

PART 2: OPERATIONS AND PERFORMANCE

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OPERATIONS AND PERFORMANCE

Introduction

The principal functions of the AOFM are:

- funding the Budget through the issuance of Australian Government debt;
- managing the Australian Government's daily cash balances through short-term borrowings and investments;
- undertaking investments in financial assets in accordance with Government policy objectives;
- managing its portfolio of debt and financial assets cost effectively, subject to acceptable risk; and
- supporting the efficient operation of Australia's financial system.

This section outlines the activities undertaken in 2008-09 and reports on their performance.

Treasury Bond issuance

Objectives

Between 1 July 2008 and 3 February 2009 the Budget was forecast to have a positive Underlying Cash Balance in 2009-10 so that there was no need to borrow for Budget funding. Treasury Bond issuance during this period was undertaken simply to support the efficient operation of the Treasury Bond and Treasury Bond futures markets. These markets play an important role in the operation of the Australian financial system, as they are used in the pricing and hedging of a wide range of financial instruments and in the management of interest rate risk. The existence of active and efficient Treasury Bond and Treasury Bond futures markets also strengthens the robustness of the financial system and reduces its vulnerability to shocks.

The forecast Budget outcome changed in the *Updated Economic and Fiscal Outlook* (UEFO) published on 3 February 2009. From that date, the primary objective of Treasury Bond issuance became raising monies to fund the Budget.

Achieving the objective

Supporting the Treasury Bond market

One consequence of the global financial crisis was an increase in the demand for Treasury Bonds, as investors sought high quality fixed interest investments. As a result, conditions in the Treasury Bond market tightened.

On 20 May 2008, following consultations with market participants about the adequacy of the supply of Treasury Bonds, the Treasurer announced that the Government would increase the issuance in order to ensure the continued efficient operation of the Treasury Bond and Treasury Bond futures markets. To this end, the Government legislated to allow an increase in Treasury Bonds on issue of up to \$25 billion. Legislation providing for this received Royal Assent in July 2008.

On 13 July 2008, the Treasurer directed the AOFM to issue up to an additional \$5 billion of Treasury Bonds beyond the \$5.3 billion program announced in the Budget. The amount of additional issuance was to depend on market conditions. Towards the end of 2008 it appeared that the \$5 billion limit might not be sufficient, and on 15 December 2008 the Treasurer increased the limit by a further \$5 billion.

Between 1 July 2008 and 3 February 2009, the AOFM issued a total of \$8.8 billion of Treasury Bonds (in face value terms). Of this amount, \$4.2 billion represented issuance under the core program announced in the 2008-09 Budget and \$4.6 billion represented additional issuance.

Issuance under the core program was in a new June 2014 bond line and the existing May 2021 bond line.

In order to best support the market, additional issuance was directed to bond lines that were in the shortest supply. Bonds were issued both on an outright tender basis (that is in exchange for cash) and through switch tenders where bonds were issued in exchange for State government bonds of a similar maturity. A total of 19 additional tenders were held, seven on an outright basis and 12 as switch tenders.

Funding the Budget

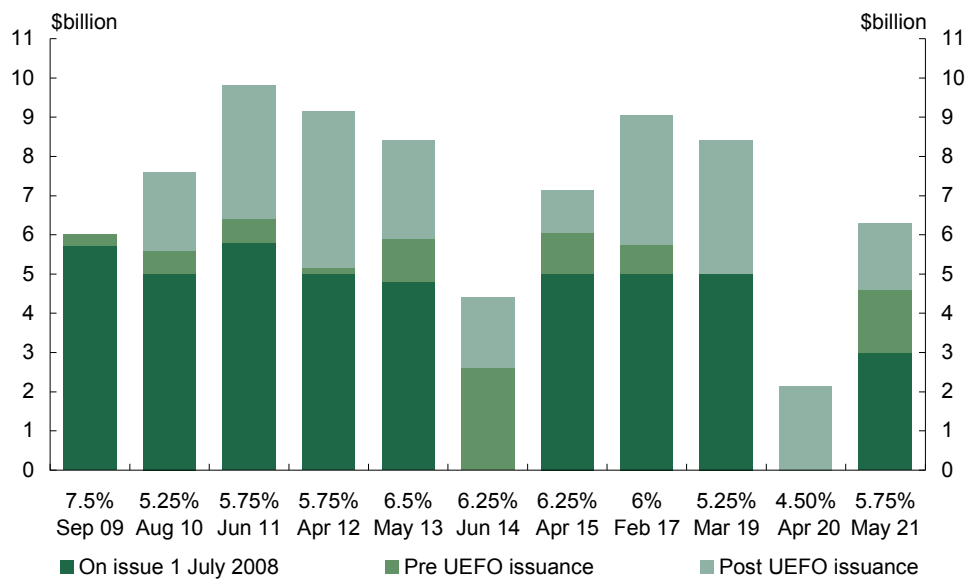
Following the change in fiscal forecasts in February 2009, Treasury Bond issuance was redirected towards raising monies to fund the Budget. The volume of issuance also increased; over \$25 billion of bonds were issued between February 2009 and June 2009.

Generally two bond tenders were held per week, each in the range \$500 million to \$700 million. The bulk of issuance was into existing bond lines in order to enhance their liquidity and improve their attractiveness to investors. A new bond line with a maturity date of April 2020 was also launched in order to establish a line that can act as the benchmark ten-year bond in 2010.

The selection of bond lines for issue took account of current market conditions, relative value considerations, the aim of increasing the liquidity of all outstanding bond lines and the need to manage the maturity structure of the debt to limit refinancing risk.

Chart 1 shows the Treasury Bonds outstanding as at 30 June 2009 and issued over the financial year.

Chart 1: Treasury Bonds outstanding as at 30 June 2009 and issuance in 2008-09



Whereas in June 2008 most bond lines had a volume on issue of around \$5 billion, by June 2009 five lines had volumes on issue of over \$8 billion. During the year the total volume of Treasury Bonds on issue (net of Australian Government holdings) increased by around \$29.0 billion, to \$78.4 billion.

Following the 2009-10 Budget, consideration was given to issuing longer-dated Treasury Bonds and resuming the issuance of Treasury Indexed Bonds. Issuance of such bonds could assist portfolio management by widening the range of available debt instruments, diversifying risk and tapping additional sources of investor demand. However no decisions had been announced by the end of the year.

Securities lending facility

The AOFM's securities lending facility allows bond market participants to borrow Treasury Bonds for short periods when they are not otherwise available. This enhances the efficiency of the market by improving the capacity of intermediaries to make two-way prices.

In August 2008 changes were made to the securities lending facility in order to enhance its effectiveness.

- The range of collateral accepted in lending Treasury Bonds through the facility was widened to include all securities accepted by the Reserve Bank of Australia as general collateral in repurchase agreements. Prior to this, acceptable collateral was limited to Commonwealth Government Securities. This limitation on the range of acceptable collateral made it potentially more difficult to access the facility when these securities were in general short supply.
- The facility was also extended to permit the borrowing of Treasury Bonds on an intra-day basis. This change was made because it would facilitate the settlement of financial transactions involving the bonds in some situations (for example where a closed chain of lending transactions has inadvertently developed between market participants).

Consultation with financial market participants

The AOFM continued to maintain an active dialogue with financial market participants, the RBA and the Australian Securities Exchange. The AOFM also participated as an observer in meetings of the Debt Securities Committee, Repo Committee and Negotiable Trading Instruments Committee of the Australian Financial Markets Association.

Following the increase in issuance from February 2009, liaison with both domestic and overseas investors was substantially expanded to promote issuance and the Office's awareness of investor needs and preferences.

Performance

Market efficiency

The Treasury Bond market experienced considerable volatility in 2008-09. In particular, in the period between the failure of Lehman Brothers in mid-September 2008 and the announcement of the Commonwealth guarantee of deposits and wholesale funding of authorised deposit-taking institutions in mid-October 2008, 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.

Despite these strains, the Treasury Bond market continued to function in a broadly satisfactory manner. Many other segments of financial markets were more severely affected by the turmoil through this period and at times some effectively ceased operating.

Tightness in the Treasury Bond market was eased by the increased issuance and its targeting into the most sought after bond lines. The timing and volume of issuance was closely aligned to market conditions. For example, in early October, when market strains were at their height, \$1.45 billion of bonds were issued in four tenders over consecutive business days.

The changes to securities lending arrangements also helped minimise pressures in the Treasury Bond market and kept the repurchase (repo) market operating reasonably smoothly. Reflecting the strong demand for Treasury Bonds, there was considerable usage of the securities lending facility in 2008-09:

- The facility was used for overnight borrowing 374 times in 2008-09 compared with 88 times in 2007-08. The face value amount lent was around \$12.8 billion compared to \$2.5 billion in 2007-08.
- Peak usage of the facility occurred in September and October, when the facility was accessed 161 times for term lending and the amount lent was \$6.7 billion.

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

- The turnover of Treasury Bonds decreased by around 10.4 per cent in 2008-09 compared to 2007-08.
- The turnover of 3-year Treasury Bond futures contracts decreased by around 30 per cent in 2008-09 compared to 2007-08, and turnover of the 10-year contracts decreased by around 38 per cent.

All Treasury Bond futures contract close-outs in 2008-09 occurred smoothly.

Efficiency of issuance

Treasury Bonds are issued by competitive tender using an electronic tender system. In March 2009 the AOFM adopted a new electronic tender system supplied by Yieldbroker Pty Ltd. The Yieldbroker DEBTS system is an online platform which operates in Australia for the trading of fixed income securities. The change to the new tender system occurred very smoothly and was well received by bidders. The system is easy to use and tender results are now available almost immediately after the close of bidding. Each bidder is also given details of the stock allotted to them almost immediately after the close of the tender.

