

MANAGING THE COST OF DEBT

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MANAGING THE COST OF DEBT

For many years, Australian Government debt has been managed with the explicit or implicit objective of minimising its servicing cost at an acceptable level of risk. Indeed, many other sovereign debt managers have the same or very similar objectives.¹

Initially, this objective was pursued in a pragmatic manner through the diversification of the debt across various markets and instruments and through the selection of individual stocks for issuance. In more recent years more formalised modelling of cost and interest rate risk has been used to set quantitative targets for the structure of the debt portfolio. This shift occurred about the same time as the development of derivative markets, which allowed decisions on the structure of the portfolio to be made separately to decisions on debt issuance and repurchases. The derivatives used in managing Australian Government debt have been cross-currency swaps (from 1987 to 2004) and interest rate swaps (since 1992).

The use of cross-currency swaps was the subject of a review article in the 2003-04 Annual Report. This article focuses on issues that have arisen in the management of the domestic debt portfolio over recent years and the use of interest rate swaps.

Development of portfolio modelling

Reviews to assess the optimal structure of the Australian Government's debt have been undertaken periodically since 1987. The reviews initially focused on the currency composition of the debt, but over time gave increasing attention to its term structure. The studies provided by external consultants in the early 1990s did not find cost saving opportunities in the term structure of domestic (Australian dollar) debt, but indicated that these were available for US dollar denominated debt. As a consequence the debt benchmarks in the early 1990s gave priority to managing the currency composition of the debt. For the Australian dollar component of the debt, the benchmark set a target fixed interest rate/floating interest rate share of 75 per cent/25 per cent. This fixed/floating share target reflected the view that if there was no expected long-term cost advantage between holding short- and long-term debt it was better to hold a higher proportion as long-term debt to reduce the cost volatility of the portfolio.

In 1996 the fixed rate/floating rates share targets were replaced by modified duration targets, as these provided a better measure of the portfolio's overall exposure to movements in interest

1 In a survey of OECD sovereign debt managers undertaken in 2006 by the AOFM, all 23 respondents had a similar broad objective for their debt management activities.

rates. The research provided by external consultants at this time indicated that a long-term cost advantage had developed in the Australian market in having a relatively higher exposure to short-term debt and a relatively lower exposure to long-term debt. Consequently, portfolios with a high modified duration would be more expensive than portfolios with lower modified duration, but exhibit less cost volatility. Cost savings could be obtained by reducing the debt portfolio's modified duration and shortening its average term to maturity. Reflecting these conclusions, a target range of 3.0 to 3.5 was set for the modified duration of the domestic debt portfolio.

Adjusting to a low debt environment

In the first half of the 1990s the volume of debt issued by the Australian Government was relatively high to meet budget financing requirements and the rollover of maturing debt. In these circumstances, the portfolio's structure could be altered by adjusting the mixture of borrowing instruments. A wide range of instruments was available at that time, including short-, medium- and long-term (fixed rate) Treasury Bonds, floating rate notes (known as Treasury Adjustable-rate Bonds), short-term Treasury Notes and inflation-linked Treasury Indexed Bonds.

In the second half of the decade a succession of budget surpluses and asset sales brought sustained reductions in the volume of debt outstanding. After 1996-97, there was no need for new debt issuance to fund the budget. The total volume of Commonwealth Government Security (CGS) stock on issue was allowed to fall, but the Government also sought to maintain the liquidity and efficiency of the Treasury Bond market. To this end, issuance was concentrated in selected benchmark bond lines spread over the yield curve which was maintained out to 12-13 years. Substantial repurchases were made of other stocks ahead of maturity. The use of Treasury Notes was reduced and issuance of Treasury Adjustable-rate Bonds was halted.

The reduction in the volume of Treasury Notes and Treasury Adjustable-rate Bonds on issue acted to increase the average duration of the remaining debt. Repurchases and maturities of Treasury Bonds, while maintaining the yield curve out to 12 to 13 years, had a similar effect. To offset these pressures and keep the duration of the domestic portfolio close to the target range, the use of interest rate swaps was increased substantially from 1997-98 onwards.

From 1998-99, some of the surplus proceeds were allowed to accumulate in the form of financial assets rather than used to repurchase debt ahead of maturity. A term deposit facility was established with the Reserve Bank of Australia (RBA). An attraction of using term deposits was that they provided an additional instrument for managing the Australian Government's cash balances as an alternative to Treasury Notes.

Budget surpluses continued into the next decade and it appeared that ongoing reductions in the volume of debt on issue could threaten the continued viability of the CGS market. In 2002-03 the

Government undertook a review of whether it was desirable to continue to reduce the level of outstanding debt. The review concluded that an efficient Treasury Bond market should be maintained because of the role it played, together with the Treasury Bond futures market, in facilitating the management of interest rate risk in financial markets and in strengthening the resilience of the financial system. In the 2003-04 Budget the Government announced that it would continue Treasury Bond issuance in order to support the Treasury Bond and Treasury Bond futures markets. The review did not see a need for maintaining markets for other government debt in the absence of a funding requirement, and the issuance of Treasury Indexed Bonds was halted.

The Government's decision to continue the Treasury Bond market had important ramifications for debt management.

