

PART 2: OPERATIONS AND PERFORMANCE

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OPERATIONS AND PERFORMANCE

Introduction

The principal functions of the AOFM are:

- issuing Treasury Bonds to support the Treasury Bond and Treasury Bond futures markets;
- managing the Australian Government's daily cash balances through short-term borrowings and investments; and
- managing its portfolio of debt and financial assets to minimise their net cost, subject to acceptable risk.

This section outlines the activities undertaken in 2007-08 and reports on their performance.

Treasury Bond issuance

Objective

For some years Treasury Bond issuance has been undertaken to support the efficient operation of the Treasury Bond and Treasury Bond futures markets rather than for budget funding purposes. These markets are supported because they allow financial market participants to better manage their interest rate risk; they thereby contribute to a lower cost of capital in Australia. The existence of active and efficient Treasury Bond and Treasury Bond futures markets alongside the banking system also strengthens the robustness of Australia's financial system and reduces its vulnerability to shocks.

On 20 May 2008, following consultations with market participants about the adequacy of the supply of Commonwealth Government Securities, the Treasurer announced that the Government would increase its issuance of Treasury Bonds. He observed that, due to budget surpluses, the Government did not need to issue securities to finance spending, but pointed out that Treasury Bonds play a special role by providing the lowest-risk, highest quality instrument in financial markets. Because they are risk-free, these bonds are the benchmark used by market participants to set interest rates beyond the short end of the yield curve, including in the bond futures market. The Treasurer said that the Government is committed to ensuring that its bonds can play this role efficiently.

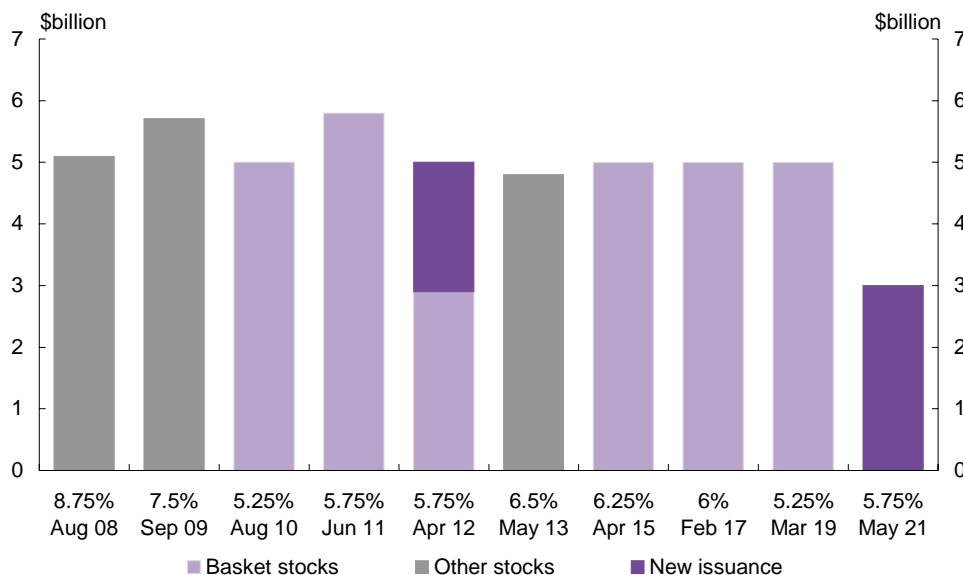
The Treasurer announced that the Government would legislate to allow an increase in Treasury Bonds on issue of up to \$25 billion, with an increase of \$5 billion in 2008-09. Legislation providing for this received Royal Assent in July 2008.

Achieving the objective

In 2007-08, the AOFM issued \$5.1 billion of Treasury Bonds. This comprised further issuance of \$2.1 billion of April 2012 Treasury Bonds, together with issuance of \$3.0 billion of a new May 2021 Treasury Bond line.

Chart 1 shows Treasury Bond issuance over the year, as well as levels of Treasury Bonds outstanding as at 30 June 2008.

Chart 1: Treasury Bond issuance for 2007-08 and Treasury Bonds outstanding as at 30 June 2008



The level of Treasury Bonds outstanding (net of Australian Government holdings) increased by around \$2.2 billion during the year, to \$49.4 billion, since bond issuance (\$5.1 billion) exceeded maturities (\$2.9 billion).

Consultation with financial markets

The AOFM increased its monitoring of market conditions following the emergence of the global financial market turbulence that began in mid-2007 by maintaining an active dialogue with market participants, the Reserve Bank of Australia (RBA) and the Australian Securities Exchange (ASX). It participated as an observer in meetings of the Debt Securities Committee and Repo Committee of the Australian Financial Markets Association (AFMA). Its consultations with

market participants were particularly valuable in the lead up to the Government's decision to increase the volume of Treasury Bond issuance.

Performance

Market efficiency

Global financial market turbulence combined with strong demand for Treasury Bonds from overseas investors led to some stress in the Treasury Bond market in 2007-08. Despite this the Treasury Bond and Treasury Bond futures markets continued to operate reasonably effectively. As a result they provided important anchors for Australia's financial system as it responded to the impact of the credit and liquidity concerns triggered by the sub-prime housing crisis in the United States of America.

The turbulence in financial markets was marked by an increased investor aversion to risk, a significant repricing of credit risk in both global and domestic financial markets and an increased demand for risk-free assets such as Treasury Bonds. Weakness in the United States dollar and favourable interest rate differentials also contributed to increased overseas investor demand for Australian Treasury Bonds. Non-resident holdings of the bonds reached record levels and at the end of the financial year exceeded 60 per cent of the bonds on issue.

With the increased demand, some Treasury Bond lines became difficult to source at times. As a result, bid-ask spreads widened, liquidity deteriorated and market makers were not always able to provide two-way prices. Bond market conditions improved in the latter part of the financial year following a general improvement in financial market sentiment and the announcement that Treasury Bond issuance would be increased.

The financial market turbulence impacted on turnover in the Treasury Bond and Treasury Bond futures markets.

