The Auditor-General
Audit Report No.42 2004–05
Performance Audit

Commonwealth Debt Management
Follow-up Audit

Australian Office of Financial Management

Australian National Audit Office

ISSN 1036–7632

ISBN 0 642 80839 2

Canberra ACT
19 April 2005

Dear Mr President
Dear Mr Speaker

The Australian National Audit Office has undertaken a performance audit in the Australian Office of Financial Management in accordance with the authority contained in the *Auditor-General Act 1997*. Pursuant to Senate Standing Order 166 relating to the presentation of documents when the Senate is not sitting, I present the report of this audit and the accompanying brochure. The report is titled *Commonwealth Debt Management Follow-up Audit*

Following its presentation and receipt, the report will be placed on the Australian National Audit Office's Homepage—http://www.anao.gov.au.

Yours sincerely

Ian McPhee
Auditor-General

The Honourable the President of the Senate
The Honourable the Speaker of the House of Representatives
Parliament House
Canberra ACT

AUDITING FOR AUSTRALIA

The Auditor-General is head of the Australian National Audit Office. The ANAO assists the Auditor-General to carry out his duties under the *Auditor-General Act 1997* to undertake performance audits and financial statement audits of Commonwealth public sector bodies and to provide independent reports and advice for the Parliament, the Government and the community. The aim is to improve Commonwealth public sector administration and accountability.

For further information contact:

The Publications Manager
Australian National Audit Office
GPO Box 707
Canberra ACT 2601

Telephone: **(02) 6203 7505**
Fax: **(02) 6203 7519**
Email: **webmaster@anao.gov.au**

ANAO audit reports and information about the ANAO are available at our internet address:

http://www.anao.gov.au

Audit Team

David Spedding
Ruth Cully
Brian Boyd

Contents

Abbreviations

AFD	Applied Financial Diagnostics Pty Ltd
AFMA	Australian Financial Markets Association
ANAO	Australian National Audit Office
AOFM	Australian Office of Financial Management
CEIs	Chief Executive's Instructions
CEO	Chief Executive Officer
CPGs	Commonwealth Procurement Guidelines
Finance	Department of Finance and Administration
FMA Act	*Financial Management and Accountability Act 1997*
ISDA	International Swap and Derivatives Association
JCPAA	Joint Committee of Public Accounts and Audit
OPA	Official Public Account
RBA	Reserve Bank of Australia
Treasury	Department of the Treasury
US	United States of America

Glossary

Bank bill swap rate	The average mid-point of banks' bid and offer rates in the bank bill secondary market.
Basis point	A fractional interest rate measure where 100 basis points equals one per cent.
Benchmark portfolio	Portfolio management is concerned with managing the ongoing cost and risk of the Commonwealth debt portfolio. This requires a focus on changes in interest rates and exchange rates as these variables can have a significant impact on borrowing costs. A benchmark or model portfolio specifies the optimal exposure to foreign currencies and interest rates (as measured by modified duration) to achieve the AOFM's debt management objective. The benchmark plays a role as a target towards which new debt issuance and Commonwealth swap activity has adjusted the composition of the debt portfolio over time.
Cross currency swap	The transfer between two parties of a principal amount plus associated ongoing interest payments from one currency to another, based on a fixed exchange rate. The principal is re-exchanged at maturity.
Derivative	A synthetic security that derives its price from a physical security.
Forward foreign exchange contract	An over-the-counter contract negotiated by the AOFM with the Reserve Bank of Australia to trade foreign exchange at a specified price that will be applied at a specified future date.
Interest rate swap	The exchange between two parties of interest payments associated with a notional principal amount.
In the money	The AOFM has, at current prices, made an unrealised profit by entering into the swap transaction, meaning that, after allowing for the time value of money, future swap receipts are expected to exceed future swap payments.
Issuance	The process of creating and distributing securities, such as Treasury bonds.

