and communicated as a loss rather than a finance cost presented in “total expenses” of the government.

- The losses from LSAP are more fairly attributed to (independent) monetary policy rather than fiscal policy which OBEGAL seeks to reflect.

The OAG’s View

18. The OAG has considered our position and made other judgments in reaching a different view. They consider losses from LSAP repurchases should be recognised in OBEGAL because in their opinion, it would be more meaningful for the readers of the financial statements to see the full extent of government controlled activities as part of OBEGAL.

19. The OAG has provided formal advice to the Treasury on 3 September and 8 October 2020, with the latter advice articulating their position in writing. They have advised that in forming their view, the following were key considerations:

    - The Reserve Bank is consolidated into the FSG and the decisions that the Reserve Bank makes should be reflected in OBEGAL where this has a financial impact on the Government. The LSAP programme is not just a monetary policy decision, but also a fiscal policy decision at the whole of government level. The whole of government is one entity therefore OBEGAL in the FSG should reflect all decisions made.

    - A specific decision has been made to enter into the LSAP programme as a response to the COVID-19 pandemic. This decision was made in the knowledge that there would be a significant loss to the Crown on repurchase. In this sense, the loss takes the form of a “transaction” of the Crown, rather than a “loss” that should be below OBEGAL.

    - The precedent of the repurchases of NZGBs by the Reserve Bank as part of its normal business is not relevant as any valuation changes have been immaterial and there is a specific decision made to respond to stimulating the economy.

    - This is the first transaction of this type and scale in New Zealand’s history, so there is no precedent to be consistent with.

    - The short to medium impact of repurchasing government bonds is to reduce interest costs in outer years, as well as allow the Government to sell new bonds in the future.

- As interest costs are included as part of OBEGAL, the losses incurred on repurchasing the instruments that give rise to this cost should be included in OBEGAL as well. This is a transaction effected by Government which has resulted in increased losses which are finance costs of repurchasing the debt.

- The LSAP programme will continue in the future, and quantitative easing is likely to be a key mechanism that the Government/Reserve Bank will continue to use to stimulate the economy.

- Similarly they do not consider consistency with the treatment of similar transactions by entities that manage funds (such as ACC or the NZS Fund), is relevant to the issue, as the Minister is providing an expectation around returns on investments, rather than direction to specifically sell certain investments.

20. Overall, the OAG are of the view that the OBEGAL amount is a key non-GAAP measure used by the Treasury and the Government to communicate the Government's performance, and given its prominence as a communication tool, the current presentation excluding the LSAP losses does not fairly present the performance of the Government for the year.

The Treasury's concerns with the OAG's view

21. Both the Treasury and OAG agree that the accounting for the losses from LSAP comply with GAAP. The Treasury acknowledges the presentation of LSAP is a difficult judgement and that the OAG view has some merit; however, we have some significant concerns around their position.

22. The OAG's position that OBEGAL should reflect all decisions the Government has control over is contrary to the purpose of OBEGAL, which is primarily to communicate against the Government's fiscal strategy rather than the results of all decisions.

23. We believe the OAG's position would create an inconsistency between transactions as there are other items that are currently reported below OBEGAL which could be argued to be a result of Government decisions. For example, the Government have provided a directive to the NZS Fund to generate investment returns; however, most of these returns are reported below OBEGAL.

24. In the past the OAG has expressed a strong view that it is important the calculation of OBEGAL is kept consistent to ensure its credibility as a fiscal indicator over time. The Treasury's current judgement is that all gains and losses from financial instruments are presented below OBEGAL. We have recommended changes in the past to include some gains and losses from financial instruments in OBEGAL; however, at the time, the OAG had a very firm view that the judgements should not change. We also have concerns that moving away from a strictly consistent approach for calculating OBEGAL over time could lead to criticism of cherry picking particular transactions or event to be included in OBEGAL in a certain year. This would undermine the credibility of OBEGAL as a fiscal indicator.