- The turnover of Treasury Bonds decreased by around 7 per cent in 2007-08 compared to 2006-07.
- The turnover of 3-year Treasury Bond futures contracts increased by around 2 per cent in 2007-08 compared to 2006-07, and turnover of the 10-year contracts increased by around 17 per cent. In 2006-07, the corresponding growth rates had been 12 per cent and 34 per cent.

All Treasury Bond futures contract close-outs in 2007-08 occurred smoothly.

The impact of financial turbulence on the repurchase (repo) market in Treasury Bonds was less marked. According to market contacts the AOFM securities lending facility greatly assisted in minimising pressures in this regard. The facility allows bond market participants to borrow Treasury Bonds for short periods, which enhances the efficiency of the market by improving the

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capacity of intermediaries to make two-way prices. Reflecting the strong demand for Treasury Bonds there was a substantial increase in use of the AOFM securities lending facility in 2007-08.

- The facility was used 88 times in 2007-08 compared with 38 times in 2006-07. The face value lent was around \$2,515 million, an increase of around 96 per cent over 2006-07.
- The majority of transactions continued to be for one day only, although there were 19 instances where bonds were lent for two days or more (compared to eight occasions in 2006-07). One loan extended to seven days.
- The largest amount lent on a single day was \$269.2 million.

Efficiency of issuance

Treasury Bonds are issued by competitive tender using an electronic tender system. In 2007-08, the turnaround time for the release of tender results was further reduced. Tender results are now available to bidders less than one minute after the close of bidding. Prior to implementation of the present electronic tender system in 2006-07 the turnaround time for the release of tender results was six to eight minutes.

Table 1 shows the results of the tenders conducted during the year.

Table 1: Treasury Bond tender results – 2007-08

Tender date	Coupon and maturity	Face value amount allocated (\$m)	Weighted average issue yield (%)	Spread to secondary market yield (basis points)	Range of bids accepted (basis points)	Times covered
14-Aug-07	5.25% 15-Apr-2012	400	6.2588	-0.32	1.00	2.56
28-Aug-07	5.25% 15-Apr-2012	401	6.1579	0.29	0.50	3.59
11-Sep-07	5.25% 15-May-2021	800	5.8540	na	2.50	2.34
25-Sep-07	5.25% 15-May-2021	600	6.1866	0.66	1.00	2.69
16-Oct-07	5.25% 15-May-2021	401	6.3031	-0.19	0.50	4.18
30-Oct-07	5.25% 15-Apr-2012	400	6.5050	-2.00	0.00	3.25
13-Nov-07	5.25% 15-Apr-2012	300	6.4322	0.22	1.50	4.07
11-Dec-07	5.25% 15-May-2021	400	6.2059	0.59	1.00	2.29
22-Jan-08	5.25% 15-Apr-2012	300	6.2652	0.65	1.50	2.29
12-Feb-08	5.25% 15-May-2021	399	6.1802	-0.78	1.50	2.78
22-Apr-08	5.75% 15-Apr-2012	300	6.3900	-1.25	0.00	4.88
17-Jun-08	5.25% 15-May-2021	401	6.7438	1.38	2.00	2.45
Average over year to June 2008				-0.07	1.08	3.17
Average over 3 years to June 2008				0.07	0.76	3.72
Average over 10 years to June 2008				0.37	1.13	3.73

The average weighted issue yield was just under the secondary market mid-rate yield. For five tenders, the weighted average issue yield was below the secondary market mid-rate yield.

Cash management

Objective

The AOFM manages the daily cash balances of the Australian Government in the Official Public Account (OPA).¹ The AOFM's primary objective in managing these balances is to ensure that the Government is able to meet its financial obligations as and when they fall due. Other objectives are to minimise the cost of funding the balances and to invest excess balances efficiently. In minimising cost the AOFM seeks to avoid undue use of the overdraft facility provided by the Reserve Bank of Australia.²

Achieving the objective

In 2007-08, term deposits with the RBA were the only instrument used to manage the cash balances. Cash balances not required immediately are invested outside the OPA with the RBA for nominated periods of time, with the maturity dates set primarily to finance large future outlays. The magnitudes and tenor of the term deposits are determined by the AOFM. Interest rates for term deposits are based on Overnight Indexed Swap rates.

The daily movement in the Australian Government's financial asset position at the RBA (OPA cash balance plus term deposits) during 2007-08 is shown in Chart 2.

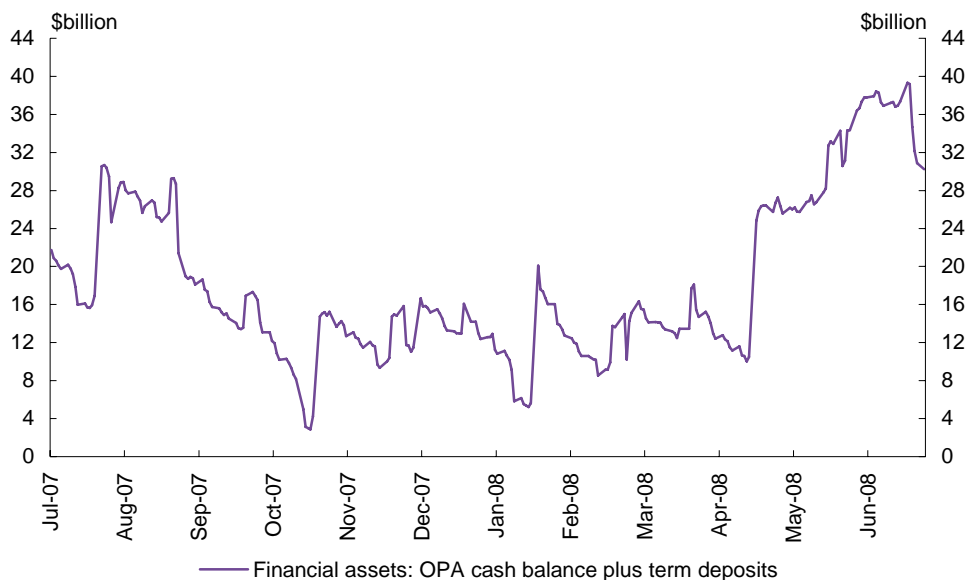
The 'peak-to-trough' swing for financial asset holdings was around \$36 billion in 2007-08, compared to \$27 billion in 2006-07 and \$28 billion in 2005-06. Daily net cash flows exceeded \$10 billion on all four of the quarterly tax collection days.