Mark-to-market	The repricing of a portfolio to reflect current market valuations.
Maturity profile	The relative proportions of assets and liabilities in a portfolio maturing at different time intervals.
Modified duration	A measure of the sensitivity of the market value of a debt security to a change in interest rates. It is measured as the percentage change in the market value of a debt instrument in response to a one percentage point change in nominal interest rates. Modified duration is also closely related to the weighted average term to repricing.[1] Portfolios with higher modified durations have more stable interest costs through time but have a more volatile market value through time.
Out of the money	The AOFM has, at current prices, made an unrealised loss by entering into the swap transaction.
Principal	The initial, or current, amount borrowed or invested.
Spot transaction	A transaction in which the foreign exchange contract value date (date on which delivery of the currency and financial settlement occurs) is two business days after the date of the transaction.
Swap	A financial transaction in which each party to the contract agrees to exchange (swap) their respective payment obligations.
Term premium	The margin over the implied path of cash rates that investors in long-term debt require to compensate them for bearing the market value risk and liquidity risk associated with long-term debt, as opposed to a series of short-term investments such as cash deposits. The term premium is typically estimated by calculating the difference between the cash rate and the ten-year bond rate on average through time.

1 Accordingly, throughout this report, the ANAO has referred to modified duration as being a certain period of years.

Summary and Recommendations

Summary

1. The Australian Office of Financial Management (AOFM) was established on 1 July 1999.[2] The AOFM is responsible for the administration, financial and operational risk management, and financial reporting of the Australian Government's portfolio of Commonwealth Government Securities and associated financial assets. The AOFM issues Treasury bonds and Treasury notes, invests in term deposits with the Reserve Bank of Australia, manages the Government's cash and conducts interest rate swaps.[3] The following table summarises the major liabilities and assets administered by the AOFM as at 30 June 2004.

Table 1

AOFM administered assets and liabilities

	30 June 2004 ($b)
Assets	
Investments	14.85
Loans to State and Territory Governments	3.81
Swaps interest receivable	0.38
Other	0.14
Total	**19.18**
Liabilities	
Commonwealth Government Securities	54.75
Interest payable	3.21
Swaps interest payable	0.34
Total	**58.30**

Source: AOFM Annual Report 2003–04, p.116.

2. Australian National Audit Office (ANAO) Audit Report No.14 of 1999–2000, tabled in October 1999, examined Commonwealth Debt Management. The report made six recommendations, all of which were agreed to by the AOFM and the Department of the Treasury (Treasury).

3. The Joint Committee of Public Accounts and Audit (JCPAA) conducted an inquiry into Commonwealth Debt Management. The Committee released its

---

2 Up to 30 June 1999, Commonwealth debt management functions were performed by the Debt Management Office in the Department of the Treasury.

3 AOFM Annual Report 2003–04, p.3.

report in early November 2000.[4] The JCPAA noted the AOFM's progress to date and made three recommendations. One of these was that the AOFM move as quickly as possible to implement all of the recommendations made in the ANAO's 1999 audit report.

4. A number of other reviews in relation to the management of the Commonwealth debt have also been undertaken since the 1999 audit. In September 2001, the Treasurer agreed to the gradual elimination of all foreign currency exposure from the Commonwealth debt portfolio following an internal AOFM review. Around February 2002, there was considerable media and Parliamentary attention, particularly in Senate Estimates hearings, surrounding the performance of the cross currency swaps component of the Commonwealth debt portfolio. In addition, in 2002–03, the Government reviewed the future of the Commonwealth Government Securities market. In the 2003–04 Budget, the Government announced its decision that, in the future, it would issue sufficient Treasury bonds to support the bond futures market.

Audit objective

5. The objective of this audit was to assess the extent to which the recommendations and major findings of the ANAO's 1999 audit of Commonwealth Debt Management have been addressed, and the impact of any changes.

Audit conclusion

6. Overall, the ANAO found that the majority of the recommendations from the ANAO's 1999 audit report had been implemented or satisfactory progress has been made on their implementation. To show the AOFM's progress in implementing recommendations from the 1999 audit report, the following table indicates, in respect of each recommendation, the AOFM's abbreviated response to the ANAO at the time of the 1999 audit report, the AOFM's advice on progress provided to the JCPAA in June 2000 (in brackets),[5] and the ANAO's 2005 assessment of whether the recommendation has been implemented. It also identifies the location within this current report of supporting analysis for the ANAO's assessment.

---

4 JCPAA Report No.378, Debt Management, *Review of Auditor-General's Reports 1999–2000 Second Quarter*, October 2000, p.18.

5 The AOFM's June 2000 advice to the JCPAA detailing progress in respect of implementation of the ANAO's recommendations is reproduced in full at Appendix 1.