25. The treatment is not aligned with international practice for reporting government or national reporting statistics. No jurisdiction that we are aware of reports such losses in their underlying performance measure.

Attempts to reach a common view

26. There have been a number of discussions between the OAG and the Treasury as we have sought to reach a common view on this issue.

27. There has also been detailed discussions on this issue with the FSG Audit Committee, who agreed that the losses from LSAP are of significant public interest, material and unique, and therefore, should be made transparent and be clearly explained in the FSG. However, while the FSG Audit Committee noted it is a difficult judgement to make in respect of the OBEGAL presentation, a consensus view was not reached by them on whether the losses should be included or excluded from OBEGAL.

28. As a consequence of these discussions, the Treasury decided to separately disclose the losses from LSAP on repurchases on the face of the Statement of Financial Performance (rather than combine them in the "gains and losses" line for financial instruments). We believe this provides greater transparency of the transaction and made this change in the recent *Pre-election Economic and Fiscal Update* (Pre-election Update). The OAG acknowledge this is helpful and are pleased that this presentation has also been reflected in the unaudited FSG.

29. However, we have not been able to reach a common view on the main issue in respect of the OBEGAL presentation. At its heart, there seems to be three irreconcilable main differences in professional opinion:

- Whether the losses are due to market movements in the value of NZGBs since the period of their issue; or, whether the losses are due to a Government mandated transaction to repurchase bonds at a higher price on the secondary market and thereby incur an avoidable loss.

- Whether OBEGAL is an appropriate yardstick for measuring the Government's performance against its fiscal strategy, without the noise of market fluctuations, or whether the appropriate measure of financial performance of the Government should reflect the full extent of government-controlled activities, which would be the operating balance.

  Whether the decision was for the purpose of monetary policy or fiscal policy what control the Government had around the decision.

30. The first issue represents two different lenses on the cause of the loss, both of which have some merit. The other two issues however goes to the heart of how the Government develops, articulates and measures progress against its fiscal strategy.

31. Discussions on the issue are likely to continue until the signing date of the FSG (scheduled to be 30 October 2020). We see three possible outcomes from these discussions. The next section outlines the three possible outcomes and their potential consequences.

Possible Options and Outcomes

32. Ideally the Treasury would like to reach a common view with the OAG where the current presentation is accepted by the OAG as a fair reflection of the Government's performance against its fiscal strategy. At this point in time, we consider there is a low probability of this outcome. We believe that there are three possible options/outcomes from the issue around the presentation of losses from LSAP, which are:

- Presentation remains unchanged with LSAP losses in gains and losses reported below OBEGAL **(Option 1)** – likely results in a qualified audit opinion.

- OBEGAL is removed from the audited section of the FSG and is given reduced prominence in the commentary **(Option 2)** – reduces the risk of a qualified audit opinion, but as the losses would still be part of "gains and losses" and not "total expenses", this option does not remove the qualification risk entirely.

- Presentation changes where LSAP losses are reported in the calculation of OBEGAL **(Option 3)** – likely results in an unqualified audit opinion, but it is a different presentation to the Pre-election Update.

33. Overall, our assessment is that all the options pose minimal risk to the Government's credit rating and investor confidence.

34. Given that there are currently no specific point targets for fiscal objectives, we believe there is limited risk to the Government in achieving their fiscal strategy and the need to change fiscal policy.

35. The Treasury's ideal outcome would be to make no changes to the presentation and receive a clear audit opinion. However our assessment is that this outcome is unlikely and therefore on balance, the Treasury's preference would be **Option 2** based on the fact it reduces the risk of a qualified audit opinion and is likely to pose the least credibility risk to the Government and the Treasury. A full analysis of the options is outlined in Annex Two.

36. There could be communication challenges and it is possible media and readers of the accounts would look through the formatting change and still focus on OBEGAL. However, it would still be a good opportunity to re-focus the media and readers on the operating balance as a more comprehensive measure of annual performance. Annex One provides an illustration of how the Statement of Financial Performance would look under Option 2 and the other options. We have tested this option with the OAG and they are open to accepting this approach, subject to seeing the final presentation.