In August 2008, the AOFM commenced investing cash balances in a broader range of low credit risk short-term investment assets, namely highly-rated bank accepted bills, certificates of deposit issued by Authorised Deposit-taking Institutions. The broader range of short-term investment options is expected to enhance investment returns on surplus cash balances.

1 The Official Public Account (OPA) is the collective term for the Core Bank Accounts maintained at the RBA for Australian Government cash balance management.

2 The overdraft facility is more costly than equivalent short-term borrowing (for example, issuance of Treasury Notes). The terms of the facility provide that it is to cover only temporary shortfalls of cash and is to be used infrequently and, in general, only to cover unexpected events.

Chart 2: Australian Government financial asset holdings at the Reserve Bank of Australia 2007-08



Performance

During 2007-08 the AOFM placed 376 term deposits with the RBA. The stock of term deposits fluctuated from a minimum of \$2.2 billion in October 2007 to a maximum of \$38.8 billion in June 2008. It was not necessary to issue Treasury Notes to help meet the within-year funding requirement. Treasury Notes were last issued in 2003.

The objective of meeting the Government’s financial obligations when they fall due was met, with the overdraft facility provided by the RBA accessed only once for one day.

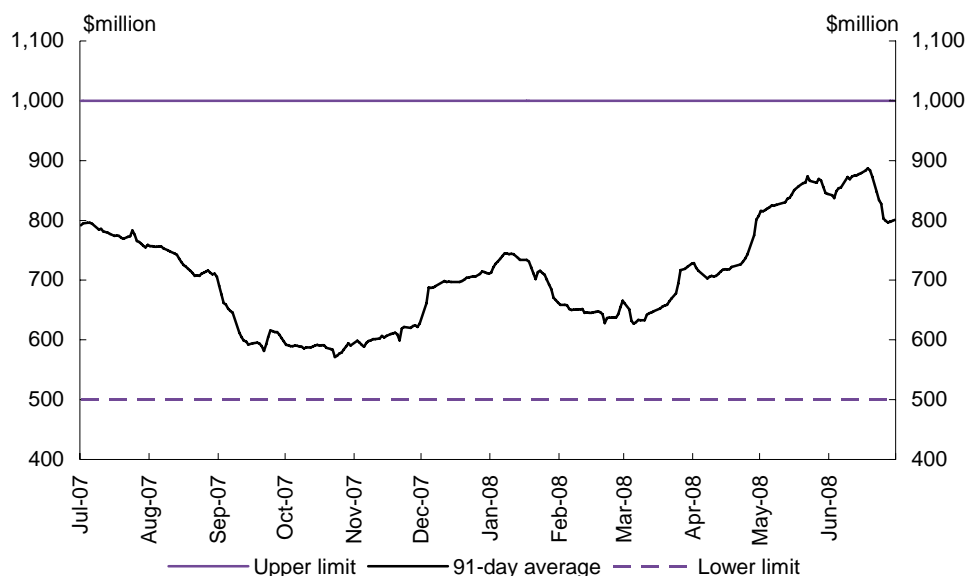
The yield obtained on term deposits during 2007-08 was 6.89 per cent, compared with 6.15 per cent in 2006-07.

In undertaking its cash management activities, the AOFM is required to maintain the 91-day rolling average of the daily OPA cash balance within operational limits around a target level. In 2007-08 these limits were the same as applied in 2006-07, with an operational target of \$750 million and upper and lower limits of \$1,000 million and \$500 million respectively. There is also a Ministerially-approved upper limit of \$1.5 billion.

The 91-day moving average OPA cash balance was maintained within operational limits, and within the Ministerial limit, throughout the year.

Movements in the 91-day rolling average OPA cash balance over the year are shown in Chart 3.

Chart 3: 91-day moving average cash balance



Minimising debt servicing costs subject to acceptable risk

Objective

In managing its debt portfolio, the AOFM has sought to minimise debt servicing costs over the medium-term at an acceptable level of risk, by which is meant an acceptable level of variability in cost outcomes.

In this context, the measure of cost used is historic accrual debt servicing cost. This includes interest on physical debt and derivatives, realised market value gains and losses, capital indexation of inflation-linked debt and the amortisation of any issuance premiums and discounts. However, it does not include unrealised market value gains and losses. Accrual debt servicing cost is the most appropriate measure of cost in circumstances where financial assets and liabilities are intended to be held or to remain on issue until maturity and there is little likelihood that unrealised market value gains and losses will be realised.

Information on unrealised market value gains and losses is useful in circumstances where it is possible that they may be realised in the future. In the AOFM's financial statements, debt servicing cost outcomes are presented on a 'fair value' basis that includes movements in the unrealised market value of physical debt, assets and interest rate derivatives. However a comprehensive income format is used that allows revenues and expenses on an historic basis to be distinguished from the effects of unrealised market value fluctuations.

Achieving the objective

The composition of the physical debt in the AOFM's portfolio provides little opportunity for reducing debt servicing costs, because the volume and nature of the debt is determined by the policy of issuing to support the Treasury Bond and Treasury Bond futures markets. Furthermore, the volume and tenor of assets held as term deposits are largely determined by cash management requirements.

However, for many years the AOFM has been able to reduce debt servicing costs by using derivative instruments to adjust the portfolio's cost and risk characteristics, such as modified duration and short-dated exposure. It has used interest rate swaps³ to achieve this objective by shifting the characteristics of the portfolio from those of the physical debt towards those of a target or 'benchmark' portfolio.

