# REVIEW BY THE CHIEF EXECUTIVE OFFICER

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## Treasury Bond market

Last year's annual report included an article which reviewed the role of the Treasury Bond market in the Australian financial system in the light of developments over the preceding five years. In 2003 the then Government had announced that it would continue to issue Treasury Bonds in periods when borrowing was not needed for Budget funding in order to maintain a liquid and efficient bond market. This policy was continued by the present Government when it took office in 2007.

The decision to continue issuance was based on the benefits that the economy derives from having an active and efficient Treasury Bond market, together with the related market in Treasury Bond futures. 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.

Taking account of developments over subsequent years, the article in last year's annual report concluded that these benefits remained important for the Australian economy. In particular, the experience of financial market turbulence in 2007-08, as the global financial crisis began to have its impact, had highlighted the roles of the Treasury Bond market and the futures market as anchors for the financial system.

During 2008-09, the global financial crisis intensified, generating further turbulence in Australian financial markets, particularly in the period between the failure of Lehman Brothers in mid-September 2008 and the announcement by the Government in mid-October that it would guarantee the deposits and wholesale funding of Authorised Deposit-taking Institutions. Over this period, the Treasury Bond market came under considerable buying pressure as investors sought safe haven assets. In addition, existing investors tended to hold the bonds more tightly, while some with large holdings reportedly stopped lending their securities to market makers. The AOFM increased its issuance to relieve these strains, and the Treasury Bond market and the Treasury Bond futures market continued to function in a broadly satisfactory manner.

Many other segments of financial markets were more severely affected by the turmoil and some effectively ceased operating through this period. The interest rate swaps market continued, but at a reduced level. The operation of the swaps market was helped by the continued functioning of the Treasury Bond futures market, as it allowed parties to undertake swaps to hedge their positions if needed.

In short, the experience of the past year further confirmed the value of the Treasury Bond and bond futures markets for the resilience of the financial system, while the global financial crisis has itself underscored the importance of financial system stability for economic prosperity.

The past year also highlighted one other benefit of maintaining an active and efficient Treasury Bond market that was not considered in the article in last year's report. This was that the existence of an active market, with its supporting networks of investors, dealers and other market intermediaries, tender arrangements and established procedures, enabled the AOFM to increase the volume of issuance very quickly when the need arose. It thus allowed the Government to act proactively and decisively in responding to the financial crisis and providing stimulus to the economy.

The AOFM was able to launch an increased issuance program in the same week that the Government announced the revised Budget outlook. In the subsequent five months, over $25 billion of Treasury Bonds were issued. This speedy response would not have been practicable if the sovereign bond market had no longer existed.

The increased issuance was readily taken up by investors, prompted by the energetic promotional efforts of our bond dealers and intermediaries. The AOFM also engaged actively with major investors, both domestically and overseas. The Treasurer gave presentations to investors in Tokyo, London and New York, and I visited investors in Hong Kong, Beijing, Tokyo, London, Paris and Dubai (the latter at a forum for investors in AAA bonds that included many central banks and reserve asset managers from around the globe). Meetings were also held in Sydney and Melbourne. Several financial institutions assisted in arranging meetings, including the Commonwealth Bank of Australia, Deutsche Bank, HSBC Bank, Nomura Securities, UBS and Westpac, and also the Australian Business Economists. I thank them for their support.

Additional funding was provided in the 2009-10 Budget for the Office to expand its investor relations and bond promotion activities. The main selling points for our bonds are the very strong position of the Australian economy and the Budget, the Australian Government's high credit status within the ranks of AAA-rated sovereigns, Australia's close links with strongly growing Asian economies, and the liquidity of our bond lines.

## Additional Treasury Bond issuance and investment of the proceeds

During the first part of 2008-09 (prior to the change in the Budget outlook announced on 3 February 2009), the AOFM undertook additional issuance of Treasury Bonds over the program originally announced in the 2008-09 Budget. This was to maintain the liquidity and efficient operation of the market in the face of increased demand for the bonds. The proceeds of this additional issuance were invested to offset the cost and risk of the additional issuance.

The additional issuance program ended with the change in Budget estimates published on 3 February 2009. The additional issuance and investment undertaken up to that date amounted to $4.6 billion. The investments were predominantly in semi-government and Kangaroo bonds with risk characteristics closely matched to those of the additional Treasury Bonds. On 3 February 2009 the program had provided a positive net return of $21.5 million on an historic accruals basis, but a negative net return of $12.1 million on a mark-to-market basis.