37. We seek the Minister of Finance's feedback on the issue and confirmation of our preferred option as we continue our work with the OAG.

38. The Minister of Finance is required to sign a Statement of Responsibility on the FSG that attest to their integrity, compliance with the PFA and that they fairly reflect the financial position and performance of the Government.

39. In order to sign off on the FSG the Minister of Finance will need to form a view on the appropriate presentation of losses from LSAP. The Treasury are available to discuss our view on the presentation. The Minister of Finance may also want to consider discussing the presentation with the Controller and Auditor-General directly.

Next Steps

40. The Treasury will continue working to finalise the FSG once we have received the Minister of Finance's comments on this report. Once we get closer to finalisation we will report back to the Minister of Finance with further advice.

41. Under any of the above outcomes, there is a likely need to review the fiscal indicators that are used for the Government's fiscal strategy and how they are presented in the interim financial statements and forecast financial statements. It is not a sustainable strategy to risk further qualified opinions in future years by leaving the current indicators unchanged. If the OAG issues a qualified audit opinion this year, it may be appropriate to undertake a review and consult with key stakeholders, including the public, on the use of fiscal indicators.

Annex One: Changes to the FSG

Option 1 – Statement of Financial Performance (Presentation unchanged)

2020 Forecast at Budget 2019 $m	2020 Forecast at Budget 2020 $m		Note	Actual 30 June 2020 $m	Actual 30 June 2019 $m
		Revenue			
88,541	81,588	Taxation revenue	4	84,349	85,723
6,027	6,126	Other sovereign revenue	4	6,269	6,028
94,568	**87,714**	**Total sovereign revenue**		**90,618**	**91,751**
19,041	19,196	Sales of goods and services	5	18,437	19,796
2,748	2,440	Interest revenue	6	2,300	2,646
4,397	5,053	Other revenue	7	4,416	4,949
26,186	**26,689**	**Total revenue earned through operations**		**25,153**	**27,391**
120,754	**114,403**	**Total revenue (excluding gains)**		**115,771**	**119,142**
		Expenses			
29,690	42,831	Transfer payments and subsidies	8	42,607	28,086
25,711	27,314	Personnel expenses	9	27,775	25,933
5,217	5,465	Depreciation	17	5,294	4,554
49,012	52,478	Other operating expenses	10	52,571	42,693
4,181	3,896	Interest expenses	6	3,754	4,298
5,547	6,418	Insurance expenses	12	6,903	5,812
1,266	5,357	Forecast new operating spending		-	-
(1,400)	(1,075)	Top-down expense adjustment		-	-
119,224	**142,684**	**Total expenses (excluding losses)**		**138,904**	**111,376**
375	12	Less minority interests share of operating balance before gains and losses		144	337
1,155	**(28,293)**	**Operating balance before gains and losses (OBEGAL) (excluding minority interests)**		**(23,277)**	**7,429**
-	(1,624)	Net gains/(losses) on large scale asset purchases	6	(3,258)	-
3,290	(4,470)	Net gains/(losses) on financial instruments	6	1,908	4,444
(71)	(1,297)	Net gains/(losses) on non-financial instruments	11	(7,430)	(11,575)
3,219	**(7,391)**	**Total gains/(losses)**		**(8,780)**	**(7,131)**
(3)	(50)	Less minority interests share of total gains/(losses)		(572)	115
3,222	**(7,341)**	**Gains/(losses) (excluding minority interests)**		**(8,208)**	**(7,246)**
273	143	Net surplus from associates and joint ventures		1,193	206
4,650	**(35,491)**	**Operating balance (excluding minority interests)**		**(30,292)**	**389**
		Operating balance consists of:			
4,650	(35,491)	Operating balance (excluding minority interests)		(30,292)	389
372	(38)	Minority interests share of operating balance	23	(428)	452
5,022	**(35,529)**	**Operating balance (including minority interests)**		**(30,720)**	**841**