Despite the large increase in issuance, tender performance measures in 2008-09 were broadly in line with those in recent years. Table 1 shows the results of the tenders conducted during the year.

Table 1: Treasury Bond tender results — 2008-09

Tender date	Coupon and maturity	Face value allocated (\$m)	Weighted average issue yield (%)	Spread to secondary market yield (basis points)	Range of bids accepted (basis points)	Times covered
21-Jul-08	6.25% 15-Jun-2014	750	6.4774	na	1.50	2.68
30-Jul-08	6.25% 15-May-2013	150	6.2167	-0.33	1.00	5.69
6-Aug-08	6.50% 15-Apr-2012	149	5.8899	-0.51	1.00	6.05
11-Aug-08	6.25% 15-Jun-2014	600	5.8867	0.67	3.00	2.43
13-Aug-08	5.75% 15-Jun-2011	151	5.6800	na	na	8.47
18-Aug-08	6.25% 15-May-2013	149	5.7150	na	na	6.70
20-Aug-08	5.75% 15-Jun-2011	151	5.6700	na	na	8.19
27-Aug-08	6.00% 15-Feb-2017	152	5.7000	na	na	8.55
3-Sep-08	6.25% 15-Apr-2015	300	5.6500	na	na	4.44
8-Sep-08	6.25% 15-Apr-2015	401	5.7991	-0.09	1.50	4.48
17-Sep-08	6.25% 15-May-2013	300	5.4850	na	na	5.15
22-Sep-08	5.75% 15-May-2021	400	5.7866	-0.59	1.50	2.94
1-Oct-08	6.00% 15-Feb-2017	301	5.485	na	na	3.26
8-Oct-08	5.75% 15-May-2021	399	5.1204	1.29	1.00	3.05
9-Oct-08	6.25% 15-Jun-2014	450	4.7310	1.10	2.50	1.50
10-Oct-08	5.25% 15-Aug-2010	301	4.0300	na	na	2.55
13-Oct-08	7.50% 15-Sep-2009	300	4.0983	9.83	5.00	3.43
24-Oct-08	5.25% 15-Aug-2010	300	4.1900	na	na	2.98
5-Nov-08	6.00% 15-Feb-2017	299	5.2000	na	na	4.08
12-Nov-08	6.25% 15-Apr-2015	299	4.5500	na	na	4.59
19-Nov-08	6.25% 15-May-2013	200	4.1100	na	na	3.15
5-Dec-08	6.25% 15-Apr-2015	300	3.8856	-0.44	2.00	3.00
8-Dec-08	6.25% 15-May-2013	299	3.8411	-0.64	0.50	3.25
10-Dec-08	6.25% 15-Jun-2014	400	3.9244	1.44	3.00	2.03
7-Jan-09	5.75% 15-Jun-2011	300	3.2950	-1.00	0.00	3.70
12-Jan-09	6.25% 15-Apr-2015	150	3.6850	-1.00	0.00	5.90
16-Jan-09	6.25% 15-Jun-2014	401	3.4413	0.83	2.00	2.51
21-Jan-09	5.75% 15-May-2021	399	4.0692	2.92	4.00	1.44
6-Feb-09	6.25% 15-Apr-2015	601	3.9113	0.38	1.50	2.62
11-Feb-09	6.25% 15-May-2013	601	3.4608	1.08	1.50	2.58
13-Feb-09	6.25% 15-Jun-2014	601	3.6905	0.75	3.00	2.87
18-Feb-09	6.50% 15-Apr-2012	600	2.9851	-0.99	1.50	4.78
20-Feb-09	5.75% 15-Jun-2011	599	2.9321	-2.29	0.50	4.45
25-Feb-09	6.25% 15-May-2013	600	3.4804	0.54	1.50	4.08
27-Feb-09	5.75% 15-May-2021	501	4.5176	-2.24	1.50	3.91
3-Mar-09	6.50% 15-Apr-2012	600	3.3029	0.29	1.50	3.88
6-Mar-09	6.25% 15-Jun-2014	598	3.7168	0.18	2.00	3.14
11-Mar-09	6.00% 15-Feb-2017	601	4.1811	-0.61	2.50	2.97
13-Mar-09	5.25% 15-Aug-2010	600	2.5880	0.30	2.00	2.55
18-Mar-09	5.75% 15-Jun-2011	701	2.9546	1.46	2.00	4.48
20-Mar-09	5.75% 15-May-2021	500	4.4176	1.26	3.50	2.46
25-Mar-09	6.25% 15-Jun-2014	601	3.9811	1.61	4.00	2.71
27-Mar-09	5.25% 15-Mar-2019	600	4.5506	1.06	2.00	2.98
1-Apr-09	6.00% 15-Feb-2017	600	4.2867	1.17	2.00	3.66
3-Apr-09	6.25% 15-May-2013	599	3.8374	2.24	2.00	3.40
8-Apr-09	5.75% 15-May-2021	700	4.8736	0.61	1.50	3.36
15-Apr-09	5.25% 15-Mar-2019	700	4.6351	1.01	1.50	3.16
17-Apr-09	5.75% 15-Jun-2011	701	3.3248	-0.02	2.00	4.94

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Table 1: Treasury Bond tender results — 2008-09 (continued)

Tender date	Coupon and maturity	Face value allocated (\$m)	Weighted average issue yield (%)	Spread to secondary market yield (basis points)	Range of bids accepted (basis points)	Times covered
22-Apr-09	6.50% 15-Apr-2012	700	3.5375	-1.25	2.50	5.46
24-Apr-09	6.00% 15-Feb-2017	700	4.3763	0.13	1.00	3.56
29-Apr-09	4.50% 15-Apr-2020	750	4.6844	na	10.50	2.89
1-May-09	5.25% 15-Aug-2010	700	2.6779	-2.21	2.00	5.46
6-May-09	4.50% 15-Apr-2020	699	5.0042	0.92	3.00	3.19
8-May-09	5.25% 15-Mar-2019	702	4.9563	0.13	1.00	3.80
13-May-09	6.50% 15-Apr-2012	701	3.8646	-0.29	1.00	4.36
15-May-09	6.00% 15-Feb-2017	700	4.7633	0.58	1.00	2.59
20-May-09	4.50% 15-Apr-2020	699	5.2237	1.07	1.50	3.04
22-May-09	5.75% 15-Jun-2011	700	3.7275	-1.00	0.50	5.66
27-May-09	5.25% 15-Mar-2019	699	5.3471	1.21	1.50	2.76
29-May-09	6.50% 15-Apr-2012	698	3.9845	-0.30	1.50	4.58
3-Jun-09	6.00% 15-Feb-2017	700	5.3252	1.02	1.50	3.27
5-Jun-09	6.25% 15-May-2013	700	4.5704	0.04	1.00	3.46
10-Jun-09	6.25% 15-Apr-2015	499	5.2852	0.00	2.00	2.11
12-Jun-09	5.75% 15-Jun-2011	699	4.0056	0.06	3.00	3.39
17-Jun-09	5.25% 15-Mar-2019	700	5.4372	1.72	3.00	1.78
19-Jun-09	6.50% 15-Apr-2012	700	4.5279	1.29	3.00	1.87
24-Jun-09	5.25% 15-Aug-2010	701	3.4161	0.86	4.00	3.85
Average over year to June 2009				0.48	2.06	3.76
Average over 3 years to June 2009				0.33	1.66	3.76
Average over 10 years to June 2009				0.41	1.42	3.83

Denotes switch tender

Investment of the proceeds of additional Treasury Bond issuance

Objective

Additional Treasury Bond issuance totalling around \$4.6 billion (in face value terms) was undertaken between 1 July 2008 and on 3 February 2009 to support the operation of the Treasury Bond and Treasury Bond futures markets. The proceeds were invested with the aim of providing returns commensurate with the debt serving costs of the additional issuance, while adopting a prudent approach to credit and interest rate risk.

With the change in fiscal outlook published on 3 February 2009, the objective of issuance changed to funding the Budget. The distinction between core and additional issuance was removed and the AOFM began selling the investments acquired with the proceeds of additional issuance.

Achieving the objective

To facilitate performance monitoring, the assets and liabilities arising from the additional Treasury Bond issuance were allocated to a separate portfolio, called the Debt Hedge Portfolio. The portfolio was managed to minimise maturity gaps and to have an overall net interest rate exposure approaching zero.

The investment mandate approved by the Secretary to the Treasury provided for the proceeds of the additional issuance to be invested in a range of highly-rated Australian dollar denominated debt securities. It also allowed funds to be invested in short-term money market investments such as negotiable certificates of deposit issued by Authorised Deposit-taking Institutions and term deposits at the RBA.

The bulk of the proceeds were invested in semi-government bonds and Kangaroo bonds,¹ as these Australian dollar denominated securities matched relatively closely the characteristics of Treasury Bonds. Purchases of securities were transacted by the following means:

- on an outright basis in the secondary market, where the AOFM contacted at least three market-makers for either two-way prices or offers;
- on a switch basis, where the AOFM contacted at least three market-makers for prices to switch from an existing investment to another;
- as part of a placement of new securities (as either a new primary issue or tap of existing securities) on an outright or switch basis; and
- tenders for the issue of additional Treasury Bonds conducted on a switch basis for semi-government bonds.

An advantage of the switch tenders was that the issuance of the Treasury Bonds and the investment of their proceeds occurred simultaneously. This removed the risk of losses due to unfavourable movements in market rates between issuance and investment.