## 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. For much of this period it used interest rate swaps to achieve this aim. However over recent years, market yield curves flattened and, at times, became inverted. This reduced the potential savings available from adjusting the portfolio's cost and risk characteristics through interest rate swaps. In the 2008 regular review of its portfolio management strategy, the AOFM concluded that this approach no longer provided a firm basis for achieving future savings. It therefore decided to end the strategy from the end of 2007-08.

Under the new approach followed in 2008-09, interest rate swaps are no longer used; the cost and risk characteristics of the portfolio are determined by issuance decisions, including the selection of the bond maturities to be issued.

Initially, issuance was planned to continue in accordance with the model set out in the 2003-04 Budget papers, which was designed to maintain a stable Treasury Bond market while also supporting the 3 and 10-year Treasury Bond futures contracts. In the absence of interest rate swaps, this approach would have caused the duration of the portfolio to rise gradually towards 4 over a period of years.

In the first half of 2008-09, the global financial crisis generated increased demand for Treasury Bonds in view of their high credit quality. This reduced the liquidity of the market and, to offset this, the Government directed the Office to undertake additional issuance as a temporary measure. The cost and risk of this additional issuance were offset by investing the proceeds in matched assets.

However, with the revised Budget outlook announced on 3 February 2009, investments in matched assets ceased and the selection of bond lines and the size of tenders now directly affected the risk characteristics of the portfolio. Henceforth issuance decisions needed to have regard to their impact on the overall maturity structure of the portfolio.

The revised approach to issuance adopted by the AOFM was designed to provide short-term flexibility within a framework directed to medium-term objectives. Decisions on the bond lines to be offered at tender were made weekly, taking account of market conditions, but a balance was maintained between issuing shorter and longer bonds. Issuance was spread over almost all the existing bond lines to increase their liquidity. Refinancing risk was managed by limiting the volume of debt maturing in the early years. The cumulative effect of these decision processes was that the average maturity and duration of the bonds issued between February and June 2009 was longer than if the selection of the bond lines to be issued had been guided simply by relative market demand.

## Interest rate swap terminations

Although interest rate swaps are no longer used in the management of the AOFM's portfolio, at the start of the year it held a substantial volume of swaps as a legacy from their past use. During the year, the AOFM unwound 131 swaps with a notional face value of $15.35 billion. Of these, 130 were undertaken as part of an unwind program that commenced in November 2008. The program generated a net realised value of $1.029 billion in favour of the Commonwealth.

At end-June 2009 the portfolio contained 21 remaining swaps with a total notional face value of $2.425 billion. These are all due to mature by mid-May 2010; the AOFM expects to allow them to mature without early termination.

## Residential mortgage-backed securities

In October 2008 the Treasurer directed the AOFM to invest up to $8 billion in residential mortgage-backed securities (RMBS) to support competition in lending for housing in Australia. The AOFM adopted a cornerstone investor approach to these investments with the aim of encouraging other investors to return to the RMBS market. The selection criteria used in assessing proposals was directed towards the objective of supporting competition in lending for housing and in ensuring that the funds provided would be used to originate new residential mortgages.

Consistent with the purpose of the program, the pricing of RMBS issues was determined by balancing the objective of providing a flow of funds that would allow competitive lending for new housing with the objective of attracting other investors. Where third party investors participated in transactions, the AOFM participated at the same price. This approach resulted in spreads over BBSW rates which were lower than the spreads available in the secondary market on previously issued RMBS, but which were still attractive in historic terms (relative to past primary issuance).

By end-June 2009, a total of 13 issues had been completed, in which the AOFM invested $6.2 billion and other investors $1.8 billion.

RMBS are complex financial and legal instruments and the AOFM has needed to expand its skills base to manage them. A new position of RMBS Portfolio Manager was established and filled by the recruitment of a person with extensive market experience of securitisation in Australia and overseas.

## Other changes

Other substantial changes made during the year included:

- The resumption of issuance of Treasury Notes. These will be used primarily for within-year cash management, although in 2008-09 the volume of notes on issue was built up to allow a continuing market to be established;

- The use in cash management of short-term money market investments in highly-rated bank accepted bills and certificates of deposit. This provides the AOFM with a broader range of investment options and allows higher yields than on term deposits with the Reserve Bank of Australia; and

- The closure of the Communications Fund on 1 January 2009. The AOFM managed the investments of this Fund on behalf of the Department of Broadband, Communications and the Digital Economy. It was not part of the AOFM's own balance sheet.

