Australian Office of Financial Management

Annual Report 2002-03

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Australian Government

Australian Office of Financial Management

3 October 2003

The Hon Peter Costello, MP
Treasurer
Parliament House
CANBERRA ACT 2600

Dear Treasurer

I have pleasure in presenting to you the Annual Report of the Australia Office of Financial Management for the year ending 30 June 2003. The Report has been prepared in accordance with section 63 of the *Public Service Act 1999.* Subsection 63(1) of the Act requires the provision of reports to Agency Ministers, for presentation to the Parliament.

As provided in subsection 63(2) of the Act, the Report has been prepared in accordance with guidelines approved on behalf of the Parliament by the Joint Committee of Public Accounts and Audit. These guidelines provide that a copy of the Annual Report is to be laid before each House of the Parliament on or before 31 October.

Yours sincerely

SIGNED

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AOFM OBJECTIVE

The AOFM aims to manage the Commonwealth net debt portfolio at least cost over the medium term, subject to the government's policies and risk preferences.

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REVIEW BY THE CHIEF EXECUTIVE OFFICER

It has been a pivotal year for Commonwealth debt management, with important developments on many fronts. The low level of net debt continued to be a primary driver, with the year dominated by the outcome of the review on the future of the Commonwealth Government securities market. Decisions stemming from the review establish a soundly based medium-term framework to guide debt management operations going forward.

The Australian Office of Financial Management (AOFM) also completed a review of the portfolio benchmark and recommended a new approach to the Treasurer during the year. Substantial progress was made towards eliminating foreign currency exposure in the debt portfolio. The cross-currency swap portfolio now shows a positive economic return. Finally, the AOFM's new treasury management system, Quantum, came online late in the year, further enhancing our capacity to monitor, manage and report risk exposures.

Review of the Commonwealth Government securities market

The Government's continuing disciplined approach to fiscal management has significantly reduced Australian Government general government net debt. Net debt, at under $30 billion, is less than one-third of the level of 1995-96. Gross debt also has been reduced significantly. Treasury Bonds on issue have fallen by more than half since 1995-96 to around 6.6 per cent of GDP at the end of 2002-03.

The Government publicly reviewed the future of the Commonwealth Government securities market during the year against a backdrop of financial market concern about the future viability of the market. The review concluded that sufficient Treasury Bonds should be issued to support the Treasury Bond futures market. Without a Treasury Bond futures market, higher costs associated with managing interest rate risk would lead to slightly higher interest rates across the economy.

The outcome of the review, as set out in the 2003 Budget papers, establishes a clear medium-term framework for the AOFM's debt management operations. While recent borrowing and repurchase programs have been structured to a broad objective of maintaining the viability of the Commonwealth Government securities market, programs going forward will be tightly targeted to support the Treasury Bond futures market. Accordingly, the AOFM has suspended issuance of Treasury Indexed Bonds given the focus on Treasury Bond issuance. We will continue to issue Treasury Notes only on an as-required basis.

New domestic interest rate benchmark

From 1996-97 until 2002-03, the Australian dollar share of the net debt portfolio was managed by reference to a benchmark modified duration target range of 3 to 3.5. The modified duration target range struck a balance between the expected debt service cost and the risk to expected debt service costs in a dynamic interest rate environment.

The performance of the total net debt portfolio, including both physical debt and derivative instruments, is ultimately what determines the costs and risks borne by the Commonwealth. Indeed, focusing indiscriminately on particular elements of the portfolio can paint a misleading picture of performance overall. That said, given the low level of issuance of physical debt, interest rate swaps have become a key operational tool in managing to the duration target. With the low level of physical debt issuance, it would seem reasonable to look to the longer-term performance of the swap portfolio as a measure of the cost-effectiveness of portfolio management operations.

To date, the interest rate swap program has been a success. Since its inception, the program has generated a realised gain of $1,440 million in nominal terms ($1,630 million in net present value terms) to the end of June 2003. On a broader economic return basis, the interest rate swap program has generated a gain of $2,977 million to the end of June 2003.

In 2002-03, the AOFM completed a major review of the interest rate risk benchmark. The review was undertaken partly because the success in reducing net debt since 1996 has resulted in a rising share of indexed debt exposure in the net debt portfolio and an increased impact of within-year seasonal cash flows.

The new benchmark, recently approved by the Treasurer, is an evolution of the previous successful approach. It maintains the same broad philosophy while also addressing the issues raised by a low debt environment. The new benchmark establishes separate cash management and long-term debt portfolios for management purposes, and specific measures for the treatment of indexed debt and the proportion of the portfolio subject to immediate repricing. The AOFM has also taken the opportunity to establish a new benchmark to enhance existing governance arrangements surrounding risk limits.

