

Chair
CABINET SOCIAL POLICY AND HEALTH COMMITTEE

ESTABLISHING A CROWN FINANCING AGENCY FOR DISTRICT HEALTH BOARDS

EXECUTIVE SUMMARY

1. The Government has made 'in-principle' decisions to finance District Health Boards (DHBs) with a mixture of debt and equity, and not to allow DHBs access to private sector financing [CAB (00) M 20/4 refers].
2. Implementing these decisions will require the establishment of an agent, provisionally called the Crown financing agency (CFA), to manage loan administration and monitoring.
3. The Residual Health Management Unit (RHMU) is recommended as the best option for the CFA role because it has existing experience and expertise in the area, and it will bring a focus and independence to the role that would be more difficult to obtain through a government department.
4. Implementing the CFA role through RHMU will be a simpler and faster option than establishing a new agency.

PROPOSAL

5. The Government has made 'in-principle' decisions to finance DHBs with a mixture of debt and equity, and not to allow DHBs access to private sector financing except for working capital [CAB (00) M 20/4 refers].

BACKGROUND INFORMATION

Core Functions

7. There are certain 'core functions' that are fundamental to the CFA role. To qualify as a candidate for the CFA, any potential candidate must be able to perform the following functions efficiently and effectively:

- ?? approving or declining individual DHB loan applications;
- ?? setting terms and conditions of loans;
- ?? ensuring that the total amount on loan at any time fits within the appropriated funding;
- ?? ensuring compliance with loan conditions;
- ?? ensuring loan repayment; and
- ?? managing 'at risk' loans.

Additional Functions

8. In addition to the core functions there are other functions that the CFA could perform that would assist in improving financial management within the sector. These include:

- ?? determining sector standards for financing levels and credit worthiness;
- ?? monitoring credit worthiness of DHBs;
- ?? providing early warning of fiscal risks;
- ?? giving an independent view of the financial performance of DHBs;
- ?? providing another incentive for prudent financial management of DHBs;
- ?? assessing business cases for capital investment from a financing perspective;
- ?? managing the process of conversion of existing private sector debt into public

11. The CFA or the Debt Management Office of The Treasury (NZDMO) could perform the cash management function. This issue will be the subject of further work by officials.

COMMENT

Options for the CFA

12. Five main options for the agency to carry out the CFA role have been identified. These are:

?? the Ministry of Health;

?? The Treasury;

?? the Residual Health Management Unit (RHMU);

?? a new Crown entity; or

?? a private entity.

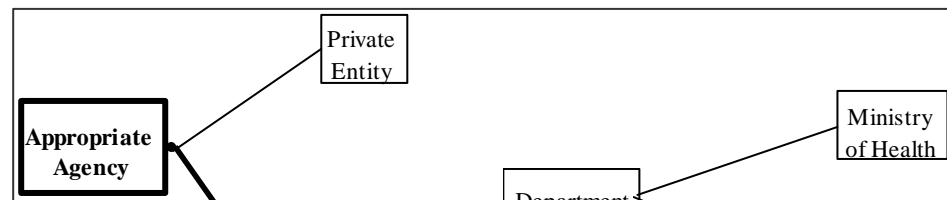
13. A three step process was used to determine which of the five options was most appropriate:

?? should the CFA role be outsourced or provided within the Crown?

?? should the CFA be a government department or a Crown entity?

?? should RHMU be used or a new Crown entity formed?

14. The logic of this process is shown in the decision-tree diagram below:



The bold lines indicate the recommended path, with RHMU as the preferred financier.

Outsourcing to the Private Sector

15. It would be possible to find an existing private financial institution that would be willing to act as the CFA in return for a fee. The advantages of such an arrangement would include:

- ?? providing the Crown with access to private sector financial expertise; and
- ?? the agency having its reputation at risk, which should motivate it to provide independent monitoring advice if the lender considers there is a risk that the entity would fail.