Historically, debt issued for long periods at fixed rates of interest has typically commanded a higher interest rate than shorter-term debt, because lenders demand a higher return for having their funds locked away for longer periods. Interest rate swaps can provide savings in debt service costs by swapping from longer to shorter-term debt (or from fixed rate debt to floating rate debt). However, increasing the amount of short-term or floating rate debt in the portfolio increases the potential variability of debt service costs, as interest rate movements are able to flow through to the overall cost of funds more quickly.

Over recent years market yield curves have flattened and, at times, become inverted. Part of this shift 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 in global and domestic financial markets that have affected the term premium for holding longer-term debt. This has reduced the potential savings available from adjusting the portfolio's cost and risk characteristics through interest rate swaps.

In seeking to reduce debt servicing costs, the AOFM has used a benchmark portfolio which identifies the desired trade-off between cost savings and variability in debt servicing costs over the medium-term. The benchmark portfolio is reviewed annually. In 2005 and 2007, the annual reviews concluded that the savings expected to be generated from targeting a modified duration significantly below that of the physical debt portfolio had reduced. There had also been some reduction in the expected variability in debt servicing costs, but smaller in magnitude than the reduction in expected savings. Accordingly, the modified duration of the benchmark portfolio was increased in these reviews from 2.0 to 2.5 years and again from 2.5 years to 3.0 years. (By comparison, the modified duration of the nominal physical debt (before swaps) has generally been a little above 4.0 years.) The short-dated exposure of the benchmark portfolio was also reduced from 35 per cent to 25 per cent.

3 An interest rate swap is a financial contract where one party agrees to pay another a stream of fixed interest payments on an agreed notional principal amount, in return for a stream of floating interest rate payments on the same notional principal.

Higher duration targets for the benchmark, that are closer to those of the unswapped portfolio, entail smaller swap programs to keep the actual portfolio in line with the benchmark but they also offer less scope for savings in debt service costs over the medium-term.

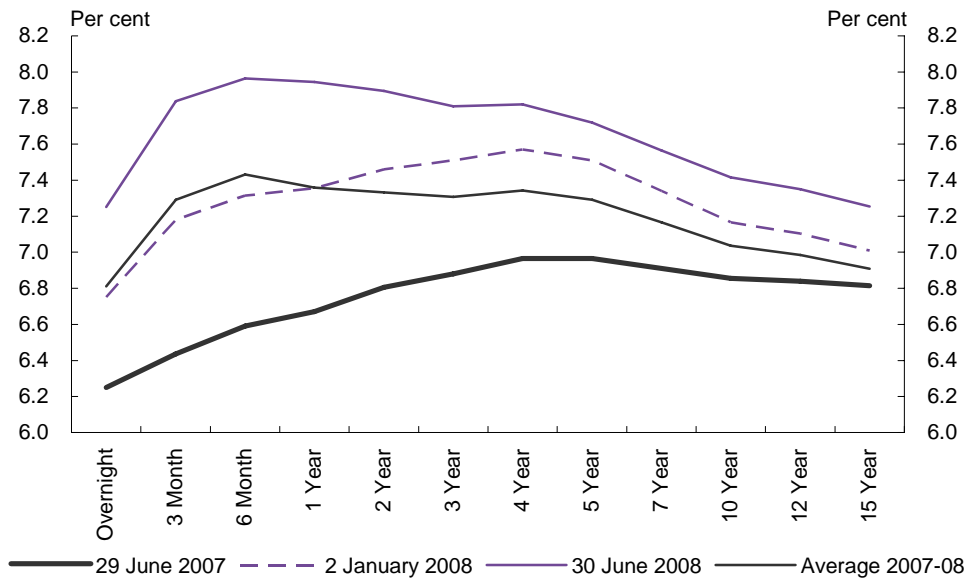
Management of the portfolio during 2007-08

The benchmark parameters for 2007-08 were set at a modified duration of 3.0 years and a short-dated exposure of 25 per cent. Guided by the new benchmark, it was planned that the average term to maturity of the actual debt portfolio would increase gradually, and its short-dated exposure would fall, as debt was rolled over and existing interest rate swaps matured. Provision was made for a small program of new swaps to provide flexibility to respond to changing market conditions, but swaps would be executed only if they were expected to provide savings to the Commonwealth over the medium-term, or a reduction in risk.

Undertaking swaps to pay fixed rates would have accelerated the transition of the portfolio towards the benchmark, but was unattractive because it required commitments to pay fixed rates that were high relative to the levels that had applied in previous years.

On the other hand, the attractiveness of undertaking swaps to receive fixed rates changed over the course of the year with changes in the shape of the swap yield curve. Movements in swap yields and the shape of swap yield curves during the year are illustrated in Chart 4.

Chart 4: Australian swap yield curves 2007-08

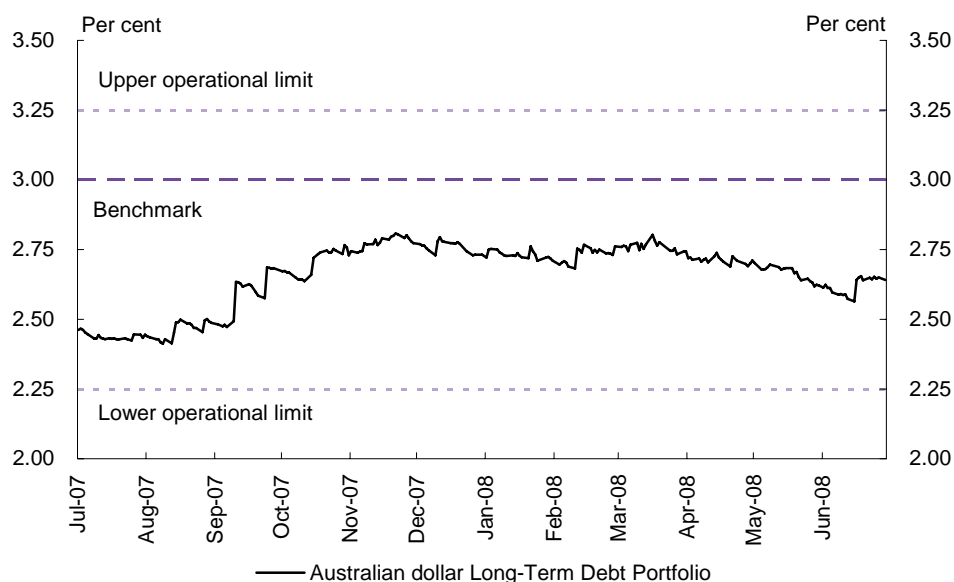


Source: Australian Financial Markets Association, Reuters.