- Firstly, the Treasury Bond lines issued would, in future, be selected to support the 3-year and 10-year Treasury Bond futures contracts listed by the Sydney Futures Exchange. As a result, Treasury Bond issuance would be closely tied to the composition of the futures contract baskets, and there would be very little scope to adjust the structure of the debt portfolio through issuance decisions. Domestic interest rate swaps thus became virtually the only instrument available for managing the cost and risk of the portfolio.
- Secondly, the proceeds of budget surpluses and asset sales would continue to accumulate as financial assets rather than be used to reduce the stock of debt on issue. These assets would continue to be placed as term deposits with the RBA and be used for cash management. Being short-term instruments, the term deposits offset the cost and risk of short-term debt, and so would increase the modified duration of the net debt portfolio.

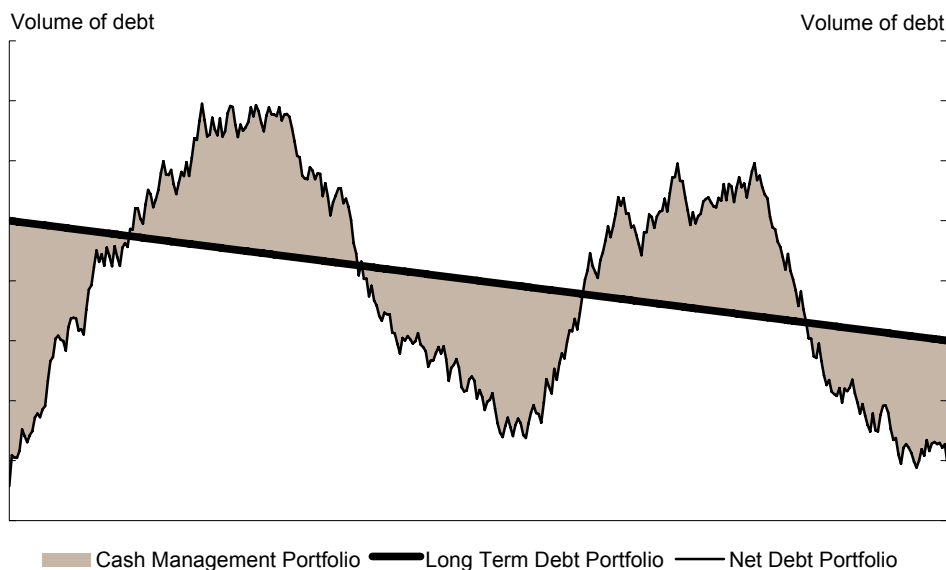
Balancing cost and risk

The AOFM was established in July 1999 as a specialised agency to enhance the management of Australian Government debt. The new agency reviewed the framework for managing debt in the light of these emerging issues. This was done in conjunction with the AOFM Advisory Board chaired by the Secretary to the Treasury. Several steps were taken to strengthen the framework:

- A new portfolio structure was introduced which placed ongoing assets and liabilities in a Long-Term Debt Portfolio (LTDP) and short-term ones in a separate Cash Management Portfolio. This change was designed to insulate the LTDP from intra-year volatility in the Government's receipts and expenditures and allow the balance of cost and risk on ongoing assets and liabilities to be assessed in a medium-term context. The ongoing (trend) level of assets was included in the LTDP

so these assets could be managed along with ongoing debt. This is illustrated in a stylised manner in Figure 1.

Figure 1: The structure of the Net Debt Portfolio



- Portfolio management was focussed on the nominal (non-inflation indexed) component of the LTDP using interest rate swaps. This change recognised that there was no suitably liquid instrument for managing the specific risks associated with indexed debt. However, the cost and risk of the remaining Treasury Indexed Bonds in the portfolio would be taken into account in setting benchmark parameters.
- The accrual historic cost of funds, exclusive of revaluation effects, was endorsed as the prime measure of debt servicing cost. This recognised that, under the policy of maintaining the Treasury Bond market, all debt issued is intended to remain on issue until maturity, so that changes in the market value of the debt have no direct impact on funding costs.
- The governance framework was also strengthened, with requirements to review the benchmark annually and to specify targets and limits on the key risk parameters of the portfolio for the year ahead. Daily revaluation and compliance checks were introduced to ensure adherence to these limits.

In considering possible strategies for reducing debt servicing costs subject to an acceptable level of risk, the AOFM assessed the expected costs of various alternative benchmark portfolios over the medium term. Investments in long-term fixed rate bonds normally command a higher interest rate than short-term investments. This margin depends on investors' expectations about

future movements in short-term interest rates, but also includes an element, called the term premium, that compensates investors for the extra risk in having their funds tied up for a longer period. When there is a positive term premium, portfolios with a high duration will tend to be more expensive than portfolios with low duration. On the other hand, portfolios with a high duration require less frequent refinancing than portfolios with low duration and therefore exhibit relatively lower levels of volatility in their accrual cost.² There is then a trade-off between accrual cost and risk, where risk is measured as the potential variability in accrual cost due to changing interest rates.

The process for selecting the benchmark involved modelling the impact of numerous interest rate shocks over a range of alternative portfolio structures with varying maturity and repricing profiles. Short- and long-run cost outcomes and risks were calculated for each scenario. The benchmark was framed in terms of targets for modified duration and short-dated exposure³ for the nominal component of the Australian dollar LTDP. The new benchmark adopted in September 2003 had modified duration and short-dated exposure targets of 2.00 and 35 per cent respectively.

The most important assumption underpinning the selection of the benchmark portfolio relates to the term premium. While the slope of the yield curve can be observed at any time, it reflects both market expectations regarding future movements in short-term interest rates and the term premium. The term premium itself is not directly observable and must be estimated. At the time of the 2003 benchmark review, the AOFM estimated the term premium for 10-year bonds over cash deposits at 0.90 per cent.