Option 2 – Statement of Financial Performance (with OBEGAL removed)

2020 Forecast at Budget 2019 $m	Budget 2020 $m		Note	Actual 30 June 2020 $m	Actual 30 June 2019 $m
		Revenue			
88,541	81,588	Taxation revenue	4	84,349	85,723
6,027	6,126	Other sovereign revenue	4	6,269	6,028
94,568	**87,714**	**Total sovereign revenue**		**90,618**	**91,751**
19,041	19,196	Sales of goods and services	5	18,437	19,796
2,748	2,440	Interest revenue	6	2,300	2,646
4,397	5,053	Other revenue	7	4,416	4,949
26,186	**26,689**	**Total revenue earned through operations**		**25,153**	**27,391**
120,754	**114,403**	**Total revenue (excluding gains)**		**115,771**	**119,142**
		Expenses			
29,690	42,831	Transfer payments and subsidies	8	42,607	28,086
25,711	27,314	Personnel expenses	9	27,775	25,933
5,217	5,465	Depreciation	17	5,294	4,554
49,012	52,478	Other operating expenses	10	52,571	42,693
4,181	3,896	Interest expenses	6	3,754	4,298
5,547	6,418	Insurance expenses	12	6,903	5,812
1,266	5,357	Forecast new operating spending		-	-
(1,400)	(1,075)	Top-down expense adjustment		-	-
119,224	**142,684**	**Total expenses (excluding losses)**		**138,904**	**111,376**
1,530	**(28,281)**	**Total revenue less expenses (excluding gains/losses)**		**(23,133)**	**7,766**
-	(1,624)	Net gains/(losses) on large scale asset purchases	6	(3,258)	-
3,290	(4,470)	Net gains/(losses) on financial instruments	6	1,908	4,444
(71)	(1,297)	Net gains/(losses) on non-financial instruments	11	(7,430)	(11,575)
3,219	**(7,391)**	**Total gains/(losses)**		**(8,780)**	**(7,131)**
273	143	Net surplus from associates and joint ventures		1,193	206
(372)	38	Less minority interests share of operating balance		429	(452)
4,650	**(35,491)**	**Operating balance (excluding minority interests)**		**(30,291)**	**389**
		Operating balance consists of:			
4,650	(35,491)	Operating balance (excluding minority interests)		(30,291)	389
372	(38)	Minority interests share of operating balance	23	(429)	452
5,022	**(35,529)**	**Operating balance (including minority interests)**		**(30,720)**	**841**

Additional Supplementary Information (part of the FSG but not audited), noting that there is still some work to be completed on this presentation.

2020 Forecast at Budget 2019 $m	Budget 2020 $m		Actual 30 June 2020 $m	30 June 2019 $m
		OBEGAL Reconciliation		
120,754	114,403	Total revenue (excluding gains)	115,771	119,142
119,224	142,684	Less Total expenses (excluding losses)	138,904	111,376
375	12	Less minority interests share of operating balance before gains and losses	144	337
1,155	**(28,293)**	**Operating balance before gains and losses (OBEGAL) (excluding minority interests)**	**(23,277)**	**7,429**
-	(1,624)	Net gains/(losses) on large scale asset purchases	(3,258)	-
3,290	(4,470)	Net gains/(losses) on financial instruments	1,908	4,444
(71)	(1,297)	Net gains/(losses) on non-financial instruments	(7,430)	(11,575)
3	50	Minority interests share of total gains/(losses)	572	(115)
273	143	Net surplus from associates and joint ventures	1,193	206
4,650	**(35,491)**	**Operating balance (excluding minority interests)**	**(30,292)**	**389**

Option 3 – Statement of Financial Performance (Presentation changed)