When the investment of the proceeds of the additional issuance ceased in February 2009, the Debt Hedge Portfolio was closed and its assets and liabilities transferred to the Long-Term Debt Portfolio.

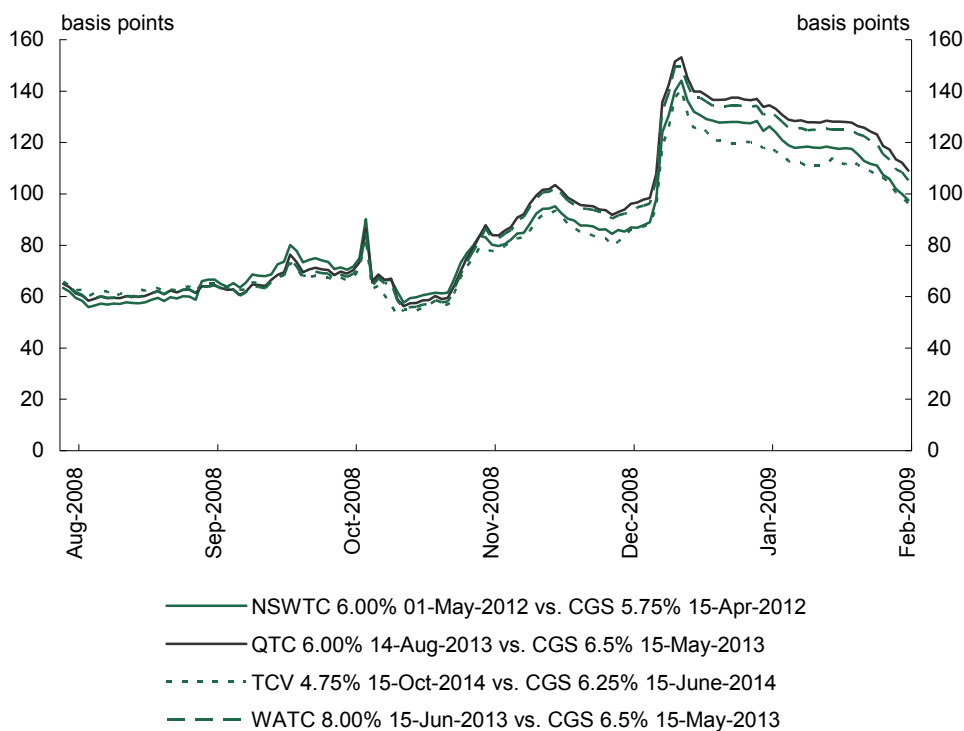
Performance

On an accruals (historic cost) basis, the Debt Hedge Portfolio had provided a net return of \$21.5 million when it was closed on 4 February 2009.

¹ A Kangaroo bond is an Australian dollar denominated bond issued into the Australian market by a foreign issuer.

Up until early December 2008, the mark-to-market performance of the Portfolio experienced only relatively small deviations around zero. In mid-December 2008, in line with a general widening of credit spreads coinciding with the first usage of the wholesale funding guarantee by domestic banks, there was a significant widening in the spread of semi-government bond yields to Australian Government bond yields. This led to a deterioration in the mark-to-market performance of the Portfolio. By early February 2009, semi-government bond spreads had narrowed from their peaks, but still remained much wider than over most of 2008. Chart 2 shows semi-government bond spreads for select semi-government bond lines.

Chart 2: Semi-government bond spreads for select semi-government bond lines



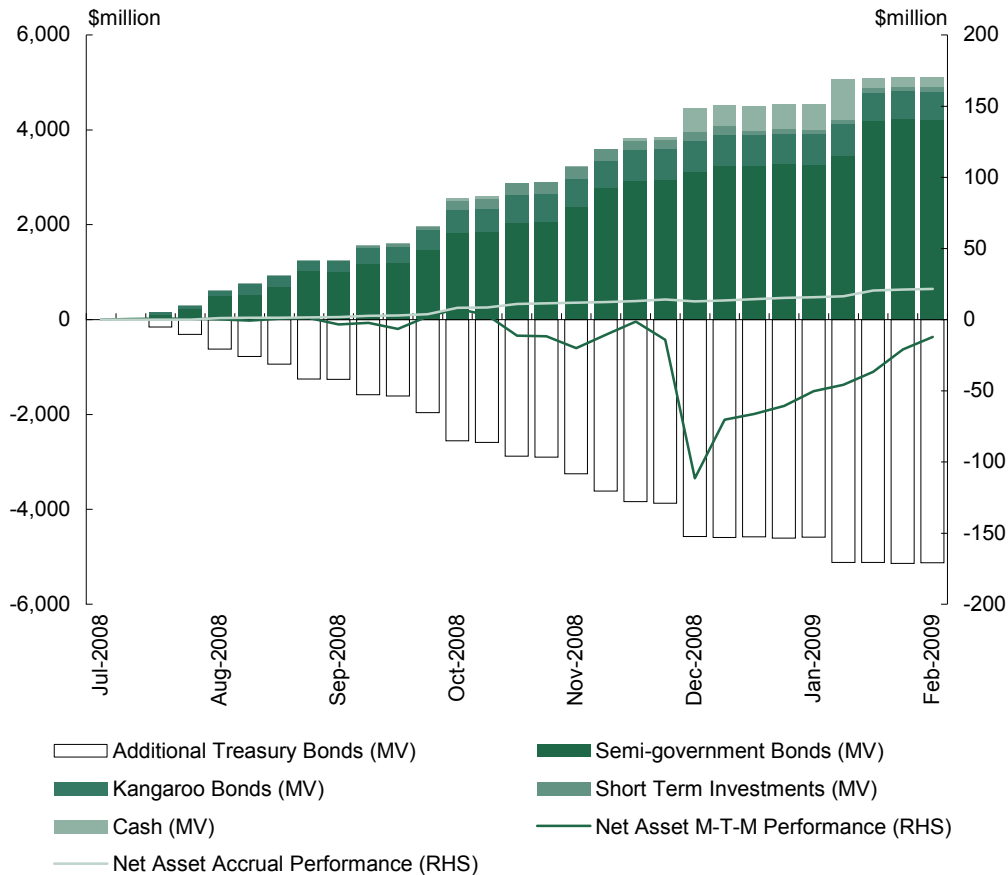
Source: Bloomberg

Mid-curve semi-government bonds experienced the greatest widening in spreads. While the additional Treasury Bond issuance was allocated across virtually all bond lines, it centred on mid-curve lines that were most in demand in the market. The investment strategies followed to reduce the interest rate risk exposure of the Portfolio produced a similar maturity structure for investments, with a concentration of mid-curve semi-government bonds. This exacerbated the impact of the movements in spreads on the market value of the Portfolio.

At 3 February 2009, the Portfolio had a mark-to-market return of negative \$12.1 million.

The net accrual and mark-to-market performance of the Debt Hedge Portfolio through time is shown in Chart 3. The chart also displays the volume and make-up of investment holdings and the corresponding volume of additional Treasury Bond issuance through time.

Chart 3: Net mark-to-market and accrual performance of Debt Hedge Portfolio



The assets and liabilities in the Debt Hedge Portfolio were transferred to the Long-Term Debt Portfolio on 4 February 2009. The investments were no longer required and were completely divested by end-July 2009.

Yields for both Kangaroo and semi-government bonds began to rise in the first quarter of 2009 and continued rising over the remainder of the financial year. This was a consequence of the general steepening in yield curves that occurred at this time.

Over their entire holding period, Kangaroo and semi-government bonds generated a positive return of \$175.4 million, comprising \$165.5 million in interest revenue and \$9.9 million in realised capital gains.

Cash management

Objective

The AOFM manages the daily cash balances of the Australian Government in the Official Public Account (OPA).² 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 RBA.³

Achieving the objective

Achieving the objectives in relation to cash management involves undertaking appropriate short-term investment and debt issuance.

Cash balances not required immediately are invested outside the OPA for nominated periods of time, with the maturity dates set primarily to finance large future outlays. The magnitudes and tenors of the short-term investments are determined by the AOFM.

In August 2008, the AOFM began investing excess cash in a broader range of short-term investment assets, namely highly-rated bank accepted bills and certificates of deposit issued by Authorised Deposit-taking Institutions. Prior to this, excess cash was invested only in term deposits at the RBA. The broader range of investment options should help enhance investment returns on surplus cash balances.

- Interest rates for term deposits at the RBA are based on Overnight Indexed Swap rates.
- Interest rates for bank accepted bills and certificates of deposit reflect prevailing market rates for those instruments.

