

BY THE CHIEF EXECUTIVE OFFICER

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REVIEW BY THE CHIEF EXECUTIVE OFFICER

The Australian Office of Financial Management (AOFM) was established on 1 July 1999 as a specialised agency within the Treasury portfolio ‘to enhance the Commonwealth’s capacity to manage its net debt portfolio, offering the prospect of savings in debt servicing costs and an improvement in the net worth of the Commonwealth over time’. Its establishment recognised the need to expand the resources dedicated to debt management, recruit specialised financial skills and introduce new systems and technology in order to achieve these objectives.

Over the past five years, much has been accomplished. An expert staff has been recruited, governance arrangements put in place, policies formulated, financial and operational risk management strategies developed, and new treasury management systems installed. Although the volume of net debt managed has declined due to sustained fiscal surpluses and sales of government assets, the complexity of the task has increased and new challenges have been taken on.

In particular:

- the objective of Commonwealth debt issuance has changed from budget funding to supporting the effectiveness of markets in managing financial risk;
- the AOFM now manages a growing volume of financial assets as well as debt (consistent with the ambitions held for it at the time of its establishment);
- the net debt portfolio has become much more volatile because of the increased relative size and variability of within year cash flows;
- the cash management task has been substantially reoriented through the use of term deposits, rather than Treasury notes, as its main operational tool; and
- increased attention is being given to communications with markets and the public, and to a more systematic approach to managing operational as well as financial risk.

This annual report reflects these developments. It focuses more on identifying performance and outcomes, and linking them to program objectives, than in previous years. This is possible because implementation of the Quantum/Orisk Treasury Management System is now reaching its completion and is starting to provide improved reporting and analysis, as well as strengthened accounting and risk monitoring.

Supporting financial markets

The Government announced in last year's Budget its decision to maintain the issuance of Treasury bonds beyond Budget funding requirements in order to support the efficiency of financial markets in managing financial risk. Trading in Treasury bond futures facilitates financial risk management in markets as diverse as swaps and mortgage backed securities, in the balance sheets of financial institutions, and in individual projects with financial exposures. Following the Government's decision, Treasury bond issuance is now closely linked to the composition of the baskets underlying the Treasury bond futures contracts and the timing of the listing of those contracts.

Although the volume of Treasury bonds on issue fell during 2003-04, outright trading volumes in the secondary market picked up by around 6 per cent over the previous year, while trading in Treasury bond futures increased by 24 per cent in the 3-year contract and by 31 per cent in the 10-year contract. Some tightness was experienced in particular bond lines included in the futures contracts, but this proved to be short lived. Overall, the Treasury bond and bond futures markets operated efficiently over the year.

The AOFM kept in close touch with developments in markets during the year and will continue to do so in the year ahead. It demonstrated flexibility in arranging the issue of additional August 2008 bonds to bring this line up to the target of \$5 billion announced by the Government for benchmark stocks.

The agency also worked during the year on developing arrangements for a stock lending facility to help relieve pressures that may develop in the future in the Treasury bond market.

Establishing a new debt management framework

Following the Government's decision on the maintenance of the Treasury bond market, the AOFM moved quickly during the year to put in place key elements of a new framework for managing its net debt portfolio.

A new Book structure was introduced to allow separate policy objectives in different parts of the portfolio to be managed separately. This is outlined in Part Two of the annual report.

The AOFM does not 'trade' in financial markets nor take views about market trends in managing the Commonwealth debt portfolio. Rather, the appropriate structure for Commonwealth debt is reviewed periodically in the light of the level of debt, Government budgetary policies and institutional conditions in financial markets. Once an appropriate structure is approved by the Government, the portfolio is then managed to that structure until the next review.

A new benchmark portfolio was approved by the Treasurer in September 2003, with the transition to the new benchmark to be accomplished over two to three years. Issuance linked to Treasury bond futures contracts involves medium and long term bonds. The benchmark review concluded that a shorter average duration than would result from that issuance pattern, or than in the previous benchmark, was appropriate. The shorter duration is expected to lower the cost of Commonwealth debt over time without introducing unacceptable volatility in debt service costs at current low levels of debt. The reduction in the average duration of the portfolio is implemented through interest rate swaps.

Interest rate swaps were resumed from October 2003 and substantial progress was made on the transition to the benchmark. The benchmark was confirmed in the first regular review in April 2004.

A set of detailed financial risk management policies including balance sheet, liquidity management and interest rate risk management policies, and business procedures were adopted during the year, while progress was made in strengthening operational risk management.

Performance in 2003-04

On an AAS31 accounting basis, the total debt service cost of the net debt portfolio managed by the AOFM for 2003-04 was \$2.9 billion, which represented a net cost of funds of 6.46 per cent. This includes savings from the net margins obtained on interest rate swaps (0.65 per cent), foreign exchange revaluation effects (0.36 per cent) and net interest margins on cross-currency swaps (0.09 per cent).