16. However, the disadvantages of the Crown contracting out such a role include:

- ?? previous experience that private sector financiers added very little value, in the way of risk transfer or monitoring, to the financing of HHSs. This was due to the perception that HHSs had an implicit Crown guarantee. Given that this proposal would see the financial institution lending Crown funds rather than its own, it is difficult to see that the private financier would have increased incentives to add value;
- ?? it is likely to be more difficult to set up accountability and incentive arrangements that protect the Crown's interests for a private institution than for a Crown entity; and

?? a private financier is likely to charge the Crown a reasonable margin over costs to provide such services. Unless there are considerable economies of scale, which appears improbable, this is therefore likely to be a more costly option.

17. We would therefore not recommend contracting this service out to a private sector institution.

Department or Crown Entity

18. Within government departments, the CFA role would most appropriately fit with either the Treasury or the Ministry of Health. The following table summarises the relative merits of the role being undertaken by a department versus a Crown entity that is more distant from the Crown.

Table 1: Comparison of Department and Crown Entity

<i>Benefits of a Department</i>	<i>Benefits of a Crown Entity</i>
<p>Both Treasury and the Ministry of Health already have sections concentrating on monitoring the financial performance of HHSs.</p> <p>Benefits particular to the Ministry:</p> <p>?? the Ministry is responsible for gathering DHBs' financial information and monitoring their performance. Including the financier's role within the Ministry would leverage this and avoid duplication.</p> <p>Benefits particular to Treasury:</p> <p>?? as the New Zealand Debt Management Office is within Treasury it may be easier to integrate the financing and</p>	<p>As the Crown entity's sole (or major) role would be that of a financier, incentive arrangements are likely to be more effective than in an organisation with multiple objectives.</p> <p>The Crown entity's focus on the financier role would provide a more credible signal to DHBs that the financier would be fair and without conflicting interests.</p> <p>It would be easier to monitor and hold accountable for performance a stand-alone entity rather than an entity with multiple objectives.</p> <p>A Crown entity would be more removed from the Crown and would therefore be less prone to Ministerial interventions (which could distort accountabilities and weaken the financier's ability to influence</p>

recommend that the CFA role be located within either the Treasury or the Ministry of Health.

RHMU or a New Crown Entity

20. RHMU has been operating as the Crown’s lender to Crown Health Enterprises and HHSs since 1993. The Public New Zealand Health and Disability Bill legislates for the continued existence of RHMU and allows the Minister of Health to add functions to RHMU’s mandate.

21. RHMU is currently the ‘lender of last resort’ and has been winding down its operations as HHSs have been encouraged to seek private sector financing. The move to refinancing HHSs within the Crown through RHMU would therefore require a greater focus on this role and increased resources. The alternative would be to establish a new Crown entity to undertake the financier role.

22. The relative merits of each alternative are summarised in the following table.

Table 2: Comparison of RHMU and a New Crown Entity

<i>Benefits of RHMU</i>	<i>Benefits of a New Crown Entity</i>
<p>RHMU already has banker expertise, institutional knowledge and working relationships with most HHSs.</p> <p>Because RHMU is already established with a mandate to undertake this role, start-up costs would be significantly lower. In particular, a new Crown entity will require legislation.</p> <p>On-going operating costs should also be lower as the new functions can ‘piggy-back’ on existing work.</p> <p>RHMU has experience, and a solid reputation, in assessing the risk associated</p>	<p>A new entity would start with a ‘clean sheet’ and would not have complicating residual functions to carry over from a previous role.</p> <p>RHMU has a several other functions that would need to be clearly separated from the financing role.</p>

25. Therefore, we recommend allowing RHMU to expand its existing role rather than establishing a new Crown entity.

Ministerial Responsibility

26. The Minister of Health holds overall responsibility for RHMU and will continue to hold this responsibility following enactment of the New Zealand Health and Disability Bill. Some current functions of RHMU are delegated to other Ministers, including new HHS debt and surplus HHS property.

27. Given the focus of the CFA, involvement of the Minister of Finance is warranted in this function. Ministerial responsibility for the CFA functions of RHMU will be delegated to the Ministers of Health and Finance.

Further Work to Implement Recommendation

28. We have instructed officials to report back to us on the work described below:

A Definition of Terms of Reference

29. Terms of reference for the CFA must be defined. These terms should include agency responsibilities, powers, membership, structure, performance measures, reporting lines and accountability arrangements. The terms of reference should mandate the CFA to:

- ?? provide a range of financing instruments with sufficient flexibility to meet the reasonable need of DHBs;
- ?? operate in a transparent manner; and
- ?? operate efficiently.