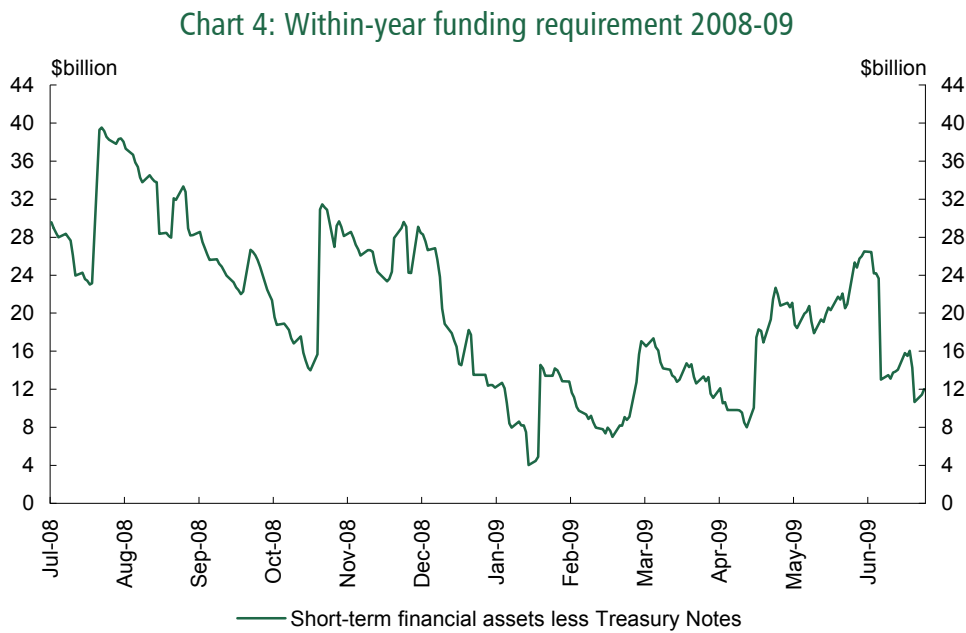
Treasury Notes are short-term debt securities that can be issued to provide short-term funding. In recent years their issuance has not been needed because the AOFM's holdings of short-term assets have been sufficient to cover fluctuations in OPA balances. However, with the Budget balance moving into deficit and the transfer of monies to funds managed by the Future Fund, it was evident that the AOFM's short-term asset holdings would soon become insufficient to meet all within-year funding needs and that short-term borrowings would also be required.

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

3 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.

To this end, the issuance of Treasury Notes recommenced in March 2009. The notes on issue were built up over the remaining months of the financial year. The AOFM plans to keep at least \$10 billion of notes on issue at all times so as to maintain a liquid market in them.

The size and volatility of the within-year funding requirement are indicated by changes in the short-term financial asset holdings managed by the AOFM, after deducting Treasury Notes on issue. Chart 4 shows the movement in the funding requirement in 2008-09.



Performance

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 in 2008-09.

During 2008-09 the AOFM placed 473 term deposits with the RBA. The stock of term deposits fluctuated from a minimum of \$3.1 billion in January 2009 to a maximum of \$39.0 billion in June 2009.

- The average yield obtained on term deposits during 2008-09 was 4.97 per cent, compared with 6.89 per cent in 2007-08.

Short-term investment in bank accepted bills and certificates of deposit was undertaken when excess funds were available for investment and there was an acceptable higher return from investing in such paper compared with placing funds on deposit at the RBA. (While investment

in highly-rated bank issued paper carries low credit risk, it is not completely risk free, unlike a deposit at the RBA, and requires an appropriately higher return.)

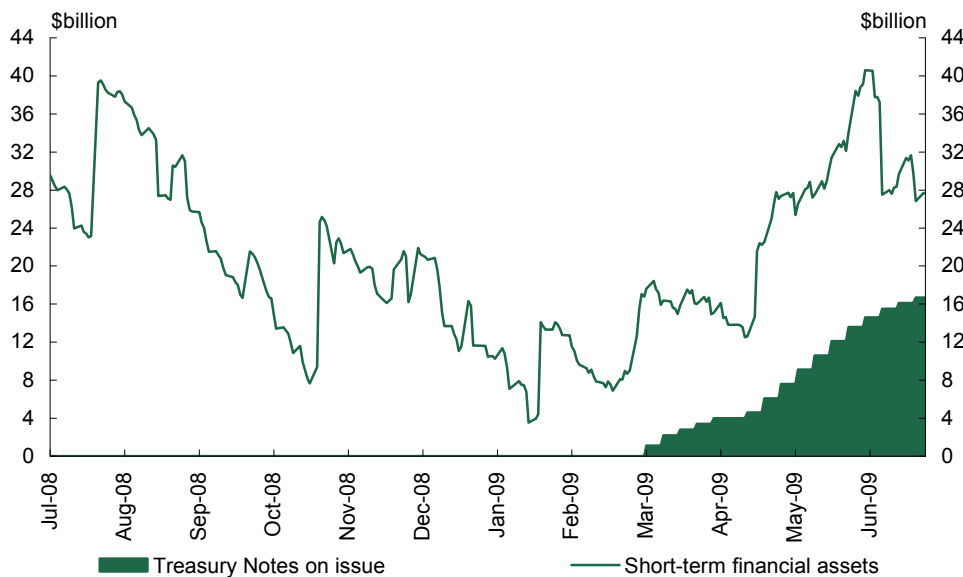
The face value amount invested in bank accepted bills and certificates of deposit peaked at \$8.25 billion in November 2008. The average additional return in 2008-09 from investing in bank accepted bills and certificates of deposit compared with investing funds on deposit at the RBA was approximately 47 basis points per annum. This is estimated to have generated additional investment earnings in 2008-09 totalling around \$10 million.

Re-establishment of the Treasury Note market occurred relatively smoothly and tenders for the issue of Treasury Notes were well supported. Sixteen tenders were conducted in 2008-09 for the issue of \$18.7 billion (in face value terms) of Treasury Notes.

- The notes were issued at tender at yields that averaged around 20 basis points less than bank bill yields of the corresponding maturity. This is broadly similar to the spread to bank bill yields that Treasury Notes were issued at in the past.

The movement in total short-term financial asset holdings managed by the AOFM (OPA cash balance plus term deposits with the RBA and other short-term investments managed by the AOFM), together with the volume of Treasury Notes on issue, during 2008-09 are shown in Chart 5.

Chart 5: Short-term financial asset holdings and Treasury Notes on Issue 2008-09



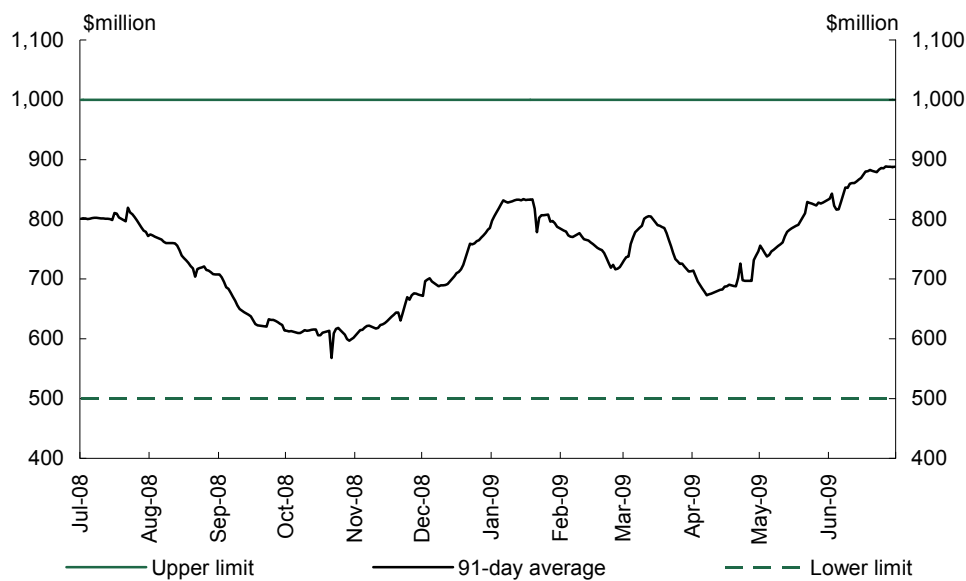
In undertaking its cash management activities, the AOFM is required to maintain the 91-day rolling average of the daily OPA cash balance within operational limits around a target level. In

2008-09 these limits were the same as applied in 2007-08, 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 6.

Chart 6: 91-day moving average cash balance



Minimising debt servicing costs subject to acceptable risk

Objective

In managing its debt portfolio, the AOFM generally seeks 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.

The primary measure of cost used in this context 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. 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

For several years prior to 2008-09, the composition of the physical debt in the AOFM's portfolio provided little opportunity for reducing debt servicing costs, because the volume and maturity structure of the debt was 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 were largely determined by cash management requirements. However, the AOFM was 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 used interest rate swaps⁴ to achieve this objective.

Historically, debt issued for long periods at fixed rates of interest has required higher interest rates than shorter-term debt, because lenders demand a higher return for having their funds locked away for longer periods. Interest rate swaps provided 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 increased the potential variability of debt service costs, as interest rate movements were able to flow through to the overall cost of funds more quickly.

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 its 2008 review of its portfolio management strategy, the AOFM concluded that this strategy no longer provided a firm basis for achieving future savings in debt servicing costs. While the strategy had produced substantial savings over many years, in the changed circumstances it was considered better to accept the maturity structure of the debt portfolio that resulted from debt issuance.

As a result, the previous portfolio management framework was terminated from the end of 2007-08. Existing swaps were regarded as a legacy component of the portfolio to be managed in light of market conditions. Initially the legacy swaps were allowed to remain and mature, but when swap rates fell significantly in late 2008, the AOFM began terminating them, a process that was largely completed by May 2009.

⁴ 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.

Under the new strategy, the duration of the nominal debt portfolio was determined by the cumulative effect of issuance decisions. It was recognised that the policy of issuing into bond lines that supported the baskets for the 3 and 10-year bond futures contracts would cause the duration of the nominal debt portfolio to tend towards a value of four over a period of years as the legacy swaps matured.⁵ This governed the interest rate risk of the portfolio. The portfolio management strategy was thus to allow duration to move to four; the decision to actively unwind swaps accelerated this transition.