Table 2

Progress on implementing recommendations from the 1999 audit report

	1999 audit report recommendation	Agency response	ANAO Assessment	Ref paras
1.	Consistent with its increasing focus on risk management and having regard to the changed economic circumstances since its original analysis and the planned reduction in Commonwealth net debt, the AOFM:			
	(a) as part of its ongoing portfolio management activities, continue to evaluate the data and assumptions underlying the target of seeking United States dollar exposures in the debt portfolio;	Agreed. (Review in progress)	■	2.10 to 2.14
	(b) re-examine the benchmark portfolio targets as part of its next portfolio management consultancy; and	Agreed. (Review in progress)	■	2.10 to 2.14
	(c) obtain formal Ministerial endorsement of the portfolio benchmark targets.	Agreed. (Treasurer's approval will be sought)	■	2.10 to 2.14 & 2.31
2.	AOFM enhance accountability for its debt management performance by regularly assessing the cost and risk implications of departures from the portfolio benchmark targets and reporting key performance indicators in its Annual Report.	Agreed. (Reporting framework to be introduced in 2000–01)	⊡	2.24 to 2.30
3.	Given the significant risks involved in derivative transactions, the AOFM undertake periodic internal audits and commission external reviews of the application and effectiveness of the control framework for its use of financial derivatives and take appropriate action if necessary.	Agreed. (AOFM Audit Committee to implement)	■	3.55
4.	AOFM improve its management of legal risk associated with derivative transactions by:			
	(a) prioritising the periodic update of Master Agreements with its major counterparties through amendment agreements or negotiating new Master Agreements;	Agreed. (Pre requisite for new business post 30/6/00)	◘	3.42 to 3.45
	(b) identifying opportunities to increase the number of Master Agreements that are subject to Australian governing law; and	Agreed. (AOFM's opening negotiation stance)	■	3.42

Key: ■ Implemented ◘ Satisfactory progress
⊡ Further progress required □ Not implemented

1999 audit report recommendation		Agency response	ANAO Assessment	Ref paras
	(c) obtaining greater assurance concerning the power, capacity and due authorisation of counterparties to enter into swap transactions.	Agreed. (Now standard procedure)	■	3.51 to 3.53
5.	AOFM enhance the swap tender process by:			
	(a) electronically recording swap tenders in order to assist resolution of any disagreements with counterparties over swap terms and/or assist enforcement of any undocumented trades;	Agreed. (In place by Jan 2001)	■	3.13
	(b) prioritising its follow-up of outstanding counterparty confirmations according to the age of the transaction, the amount of time before a payment is due, and whether the transaction involves a credit exposure for the Commonwealth; and	Agreed. (Implemented)	⊡	3.32 to 3.35
	(c) as part of its swap confirmation process, formally checking swap confirmations against lists of authorised signatories supported by resolutions of the counterparty.	Agreed. (Now checked)	■	3.36 to 3.37
6.	Having regard to the significant unanticipated financial losses that can occur due to market risk involving derivatives, the Board of the AOFM:			
	(a) enhance existing documentation of the AOFM's risk management policies and procedures in a comprehensive procedures manual;	Agreed. (Will revisit when benchmark reviewed)	◘	3.57 to 3.58
	(b) ensure that internal controls are periodically independently reviewed;	Agreed. (AOFM Audit Committee to address)	■	3.55
	(c) consistent with the objective of seeking long-term cost savings subject to acceptable short-term cost volatility, require the timely review and reporting of significant movements in the net exposures around the mid-point of the relevant benchmark ranges for cross-currency and interest rate swaps; and	Agreed. (Will be part of reporting against benchmark)	■	2.43 to 2.44
	(d) ensure that the Treasurer is consulted on matters of significance which may affect Government decisions on financial exposures.	Agreed. (Treasurer's approval to be sought)	■	2.38 to 2.39

Key: ■ Implemented ◘ Satisfactory progress
⊡ Further progress required □ Not implemented

Recommendations and AOFM response

7. In this current audit, the ANAO has made two recommendations to improve the management of the Commonwealth debt. Where further action is required in relation to previous recommendations, the ANAO has not made a further recommendation, but reiterates the importance of the earlier recommendations being implemented. The AOFM's full response to the proposed report for this current audit can be found at Appendix 2. The following was the AOFM's summary response:

> The AOFM notes that the Report indicates that the ANAO considers that most of the recommendations in the 1999 performance audit have been implemented, or satisfactory progress made. The AOFM broadly accepts the two new recommendations. The AOFM has differences of view on various aspects of the Report. Some of these are indicated at the relevant points in the Report; others may be found in the AOFM comments [at Appendix 2].

