

REVIEW BY THE CHIEF EXECUTIVE OFFICER

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Treasury Bond market

Five years ago, in the 2003-04 Budget, the Government announced that it would continue to issue Treasury Bonds in order to maintain the Treasury Bond market. Budget surpluses and the proceeds from asset sales had removed the need to borrow for budget funding, so the decision to continue issuance was based entirely on the benefits that the economy derives from having an active and efficient Treasury Bond market, together with the market in Treasury Bond futures contracts. These markets help financial institutions manage their interest rate risk and thereby contribute to a lower cost of capital in Australia. They also strengthen the financial system against the potential impact of financial shocks.

Over the subsequent five years, the volume of Treasury Bonds on issue remained around \$50 billion, while other financial markets, and the economy, grew substantially. Thus the relative size of the Treasury Bond market gradually declined. For much of this period, the financial system adjusted without apparent difficulty to this relative contraction. Adjustments occurred in various ways. Some domestic investors reduced their holdings of Treasury Bonds by switching to other assets. Market traders made greater use of derivatives (including Treasury Bond futures contracts) in place of Treasury Bonds in adjusting their trading positions and managing interest rate risk. The Reserve Bank of Australia widened the range of securities it would accept in its open market operations, increasing the relative attractiveness of other securities and reducing the dependence on Treasury Bonds. Demand for Treasury Bonds from overseas investors increased strongly, but this increase was initially able to be accommodated through reductions in holdings by domestic investors. However, there was a limit on how far these trends could continue.

During 2007-08 the demand from overseas investors for Treasury Bonds intensified, underpinned by the strength of the Australian economy and exchange rate, and boosted by the turbulence in global financial markets triggered by the sub-prime housing crisis in the United States of America. As a result of this increased demand, some Treasury Bond lines became difficult to source, bid-ask spreads widened, liquidity deteriorated and market makers were not always able to provide two-way prices. However, overall, the Treasury Bond and Treasury Bond futures markets continued to operate reasonably effectively and were less affected by the turmoil than many other financial sectors. They continued to provide an efficient central reference point for the pricing of financial assets and the management of interest rate risk. As a result they provided important anchors for Australia's financial system as it responded to the impact of global credit and liquidity concerns.

Nevertheless it became apparent that some increase in the volume of bonds on issue was desirable to ensure that Treasury Bonds continue to play their role in the effective operation of Australia's financial markets. Following consultations by AOFM with market participants, the Treasurer announced on 20 May 2008 that the Government would increase issuance by \$5 billion in 2008-09, with scope for further increases in subsequent years.

The Treasurer also announced two other measures to enhance market efficiency. First, the AOFM's securities lending facility would accept a wider range of securities as collateral. This facility allows bond market intermediaries to borrow Treasury Bonds for short periods, improving their capacity to make two-way prices. In a tight market, its operation had become constrained by a requirement that other Commonwealth Government Securities be provided as collateral. Relaxing this requirement will improve its effectiveness in supporting the smooth operation of the market.

Second, bonds issued by State and Territory governments will be exempted from interest withholding tax. This should increase the attractiveness of these bonds as a low-risk alternative to Treasury Bonds and allow them to make a greater contribution to financial market stability.

Treasury Bond market conditions improved in the latter part of the financial year following the announcement that issuance would be increased, supported by a general improvement in financial market sentiment.

Legislation to provide for the increase in bond issuance and securities lending received Royal Assent in July 2008. Additional issuance commenced later in the month.

This report includes an article which reviews the role of the Commonwealth Government Securities market in the light of developments since the 2003 review, including the experience in 2007-08.

Management of the portfolio

Since its establishment in 1999, the AOFM has sought to manage its debt portfolio to reduce debt servicing costs over the medium term at acceptable risk. It has used interest rate swaps to achieve this aim. By swapping from longer to shorter-term debt, debt servicing costs can normally be reduced. However over recent years market yield curves have flattened and, at times, become inverted, reducing the savings potentially available through the use of swaps. A major part of this shift appears to have been due to structural changes in global and domestic financial markets that have reduced the term premium for holding longer-term debt. Transient factors, such as changes in expectations about future movements in short-term interest rates, shifts in monetary policy and the impact of credit concerns on credit spreads, have also played a role.

In its 2007 review of the portfolio management strategy, the AOFM decided to continue the interest rate swap program but adjusted its benchmark portfolio to move it closer to the structure that would result from debt issuance without swaps. This followed a similar adjustment in 2005. Consequently, the volume of swaps required to manage the portfolio to the benchmark was reduced, as were the expected savings in debt service costs.

Movements in market interest rates over the course of 2007-08 made it generally unattractive for the Commonwealth to undertake swaps to receive fixed rates, and only a small volume of swaps (\$300 million) was executed.

The analysis undertaken for the 2008 review indicated that the evidence for a positive term premium had weakened further. It concluded that, while the portfolio management strategy based on a positive term premium had produced substantial savings over an extended period, it no longer provided a firm basis for achieving future savings in debt servicing costs. It was therefore decided to change the strategy and the existing interest rate risk management framework was terminated from the end of 2007-08.