The Treasurer's direction in May 2008 for the AOFM to undertake additional Treasury Bond issuance to support the market did not affect the strategy, as the cost and risk of the additional issuance was offset by the investment of the proceeds in matched assets comprising semi-government and Kangaroo bonds. The Office was thus able to be flexible in responding to shortages in particular bond lines without disturbing the cost and risk characteristics of the core portfolio.

The reorientation of the AOFM's borrowing task to funding the Budget had a bigger impact on portfolio management. The distinction between core and additional issuance was removed, investments in matched assets ceased and the selection of bond lines and the size of tenders now had a direct impact on the cost and risk of the overall portfolio. Henceforth issuance decisions needed to have regard to the overall maturity structure of the portfolio – including its exposure to market risk and refinancing risk over the medium term – as well as to short-term market conditions and the relative demand and cost of different bond lines.

The approach adopted to issuance after 3 February 2009 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 was that the average maturity and duration of the bonds issued between February 2009 and June 2009 was longer than if the selection of the bond lines to be issued had been guided simply by relative market demand.

⁵ The modified duration of the nominal physical debt before swaps has generally been a little over 4.0 over recent years.

Performance

Reducing debt servicing cost

The debt servicing cost⁶ of the gross debt managed by the AOFM in 2008-09 was \$3.0 billion (after swaps), on an average book value of \$67.8 billion. This represented a cost of funds of 4.39 per cent.

The return on gross assets was \$1.6 billion, on an average book value of \$29.4 billion, over the same period. This represented an average yield of 5.36 per cent.

These aggregates were affected by the inclusion of a number of new instruments in 2008-09. On the debt side, the issue of Treasury Notes resumed during the year, while new assets included bank paper (money market instruments), term investments in semi-government and Kangaroo bonds, and residential mortgage-backed securities. The AOFM's holdings of Commonwealth advances to State and Territory governments for public housing are also included for the first time.⁷

Taken together, the combined portfolio of debt and assets managed by the AOFM had a net interest expense (before re-measurements) of \$1.4 billion, at an effective yield of 3.64 per cent. The corresponding figure for 2007-08 was 6.44 per cent.

The large decrease in net interest expense for 2008-09 compared to 2007-08 was driven by a number of factors, the largest of which was the substantial revenue from swaps over the year. Interest rate swaps reduced the effective yield of gross CGS debt by 1.43 per cent through realising \$969 million from swap terminations and net interest receipts. Also contributing to the reduced net interest expense of the AOFM portfolio was the return obtained from investments in short-term bank paper and term investments in semi-government and Kangaroo Bonds.

Table 2 provides further details of the cost outcomes for the combined portfolio by instrument and portfolio for 2007-08 and 2008-09. In this table, the Debt Hedge Portfolio (which operated separately for only part of the year) has been grouped with the Long-Term Debt Portfolio (in which its assets and liabilities were subsumed on 4 February 2009). Information on the separate performance of the Debt Hedge Portfolio is provided on page 14 above.

6 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.

7 These advances were made under Commonwealth-State Housing Agreements and have been administered by the AOFM for many years, but were not previously reported in the debt portfolio cost outcomes.

Table 2: Australian Government debt and assets administered by the AOFM

	Interest expense		Book volume		Effective yield	
	2007-08	2008-09	2007-08	2008-09	2007-08	2008-09
	\$ million		\$ million		per cent per annum	
Contribution by instrument						
Treasury fixed coupon bonds	(2,947)	(3,182)	(48,476)	(56,514)	6.08	5.63
Treasury inflation indexed bonds	(593)	(687)	(8,317)	(8,677)	7.13	7.92
Treasury notes	-	(75)	-	(2,641)		2.85
Other miscellaneous domestic debt	(0)	(0)	(4)	(0)	8.22	7.20
Foreign loans (a)	0	(2)	(6)	(7)	-3.42	23.27
Gross physical CGS debt	<u>(3,540)</u>	<u>(3,946)</u>	<u>(56,804)</u>	<u>(67,840)</u>	<u>6.23</u>	<u>5.82</u>
Interest rate swaps	(180)	969	-	-		
Gross CGS debt (after swaps)	<u>(3,721)</u>	<u>(2,977)</u>	<u>(56,804)</u>	<u>(67,840)</u>	<u>6.55</u>	<u>4.39</u>
Term deposits with the RBA	1,197	981	17,378	19,759	6.89	4.97
Investments in bank paper	-	140	-	2,108		6.64
Term investments (b)	-	199	-	2,864		6.96
RMBS investments	-	89	-	1,859		4.80
State Housing Advances	171	166	2,899	2,826	5.89	5.89
Gross assets	<u>1,368</u>	<u>1,576</u>	<u>20,277</u>	<u>29,416</u>	<u>6.75</u>	<u>5.36</u>
Total debt and assets	<u>(2,353)</u>	<u>(1,400)</u>	<u>(36,527)</u>	<u>(38,423)</u>	<u>6.44</u>	<u>3.64</u>
Contribution by portfolio						
Long Term Debt Portfolio (c)	(3,727)	(2,690)	(56,892)	(62,070)	6.55	4.33
Cash Management Portfolio	1,204	1,034	17,466	18,961	6.89	5.45
RMBS Portfolio	-	89	-	1,859		4.80
State Housing Portfolio	171	166	2,899	2,826	5.89	5.89
Total debt and assets	<u>(2,353)</u>	<u>(1,400)</u>	<u>(36,527)</u>	<u>(38,423)</u>	<u>6.44</u>	<u>3.64</u>
Re-measurements (d)	(118)	(232)				
Total after re-measurements	<u>(2,471)</u>	<u>(1,632)</u>	<u>(36,527)</u>	<u>(38,423)</u>		

(a) Interest expense and effective yield on foreign loans incorporates foreign exchange revaluation effects. The reported interest expense for Foreign Loans in 2007-08 has been corrected from that reported in the AOFM's 2007-08 annual report.

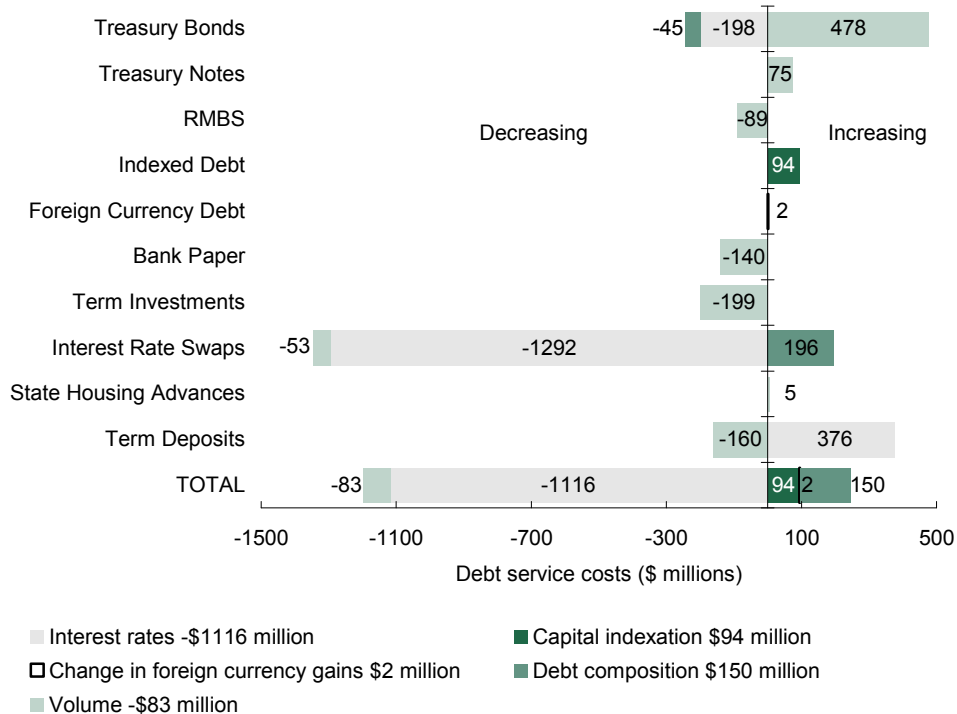
(b) Investments in State and Territory government bonds and Kangaroo bonds.

(c) Includes the Debt Hedge Portfolio which operated separately for part of the year.

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

Despite the volume of debt increasing in 2008-09 over 2007-08, the debt servicing cost of the total portfolio fell by \$953 million. Chart 7 sets out the components of this change by instrument, broken down to show contributions from changes in the overall volume of debt and in the composition of the portfolio, and from movements in interest rates, exchange rates and the Consumer Price Index (CPI).

Chart 7: Changes in debt servicing cost between 2007-08 and 2008-09



The reduction in total debt servicing costs was dominated by increased savings from interest rate swaps. Returns on swaps increased by \$1.15 billion compared to 2007-08. A driving factor for this was the proceeds from the termination of swaps, which crystallised significant gains in market value. Also contributing to the increased returns from swaps were falls in market interest rates and a reversal in the shape of yield curves. In particular, lower short-term interest rates reduced the cost of the floating legs of swaps and brought a large increase in interest receipts from swaps in the second half of the financial year. Overall, swaps reduced the interest costs of the portfolio (before re-measurements) by \$969 million during 2008-09.

The debt servicing cost of physical debt increased by \$406 million compared to 2007-08, as a result of the increased Treasury Bond issuance and the resumption of issuance of Treasury Notes. Also contributing were higher capital accretion costs on indexed bonds due to larger CPI increases. This was partially offset by relatively expensive debt maturing and being replaced with new debt issued at significantly lower interest rates.