Recommendations

Set out below are the ANAO's recommendations and the AOFM's abbreviated responses. The AOFM's more detailed responses are shown in the body of the report immediately after each recommendation.

Recommendation No.1 **Para 2.40**	The ANAO recommends that the AOFM establish a reporting trigger to inform the Treasurer and Treasury Secretary when the swap portfolio has significant unrealised losses. ***AOFM Response***: Agreed with qualification.
Recommendation No.2 **Para 3.29**	The ANAO recommends that, to improve transparency and accountability, the AOFM report more comprehensively and consistently on the efficiency of its swap dealings in future Annual Reports. ***AOFM Response***: Agreed.

Audit Findings and Conclusions

1. Introduction

This chapter provides background information about the Australian Office of Financial Management; outlines the background to the audit; and explains the audit approach.

Background

1.1 The Australian Office of Financial Management (AOFM) was established on 1 July 1999 as a specialised agency within the Treasury portfolio to enhance the Commonwealth's capacity to manage its net debt portfolio. Its establishment recognised the need to expand the resources dedicated to debt management; recruit specialist financial skills; and introduce new systems and technology in order to achieve these objectives.[6]

1.2 The AOFM's debt management objective is to manage the Commonwealth net debt portfolio at least cost over the medium term, subject to the Government's policies and risk preferences.[7] Debt management is undertaken by the AOFM through:

- the issue of various borrowing instruments;
- the redemption (and in the past, the early repurchase) of Commonwealth Government Securities;
- maintenance of sufficient cash balances in the Official Public Account to meet the Commonwealth's daily expenditure requirements;
- investment of surplus cash holdings in Reserve Bank of Australia (RBA) term deposits;
- the formulation and undertaking of portfolio management; and
- assessment of the cost of the debt portfolio.

1.3 Australia's net debt represents around 4.9 per cent of the nation's Gross Domestic Product.[8] As at 30 June 2004, the net debt portfolio managed by the AOFM totalled about $40 billion and had a market value of about $45 billion.[9] The portfolio held assets of about $15 billion in term deposits and $825 million

---

6 AOFM 2003–04 Annual Report, p.xiii.

7 ibid, p.v. The AOFM also has an objective of maintaining an efficient Treasury bonds market that supports an efficient Treasury bonds futures market. Source: Portfolio Budget Statements 2004–05, Treasury Portfolio, p.113.

8 AOFM Website, Table P17.

9 ibid.

in overnight cash placed with the RBA,[10] along with some 252 interest rate swaps across 20 counterparties that had a total market value of about $249 million as at 30 June 2004.[11]

1.4 Although the volume of net debt managed has declined over the period since the AOFM commenced operations, the complexity of the task has increased. During 2003–04, the AOFM employed around 36 full-time equivalent staff and incurred operating expenses of $7.7 million.[12]

Audit report in 1999

1.5 An ANAO audit report, tabled in mid-October 1999, examined Treasury's management of the Commonwealth debt portfolio.[13] The audit identified several areas where improvements could be made to the risk management and control environment for Commonwealth debt management, and where accountability for debt management performance could be enhanced. The audit found that the portfolio management approach of borrowing in United States (US) dollars (through derivatives) had increased the short-term risk of increased debt costs. A key recommendation of the report was that there be continued evaluation of the data and assumptions underlying the target of seeking US dollar exposures in the debt portfolio. The report made six recommendations, all of which were agreed to by the AOFM and Treasury.

Parliamentary inquiry

1.6 The Joint Committee of Public Accounts and Audit (JCPAA) inquired into Commonwealth Debt Management in May 2000. The Committee took evidence on the following topics raised in the ANAO's 1999 audit report:[14]

- AOFM resourcing;
- debt portfolio benchmark;
- foreign currency exposures;
- derivatives and risk management; and
- cash management framework.

---

10 AOFM Website, Table P17 and Table A6.

11 AOFM 2003–04 Annual Report, p.113 and AOFM Website, Table P11.

12 AOFM 2003–04 Annual Report, pp.35 and 59.

13 Field work for the 1999 audit was completed in Treasury before the AOFM commenced operations on 1 July 1999.

14 JCPAA Report 378, op.cit., p.18.

1.7 The JCPAA recommended that the AOFM: take action to obtain and maintain in-house expertise; monitor risks and identify weaknesses impacting on the AOFM's portfolio benchmark review; and move as quickly as possible to implement all of the recommendations made by the ANAO. The Committee's recommendations were supported by the AOFM.[15]

Audit approach

1.8 The objectives of this performance audit were to assess the extent to which the recommendations and major findings of the ANAO's 1999 audit of Commonwealth Debt Management have been addressed, and the impact of any changes.