A transitional period of up to three years may be necessary to bring the parameters of the existing net debt portfolio into line with new benchmark interest rate risk limits. Interest rate swaps will be an integral element of the transition path and beyond. The new benchmark is detailed in Part 2.

Foreign currency exposure

The AOFM commenced a program to use cross-currency swaps to maintain a 10-15 per cent share of the net debt portfolio in US dollars in 1988. In December 2000, the Treasurer initiated a review of this policy. In September 2001, the Treasurer endorsed the AOFM review's conclusion to discontinue the policy. The Treasurer then instructed the AOFM to run down the existing exposure according to a schedule agreed between the AOFM, Treasury and the Reserve Bank of Australia.

In line with the agreed schedule, around $2 billion of US dollar exposure was run off in 2002-03. Portfolio US dollar exposure stood at $3.6 billion at the end of June 2003, less than half of the US$9.2 billion peak in 1997-98. If the exchange rate remains at around the average level of recent months, the exposure will be completely eliminated by June 2004.

The ultimate financial consequences of the strategy will not be known with certainty until the foreign currency exposure is eliminated. That said, the most recent estimates provided below indicate that the strategy has to date returned a net gain to the Government.

Since the cross-currency swap strategy began in 1987-88, the aggregate realised gain on the total portfolio to end-June 2003 was $311.1 million (in nominal terms) and $982.9 million (in net present value terms).

On a broader economic return basis the performance of the strategy was a gain of $599.2 million as at 30 June 2003. The economic return basis is the most comprehensive measure that takes into account both realised cash flows and the market value of the residual exposure.

Market operations in 2002-03

The AOFM held six Treasury Bond tenders for issuance into the April 2015 line in 2002-03, each of $400 million. The six Bond tenders were well supported by the market.

The AOFM conducted one Treasury Bond conversion tender during the year, with $300 million of the October 2007 line offered for conversion into the May 2013 maturity.

Three tenders of Treasury Indexed Bonds were also held, each of $50 million. A scheduled fourth Indexed Bond tender was cancelled late in the year, given the decision to suspend the program.

For short-term funding operations, the AOFM now uses the term deposit asset position at the Reserve Bank of Australia as the primary vehicle for managing within-year mismatches in the timing of cash receipts and outlays. Term deposit balances at the Reserve Bank of Australia fluctuated widely through the year, but ended at $12.2 billion, an increase of $1.8 billion over the year.

The AOFM issued Treasury Notes at tender only when term deposit balances were insufficient to meet short-term funding requirements. Around $13.6 billion Treasury Notes were issued in 2002-03, across 18 tenders. However, for the first time in over 40 years, no Treasury Notes were outstanding at 30 June 2003.

Governance and infrastructure

The AOFM continued to make good progress during the year in further enhancing capability and infrastructure on a number of fronts, including governance structures, risk reporting, compliance frameworks and internal audit. These issues are addressed in the report. I highlight one development of particular significance here — the implementation during the year of a comprehensive front to back office treasury management system.

The AOFM successfully concluded the initial phase of the implementation of the Quantum / Qrisk Treasury management system in June 2003. Quantum is the deal capture, back office and accounting system and Qrisk is the market risk management system.

With the conclusion of the first implementation phase, the AOFM is now operating on a single database for all settlements, accounting and risk management activities with straight through processing and single deal entry. Phase 2 of the project is now underway, with the AOFM now looking to take advantage of the Quantum platform to further enhance risk-reporting capabilities.

Looking forward

It has been a critical year for debt management and for the AOFM. Going forward, the AOFM plans to build further on the initiatives and key developments of the past year as it continues to adapt to the challenges of managing debt in a low debt environment.

Putting into effect the outcomes of the review of the Commonwealth Government securities market, commencing the transition to the new interest rate benchmark, further building on established channels of communication with the market and completing the implementation of Quantum are just some of the main priorities for the period ahead. It will be a busy year.

Finally, I would like to take this chance to thank the dedicated, professional team at the AOFM for their hard work and support over the past year.

I would also like to acknowledge the enormous contribution that the inaugural Chief Executive Officer, Mike Allen, made to the AOFM. Mike's boundless enthusiasm, professionalism, hard work, and unstinting focus on clear accountability and good governance were invaluable in guiding the AOFM through its early stages of development. I join with all the staff of the AOFM in wishing him well in his future endeavours.

Blair Comley
Acting Chief Executive Officer