

# REVIEW BY THE CHIEF EXECUTIVE OFFICER

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## **REVIEW BY THE CHIEF EXECUTIVE OFFICER**

The AOFM was established to enhance the management of Australian Government debt and financial assets, to reduce debt servicing costs and to improve net worth. Its role has expanded over time as the agency has taken on new responsibilities for maintaining the Treasury Bond market, managing a wider range of financial assets, and providing support for other sovereign debt managers in the region.

Initiatives undertaken in 2006-07, or that came to fruition during the year, included the introduction of a new electronic tender system for issuing debt securities, implementation of extended investment arrangements for the Communications Fund, strengthening compliance, anti-fraud and operational risk activities, reviews of our recordkeeping systems and registry arrangements, and adjusting to further changes in accounting standards and regulatory requirements. In addition, market conditions became more challenging for the management of the net debt portfolio.

### **Treasury Bond issuance and markets**

In recent years debt issuance by the AOFM has been undertaken solely with the objective of maintaining the Treasury Bond and Treasury Bond futures markets. This has been because successive budget surpluses have removed the need to borrow to fund the budget. The Government decided in 2003 to support the continued operation of these markets because they allow market participants to better manage their interest rate risk and thereby contribute to a lower cost of capital in Australia. They also help strengthen the financial system against the potential impact of financial shocks.

During 2006-07, the AOFM issued \$5.3 billion of Treasury Bonds in lines targeted to support the 3- and 10- year Treasury Bond futures contracts. Maturities amounted to \$6.1 billion, so the stock of Treasury Bonds on issue contracted. The stock stood at \$47.2 billion at the end of the year. Maturities will vary over the next few years due to past issuance and repurchase decisions. With new issuance steady at around \$5 billion each year, the stock of Treasury Bonds on issue is projected to rise in 2007-08, but then fall again until it settles around \$44 billion from June 2011. Secondary market turnover in Treasury Bonds remained fairly steady during 2006-07.

In contrast with the relative stability in the size of the Treasury Bond market, the Treasury Bond futures market has continued to grow strongly. The turnover of the 3-year Treasury Bond futures contract increased by 12 per cent in 2006-07 over 2005-06, and that of the 10-year contract

by 34 per cent. This continued the pattern established over past years where the growth in trading has been concentrated in futures rather than the physical bonds.

Both the Treasury Bond market and the Treasury Bond futures market operated efficiently during the year.

A new electronic system for the conduct of tenders for the issuance of Commonwealth Government securities was introduced in October 2006. It has improved the speed of tenders, made bidding easier for users and reduced the potential for erroneous bids. The new system is popular with bidders and appears to have had a favourable impact on tender results: the ratio between the volume of bids received and the stock offered in tenders has been markedly higher since the new system came into operation, while the range of bids accepted has remained very narrow.

## Cash management

The AOFM manages the daily cash balance in the Government's accounts using term deposits with the Reserve Bank of Australia. The volatility of the within-year cash flows remained high during the year, with the daily net cash flows in the Official Public Account exceeding \$10 billion on four days. Balances were kept within the target limits throughout the year.

The Government transferred a total of \$22.4 billion in cash to the Future Fund in 2006-07. The size and timing of these transfers are important for the volume of term deposits that the AOFM has available over the course of the year for use in its daily cash management activities. In the absence of sufficient term deposits, Treasury Notes would be issued to provide additional within year financing. This was not needed in 2006-07.

## Management of the portfolio

The AOFM uses interest rate swaps to manage the term structure of its debt portfolio. By swapping from longer-term to shorter-term debt, debt servicing costs can normally be reduced. However, for several years there has been a sustained flattening of yield curves and in successive annual reviews we have reduced our estimate of the term premium.<sup>1</sup> This implies a corresponding reduction in the saving in debt servicing costs potentially available through the use of interest rate swaps over the medium term.

The flattening in the slope of the yield curve has not been unique to Australia; similar trends have occurred in the US and the Euro Zone. Both structural and cyclical factors have contributed to these trends. One important structural factor appears to have been reduced volatility in

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<sup>1</sup> Technical terms are explained in the glossary.

inflation and inflationary expectations arising from more stable economic conditions, improvements in monetary policy, and increased price competition through reductions in trade barriers and globalisation. More stable financial markets have in turn reduced the risk involved in holding longer-term fixed interest assets compared with shorter-term ones. Other structural factors may have been increased demand for longer-term bonds, due to defined benefit pension funds and life insurance companies seeking to match their assets more closely to their longer-term liabilities, and increased global savings from increases in the relative size of high savings economies.

Together, these structural factors may explain some flattening in yield curves but appear unlikely to have caused the term premium to become negative. Long-dated securities are inherently more risky than short-term ones and investors are unlikely to accept a situation where longer-term rates remain below short-term rates on a sustained basis, after allowing for expected movements in short-term rates.