It was estimated that by managing the LTDP to the new benchmark using interest rate swaps to convert a proportion of the portfolio's stock of fixed rate debt into the equivalent of shorter-term liabilities, cost savings averaging about 0.37 percentage points or around \$200 million per annum could be achieved⁴. These savings were long-term in nature and were not expected to occur every year, as short-term interest rates may be higher in one year and lower in another. In setting the benchmark portfolio, the AOFM sought to balance the expected savings and risks and to ensure that this balance was acceptable.

2 When revaluation effects are included, the opposite conclusions are drawn, namely that lower duration portfolios are less risky than higher duration portfolios. However, as indicated above, where debt is intended to be held to maturity, accrual cost excluding revaluation effects provides the more relevant measure of cost.

3 Short-dated exposure measures the proportion of the portfolio subject to immediate repricing. Refer to the glossary for further explanation.

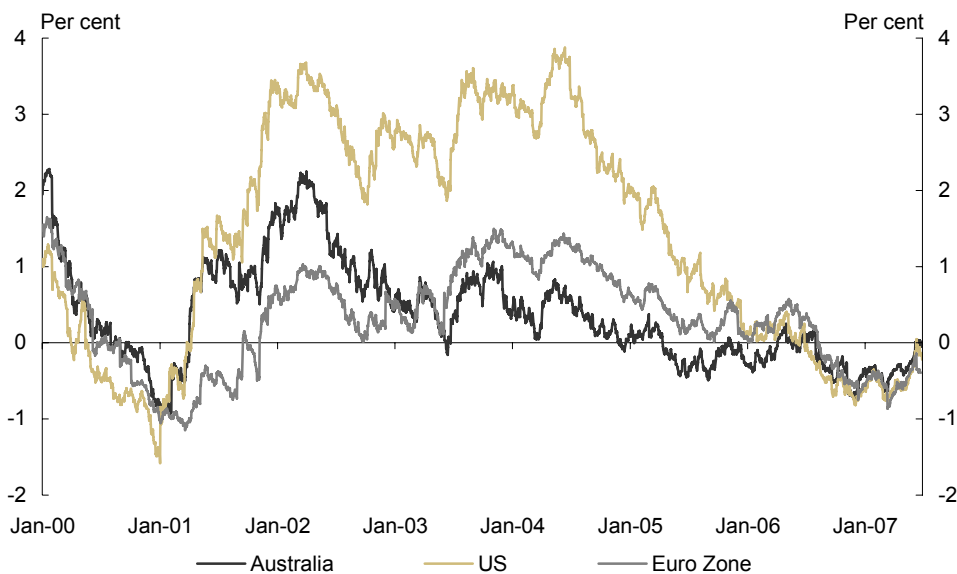
4 The estimates were calculated assuming that the portfolio has fully transitioned to the benchmark. In practice the transition can take some time when large adjustments are required.

Falling term premium

Over recent years, yield curves have flattened and, at times, become inverted. Part of this change may have reflected changes in expectations about future movements in short-term interest rates, but part also appears to have been due to structural changes that have affected the term premium.

The trend towards flatter yield curves has not been unique to Australia; similar movements have occurred in several other economies. Chart 1 plots the margin between 10-year government bond rates and overnight cash rates in Australia, the US and the Euro Zone since January 2000. While there are differences in timing and degree, all three economies have exhibited downward trends in the slope of their yield curves, with negative slopes in the (Australian) 2006-07 financial year.

Chart 1: Slope of Government yield curves (10 year bond less cash)



The AOFM evaluates term premiums in Australia in its annual benchmark reviews. At each review since 2003 it has successively lowered its estimate of the term premium for 10-year bonds over cash deposits, from 0.90 per cent in 2003 to 0.25 per cent in 2007. The reduction in the term premium for swaps has not been quite as dramatic, although still very substantial, reflecting the estimated higher exposure of swap credits to risk and uncertainty. The AOFM has lowered its estimates of the ten year swap to cash term premium from 1.20 per cent at the time of the 2003 review to 0.70 per cent at the time of the 2007 review.

Over this period, the AOFM has extended the breadth and depth of the material it has considered in its annual benchmark reviews. In the 2007 review it considered in greater depth the factors that appear to have contributed to the reduction in the slopes of yield curves and in

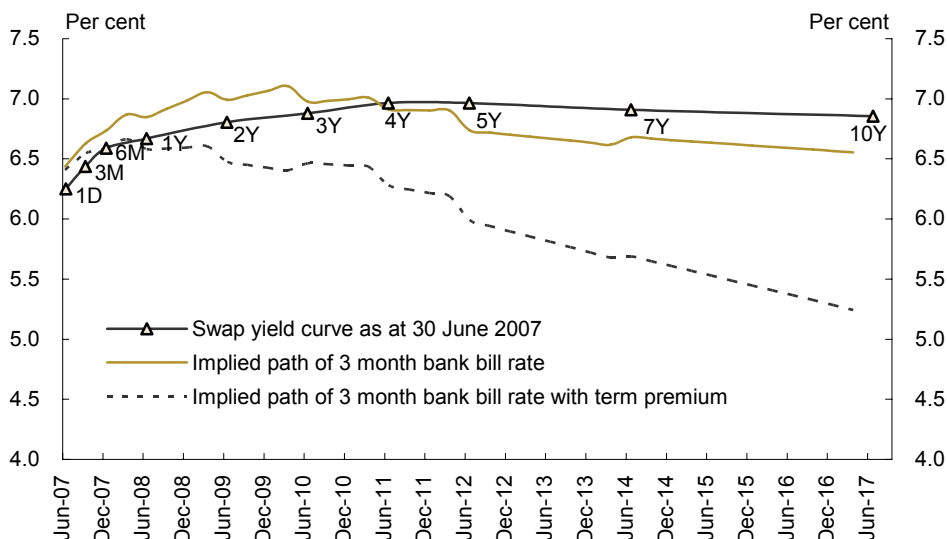
the term premiums that underlie them. Factors which may be driving lower term premiums include:

- a decline in long-term inflation and inflationary expectations, arising from improvements in monetary policy, more stable economic conditions and increased price competition through globalisation and reductions in trade barriers. Lower and more stable inflation may have reduced the risk and uncertainty involved in investing in longer-term securities, and so reduced the term premiums for holding such securities.
- the demand for long-dated bonds appears to have increased over recent years, relative to the total demand for bonds, in part due to efforts by defined benefit pension funds and life insurance companies to match their assets more closely to their longer-term liabilities. In some countries this trend has been strengthened by changes in accounting standards and regulations. The increased relative demand for long-dated bonds is likely to have placed some downward pressure on term premiums.
- some East Asian and other central banks have accumulated large holdings in offshore government bonds over the last decade and this may also have contributed to the flattening of yield curves by altering the relative demand for bonds across the yield spectrum.

Together, these structural factors are likely to have produced some reduction in term premiums. But they appear unlikely to have caused premiums to become negative. From an investor's point of view, long-dated securities are inherently more risky and uncertain than short-term ones and investors always have the option of rolling over short-dated securities as an alternative to holding longer-term investments. Consequently, investors are unlikely to accept a situation where longer-term rates remain below short-term ones on a sustained basis, after allowing for expectations about movements in rates.

If the term premium is likely to have remained positive, what has driven the recent inversion in the yield curve? In the presence of a positive term premium, a flat or inverted yield curve would indicate that the market expects short-term interest rates to fall over the relevant time horizon. This is illustrated in Chart 2, which shows the relation between the swap yield curve and expected cash rates at 30 June 2007, assuming a 10-year swap to cash term premium of 0.70 per cent.

Chart 2: Swap yield curve and implied cash rates at 30 June 2007



A fall in expected short-term interest rates can reflect expectations of a slowing in economic activity, although slowly extending over a period as long as that shown in Chart 2 appears unlikely based solely on cyclical factors. An alternative explanation for the recent inversion has been offered by others, including by Federal Reserve Chairman Bernanke⁵—that structural developments in the international economy may be producing a progressive decline in real interest rates. Sustained economic growth in high-savings countries and a surge in oil revenues have increased the global supply of investible funds, while demographic changes in developed countries and the ongoing consequences of the Asian financial crises have caused investment and the global demand for investible funds to grow less rapidly than the supply of funds. If these factors are expected to persist and increase in importance over a period of many years, they would lead to expectations of future reductions in short-term rates, and thus to a flattening or inversion of the yield curve.

Overall, taking account of these various factors, the AOFM’s assessment is that term premiums have remained positive, although at a lower level than in the past, and are likely to continue so.

Responding to the falling term premium

The assessment that term premiums are likely to have declined since 2003 implies that the scope for medium-term savings on debt servicing costs has fallen, but remains positive. The volatility

5 See, for example Chairman Bernanke’s speech on 20 March 2006 at <http://federalreserve.gov/boarddocs/speeches/2006/20060320/default.htm>