Under the new approach to be followed in 2008-09, the maturity structure of the portfolio will follow from the outcomes of debt issuance. Consequently, no new interest rate swaps are planned for 2008-09. Existing swaps will be managed in the light of market conditions and run off gradually over time.

In his announcement of increased Treasury Bond issuance, the Treasurer also announced that the AOFM would manage the investment of the proceeds of the additional issuance and that the Government would widen its investment powers to allow it to invest in a broader range of assets. As a result, the increase in issuance was not expected to involve any net cost to the Government. Since July 2008 the AOFM has invested the proceeds of additional issuance in a range of low risk securities, including bonds issued by State governments and Kangaroo bonds issued by supranational organisations. It is managing these assets together with the liabilities to which they relate, separately from other assets and liabilities in its portfolio.

Portfolio outcomes

The debt servicing cost of the debt and swaps in the portfolio increased to 6.55 per cent in 2007-08, compared with 6.42 per cent the previous year. The yield on physical debt fell as relatively expensive debt issued in the 1990s matured and was replaced by new debt issued at lower interest rates. However, high short-term interest rates increased the cost of swaps, which added to the overall cost of the debt portfolio.

Higher short-term rates also had a positive impact on the return obtained from term deposits, which yielded an average of 6.89 per cent during the year.

The net cost of funds on the combined portfolio of debt and assets in 2007-08 was 6.40 per cent, compared with 6.56 per cent the previous year.

Movements in market interest rates had an unfavourable impact on the market value of the portfolio in 2008-09. Unrealised losses from re-measurements amounted to \$118 million. This was largely driven by the widening in credit spreads in the swap curve, as swap rates rose significantly more than the yields on Treasury Bonds.

Communications Fund

The AOFM manages the investments of the Communications Fund on behalf of the Department of Broadband, Communications and the Digital Economy. Investments are made in high quality money market instruments including bank accepted bills and negotiable certificates of deposit. The return obtained by the Fund in 2007-08 was 7.36 per cent, which was four basis points above the return for the UBS Australian Bank Bill Index. This Index is the performance benchmark for the Fund before fees.

In the 2008-09 Budget the Government announced that the Communications Fund will be closed and its assets transferred to a new fund, the Building Australia Fund, which will be managed by the Future Fund Board of Guardians. The transfer of assets from the Communications Fund to the Building Australia Fund is expected to occur in 2008-09.

Operational risk

The AOFM has continued its efforts to strengthen its management of operational risk. Activities undertaken during the year included an enterprise risk assessment to re-evaluate the operational and financial risks affecting the Agency and the controls in place to mitigate them, a review of the Fraud Control Plan and completion of an Anti-Money Laundering and Counter-Terrorism Financing Program.

Cooperation with other debt managers

The AOFM actively supports sovereign debt management in other countries. It has seconded one staff member to assist in capacity development in debt management in Papua New Guinea under the Strongim Gavman program and one in the Solomon Islands as part of the Regional Assistance Mission Solomon Islands. These deployments aim to develop cash and debt management capabilities through training and mentoring, as well as the development of systems and procedures. Another AOFM staff member was seconded to the Papua New Guinea Department of Treasury for a period of three weeks to help develop its debt reporting and recording capacity. This year a forum was conducted by the AOFM in Brisbane attended by

officials responsible for sovereign debt management of the two countries, together with seconded AOFM staff, to improve the assistance provided.

The AOFM hosted visits from debt management officials from Indonesia and Thailand, and made presentations on debt management to Chinese and Indonesian public sector officials attending a residential study course on fiscal management at the Australian National University.

AOFM officers participated as speakers in the Organisation for Economic Cooperation and Development's Working Party on Public Debt Management, in a forum on Public Debt Management and Government Securities Markets conducted in Beijing by the OECD and the Chinese Government, and in the OECD's Global Forum on Public Debt Management in Amsterdam.

Staff

Since its establishment in 1999, all AOFM staff have been engaged under Australian Workplace Agreements. With the change in government policy on 13 February 2008, the AOFM is working towards the establishment of a collective agreement. Since that date, no new Australian Workplace Agreements have been made. As an interim arrangement, new recruits are engaged under common law contracts.

There were no changes in the senior staff of the Agency during 2007-08.

2007-08 was an eventful year, with turbulent financial markets, sharp movements in interest rates and spreads, together with a change of Government. At the end of the year, it appeared that volatility in global financial markets could continue for some time. On the other hand, decisions by the incoming Government, confirming the commitment to sustain the Treasury Bond market, increasing Treasury Bond issuance in 2008-09 and expanding the Agency's investment mandate, have provided clear strategic directions for the future.

The AOFM faced considerable challenges in 2007-08 in managing its portfolio and implementing policy initiatives. Staff rose to meet these challenges with skill and determination. I thank them all for the contributions they have made during the year.

Neil Hyden
Chief Executive Officer