B Operating Costs of the CFA

30. The cost of the CFA will be determined once the appropriate Terms of Reference and structure have been designed.

31. A decision on the source of funding for the CFA is required. The two main options for funding are through a separate appropriation or by 'self funding', with the CFA adding an interest margin on loans to cover its own costs. The decision on

34. Further work, including consultation between NZDMO and the chosen CFA, will be required to determine the best agency to handle the cash transactions and determine the resources needed to fulfil this function.

D Interest Rate Policy

35. The mechanism for setting the interest rates for DHBs needs to be established. Interest rates could be set to match the risk profile of the individual DHB, be based on the risk profile of the sector as a whole, or passed on at cost. These options are fiscally neutral providing the appropriate adjustment is made to Vote: Health. However, the different options create different incentives and may influence investment behaviour in the sector.

E Implementation Plan

36. An implementation plan is required to ascertain the further actions needed to establish the CFA. This plan should include identification of any legislative changes that are needed and assign responsibilities for the work.

Report Backs

37. Officials have been directed to report back to shareholding Ministers on the issues (A)-(E) above by 30 November 2000.

FINANCIAL IMPLICATIONS

38. It is expected that there will be a net fiscal benefit arising from the transition from private to public sector debt. The cost of debt from the NZDMO will be less than the cost of private sector debt and this difference is expected to exceed the additional costs to fund the CFA. Exact fiscal implications will be determined in the report backs described above.

39. The Minister of Finance has agreed that refinancing the existing private sector debt of hospitals will not impact on the capital provision framework. New debt will impact on the capital provisions and will have to be planned accordingly.

LEGISLATIVE IMPLICATIONS

40. There are no legislative implications at this time. We will report back on any legislative changes identified during implementation planning.

PUBLICITY

43. Publicity requirements will be managed through the existing DHB Establishment communication process.

CONSULTATION

44. Consultation has taken place with Treasury, Ministry of Health, RHMU and NZDMO.

CONCLUSIONS

45. Use of an independent, dedicated Crown entity as the Crown financing agency for DHBs provides the best opportunity to improve financial management in the sector. As RHMU already has experience and expertise in this area it is concluded that RHMU is the best agency to take the CFA role.

AT THE MEETING ON 6 NOVEMBER 2000, CABINET CONFIRMED THE FOLLOWING DECISIONS OF THE FINANCE, INFRASTRUCTURE AND ENVIRONMENT COMMITTEE [FIN (00) M 32/1, CAB (00) M 36/1B refer]

FIN (00) M 32/2

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- a **noted** that the decision to finance District Health Boards (DHBs) through a mixture of debt and equity creates a need to establish an agency to administer and monitor DHB debt financing [CAB (00) M 20/4 and FIN (00) M 32/1 refer];

Minimising Risks

- b **noted** that there are a number of risks to the Crown from bringing the debt financing role in-house and that to minimise these risks and maximise the net benefits, the agency will need to carry out the following functions competently and efficiently:

The Residual Health Management Unit as Crown Financing Agency

- c **agreed** that the Residual Health Management Unit (RHMU) provides the Crown with the best option for providing these functions;
- d **agreed** that the role of RHMU should be expanded to enable it to act as the Crown financing agency (CFA) to DHBs;
- e **agreed** that Ministerial responsibility for the CFA functions of the RHMU be delegated to the Ministers of Health and Finance jointly;

The Debt Management Office

- f **noted** that the Debt Management Office of Treasury (NZDMO) will be the source of funds to finance DHB debt and that management of individual cash transactions between the Crown and DHBs could be performed by the CFA or by the NZDMO;

Further Work

- g **directed** officials to report back to the Ministers of Health and Finance by 30 November 2000 with recommendations on:
 - i terms of reference, membership, structure, accountability arrangements and ministerial responsibility for the CFA;
 - ii costs of the CFA and how they should be funded;
 - iii the interest rate policy for DHBs;
 - iv the appropriate agency to handle the cash management functions (either the NZDMO or the CFA); and
 - v implementation plans and timing, including any legislative requirements to establish the CFA.