At the start of the year the curve was 'humped', with an upward slope to the mid-part of the curve. A small volume of swaps to receive fixed rates was undertaken to offset the medium-term cost impact of issuing mid-curve Treasury Bonds (specifically into the April 2012 line) at historically high yields in October and November 2007.⁴ However, only \$300 million in swaps were executed to this end. After this time, significant increases in short-term bank bill rates (the floating rate reference point for interest rate swaps) resulted in an inverted curve beyond six months. This reduced the likelihood that any additional swaps would actually reduce the cost of mid-curve issuance. Consequently, no further swaps were executed from mid-November 2007.

The resultant path of modified duration for the nominal component of the Long-Term Debt Portfolio over the year is shown in Chart 5.

Chart 5: Modified duration – nominal component of Australian dollar Long-Term Debt Portfolio 2007-08

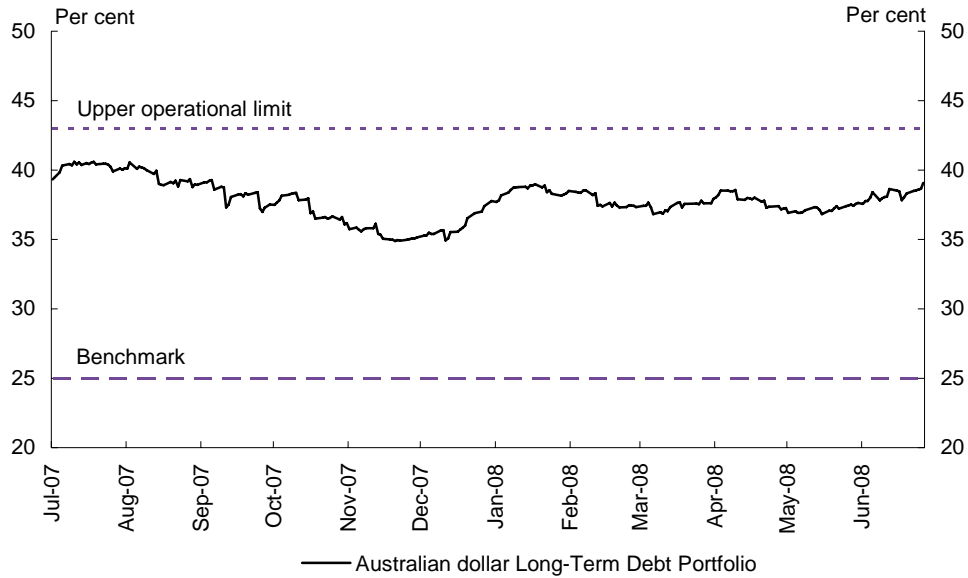


The downward drift through the last quarter of 2007-08 was a consequence of the relatively low volume of Treasury Bond issuance during this period. At the end of the financial year, the modified duration of the portfolio stood at 2.64 years.

Short-dated exposure remained above the benchmark target throughout the year. However, changes in the volume and composition of the debt on issue, together with maturities of existing swaps, provided some downward movement in short-dated exposure over the course of the year. Chart 6 shows the course of short-dated exposure of the portfolio during 2007-08.

⁴ Refer to Table 1.

Chart 6: Short-dated exposure – nominal component of Australian dollar Long-Term Debt Portfolio 2007-08



Swap execution in 2007-08

The \$300 million of interest rate swaps undertaken in 2007-08 were executed with maturities of four years. The average spread from mid-market was 0.67 of a basis point.

Table 2: Spreads from mid-market on interest rate swaps

	2006-07			2007-08		
	Amount (\$m)	Average bp	Range bp	Amount (\$m)	Average bp	Range bp
Mid-dated swaps (receive)	1,500	-0.25	-0.9 to 0.3	300	-0.67	-1.2 to -0.3
Long-dated swaps (receive)	1,000	-0.16	-0.7 to 0.3	0		

With swaps to receive fixed rates, the AOFM expects on average to receive a margin under the mid-market rate.

Performance

Reducing debt servicing cost

The debt servicing cost⁵ of the gross debt managed by the AOFM in 2007-08 was \$3.7 billion (after swaps), on an average book value of \$56.8 billion. This represented a cost of funds of 6.55 per cent. Term deposits held with the RBA generated interest revenue of \$1.2 billion on an average book value of \$17.4 billion, giving a yield of 6.89 per cent.

Taken together, the combined portfolio of debt and assets managed by the AOFM⁶ had a net interest expense (before re-measurements) of \$2.5 billion, at an effective yield of 6.40 per cent. The corresponding figure for 2006-07 was 6.56 per cent.

Table 3 provides further details of the cost outcomes for the combined portfolio by instrument and portfolio for 2006-07 and 2007-08.

5 Debt servicing cost includes net interest expenses (measured on an accruals basis) plus foreign exchange revaluation gains and losses. Unrealised changes in the market valuation of domestic debt and derivatives are not part of this measure.

6 The figures given in this section relate to net CGS debt which includes all administered assets and liabilities on the AOFM's balance sheet, apart from loans to the States arising from Commonwealth-State Housing Agreements, which are managed separately. Housing Agreement assets are included in the figures in the financial statements in Part 4.