## Portfolio outcomes

The debt servicing cost of the gross debt managed by the AOFM in 2008-09 was $3.0 billion (after swaps). This represented a cost of funds of 4.39 per cent, compared with 6.55 per cent the previous year. The yield on physical debt fell as new debt was issued at lower interest rates than the debt issued in previous years. However, the major part of the change was due to increased revenues from interest rate swaps, as market interest rate movements during the year brought the value of the swap portfolio strongly into-the-money in the AOFM's favour and swap terminations allowed these gains to be realised.

The yield on assets in the portfolio was 5.36 per cent in 2008-09, compared with 6.75 per cent the previous year. This reflected lower yields on term deposits with the Reserve Bank of Australia, partially offset by higher yields from term investments (made with the proceeds of the additional issuance undertaken in the first part of the year). The returns from investments in residential mortgage-backed securities also lowered the average yield on gross assets.

The net cost of funds on the combined portfolio of debt and assets in 2008-09 was 3.64 per cent, compared with 6.44 per cent the previous year.

## Public Register of Government Borrowings

The *Guarantee of State and Territory Borrowing Appropriation Act 2009* (the Guarantee Act), which was enacted in June 2009, includes provisions which require the AOFM to establish, and publish on its website each quarter, a register recording the beneficial ownership, by country, of all securities issued by the Commonwealth. The register must also record the beneficial ownership of any issuance by Australian States or Territories that is guaranteed by the Commonwealth. The AOFM must include in the register a statement of the Office's opinion as to the domicile of the beneficial owner of securities if nominal ownership is registered in a country other than the actual domicile.

These provisions were introduced as an amendment to the legislation in the Senate. The Government did not support the amendment there on the grounds that it was impractical and would not create greater transparency. However, the Government ultimately accepted the amendment in order to achieve passage of the Act.

The AOFM is consulting with the Treasury and the Australian Bureau of Statistics to establish whether there is a practicable way of providing better information on bond holdings. However this would need to take into account the following concerns:

- Many non-resident investors with large holdings of fixed securities are unwilling to disclose details of their investments for commercial reasons. Some public sector investors, such as central banks and foreign reserve managers, also have policy reasons for maintaining confidentiality about their activities.

- Such investors are likely to withdraw from securities where their holdings are required to be revealed. This would make it more difficult, and more costly, for the Commonwealth to issue securities and for States and Territories to issue guaranteed debt.

- The Guarantee Act contains no provisions to ensure participation by State and Territory governments that would be disadvantaged by its operation.

- The AOFM is unlikely to be able to form an opinion on the domicile of beneficial owners of securities where the nominal owners do not cooperate in identifying them.

- The Act contains no provisions to compel the provision of information by beneficial or notional bond holders.

- No provision has been made for additional resources for the AOFM to undertake this new function.

- No other country has similar requirements.

The Guarantee Act provides that the proposed public register must be in a form to be prescribed by regulations. No regulations have yet been made. The AOFM considers that this should not be done until a practicable set of arrangements has been devised that meets these concerns.

## Operational risk

The AOFM has continued its efforts to strengthen its management of operational risk. Activities undertaken during the year included an update of the AOFM's Fraud Control Plan, completion of processes to support the provision of an annual Certificate of Compliance under the *Financial Management and Accountability Act 1997* and a comprehensive review of the AOFM's Chief Executive Officer's Instructions.

## 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. This year a forum was conducted by the AOFM in Canberra attended by officials responsible for sovereign debt management of the two countries, together with seconded AOFM staff, to improve the assistance provided. The AOFM also hosted two visits from debt management officials from Indonesia.

## 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 2008-09.

The AOFM faced considerable challenges during the year in implementing policy initiatives and dealing with turbulent market conditions. Staff met these challenges with skill and determination. I thank them all for the contributions they have made.

## Sovereign Risk Manager of the Year award

In January 2009 the AOFM was presented with the Sovereign Risk Manager of the Year award by Risk Magazine in London. The commendation referred to a range of activities undertaken by the AOFM in 2008, including issuance to maintain an active sovereign debt market, execution of interest rate swap terminations, investments in residential mortgage-backed securities and risk management initiatives aimed at reviewing, prioritising and mitigating the operational risks faced by the Agency.

It was pleasing to receive this award in the tenth year of the Office's operations as a separate agency. The Office has come a long way over this period in developing its expertise and systems and in responding to changing policy and market needs.

Nevertheless, it faces a challenging period ahead. Now is not the time to rest on our laurels.

Neil Hyden
Chief Executive Officer