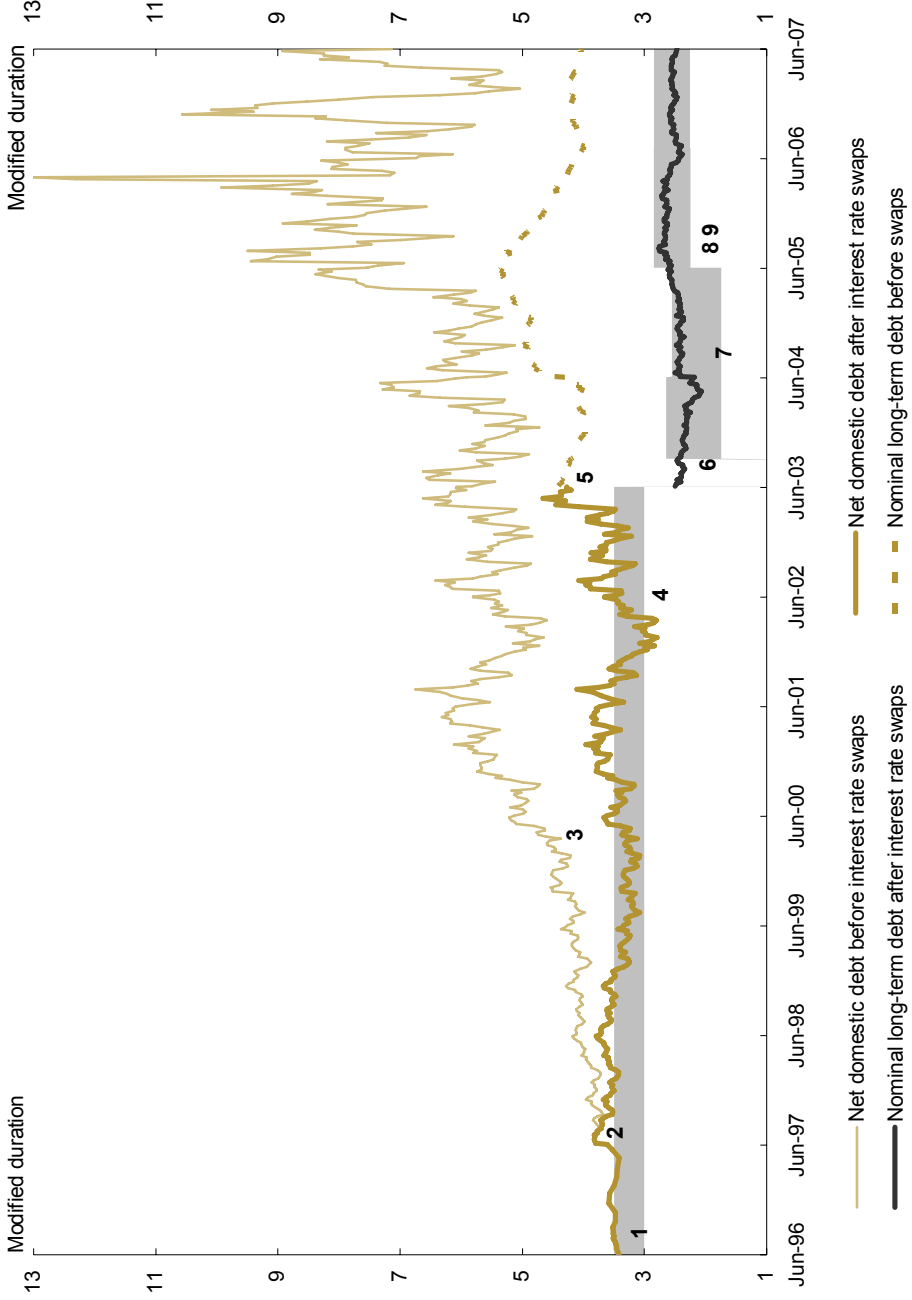
of market interest rates has also contracted, mainly in 2003-04 and 2004-05, and this has reduced the projected variability in debt servicing costs. Taking account of the reductions in the scope for savings and balancing them with the reduction in risk due to reduced volatility, the AOFM made changes to the benchmark portfolio in 2005. The modified duration target was raised to 2.50, while the short-dated exposure target was held at 35 per cent.

In its most recent deliberations on the appropriate benchmark, the AOFM considered whether the strategy of using interest rate swaps to lower the duration of the portfolio should continue or whether existing swaps should be unwound, allowed to mature without replacement, or offset by entering into swaps to pay fixed rates. It concluded that the estimated term premium remained sufficient to warrant continued use of interest rate swaps. However, due to the reduction in the estimated term premium, it adjusted the benchmark settings for modified duration (to 3.00) and short-dated exposure (to 25 per cent) from 1 July 2007.

The LTDP will move towards these new target benchmark settings in 2007-08, driven by bond issuance and maturities of existing swaps. Only a relatively small programme of new swaps is planned for 2007-08, so the adjustment path of the portfolio will be very similar to that which would have occurred had it been decided to stop executing new swaps and allow existing swaps to roll off as they reached maturity. The maintenance of a small swap programme will provide flexibility to respond to changing market conditions and take advantage of opportunities as they arise to reduce debt servicing cost.

Chart 3 shows how the management of the portfolio has affected the modified duration of domestic debt since 1996. The notes identify key developments that affected duration during this period. The shaded bands show the benchmark target ranges for duration.

Chart 3: Modified duration of the domestic debt portfolio



Notes:	
1. Jul 1996:	Modified duration benchmark first applied to the net debt portfolio. Target range set at 3.0 to 3.5 years.
2. 1997-01:	Budget surpluses and asset sales reduced the volume of debt outstanding. Swap programme was expanded to address the upward pressure on duration stemming from reductions in short-term liabilities and the accumulation of short-term assets.
3. From 2000:	Increased within-year financing swings resulted in greater volatility in net debt and duration. Duration volatility is compounded by falling debt levels, which caused within year financing to increase as a proportion of gross debt outstanding.
4. 2002-03:	Review of CGS market. Issuance of Indexed Bonds halted.
5. Jul 2003:	Portfolio split into a long-term ongoing component and cash management component.
6. Sep 2003:	Modified duration benchmark adopted for the nominal component of the LTDP. Target set at 2.0 years and operational range set at 1.75 to 2.65 years.
7. Jul 2004:	Duration benchmark target maintained at 2.0 years. The reduced term premium was considered to have been compensated by falling risk due to the reduced volume of net debt.
8. Jul 2005:	Further reduction in term premium estimate led to an upward revision in the duration target to 2.50 years.
9. 2005-06:	Asset transfers out of the long-term portfolio for payment to the Future Fund tended to reduce duration and reduced the need for swap activity to adhere to benchmark.

It can be seen from the chart that the volatility of the duration of the net domestic debt portfolio before swaps increased continuously through the period. This was due to greater volatility in the volume of short-term assets in the portfolio as a result of greater within-year variability in the Government’s cash flows. This made managing to a duration target on the whole portfolio increasingly impractical. As noted above (page 37) this problem was resolved by adopting the LTDP in 2003 as the focus of portfolio management. Thereafter, duration of the nominal LTDP after swaps was kept within a narrow band, which was adjusted twice (in 2004 and 2005).

