

REVIEW BY THE CHIEF EXECUTIVE OFFICER

TREASURY BOND ISSUANCE	XIII
SECURITIES LENDING FACILITY	XIV
CASH MANAGEMENT	XIV
MANAGEMENT OF THE NET DEBT PORTFOLIO	XIV
PERFORMANCE OF THE PORTFOLIO	XV
FOREIGN CURRENCY EXPOSURE	XV
CREDIT MANAGEMENT	XVI
OPERATIONAL RISK	XVI
INTERNATIONAL FINANCIAL REPORTING STANDARDS	XVI
INTERNATIONAL ACTIVITIES	XVI
STAFF	XVII

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The Australian Office of Financial Management (AOFM) was established to enhance the Australian Government's capacity to manage its net debt portfolio. During the year it continued to develop its role in issuing Treasury bonds, managing cash balances and minimising debt service costs subject to acceptable risk. A securities lending facility was established to support the operation of the Treasury bond market and provision was made for the collection of collateral under a revised swap counterparty credit policy. Preparations began for the impact on the portfolio of the establishment of the Future Fund in 2005-06 and work continued on strengthening the Office's procedures to manage operational risk.

Treasury bond issuance

Two years ago the Government announced that it would maintain the issuance of Treasury bonds beyond budget financing requirements in order to support the efficiency of financial markets in managing interest rate risk. Following this decision, Treasury bond issuance is now undertaken within a clear medium term framework, with the size and timing of individual issues tightly targeted to support the Treasury bond futures market.

Treasury bond issuance during the year was consistent with this framework and amounted to \$5.6 billion. The total issuance of each bond line continues to be around \$5 billion over two years. However the volume of issuance of each line in its first year has been increased to provide greater liquidity and provide stronger support for futures markets contracts.

Over the course of 2004-05, Treasury bond yields fell on secondary markets, while the yield curve flattened. By the end of the financial year, the yield curve was inverted. One factor affecting these movements was strong demand by overseas investors for Australian dollar denominated financial assets, including Treasury bonds.

The total turnover of Treasury bonds in secondary market trading declined by 1.5 per cent in 2004-05 compared with 2003-04, but the volume of Treasury bond futures contracts continued to increase strongly. Overall the markets operated smoothly and efficiently, although with some short-lived bouts of tight repo trading conditions in individual bond lines.

Securities lending facility

A securities lending facility was established in September 2004 and is operated by the Reserve Bank of Australia on behalf of the AOFM. The facility allows market participants to borrow Treasury bonds when they are not readily available from other sources in the market. It aims to enhance the efficiency of the market by improving the capacity of intermediaries to make two-way prices, particularly for bonds that become tight in the repo market.

By the end of the year, the facility had been used 40 times, with the majority of transactions being for one day only. This was consistent with the 'lender of last resort' character of the facility.

Cash management

Management of the Government's daily cash balances has been marked over recent years by increased volatility due to differences in the timing of receipts and outlays. In 2004-05, the peak to trough swing amounted to \$29 billion, compared to \$21 billion in 2003-04. Net cash flows greater than \$8 billion occurred on four days during the year.

Following a review by AOFM of its management of the cash balances, a new operational limit range of \$700 million to \$1,100 million was introduced for the 91 day moving average of the daily balance in the Official Public Account in 2004-05, and a new upper policy limit was agreed by the Treasurer and Minister for Finance and Administration. A reduction in the average cash balance (on a 91 day moving average basis) of \$204 million was achieved over the course of the year.

During the year, cash balances were managed entirely through term deposits with the Reserve Bank of Australia. There was no issuance of Treasury notes.

Management of the net debt portfolio

The AOFM employs interest rate swaps to reduce the average term to maturity of the net debt portfolio with the objective of reducing the debt service costs of the portfolio over time. In this process, reference is made to a benchmark portfolio that encapsulates the desired trade-off between cost savings and variability in debt service costs.