2020 Forecast at Budget 2019 $m	Budget 2020 $m		Note	Actual 30 June 2020 $m	30 June 2019 $m
		Revenue			
88,541	81,588	Taxation revenue	4	84,349	85,723
6,027	6,126	Other sovereign revenue	4	6,269	6,028
94,568	**87,714**	**Total sovereign revenue**		**90,618**	**91,751**
19,041	19,196	Sales of goods and services	5	18,437	19,796
2,748	2,440	Interest revenue	6	2,300	2,646
4,397	5,053	Other revenue	7	4,416	4,949
26,186	**26,689**	**Total revenue earned through operations**		**25,153**	**27,391**
120,754	**114,403**	**Total revenue (excluding gains)**		**115,771**	**119,142**
		Expenses			
29,690	42,831	Transfer payments and subsidies	8	42,607	28,086
25,711	27,314	Personnel expenses	9	27,775	25,933
5,217	5,465	Depreciation	17	5,294	4,554
49,012	52,478	Other operating expenses	10	52,571	42,693
4,181	3,896	Interest expenses	6	3,754	4,298
5,547	6,418	Insurance expenses	12	6,903	5,812
1,266	5,357	Forecast new operating spending		-	-
(1,400)	(1,075)	Top-down expense adjustment		-	-
119,224	**142,684**	**Total expenses (excluding losses)**		**138,904**	**111,376**
-	(1,624)	Net gains/(losses) on large scale asset purchases[1]	6	(3,258)	-
375	12	Less minority interests share of operating balance before gains and losses		144	337
1,155	**(29,917)**	**Operating balance before gains and losses (OBEGAL) (excluding minority interests)**		**(26,535)**	**7,429**
3,290	(4,470)	Net gains/(losses) on financial instruments	6	1,908	4,444
(71)	(1,297)	Net gains/(losses) on non-financial instruments	11	(7,430)	(11,575)
3,219	**(5,767)**	**Total gains/(losses)**		**(5,522)**	**(7,131)**
(3)	(50)	Less minority interests share of total gains/(losses)		(572)	115
3,222	**(5,717)**	**Gains/(losses) (excluding minority interests)**		**(4,950)**	**(7,246)**
273	143	Net surplus from associates and joint ventures		1,193	206
4,650	**(35,491)**	**Operating balance (excluding minority interests)**		**(30,292)**	**389**
		Operating balance consists of:			
4,650	(35,491)	Operating balance (excluding minority interests)		(30,292)	389
372	(38)	Minority interests share of operating balance	23	(428)	452
5,022	**(35,529)**	**Operating balance (including minority interests)**		**(30,720)**	**841**

1. The presentation of the Net gains/(losses) on large scale asset purchases has changed to be included in OBEGAL This is owing to the view of the Office of the Auditor-General that this more clearly reflects the performance of the total Government's performance given the prominence of OBEGAl as a communication tool.

The accompanying notes (including accounting policies) are an integral part of these statements.