Impact of interest rate swaps on debt servicing costs

Since the execution of the first domestic interest rate swap in 1992, a total of \$53 billion notional face value of interest rate swaps has been executed, comprising \$46.4 billion of swaps to receive fixed rates and \$6.6 billion of swaps to pay fixed rates. The volume of interest rate swaps undertaken each year to manage the portfolio is shown in Table 1. The size of the annual programmes has become smaller over recent years.

Table 1: Interest rate swap activity

\$billion	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
Receive fixed	6.9	9.3	7.8	7.9	2.0	0.0	4.3	4.6	0.3	2.5
Pay fixed	0.0	0.0	0.0	0.0	0.0	0.0	3.3	2.0	1.3	0.0

Debt servicing costs in the AOFM financial statements are prepared on a fair value basis consistent with the AASB 139 accounting standard for financial instruments with the operating statement presented on a comprehensive income basis. In this framework, debt servicing costs are recognised on a full mark-to-market basis, with the income presentation splitting this into a traditional accrual cost (before revaluations) component and a revaluations component. This allows debt servicing costs to be viewed from the perspective of a longer-term issue-and-hold debt manager, while allowing the implications of current market pricing to be considered⁶.

The impact of the interest rate swap programme on debt servicing costs occurs at three levels:

- Firstly, there are the *direct* cost savings from the interest received on swaps less interest paid on them. In the AOFM’s financial statements these revenues and expenses from swaps appear in the operating result before revaluations and contribute directly to the operating result.
- Secondly, the direct cost savings from swaps reduce the overall size of the AOFM’s net debt portfolio, either by reducing gross debt or by adding to the investments held as term deposits with the RBA. Such reductions in net debt further reduce the cost of

6 More information can be found in the article, *Introduction of Fair Value Accounting*, provided in the 2004-05 AOFM Annual Report.

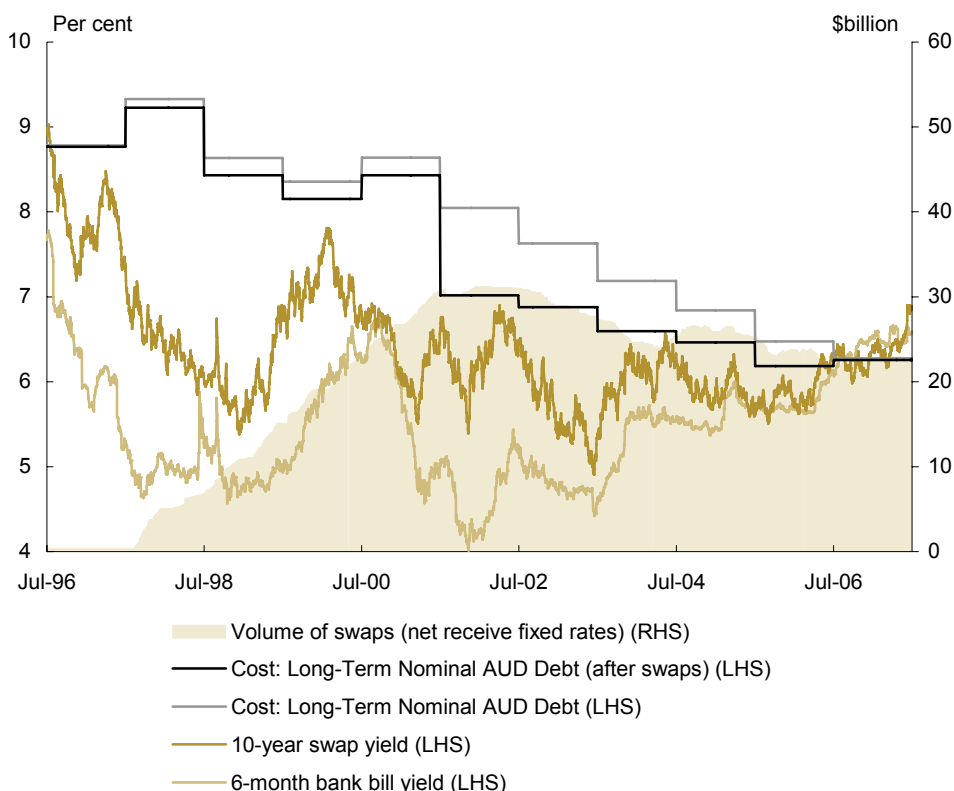
servicing the net debt portfolio. These additional *indirect* savings appear in the AOFM financial statements in the operating result before revaluations.

- Finally, unrealised changes in the market value of swaps appear as revaluations in the AOFM's financial statements. Market value represents the value of the swaps if they were to be liquidated at current market prices in normal trading. It is equal to the present value of the expected future cash flows on the swaps, which is calculated assuming that future short-term interest rates move in line with that implied by current market yield curves.⁷ To the extent that market yields provide an accurate prediction of future short-term rates (which is not always the case over longer time horizons), the market value of swaps provides a guide to the future net cash flows they will generate.

Chart 4 shows how the percentage cost of funds of gross CGS debt in accrual cost terms (before revaluations) has evolved since July 1996 and how it has been affected by the direct savings from the interest receipts and payments generated by interest rate swaps. The direct savings from swaps reduced the cost of funds in each year over this period, as short-term interest rates were generally lower than long-term rates.