However, the lower short-term interest rates had a negative impact on the return obtained on term deposits. The interest revenue on term deposits in 2008-09 was \$981 million, on an average book volume of \$19.8 billion. This represented a return on funds of 4.97 per cent, compared with 6.89 per cent in 2007-08. Overall, term deposits in 2008-09 contributed \$216 million less in interest compared to 2007-08, despite there being a slightly higher average volume. Unlike in

2007-08, term deposits in 2008-09 did not have a favourable effect on the net cost of funds in percentage terms, as the yield on term deposits was lower than the average cost of servicing gross debt.

Movements in market interest rates had an unfavourable impact on the market value of the portfolio in 2008-09, with unrealised losses from re-measurements amounting to \$232 million. They comprised a gain of \$1.01 billion on interest rate swaps, offset by losses of \$1.07 billion on nominal debt, \$35 million on term investments and \$136 million on RMBS investments. The increase in unrealised losses from re-measurements in 2008-09 compared to 2007-08 was largely driven by falling interest rates inflating the market value of debt on issue. Conversely, lower market interest rates in 2008-09 had a positive impact on swap revaluations.

Interest rate swap terminations

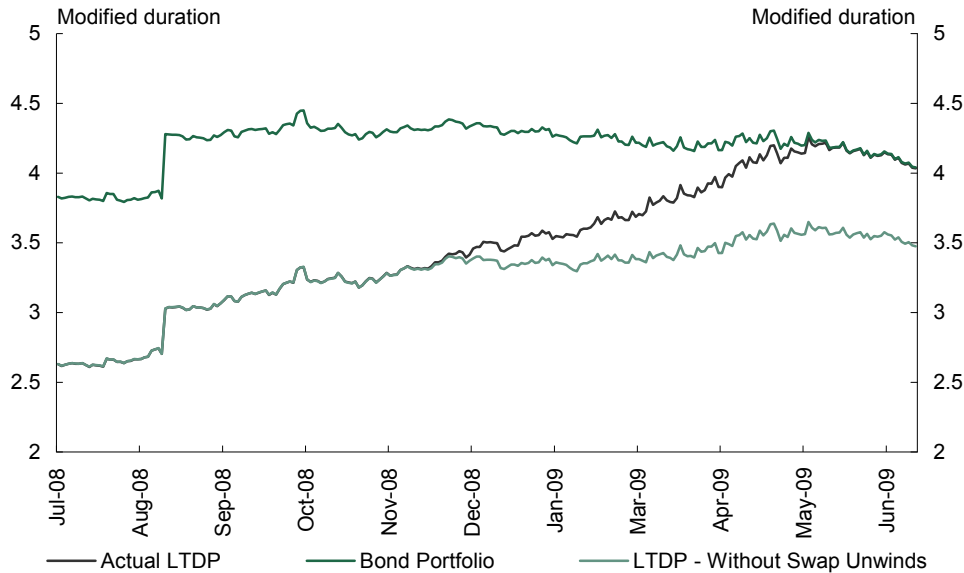
In November 2008, the AOFM commenced a program to unwind its remaining domestic interest rate swaps. At that time, the portfolio comprised 177 swaps with a notional face value of \$20.65 billion. The program was largely completed by May 2009, when the AOFM stopped actively seeking terminations. In total, 130 swaps were unwound representing a notional face value of \$15.25 billion. This included 12 swaps that were unwound in response to adjustments to credit ratings or other credit-related events.⁸ The unwind program generated a net realised value of \$1.029 billion in favour of the Commonwealth. The estimated price of unwinding the swaps was around 2.5 basis points from mid-market, equating to around \$13.5 million.

As at 30 June 2009, the AOFM's swap portfolio consisted of 21 swaps with a total notional face value of \$2.425 billion. These swaps all mature by mid-May 2010 and thus carry very little interest rate risk. The AOFM expects to allow them to mature without early termination.

With the unwind of the swaps, the modified duration of the nominal Long-Term Debt Portfolio will in future be determined by ongoing issuance and maturing debt. Chart 8 illustrates this transition over the course of the unwind program.

⁸ In 2008-09, there were a total of 13 credit-related swap terminations. The first occurred in October 2008, prior to the commencement of the unwind program. Over the course of 2008-09, therefore, a total of 131 interest rate swap terminations were undertaken.

Chart 8: Modified Duration — nominal component of Australian dollar Long-Term Debt Portfolio 2008-09



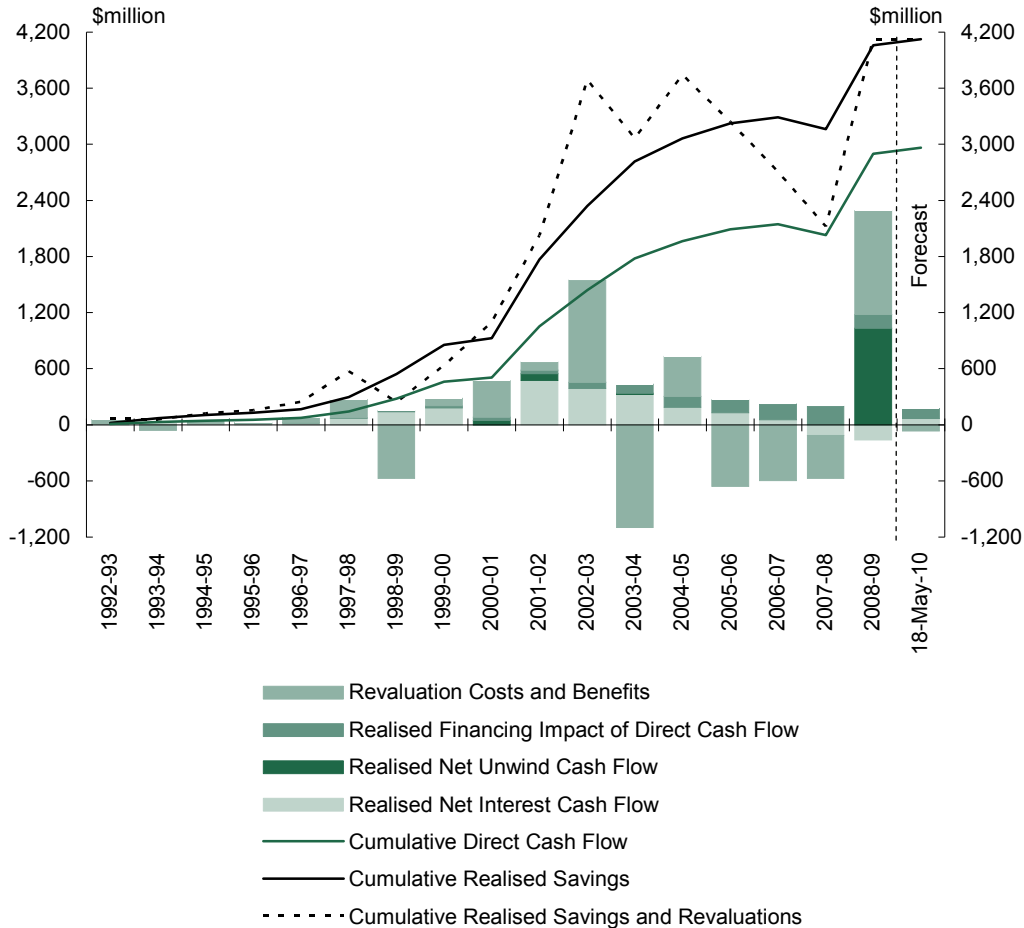
The AOFM's annual report for 2006-07 included a review article on the management of the domestic debt portfolio over recent years and the use of interest rate swaps. It concluded that the direct costs savings from interest rate payments and receipts on swaps had amounted to \$2.1 billion between 1992 (when interest rate swaps were first executed) and the end of 2006-07. It estimated that these direct savings had generated additional indirect savings through higher asset balances, and that the cumulative realised benefit to the Commonwealth from direct and indirect savings combined over this period amounted to \$2.8 billion. Against this, at 30 June 2007 the interest rate swaps portfolio had an unrealised market value of negative \$581 million.

These figures can now be updated. Realised direct savings from interest rate swaps have grown to a total of \$2.898 billion as at 30 June 2009, while the cumulative realised benefit from direct and indirect savings combined have been \$3.952 billion. At 30 June 2009 the remaining interest rate swaps had a positive unrealised market value of \$66.8 million. Thus, at 30 June 2009 swaps had generated a total benefit of \$4.019 billion.

Chart 9 shows the total savings provided by swaps over the period since 1992-93 and projected to 18 May 2010 when the final remaining swap matures. While final performance figures will not be available until then, the outcome is unlikely to differ greatly from the projections as only 21 swaps remained in the portfolio at 30 June 2009, of which 11 were subject to only one further repricing. The chart shows the cumulative direct cash flows from the swaps, cumulative realised (direct and indirect) savings and cumulative realised savings and (market value) revaluations. It also shows the yearly components of these aggregates.

Total direct savings are projected to be \$2.964 billion on 18 May 2010. Including indirect savings, the total benefit is projected to be \$4.126 billion.

Chart 9: Total Savings arising from interest rate swaps (inclusive of revaluations)



Credit management of interest rate swaps

The use of interest rate swaps brings an exposure to counterparty credit risk. In 2008-09 the AOFM continued to use collateral agreements to manage this risk. These collateral agreements require counterparties to post collateral when the AOFM's credit exposure rises above a predefined threshold. Swap terminations were also undertaken to reduce the level of credit exposure during the year.

The AOFM has Credit Support Annexes with 17 of its swap counterparties. On 30 June 2009, 84.7 per cent of the total nominal face value of the interest rate swap portfolio was covered by

collateral agreements. Table 3 indicates the average credit quality across the counterparties to which the AOFM has an exposure.