Annex Two: Analysis of Options and Outcome

	Option 1 – Presentation remains unchanged	Option 2 – OBEGAL is removed from the audited FSG	Option 3 – Presentation changes
Description	Losses from LSAP are reported as gains and losses, therefore excluded from OBEGAL. This represents no change in the presentation that was provided in the Pre-election Update.	This would involve removing the calculation of OBEGAL from the Statement of Financial Performance and changing the commentary that accompanies the FSG. We would need to consider options to communicate the results against the Government's fiscal strategy, which could include a separate section in the commentary.	This would involve moving the losses from LSAP into the calculation of the OBEGAL and would be inconsistent with the treatment in the fiscal forecasts presented in the Pre-election Update and Budget Update.
Qualified Audit Opinion	There is a high risk that the OAG will issue a qualified audit opinion.	This is likely to reduce the risk that the OAG will issue a qualified audit opinion, but does not eliminate the risk entirely.	This is likely to satisfy the OAG and eliminate the risk that the OAG will issue a qualified audit opinion.
Communication Strategy	The communication would need to focus on confirming the Government's view that losses arising from LSAP purchases should not be included in the OBEGAL, as that would diminish the relevance of reporting against the fiscal strategy, would be inconsistent with previous practice, and with other reporting frameworks (e.g. SNA and GFS), and would be less understandable to users. There would also need to be an emphasis on the rationale of using non-GAAP fiscal indicators for fiscal strategy purposes.	The communication would need to explain the reason for this change and it would need to be acknowledged that it is due to a dispute with the OAG. As the difference of views about OBEGAL between ourselves and the OAG will be clear, a similar communication strategy would need to be employed as for Option 1. The strategy will need to ensure the changes do not confuse users of the FSG.	The justification for the change will need to be made on the basis that we have revised our on-balance judgement and now consider that as the losses result from a discretionary transaction rather than market movements, and therefore the avoidable reported loss to the Government should be included in OBEGAL. The communication would need to emphasis the change has minimal impact of fiscal strategy and future fiscal policy settings.
Communication implications	The difference in opinion will undoubtedly gain some attention and different views on the matter are likely to be expressed. It is difficult to gauge the reaction of the Finance and Expenditure Select Committee, media and commentators. By being transparent in the Commentary, this will help mitigate some of the potential credibility risks.	The reaction to the change may be muted with the main negative impact of taking this option being the attenuation of the link between the fiscal indicator and the audited financial statements. OBEGAL does gain credibility and understandability from being included on the face of the financial statements, in a manner that can be contrasted with the other main fiscal indicator, net core Crown debt.	The change in judgement will receive attention from the Finance and Expenditure Select Committee, media and commentators and other users of the FSG, given the significant change in OBEGAL from the unaudited results presented in the Pre-election Update.
Capital Market implications	It is difficult to predict whether there will an impact on New Zealand's credit rating from a qualified audit opinion. As part of rating agencies assessment they look at timeliness and reliability of data, so there may be some downside risk. However, none of the rating agencies include OBEGAL as one their factors in their rating methodologies. This suggest there is minimal risk to New Zealand's credit rating in terms of fiscal metric. Some investors may be concerned by a qualified audit opinion which may impact investor confidence. We would look to carefully manage this risk through the communication process.	We would expect no impact on rating agencies assessment of the reliability of fiscal data. As noted above none of the rating agencies include OBEGAL as one of their ratings factors in their ratings methodologies. As with the other options, we would look to carefully manage the risk of any impact to investor confidence through the communications process.	Any downside risk to the credit rating of a qualified audit is reduced, although this is in effect replaced by downside risk associated with increased uncertainty about the implications for fiscal policy, and the more negative result for OBEGAL.
Fiscal Strategy and management implications	There is unlikely to be any concerns that the results are inconsistent with the current fiscal strategy. There is likely to be some credibility loss that may need to be considered when future fiscal targets are developed. There are unlikely to be any fiscal management implications.	There may a loss in credibility of the fiscal strategy as the OBEGAL is no longer communicated in the Statement of Financial Performance. There are unlikely to be any fiscal management implications.	Although there would be an increase in OBEGAL deficits we believe the results would still be consistent with the current fiscal strategy. This approach may undermine the credibility of the fiscal management approach as the fiscal impacts have been managed outside Budget allowances. The Treasury would recommend looking through the losses for the purposes of future fiscal policy decisions.

TE TAI ŌHANGA
THE TREASURY

Reference: T2020/3254 BM-1-2-3-2020

Date: 2 October 2020

To: Minister of Finance (Hon Grant Robertson)

Deadline: None

Aide Memoire: Risk-free discount rates for accounting valuations and negative yields on government bonds

The purpose of the Aide Memoire is to advise that Treasury publishes a table of risk-free rates, who uses them, how they are determined, why the Treasury publishes it five times a year and why we are publishing the latest rates now.

Treasury regularly provides a set of discount rates to government agencies to provide consistent assumptions for valuations built into regular financial reporting. For the first time, in September 2020, these will include some negative discount rates.