⁷ The interest cost on the floating leg of a swap is tied to short-term rates which are reset at three or six month intervals; to estimate the present value of a swap the expected future interest payments or receipts on this leg are derived from the current market yield curves. In contrast, the interest on the fixed leg of a swap is set when the swap is executed and does not vary during the life of the swap.

Chart 4: Direct impact of interest rate swaps on effective cost of funds



- In 1996-97 to 1998-99, swaps steadily reduced the cost of the debt portfolio as the portfolio of swaps grew. This reflected the positive slope in the yield curve during this period and the increasing volume of swaps.
- In 1998-99 to 2000-01, the cost savings generated by swaps remained fairly steady notwithstanding increases in short-term interest rates. Broadly, the reduced cost savings on existing swaps due to increased floating interest rates was offset by the yield curve slope pick up on the new swaps being executed.
- Between 2000-01 and 2001-02, the cost savings contributed by swaps increased significantly due to a large fall in short-term interest rates.
- Since then, the cost savings achieved through swaps have steadily declined, mainly because of increases in short-term rates, but also because of the flattening of the yield curve which has reduced the savings generated by new swaps. The volume of new swaps also declined as the AOFM changed its benchmark and reduced the swap programme.

Chart 5: Realised savings arising from interest rate swaps

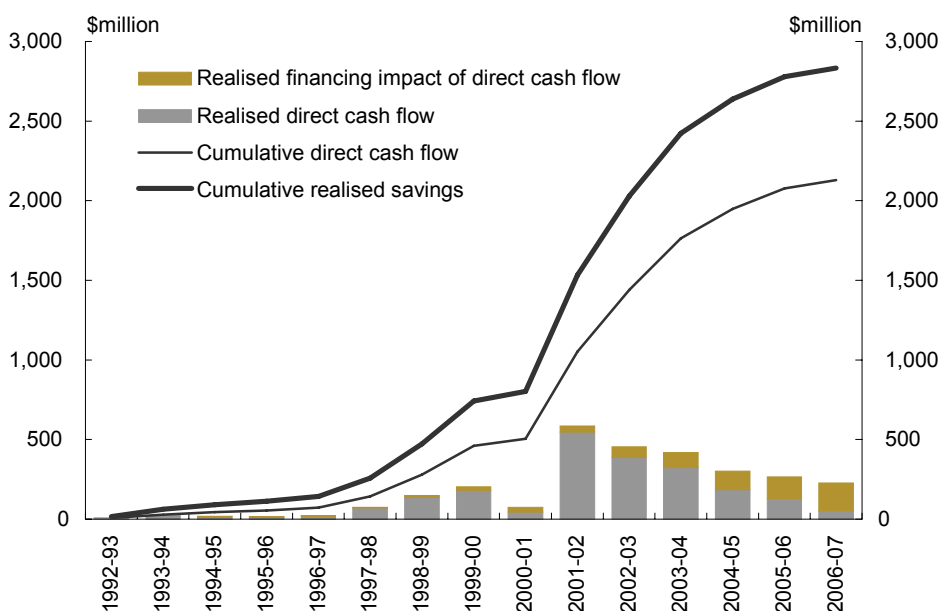
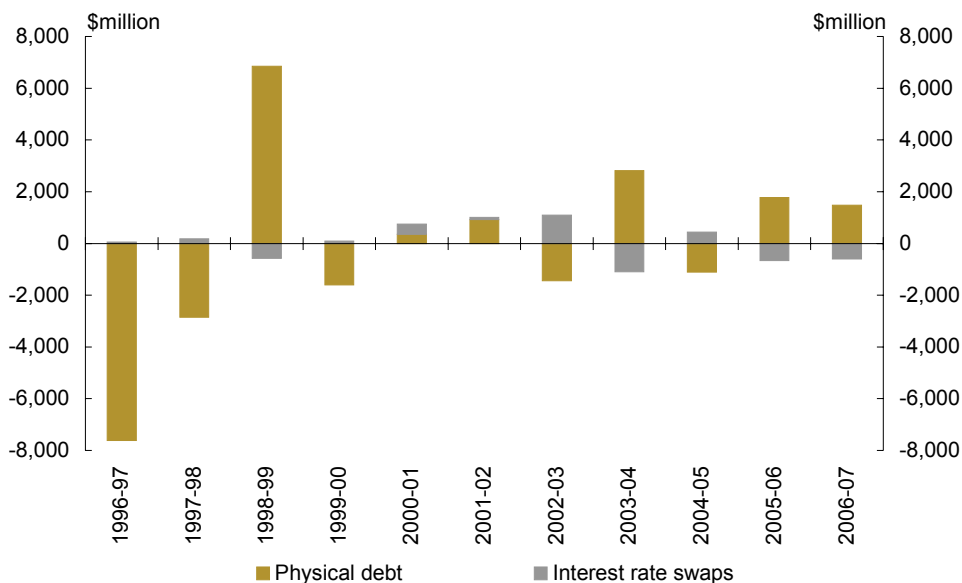


Chart 5 shows the direct cost savings from the interest receipts and payments on swaps, together with the indirect savings that have resulted from them, since interest rate swaps were first executed in 1992-93. The realised direct savings have varied from year to year, but have grown to a cumulative total of \$2.1 billion. These savings were primarily invested in higher asset balances which generated additional interest revenue and further reduced the accrual cost (before revaluations) of the net debt portfolio. Including these indirect or financing savings, the cumulative realised benefit over the period has been \$2.8 billion.