2004-05 was the second year of transition towards the benchmark portfolio adopted in September 2003. However, two developments affected this transition:

- The Government announced that some of the assets currently managed by the AOFM will be transferred to the Future Fund. While details had not been finalised, it indicated that the initial transfer could be in the order of \$16 billion. The transfer of

assets from the AOFM's portfolio will significantly reduce the need for interest rate swaps; and

- There was a marked flattening, and then inversion, of the yield curve such that the cost savings expected to be generated by the swap program were not as favourable as the assumptions underlying the benchmark.

In view of these developments, the execution of new swaps was suspended in May 2005. The benchmark was also revised and its maturity structure lengthened. Preparations for the transfer of assets to the Future Fund were also commenced. The AOFM resumed interest rate swaps in 2005-06, although the planned volume is lower than that in 2004-05.

Performance of the portfolio

The debt service cost of the net debt portfolio managed by the AOFM for 2004-05 was \$2.92 billion, or 7.02 per cent of the average book value of the portfolio.

This cost includes net savings of \$182 million from domestic interest rate swaps undertaken to shorten the portfolio's maturity profile. Without these savings, the debt service cost of the net portfolio would have been \$3.1 billion, or 7.45 per cent.

These savings may be compared with those that would have been generated if the actual portfolio had aligned with the benchmark portfolio. While the benchmark portfolio involves a very large volume of hypothetical interest rate swaps, the comparison indicates that the net savings obtained from actual interest rate swaps represented the major part of the savings theoretically available from adherence to the benchmark.

Details of the factors that affected debt service cost during the year, and comparisons with the cost of the portfolio without swaps and with the cost of the benchmark portfolio, are provided later in this report.

Foreign currency exposure

Since the elimination of cross-currency swaps was completed in 2003-04, the remaining foreign currency exposure in the portfolio has been in the form of small residual physical loans. These are being repurchased when opportunities arise, or allowed to mature.

During the year, three outstanding British pound denominated loans with a total face value of £39.1 million were fully redeemed. This followed agreement at meetings of loan stockholders to resolutions proposed by the AOFM to bring forward the maturity dates of the loans.

The remaining currency debt now comprises two US dollar denominated loans with a face value of US\$17.9 million.

Credit management

The use of interest rate swaps exposes the Commonwealth to counterparty credit risk, although no default has been experienced since swap activities were commenced. The AOFM manages this risk by reference to a detailed credit policy which was revised and enhanced during the year. A major initiative was the introduction of collateral arrangements. These arrangements reduce credit risk as counterparties are required to post collateral when the AOFM's exposure rises above a predefined threshold. By the end of the year collateral agreements had been concluded with 10 current swap counterparties.

The introduction of collateral will allow participation in swaps to be expanded to lower rated counterparties, while reducing exposures to credit risk overall since the exposure to these counterparties will be capped at modest levels as a result of the collateral arrangements.

Operational risk

Further progress was made during the year in strengthening the Office's management of operational risk, including the development of business continuity and disaster recovery plans.

International Financial Reporting Standards

From 1 July 2005 the AOFM is subject to the new international financial reporting standard that is being applied in Australia by the Australian Accounting Standard 139. A later section in this annual report reviews some implications of the new standard for the AOFM and outlines our proposal to adopt a comprehensive income presentation format in reporting our administered operating results for 2005-06 onwards.

International activities

The AOFM supports sovereign debt management activities in other countries, including through the secondment of officers to the Solomon Islands and Papua New Guinea.

Two staff members are currently working to support debt management in the Finance Department of the Solomon Islands under the Regional Assistance Mission – Solomon Islands. Another is working as Debt and Cash Advisor in the Papua New Guinea Department of Treasury and Finance as part of the Enhanced Cooperation Program.

A senior staff member worked in the Thai public debt management office for two months, providing advice on plans to further develop the Thai bond market. A group of Thai debt management officials also visited the AOFM for five weeks.

Other contacts during the year involved visits to or from China, Denmark, France, Indonesia, Norway, South Africa and South Korea.

Staff

In February 2005, Michael Bath was promoted to the vacant position of Director, Financial Risk.

The past year provided many challenges for the office. I thank all of the staff for their hard work and commitment during the year. We look forward to making further progress together over the year ahead.

Neil Hyden
Chief Executive Officer