We also provide commentary on the current market yields, which for some Government Bonds are negative and why the risk-free discount rates published for accounting valuations are different from the Reserve Bank's current position on the OCR rate.

The Treasury's role in publishing risk-free discount rates for accounting valuations

The publishing of rates five times a year (30 June, 30 September, 31 December, 31 January and 31 May) on the Treasury website was designed to coincide with major financial reporting and valuation exercises in the Government's and the agency's own reporting cycle. These have been published since 2010 and have we contracted PWC to develop (and maintain) the methodology in accordance with accounting standards and provide rates to the Treasury, which we then check prior to publication.

The table of risk-free discount rates as at 30 September 2020 that the Treasury expects to publish in the week beginning 5 October, specifically for use in accounting valuations, will include for the first time some negative rates.

The Treasury publishes a table of risk-free discount rates (and consumer price index (CPI) assumptions) that must be used in certain accounting valuations by entities in the government reporting group for the purpose of preparing the actual and forecast Financial Statements of the Government of New Zealand (FSG).

Accounting standards require risk-free discount rates to be used in valuing ACC outstanding insurance claims and employee benefits such as the Government Superannuation Fund (GSF) defined benefit pension scheme and the Veteran's Pension and Disability Scheme. The most significant Government obligations are valued using present value calculations where projected cash flows, adjusted where necessary for inflation, are discounted to today's dollars.

Accounting standards also require the use of market data where it exists. The Treasury took on the central role of providing these valuation assumptions in 2010 to ensure consistency and efficiency in the same assumption across different reporting entities within the government group.

Why Government Bonds are being traded at negative yields and why this is different to the Reserve Bank's Official Cash Rate (OCR).

The table of risk-free discounts rate are taken from market yields of New Zealand government bonds (as these assets are considered the best proxy of a risk-free asset in New Zealand). In September, for the first time, the yields on some New Zealand Government bonds traded at negative rates.

The Government Bond rate is market driven, while the OCR is determined by the Reserve Bank taking into consideration economic factors. The current target for the Reserve Bank is to keep inflation between 1 and 3 percent.

New Zealand government bond yields are a function of the OCR and expectations of the future OCR. The market is currently pricing in a negative OCR in early 2021 (eg, current implied OCR as at the August 2021 meeting is -0.176%). This is because the RBNZ have stated that a negative OCR remains an option for further monetary stimulus. Consequently, the yields on some shorter-term New Zealand government bond rates are now negative.

There is a risk that the publication of these rates may lead to some market interest and speculation as to what this may mean for the future OCR announcements by the Reserve Bank. However, there is already public information available about the negative yields on government bonds. If the office need support with communications the Treasury can assist.

The methodology for determining risk-free discount rates for accounting valuations and fiscal impacts in the FSG

The risk-free discount rate methodology uses the market yield curve of New Zealand Government Bonds as the most appropriate proxy for the return on a very safe asset (which covers around 15 – 20 years of future cash flows to be present-valued). For valuing cash flows beyond this timeframe, the methodology assumes a single long-term risk-free rate (4.30% nominal, and 2.30% real after inflation expectations) and a bridging assumption to determine a gradual line between the market yields and the long-term rate[1].

[1] The methodology adopted to determine the table of risk-free discount rates is fully explained in www.treasury.govt.nz on the page: Discount Rates and CPI Assumptions for Accounting Valuation Purposes.

When risk-free discount rates fall, including going negative, the value of liabilities in today's dollars increases. In the FSG we present the changes in the ACC insurance liability as a result of a change in the discount rate (and CPI assumption) as 'actuarial gains and losses' below the OBEGAL line, but does impact the operating balance. The changes in the GSF pension and Veterans' pension and disability liability due to the discount rate (and CPI assumption) are presented in "other comprehensive revenue and expenses" (sometimes referred to as "reserves") but these movements are not included in OBEGAL or the operating balance.

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