Table 3: Derivative counterparties by credit rating as at 30 June 2008 and 30 June 2009

Credit rating: Moody's/ Standard & Poors (a)	Number of AOFM counterparties by credit rating as at 30 June 2008	Number of AOFM counterparties by credit rating as at 30 June 2009
Aaa/AAA	0	0
Aa1/AA+	1	0
Aa2/AA	10	2
Aa3/AA-	7	2
A1/A+	2	2
A2/A	2	3
Total number of counterparties	22	9

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

(b) The number of counterparties listed as at 30 June 2008 has been corrected from that of the AOFM's 2007-08 report which had listed a total 24.

As a result of credit downgrades and movements in interest rates, the AOFM made five collateral calls from two counterparties totalling \$106.3 million, and executed 13 credit-related swap terminations across five different counterparties, recouping \$125.4 million in order to reduce its credit exposures to these counterparties.

The AOFM's exposure to counterparty credit risk on swaps was \$66.8 million at 30 June 2009. All remaining swaps will mature in 2009-10.

Residential mortgage-backed securities

Objective

Since the late 1980s, the securitisation of mortgages into residential mortgage-backed securities (RMBS) has provided an important source of funding for new and small mortgage lenders to compete with the major banks in lending for housing. Commencing in 2007-08, developments in global financial markets reduced liquidity in the Australian RMBS market and constrained the ability of lenders to access funding from the source. In particular, margins on existing mortgage-backed bonds widened to a point that rendered securitisation uncompetitive as a source of finance for mortgage providers. This deterioration occurred despite the high quality of Australian RMBS and the fact that there has never been a credit-related loss on a rated prime residential mortgage-backed security in Australia.

In view of these developments, the Government decided to invest in Australian RMBS to support competition in Australia's mortgage market during the current market dislocation. In

October 2008, the Treasurer directed the AOFM to invest up to a total of \$8 billion in eligible RMBS, including \$4 billion to be invested in securities by issuers that were not Authorised Deposit-taking Institutions (non-ADIs). The allocation to the non-ADI sector was made in conjunction with the Government's decision to guarantee the deposits and wholesale funding of ADIs.

Securitisation and RMBS

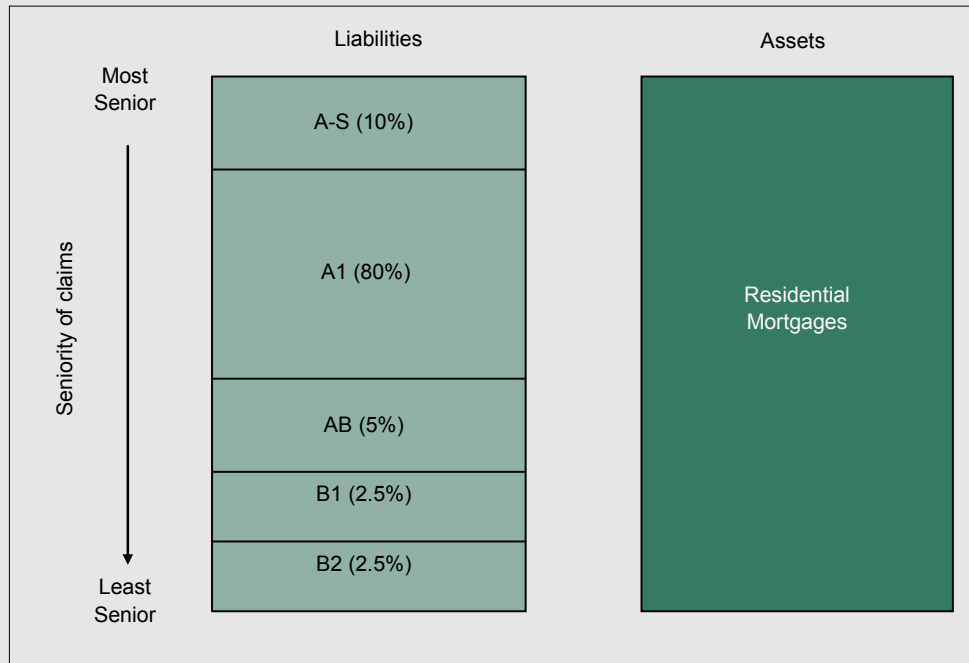
Securitisation is the process whereby income producing assets are pooled together to produce bond-like securities. Cash flows from the assets are directed to bondholders through a special purpose vehicle. The special purpose vehicle is legally separate to the originator of the assets, and is structured to remain unaffected in the event that the originator becomes bankrupt.

The first RMBS transaction was undertaken in 1977 by Bank of America, and consisted of a simple 'pass-through' structure. The asset class has evolved, however, and now investors can benefit from credit enhancement techniques such as subordination and over-collateralisation.

Subordination is the name given to the structure whereby the securities that are supported by the pool of mortgages are structured into 'tranches' that allow 'senior' notes to be repaid before the other 'mezzanine' and 'junior' or 'subordinated' notes. As the underlying pool of mortgages repays both principal and interest through time, the most senior tranches will be repaid before the mezzanine and subordinated notes, and the mezzanine notes will in turn be repaid before the subordinated notes. Based on historic mortgage prepayment experience, the cash flows associated with each tranche can be modelled with some degree of accuracy.

In Figure 1 below, the senior notes are shown as classes A-S and A1, class AB is a mezzanine note and classes B1 and B2 are the subordinated notes. The senior tranches typically comprise the major part of an RMBS issue; in Figure 1, the senior notes make up 90 per cent of the total, whereas the mezzanine notes and subordinated notes together represent 10 per cent. With this deal structure, the senior notes and mezzanine note respectively have 10 and 5 per cent credit enhancement through subordination. While there is some variation from deal to deal, depending on pool characteristics, the senior and mezzanine notes typically obtain AAA credit ratings and subordinated notes are typically assigned lower ratings.

Figure 1: Typical RMBS Structure



The 'Weighted Average Life' (WAL) of an RMBS tranche represents the duration of the tranche. It is calculated as the sum of its cash flows weighted by the periods in which they are paid, divided by the initial face value of the tranche. While repayments can stretch out for much longer than the WAL, this is a useful measure in making comparisons with equivalent standard bonds, or 'bullet' securities.

In the event that the mortgage pool suffers losses, for example through defaults on underlying mortgages, the subordinated tranches suffer the first losses. In so doing, the senior notes enjoy a buffer, making them less risky. Under the AOFM's investment program, only AAA-rated pieces have been purchased. Occasionally, the AOFM has purchased small amounts of the most senior, fastest paying tranches (see class A-S in Figure 1 above), but these tranches have typically been purchased solely by other investors. The amount of subordination in the tranches below the AOFM's lowest-ranked investments has varied from 2.7 per cent to 9.4 per cent of the pool.

Lenders mortgage insurance (LMI) is another common form of credit enhancement. LMI providers insure bondholders against defaults by mortgage borrowers. A less common form of credit enhancement has been the use of over-collateralisation, whereby the issuer injects an equity piece or 'seller note' into the structure as the lowest tranche (see class B2 in Figure 1 above).

Achieving the objective

After consulting with market participants, the AOFM concluded that the most effective means of arranging these investments would be to act as a cornerstone investor in AAA-rated tranches of eligible RMBS transactions. This recognised that a key to re-invigorating the RMBS market lay in encouraging investors to return to it. The AOFM also aimed to ensure, as far as practicable, that the proceeds on the investments would be used for further lending for housing and to promote market competition. An alternative approach that was considered, of simply purchasing existing RMBS in the secondary market, may have resulted in issuers withdrawing from housing lending and investing the proceeds in other activities.

Investment Guidelines were developed that were consistent with the Treasurer's Directions and the first Request for Proposals (RFP) was issued on 13 October 2008. The RFP specified the selection criteria and minimum requirements that would be used in selecting proposals.

The selection criteria were directed to the objective of supporting competition in the residential mortgage market, and comprised:

- (i) the extent to which the funds raised would be used to originate new residential mortgages in the near term;
- (ii) the extent to which the mortgage originators have relied on RMBS to finance their residential housing lending in the past;
- (iii) the expected participation of other investors in the transaction;
- (iv) the experience and capability of the deal arrangers and lead managers;
- (v) the extent to which the transaction would avoid congestion with other proposed transactions; and
- (vi) the capability and quality of the asset servicer.

The minimum requirements were as follows:

- (i) securities must have a AAA-rating, from two major ratings agencies;
- (ii) the transactions are to settle via Austraclear;
- (iii) the issuers are to commit to monthly reporting on the composition of the underlying mortgage pool; and
- (iv) the underlying mortgage pool must meet the following minimum standards:
 - a. mortgage insurable, Australian dollar denominated mortgages;
 - b. a closed pool, with no substitution or pre-funding of mortgages;
 - c. a maximum of 10 per cent of the pool in low-doc loans;
 - d. a maximum loan size of \$750,000;
 - e. a maximum loan term of 30 years;
 - f. a weighted average loan to value ratio of not more than 70 per cent;
 - g. a maximum individual loan to value ratio of 95 per cent;

- h. a maximum of 50 per cent of the pool in interest only loans;
- i. a maximum interest only period of 10 years; and
- j. a maximum time in arrears of 30 days of any loan.

Twelve proposals that met these requirements were received, from which a panel comprising the Chief Executive Officer, the Director of Financial Risk and the Head of Treasury Services selected the four highest ranking transactions. These deals, totalling \$1.996 billion, were transacted and settled by 15 December 2008.