Without these transactions, the debt service cost of the net debt portfolio for 2003-04 would have been \$3.4 billion, or 7.59 per cent. This cost of funds before swaps and foreign exchange effects reflects the age of the bond portfolio, as bonds are issued with initial maturities of up to 13 years. Half of the Treasury bonds on issue to the public at 30 June 2004 had been issued in the five years to February 1997, when interest rates were considerably higher than at present. The cost of funds also reflects stronger than expected growth during 2003-04 in asset balances in the Cash Management Portfolio, which are invested at rates close to the cash rate and thus add to the average cost of the net debt portfolio in percentage terms.

Leaving aside the returns from foreign exchange revaluations and cross currency swaps, which will not be repeated, and \$47 million of the return on interest rate swaps which accrued against continuing assets in the Debt Hedge Book, the benefit obtained during the year from managing the trend net debt portfolio to a benchmark with a shorter duration than bonds on issue was \$246 million, or around 0.46 percentage points.

In 2003-04, the portfolio held an average balance of \$3.9 billion in continuing assets in the Debt Hedge Book. These assets have resulted from bond issuance in excess of budget funding requirements. The average rate of return obtained on these assets in 2003-04 was 6.23 per cent.

Cash management

Within-year cash management flows continued to be highly volatile with a swing from peak to trough of over \$24 billion, which represents more than half the average book value of the entire net debt portfolio. Term deposits with the Reserve Bank of Australia have now become the prime instrument for managing these cash flows and there was little need to resort to the issue of Treasury notes, with only \$1.1 billion being issued to cover a short period in October and November 2003.

Over the course of 2003-04, short term assets in the Cash Management Portfolio fluctuated between zero and \$24 billion, with an average balance of \$9.2 billion. Reflecting the short term nature of these assets, the average rate of return on them was 5.12 per cent. The average balance in the Cash Management Portfolio will not continue at this level in 2004-05, as \$4.6 billion was identified as continuing assets and transferred to the Debt Hedge Book on 1 July 2004, while the balance has been reduced by a further \$4.6 billion by the Government's decisions to pay out its liabilities to the Australia Post and Telstra superannuation schemes.

Foreign exchange exposure

During the year, the AOFM completed the rundown in the foreign exchange derivative exposure that began in September 2001. This brings to an end a long period in which foreign currency debt has been a significant element of Commonwealth Government debt. Part Two of this report includes a review of experience with this debt, including cross-currency swaps.

A total of 31 cross-currency swaps were terminated early or novated in 2003-04. In the period since September 2001, the AOFM unwound \$US6.4 billion in US dollar exposures at a weighted average exchange rate of 0.6470 US dollars. The execution costs of these transactions was approximately \$2.1 million, about half the amount budgeted.

Over the lifetime of the policy between 1988 and 2004, the foreign currency swaps, and forward exchange contracts used in their unwind, generated a net economic benefit to the Commonwealth of \$783.7 million. This figure represents:

- the total of all realised cash flows arising from the derivatives over the life of the policy (including interest receipts and payments and exchanges of principal) amounting to \$85 million; plus

- interest savings of \$698.7 million due to the reduction in debt financing required as a result of these positive cash flows over the life of the policy.

Communications and external relations

The AOFM is seeking to devote increased attention to its communications with financial markets and the public. During the year it strengthened its contacts with financial markets and staff participated in a range of national and international forums on debt management, hosted visiting delegations and provided assistance to regional sovereign debt managers.

In particular, a staff member was seconded to work full-time on debt management issues in the Solomon Islands Finance Ministry as part of the Australian Government's assistance arrangements. The AOFM also made preparations to send an officer to work on debt management in Papua New Guinea and sent a representative to the OECD – China Public Debt Management Forum in Beijing.

The AOFM entered into an agreement to help develop the Public Debt Management Office of Thailand in the coming year, under the Thailand – Australia Government Sector Linkages Program. This project will focus on producing an action plan for the development of the bond market in Thailand and improving the skills of Thai officials, while providing AOFM staff with learning opportunities.

The agency is also looking towards new opportunities to apply its specialist expertise in both sovereign debt management and risk management within the Australian public sector and more widely in the Asia-Pacific region.

Changes in senior staff

The year saw a changeover in senior staff of the Agency. Following the resignation of Michael Allen in April 2003, Blair Comley acted as Chief Executive Officer until October 2003, pending my appointment.

Paul Power took up duty as Chief Operating Officer in January 2004. This position includes many of the responsibilities previously exercised as Director, Strategy and Business Services, by Peter McCray who returned to the Treasury in October 2004.

Paul Ferris resigned as Director, Risk Management, in April 2004. Michael Bath is acting in this position pending its permanent filling.

I thank Michael Allen, Blair Comley, Peter McCray and Paul Ferris for the enormous contributions they each made to the development of the AOFM in its foundation years. They have laid a strong foundation of quality debt management.

I would also like to take this opportunity to thank the skilled and committed staff of the AOFM for their hard work during the past year and I look forward to their support going into the future.

Neil Hyden
Chief Executive Officer