Table 3: Australian Government debt portfolio cost of funds analysis

	Interest expense		Book volume		Effective yield	
	2006-07	2007-08	2006-07	2007-08	2006-07	2007-08
	\$ million		\$ million		per cent per annum	
Contribution by instrument						
Treasury fixed coupon bonds	(2,988)	(2,947)	(47,641)	(48,476)	6.27	6.08
Treasury Inflation Indexed Bonds	(601)	(593)	(8,108)	(8,317)	7.42	7.13
Treasury notes	-	-	-	-		
Other miscellaneous domestic debt	(2)	(0)	(20)	(4)	9.81	8.22
Foreign loans (a)	0	(1)	(7)	(6)	-4.88	16.82
Gross physical CGS debt	(3,591)	(3,541)	(55,775)	(56,804)	6.44	6.23
Interest rate swaps	9	(180)	-	-		
Gross CGS debt (after swaps)	(3,581)	(3,722)	(55,775)	(56,804)	6.42	6.55
Term deposits with the RBA	1,147	1,197	18,645	17,378	6.15	6.89
Net CGS debt	(2,435)	(2,524)	(37,130)	(39,426)	6.56	6.40
Contribution by portfolio						
Long Term Debt Portfolio	(3,613)	(3,727)	(56,267)	(56,892)	6.42	6.55
Cash Management Portfolio	1,178	1,204	19,137	17,466	6.16	6.89
Net CGS debt	(2,435)	(2,524)	(37,130)	(39,426)	6.56	6.40
Remeasurements (b)	1,015	(118)				
Net CGS debt (after re-measurements)	(1,420)	(2,642)	(37,130)	(39,426)		

(a) Interest expense and effective yield on foreign loans incorporates foreign exchange revaluation effects.

(b) Re-measurements refers to unrealised changes in the market valuation of financial assets and liabilities.

The debt servicing cost of physical debt fell by \$50 million compared to 2006-07, as relatively expensive debt issued in the 1990s matured and was replaced with new debt issued at lower interest rates. This was partially offset by a higher volume of nominal debt and the impact of higher interest rates.

Returns on interest rate swaps fell by \$190 million compared to 2006-07. This was due almost entirely to higher short-term market interest rates from monetary tightening and higher margins for credit. These higher short-term rates increased the cost of the floating legs of swaps. Overall, swaps added to the interest costs of the portfolio (before re-measurements) by \$180 million during the year.

However, the higher short-term interest rates had a positive impact on the return obtained on term deposits. The interest revenue on term deposits in 2007-08 was \$1.2 billion, on an average book volume of \$17.4 billion. This represented a return on funds of 6.89 per cent, compared with 6.15 per cent in 2006-07. The average volume of term deposits was slightly lower, offsetting the absolute amount of interest received. Nevertheless, term deposits contributed an extra \$50 million in interest in 2007-08 compared to 2006-07. They also had a favourable effect on the

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net cost of funds in percentage terms on the combined portfolio of debt and assets, as the yield on term deposits was higher than the cost of servicing gross debt.

Movements in market interest rates had an unfavourable impact on the market value of the portfolio in 2007-08. Unrealised losses from re-measurements amounted to \$118 million. They comprised a gain of \$390 million on nominal debt offset by losses of \$114 million on indexed debt and \$394 million on interest rate swaps.

The sensitivity of the market value of the nominal CGS debt in the AOFM's portfolio to changes in market interest rates is over three times the sensitivity of the market value of the interest rate swaps where the changes in interest rates are uniform across the yield curve. The effects are in opposite directions, so the impact of a uniform shift in interest rates on nominal CGS debt will more than offset the impact on swaps. The net loss in the portfolio from re-measurements in 2007-08 was largely driven by the widening in credit spreads, specifically in the swap curve. That is, swap rates rose significantly more than did CGS yields.

Lower real yields on indexed debt, due to increased demand for this debt arising from market concerns about inflation, also contributed to the adverse revaluation effects.

Comparisons with alternative portfolios

The cost outcomes for the actual portfolio can be compared with the outcomes that might have been obtained with other possible portfolios. One such alternative portfolio is the physical debt in the portfolio without swaps. Another is the benchmark portfolio. Simulated outcomes for these portfolios are compared with the outcome for the actual portfolio in Table 4. The comparisons are based on the Long-Term Debt Portfolio, which is the part of the AOFM's total portfolio that is actively managed using interest rate swaps.

Table 4: Relative performance analysis: Long-Term Debt Portfolio (LTDP), benchmark and unswapped portfolios in 2007-08

	Average modified duration (nominal \$A)	Cost of funds before re-measurements (\$million)	Cost of funds effective yield (%)	Cost of funds after re-measurements (\$million)
Actual LTDP	2.66	-3,728	6.55	-3,846
Benchmark	2.87	-3,713	6.53	-3,711
Unswapped	4.03	-3,548	6.24	-3,272

As interest rates (in particular, bank bill and swap rates) trended higher throughout the financial year, portfolios with higher duration and/or lower exposure to short-term interest rates demonstrated better performance, both inclusive and exclusive of revaluation effects.