Chart 6 shows the additional costs and savings that have occurred since 1996-97 from changes in the market value of swaps due to changes in market interest rates. These costs and savings are unrealised but, as indicated above, the market value of swaps can provide a guide to future net cash flows if current market conditions accurately predict the path of future short-term interest rates. In these circumstances, revaluations in the market value of swaps provide an indication of changes in expected future net cash flows from the swaps. Also included in the chart are revaluations in the market value of the physical debt component of the portfolio. The chart shows that revaluations varied substantially from year to year as a result of changes in market interest rates over the period. It also shows that the revaluation effects on swaps have consistently been in the opposite direction to those generated by physical debt.

Chart 6: Revaluation costs on interest rate swaps



The AOFM does not seek to manage year to year revaluations by taking views on future interest rates and ‘timing the market’ by liquidating existing swaps during troughs in interest rate cycles and replacing them during peaks. Interest rate cycles may appear clear in hindsight but are unclear at the time. Rather, swap activity is directed at medium-term cost savings consistent with an issue-and-hold approach, with the benchmark portfolio being used as a medium-term guide and market conditions being used to inform decisions on new transactions.

Chart 7: Total savings arising from interest rate swaps (inclusive of revaluations)

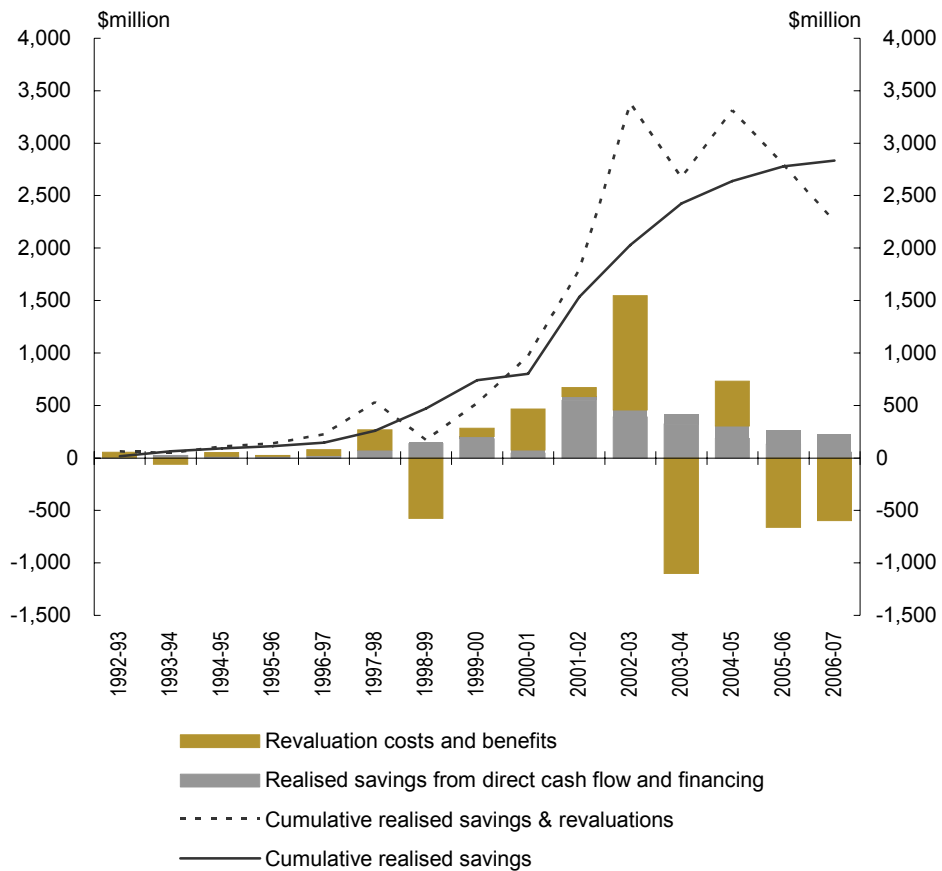


Chart 7 combines the realised savings from direct and indirect cash flows from swaps shown in Chart 5 with the costs and savings from revaluations in the market value of swaps in Chart 6. The chart shows that while the effects of revaluations have been substantial in individual years, they have to some extent been offsetting over time and their impact has remained smaller than the cumulative realised savings from direct and indirect cash flows.

Conclusion

The AOFM's domestic interest rate risk management activities have delivered significant realised cost savings over the years despite having to face some important challenges, including changes in the volume and volatility of the portfolio and more recently, flattening yield curves.

In the annual review of the portfolio management strategy and the benchmark conducted in the first half of 2007, the AOFM and the AOFM Advisory Board considered the approach that should be taken in the face of the observed flattening of yield curves, a lowering in estimated

term premiums and the consequent prospect of reduced savings from interest rate swaps. Consideration was given to whether the strategy should continue or whether existing swaps should be unwound. It was concluded that while structural factors appear to have lowered term premiums, a positive term premium remains and is likely to provide the basis for continuing savings in debt servicing costs in the long term through interest rate swaps. A revised benchmark was set to apply from 1 July 2007 with a higher modified duration and lower short-dated exposure. The swap programme has been scaled back accordingly.

The AOFM will continue to monitor market conditions and keep its portfolio management strategy under regular review to ensure that the expected savings from swap activities warrant the risks involved.