Taking these factors into account the AOFM decided, in its 2007 review of the portfolio management strategy, to continue the interest rate swap programme but to adjust the benchmark portfolio with effect from 1 July 2007. This followed a similar adjustment in 2005. Both changes in the benchmark moved it closer to a portfolio structure that would result from debt issuance without interest rate swaps. Consequently, the volume of swaps required to manage the portfolio to the benchmark has fallen, as have the savings in debt service costs expected to be obtained over the medium term. However, the continuation of the swap programme will provide flexibility to respond to changing market conditions and to take advantage of opportunities to reduce debt servicing costs as they arise.

This report contains an article on issues that have arisen in the management of the domestic debt portfolio. It discusses the use of interest rate swaps over recent years, including the flattening of yield curves and the AOFM's response to them.

## **Portfolio outcomes**

In 2006-07 the cost of servicing the debt and swaps in the portfolio increased to 6.42 per cent, compared with 6.32 per cent the previous year. The increase was primarily attributable to lower savings from interest rate swaps, due to higher short-term interest rates on the floating legs of swaps, maturities of existing swaps, and less favourable terms on new swaps. The cost of physical debt was lower than in the previous year, as relatively expensive debt issued in the 1990s was replaced with new debt, although this was partially offset by higher capital indexation costs on indexed bonds.

The interest yield obtained on term deposits in 2006-07 was also higher, at 6.15 per cent, compared with 5.55 per cent the previous year, due to higher short-term interest rates. The average volume of term deposits was lower than in 2005-06, mainly due to cash transfers to the

Future Fund. Both the higher yield and smaller volume worked to reduce the net cost of funds on the combined portfolio of debt and assets.<sup>2</sup> This fell to 6.56 per cent in 2006-07 from 6.90 per cent the year before.

Increased market interest rates also caused the market values of both physical debt and swaps to fall in 2006-07.

## Communications Fund Investment Facility

The Communications Fund was established by the Government in September 2005 with an initial capital of \$2 billion to fund improvements in telecommunications services in regional, rural and remote parts of Australia. The AOFM was authorised by the Minister for Communications, Information Technology and the Arts and the Minister for Finance and Administration to oversee the initial investments of the Fund in term deposits with the Reserve Bank of Australia until longer-term arrangements were decided.

During the year, the two Ministers agreed that the AOFM would continue to manage the Fund's investments under a longer-term investment strategy. The Fund will invest in low risk Australian denominated debt instruments and deposits including bank accepted bills, negotiable certificates of deposit and commercial paper. The AOFM established an investment dealing panel and related procedures for the extended facility and commenced the investment of monies for it in late-June 2007.

## Operational risk

Over recent years the AOFM has devoted considerable effort to strengthen its management of operational risk. This work continued in 2006-07 and included the development of a compliance regime for Communications Fund investment activities, assessment of the impact on the AOFM of the Government's new Anti-Money Laundering and Counter-Terrorism Financing legislation, and procedures to help the agency meet the new Certificate of Compliance requirements to report annually on its compliance with all aspects of the financial management framework under the *Financial Management and Accountability Act 1997*. The regulatory and policy requirements affecting the agency's operations have been expanding each year, adding to the resources needed to meet them.

During the year, the AOFM also developed further its business continuity and disaster recovery planning, including preparedness against a possible influenza pandemic.

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2 The lower volume of deposits had a favourable effect on the net cost of funds on the combined portfolio of debt and assets because the yield on term deposits is lower than the cost of physical debt and swaps.

## International activities

The AOFM has actively supported sovereign debt management activities in other countries. During the year two AOFM staff worked in the Solomon Islands and one in Papua New Guinea to support capacity building in sovereign debt management under the Australian Government's regional engagement initiatives. Their work is highly appreciated by the respective governments and has facilitated substantial improvements in debt management practice. In March 2007 debt management officials of the two countries, together with AOFM seconded staff, attended a workshop in Canberra that identified options and priorities for further cooperation on debt management between the three countries.

The AOFM also hosted visits from debt management officials from China, Chile, Indonesia and Thailand. A senior staff member conducted seminars in Bangkok on bond issuance and conversion techniques at the invitation of the Bank of Thailand. A senior staff member gave a presentation on off-balance sheet risks to the annual APEC Future Economic Leaders' Think Tank forum in Sydney. Other staff presented papers at workshops in India and Canada on government cash management and debt strategy modelling, and participated in forums for debt managers convened by the OECD and the IMF.

The AOFM's involvement in these activities allows it to share its experience and expertise and also to keep up to date with developments in debt management elsewhere. Sovereign debt managers in many countries face similar challenges, including declining debt portfolios, increasing requirements to manage financial assets, flattening yield curves, changing accounting standards, expanding performance and reporting needs, and questions about how to relate their portfolio management activities with the wider balance sheets of the governments they serve. There is much to share in all these areas.

## Staff

Mr Craig Thorburn was seconded to the Future Fund Management Agency during the year to assist in the establishment of the agency. He was subsequently appointed to the staff of the agency. Mr Thorburn has served with the AOFM since its establishment. I wish him well in his new appointment.

The past year has been an active one for the Office and I thank all the staff for their continuing commitment and hard work. We have achieved a great deal together and look forward to further progress in the year ahead.

Neil Hyden  
Chief Executive Officer