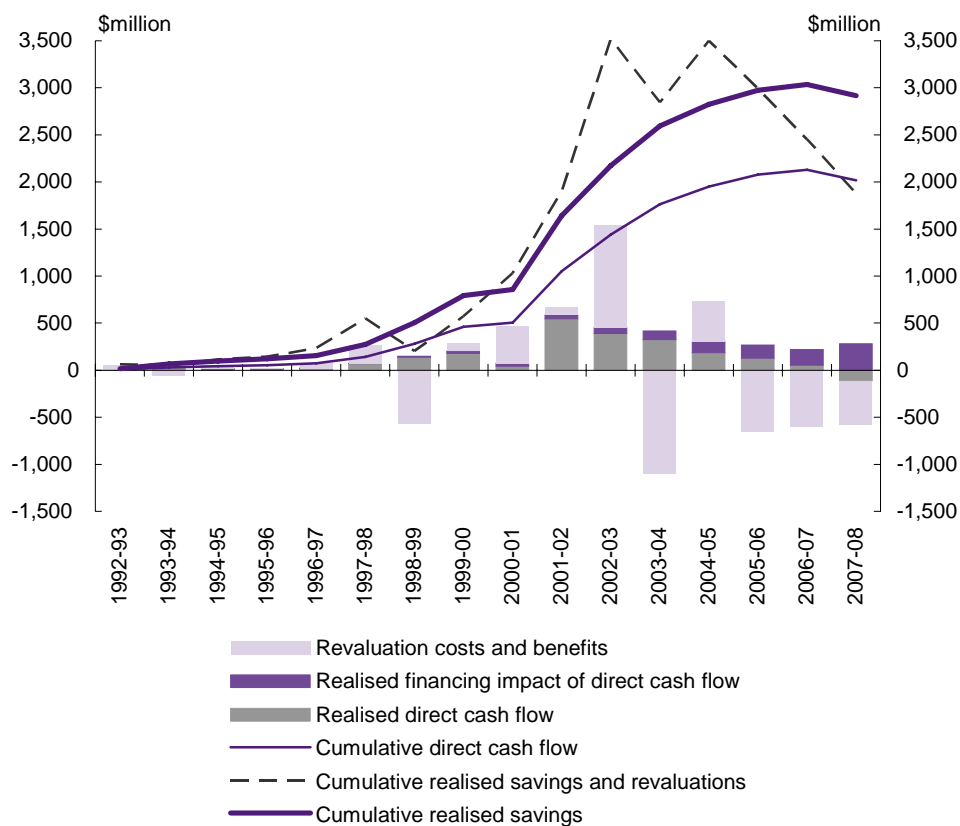
The model used to simulate the benchmark portfolio transitioned to the new benchmark targets in the first six months of the financial year. It was therefore less exposed than the actual portfolio

to the spikes in rates that occurred in the first quarter of the 2008 calendar year. Consequently, the Long-Term Debt Portfolio underperformed the model benchmark by \$15 million in accrual terms and by \$135 million in mark-to market terms.

Table 4 does not include performance data on either of the two previous benchmark portfolios (modified duration of 2.0 and 2.5 years). However it is clear that these previous benchmarks would have performed worse than the actual portfolio, given its higher modified duration averaging 2.66 years through the year. If the benchmark portfolio had not been changed at the start of the financial year, and additional swaps had been executed to hold the actual portfolio close to the unchanged benchmark, the performance of the actual portfolio during the year would have been worse than it was. The performance of the portfolio in 2007-08 thus benefited from the decision to change the benchmark.

As indicated in Table 4, the unswapped portfolio performed better in 2007-08, both before and after re-measurements, than both the actual portfolio and the benchmark portfolio. Swaps are undertaken as part of a medium-term strategy whose performance should primarily be judged over a period of years. 2007-08 was the first year that domestic interest rate swaps did not provide savings in the debt servicing costs of the portfolio (excluding revaluation effects). Chart 7 illustrates the whole of life performance of the domestic interest rate swaps since the first such swap was executed in 1992.

Chart 7: Savings arising from domestic interest rate swaps



As at 30 June 2008, interest rate swaps had generated total direct savings of just over \$2 billion. Including second round, or financing, benefits, the total savings were \$2.9 billion. However, the unrealised market value of the swap portfolio stood at negative \$1.04 billion. The total cumulative economic benefit from interest rate swaps including unrealised revaluations was thus approximately \$1.9 billion.

2008 review of the portfolio management strategy

In its annual reviews of the benchmark and the portfolio management strategy over recent years, the AOFM has considered the continued appropriateness of the strategy in the light of developments in market conditions, including changes in its assessment of the term premiums that underlie the shape of the yield curves and the margins between long and short-term market rates. The 2007 review concluded that, while structural factors appeared to have progressively lowered term premiums, a positive premium remained and was likely to provide a basis for continuing savings in debt servicing costs through interest rate swaps.

The analysis undertaken for the 2008 review indicated that the evidence for a positive term premium had weakened further and no longer provided a firm basis for achieving future savings in debt servicing costs. While the portfolio management strategy based on a positive term premium had produced substantial savings over an extended period, in current circumstances it would be better to accept the maturity structure of the debt portfolio as it exists and develops from the AOFM's issuance activities. The AOFM and the Advisory Board therefore decided to change the strategy and terminate the existing interest rate risk management framework from the end of 2007-08.

Under the new approach to be followed in 2008-09, the structure of the portfolio will follow from the outcomes of debt issuance to support the Treasury Bond and Treasury Bond futures markets, together with the management of assets resulting from the proceeds of issuance and the management of the Government's daily cash balances. Existing interest rate swap contracts will be managed in the light of market conditions and run off gradually over time. With the benchmark framework discontinued, the AOFM will no longer be reporting relative performance, however the cost outcome of the portfolio will continue to be monitored and reported.

Credit management

The use of interest rate swaps brings an exposure to counterparty credit risk. Collateral agreements, which require counterparties to post collateral when the AOFM's credit exposure rises above a predefined threshold, remained the main tool for credit risk management in 2007-08. The AOFM has Credit Support Annexes with 19 of its counterparties. On 30 June 2008, 91.8 per cent of the total nominal face value of the interest rate swap portfolio was covered by collateral agreements.

Table 5: Derivative counterparties by credit rating as at 30 June 2007 and 30 June 2008

Credit rating: Moody's/ Standard & Poors (a)	Number of AOFM counterparties by credit rating as at 30 June 2007	Number of AOFM counterparties by credit rating as at 30 June 2008
Aaa/AAA	1	0
Aa1/AA+	2	1
Aa2/AA	12	10
Aa3/AA-	6	5
A1/A+	3	2
A2/A	0	3
Total number of counterparties	24	24

(a) Where a counterparty has a split rating between the two ratings agencies it is allocated to the lower of the two ratings levels.

The AOFM's exposure to counterparty credit risk on swaps was zero at 30 June 2008.