A second RFP was issued on 18 December 2008, with minor changes based on experience and feedback from the first RFP. Specifically, the cap on the weighted average loan to value ratio was removed, the requirement for mortgage insurability was clarified and the requirement for a pool audit was specified in greater detail. An additional selection criterion, namely the overall quality of the mortgage pool and securities on offer, was also included. The main purpose of these changes was to allow greater flexibility in the composition of mortgage pools, while maintaining a level of assurance regarding the overall quality of the AOFM's investments.

Seventeen conforming proposals were received under the second RFP, including four from non-ADIs. A further nine investments were made under this RFP over the remainder of the 2008-09 financial year.

Price was not a criterion used to rank proposals in the selection process. Instead, pricing was determined in consultation with issuers after mandates had been awarded. In this, the AOFM aimed to balance the objective of maintaining a competitive flow of funds for new lending for housing with the objective of attracting other investors. Where third party investors participated in transactions, the AOFM participated at the same price.

Since mid-December 2008 when the wholesale bank guarantee was first used, the AOFM has typically been the sole investor in the longer-dated AAA-rated tranches of RMBS issues. At the same time, distressed selling in the secondary market increased, at price levels that were uneconomic for new mortgage lending. The AOFM sought to obtain margins that allowed the competitive origination of new mortgages, while maintaining consistency, on a risk-adjusted basis, in the pricing between transactions. The outcome was that the majority of investments in the longer tranches were undertaken at margins to the bank bill rate of between 1.2 per cent per annum and 1.4 per cent per annum, while smaller AAA-rated mezzanine tranches were priced at a wider margin to compensate for their subordination to the senior AAA tranches and longer WALs.

Outcome and performance

By 30 June 2009, the AOFM had completed 13 RMBS transactions, totalling \$6.203 billion, comprising \$2.75 billion in six transactions sponsored by five ADIs and \$3.453 billion invested in seven transactions sponsored by four non-ADIs. Including investments from other parties, the

total volume of RMBS that was able to be issued over this period as part of the program was \$8.042 billion. This represented approximately 6.6 per cent of residential mortgages originated in Australia over the period November 2008 to June 2009.

Interest accrued in 2008-09 was \$89 million, which represented an annualised return of 4.80 per cent. The securities purchased in 2008-09 were all floating-rate notes, paying a weighted average margin of around 1.3 per cent per annum over the one month bank bill rate.

The average credit margin of around 1.3 per cent per annum on the RMBS portfolio is above the AOFM's cost of short-term funding, which has historically been below the bank bill rate. However this average margin is narrower than margins currently available in the secondary market, and the RMBS held by the AOFM showed an unrealised mark-to-market loss of \$136 million in 2008-09. The market value of the AOFM's RMBS is determined by an independent service provider. The difference corresponds to a margin of about 80 basis points across the RMBS portfolio. This remeasurement effect can be considered to be the opportunity cost associated with purchasing these assets at prices that promote competition in housing lending, rather than at secondary market prices. If the RMBS investments had been priced at yields 80 basis points wider, they would not have provided a viable source of funding for housing.

Table 4 provides details of RMBS investments at 30 June 2009. A total of \$6.203 billion had been invested and had generated capital repayments of \$179 million.

Table 4: RMBS Investments as at 30 June 2009

Pricing Date	Issuer	ADI/ Non-ADI	Instrument Name	Expected WAL* at closing (years)	Coupon 1m BBSW + (%)	Original Face Value (\$m)	Current Face Value (\$m)
14-Nov-08	FirstMac	Non-ADI	FirstMac 2008-2 Class A1	0.7	1.25%	132.0	96.9
			FirstMac 2008-2 Class A2	3.5	1.50%	325.0	325.0
			FirstMac 2008-2 Class AB	5.0	1.80%	39.0	39.0
17-Nov-08	Members Equity Bank	ADI	SMHL 2008-2 Class A1	2.8	1.30%	500.0	454.6
4-Dec-08	Challenger	Non-ADI	Challenger 2008-2 Class A	2.8	1.35%	481.0	442.4
			Challenger 2008-2 Class AB	4.5	1.75%	19.0	19.0
10-Dec-08	RESIMAC	Non-ADI	RESIMAC 2008-1 Class A2	1.5	1.20%	280.0	250.6
			RESIMAC 2008-1 Class A3	4.5	1.40%	204.8	204.8
			RESIMAC 2008-1 Class AB	4.5	1.70%	15.3	15.3
6-Mar-09	Credit Union Australia	ADI	HarvTrust 2009-1 Class A1	3.6	1.40%	350.0	350.0
13-Mar-09	Bendigo and Adelaide Bank	ADI	TORRENS 2009-1 Class A2	4.2	1.35%	475.0	475.0
23-Mar-09	AMP Bank	ADI	PROGRESS 2009-1 Class A2	4.0	1.30%	425.0	425.0
3-Apr-09	Bank of Queensland	ADI	REDS 2009-1 Class A1	4.2	1.30%	500.0	500.0
9-Apr-09	Liberty Financial	Non-ADI	LIBERTY 2009-1 Class A1	0.1	0.90%	14.5	0.0
			LIBERTY 2009-1 Class A2	0.9	1.20%	164.7	148.4
			LIBERTY 2009-1 Class A3	3.2	1.40%	283.0	283.0
			LIBERTY 2009-1 Class AB	4.0	1.65%	37.8	37.8
15-Apr-09	Challenger	Non-ADI	CHALLENGER 2009-1 Class A2	0.5	1.00%	38.2	38.2
			CHALLENGER 2009-1 Class A3	1.5	1.30%	152.5	152.5
			CHALLENGER 2009-1 Class A4	4.3	1.45%	289.0	289.0
			CHALLENGER 2009-1 Class AB	4.4	1.70%	20.3	20.3
11-May-09	Members Equity Bank	ADI	SMHL 2009-1 Class A2	3.7	1.35%	500.0	500.0
21-May-09	RESIMAC	Non-ADI	RESIMAC 2009-1 Class A2	0.5	1.00%	10.0	10.0
			RESIMAC 2009-1 Class A3	2.9	1.40%	435.0	435.0
			RESIMAC 2009-1 Class AB	4.1	1.70%	13.8	13.8
1-Jun-09	FirstMac	Non-ADI	FirstMac 2009-1 Class A3	2.9	1.40%	458.0	458.0
			FirstMac 2009-1 Class AB	5.0	2.20%	40.6	40.6
						6,203.4	6,024.1

* Weighted average life

Communications Fund

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. The Fund was closed on 1 January 2009 and its assets transferred to the Building Australia Fund (which is managed by the Future Fund Board of Guardians). Prior to its closure the AOFM managed the investments of the Communications Fund on behalf of the Department of Broadband, Communications and the Digital Economy.

The investments of the Communications Fund comprised short-term Australian denominated dollar money market instruments and deposits, including bank accepted bills, negotiable certificates of deposit and commercial paper. When the fund was closed the value of the Fund's investments totalled approximately \$2,468 million.

The before-fees investment portfolio performance benchmark for the Fund was the UBS Australian Bank Bill Index. The after-fees performance benchmark was the UBS Australian Bank Bill Index less 2 to 3 basis points. Performance against the benchmarks for the period the fund operated in 2008-09 is as follows:

- The before-fees return of the Communications Fund underperformed against the benchmark by 0.3 basis points.
- The after-fees return of the Communications Fund exceeded the benchmark by 0.4 basis points.

Over the life of the Fund, it obtained an average return on its assets of 7.17 per cent per annum, which was 3.3 basis points higher than the before-fees Fund benchmark, and 4.2 basis points higher on an after-fees basis.

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.

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 Australian Financial Markets Association (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 2008-09, the AOFM undertook a number of activities to enhance the operational risk framework including:

- an update of the AOFM's Fraud Control Plan (FCP), including a reassessment of the risks of fraud from within the Agency and externally. 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 2008-09;
- 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 to Chief Executives) Delegation and associated government financial policies. 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 no instances of non-compliance;
- 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; and
- internal audits covering activities such as general controls, IT general controls and compliance.

Settlement operations

The AOFM handles very large volumes of payments on its administered portfolio of debt and assets. In 2008-09, it settled around \$11.0 billion of payments of CGS interest and principal payments, \$1.3 billion of swap payments and \$372.8 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 its transaction counterparties.

Settlement risk is a key risk managed by the AOFM. In 2008-09, the AOFM was not late in settling any payment obligations. There was one instance where compensation was sought from a counterparty because it failed to settle a payment obligation in line with its contractual obligations. No other compensation was sought throughout the year.

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 and investment activities.

Cooperation with other debt managers

Over the 2008-09 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 each of these countries under the auspices of the Strongim Gavman Program and the Regional Assistance Mission to the Solomon Islands 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 Canberra attended by officials responsible for sovereign debt management of the two countries, together with seconded AOFM staff, to improve the assistance provided.

During the year the AOFM also hosted two visits from debt management officials from Indonesia.

Agency financial performance

Agency activities recorded an operating surplus of \$1.97 million for 2008-09 financial year, comprising total revenue of \$9.85 million and expenses of \$7.88 million. As at 30 June 2009, the AOFM was in a sound net worth and liquidity position, reporting net assets of \$16.37 million, represented by assets of \$17.97 million (including current assets of \$0.32 million) and liabilities of \$1.60 million.

As at 30 June 2009, the AOFM maintained cash and unspent appropriations totalling \$16.78 million. These funds are held to settle liabilities as and when they fall due and for future asset replacements and improvements.

During 2008-09, the AOFM did not return or establish a provision for return, by the way of dividend, of unspent appropriation monies to Government.