Communications Fund

The AOFM manages the investments of the Communications Fund on behalf of the Department of Broadband, Communications and the Digital Economy.⁷

When the Fund was established, investments were limited to term deposits with the Reserve Bank of Australia until longer-term investment arrangements were decided. Revised investment guidelines were finalised in June 2007 and the AOFM completed the transition of the portfolio to the longer-term investment strategy in August 2007. Under this strategy, investments are held in a portfolio of short-term Australian denominated dollar money market instruments and deposits, including bank accepted bills, negotiable certificates of deposit and commercial paper. At end-June 2008 the value of the Fund's investments totalled approximately \$2.4 billion.

Following the transition to the longer-term investment strategy, the before-fees investment portfolio performance benchmark for the Fund is the UBS Australian Bank Bill Index. The after-fees performance benchmark is the UBS Australian Bank Bill Index less 2 to 3 basis points. Both performance benchmarks were exceeded in 2007-08.

- The before-fees return of the Communications Fund exceeded the benchmark by 4 basis points.
- The after-fees return of the Communications Fund exceeded the benchmark by 5-6 basis points.

Financial information concerning the operation of the Communications Fund is reported in the financial statements of the Department of Broadband, Communications and the Digital Economy.

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 new fund will finance critical economic infrastructure in transport and communications such as road, rail, ports and broadband. The transfer of assets from the Communications Fund to the Building Australia Fund is expected to occur in 2008-09.

⁷ The Communications Fund was established in September 2005 to provide an income stream to fund the Government's response to any recommendations proposed by the Regional Telecommunications Independent Review Committee in reports reviewing the adequacy of telecommunication services in regional, rural and remote parts of Australia.

Operational risk

Objective

Operational risk is the risk of loss due to operational failures resulting from internal processes, people, or systems, or from external events. It encompasses risks such as fraud risk, settlement risk, accounting risk, personnel risk and reputation risk. The AOFM aims to manage its exposure to operational risk to acceptable levels.

Achieving the objective

The AOFM maintains a culture of prudence and high ethical standards, which are reinforced by adherence to the Australian Public Service Code of Conduct and the AFMA Code of Conduct. This foundation is accompanied by detailed controls and procedures overseen by the Operational Risk Committee and the Audit Committee. The Compliance Unit also monitors compliance with financial risk management policies and procedures on a daily basis.

In 2007-08, the AOFM undertook a number of activities to enhance the operational risk framework including:

- a review, at a high level, of operational and financial risks affecting the Agency and the controls in place to mitigate these risks. The review identified AOFM activities with inherent higher operational and financial risks and found that the controls in place were effective in managing these risks. No significant operational risk failures occurred in 2007-08;
- an update of the AOFM's Fraud Control Plan (FCP), including a re-assessment of the risks of fraud from within the Agency and externally. A new FCP was developed by the Compliance Unit and approved by the AOFM Audit Committee. The review considered potential fraud risks and found that the Agency's controls were appropriate for preventing and detecting fraud. No instances of fraud were detected in the Agency in 2007-08;
- completion of the Certificate of Compliance, an annual requirement for Chief Executives of agencies governed by the *Financial Management and Accountability Act 1997* (FMA Act), to report on compliance with the financial management framework. As a part of this process the Agency reviewed the requirements of the FMA Act, FMA Regulations, FMA Orders and FMA Finance Minister Delegations and associated government financial policies. It identified 260 requirements applicable to the Agency. A risk assessment of the Agency's compliance with these requirements found that the Agency's controls and processes provide reasonable confidence of compliance. Further testing of the higher risk areas detected two minor instances of non-compliance with FMA regulation 10;

- a comprehensive review of the AOFM's Chief Executive Instructions (CEIs) and internal financial delegations issued under the *Financial Management and Accountability Act 1997*. The CEIs provide a detailed framework of financial and management controls and delegations which limit discretion, approval and spending of public monies to minor amounts or alternatively require senior executive approval;
- completion of an Anti-Money Laundering and Counter-Terrorism Financing Program to ensure the AOFM's compliance with legislation that places obligations on prescribed reporting entities in relation to, among other things, customer identification, transaction reporting and record-keeping; and
- internal audits covering activities such as general controls, IT general controls, compliance, Communications Fund investments and GST and FBT administration.

Settlement operations

The AOFM settles high value payments on its administered portfolio of debt and assets. In 2007-08, the AOFM settled around \$6.4 billion of payments of CGS interest and principal payments, \$1.8 billion of swap payments and \$318.8 billion in purchases of term deposits with the Reserve Bank of Australia. The AOFM also ensures that administered receipts are settled promptly and correctly by transaction counterparties. Settlements risk is a key risk managed by the AOFM. In 2007-08, the AOFM was late in settling one payment obligation. No compensation was sought by the counterparty. During the year all AOFM counterparties settled all payment obligations in line with their contractual obligations.

Information Technology operations

The AOFM has an established technology platform that includes integrated services for the delivery of treasury management and market data. The services provided by AvantGard Quantum, Bloomberg and Reuters continue to meet the requirements of the AOFM by providing a reliable environment that supports the Agency's debt management activities.

Cooperation with other debt managers

Over the 2007-08 financial year, the AOFM continued to provide support for debt management activities in Papua New Guinea and the Solomon Islands. One position was staffed in the Solomon Islands and one staff member seconded to Papua New Guinea under the auspices of the Regional Assistance Mission Solomon Islands and the Strongim Gavman program (previously named Enhanced Cooperation Program) respectively. These deployments aim to develop cash and debt management capabilities through training and mentoring, as well as the development of systems and procedures. 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. 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.

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.

Agency financial performance

Agency activities recorded an operating surplus of \$2.71 million for 2007-08 financial year, comprising total revenue of \$10.22 million and expenses of \$7.51 million. As at 30 June 2008, the AOFM was in a sound net worth and liquidity position, reporting net assets of \$14.40 million, represented by assets of \$15.69 million (including current assets of \$0.61 million) and liabilities of \$1.29 million.

As at 30 June 2008, the AOFM maintained cash and unspent appropriations totalling \$14.20 million. These funds are held to settle liabilities as and when they fall due and for future asset replacements and improvements.

During 2007-08, the AOFM did not return or establish a provision for return, by the way of dividend, of unspent appropriation monies to Government.