1.9 In particular, the audit focused on the actions taken by the AOFM in relation to the previous audit, and their impact, with a view to identifying areas where improvements can be made to the risk management and control environment for Commonwealth debt management. In addition, the audit included selected testing of transactions undertaken since the last audit, including for the run down of the AOFM's foreign currency exposure, in order to provide assurance about their completeness, accuracy, timeliness and probity.

1.10 Debt issued on behalf of the States, debt redemptions, and the activities undertaken on the AOFM's behalf by the RBA, were excluded from the audit.

1.11 Banking and financial markets specialists from Applied Financial Diagnostics Pty Ltd (AFD) provided advice to inform the ANAO's examination of selected aspects of the AOFM's debt management activities. Consistent with the Commonwealth Procurement Guidelines, AFD was selected following a tender process during a recent audit of the Investment of Public Funds (ANAO Audit Report No.22 of 2004–05). The Request For Tender and resulting contract included an option for the successful tenderer to be engaged to assist with the follow-up audit of Commonwealth Debt Management.

1.12 Audit fieldwork was conducted between July and December 2004. In January 2005, a discussion paper outlining the ANAO's preliminary findings was provided to the AOFM for comment. The audit was conducted in conformance with ANAO auditing standards and cost the ANAO approximately $289 000.

---

15 Government response to recommendations of the 378th report of the Joint Committee of Public Accounts and Audit, 8 June 2001.

2. Portfolio Management

This chapter discusses selected aspects of the AOFM's approach to managing the Commonwealth debt portfolio and examines the measurement and reporting of the AOFM's performance against its debt management objective.

Introduction

2.1 Portfolio management is concerned with managing the ongoing cost and risk of the Commonwealth debt portfolio. A key risk arising from the AOFM's operations is exposure to market risk, which can be broadly defined as the impact of changes in interest and exchange rates on the ongoing cost and value of the debt portfolio. An hypothetical portfolio benchmark has been established by the AOFM to serve as a target for the actual debt portfolio. The object is to manage the actual portfolio so as to match the benchmark portfolio as closely as possible. The portfolio structure is managed through debt issuance and the use of derivative products.

2.2 Use of derivatives, as part of Commonwealth debt management, commenced in March 1988. Since then, both cross currency and interest rate swaps have been used.[16] The direct economic gain or loss on swap contracts is calculated as the change in market value[17] over the relevant period adjusted for net cash flows during the period.[18] Table 2.1 outlines the economic returns on the swaps program since its inception.

---

16 More recently, the AOFM has also entered into forward foreign exchange contracts and spot foreign exchange contracts as part of the wind-down of the cross currency swaps program.

17 The market value of a swap reflects the economic value of expected future cash flows on the transaction, which are a function of movements in interest and/or exchange rates and the period to maturity of the contract.

18 1999 Audit Report, op.cit., p.99.

Table 2.1

Performance of the cross currency derivatives and interest rate swap programs to 30 June 2004

	Cross-currency derivatives program[A]			Interest rate swaps program		
	Net Cashflows $m	Change in market value $m	Economic gain/(loss) $m	Net Cashflows $m	Change in market value $m	Economic gain/(loss) $m
1987–88	-10.9	-50.4	-61.3	-	-	-
1988–89	-34.5	-64.5	-99.0	-	-	-
1999–90	-58.7	46.4	-12.3	-	-	-
1990–91	-21.7	-99.0	-120.7	-	-	-
1991–92	24.6	323.7	348.3	-	-	-
1992–93	82.6	63.8	146.4	7.3	47.0	54.3
1993–94	190.7	73.7	264.4	21.5	-60.8	-39.3
1994–95	556.0	-289.2	266.8	14.5	32.1	46.6
1995–96	450.8	856.5	1307.3	11.5	7.4	18.9
1996–97	802.8	-705.1	97.7	18.5	53.6	72.1
1997–98	89.1	-2324.5	-2235.4	69.6	193.3	262.9
1998–99	-515.2	1150.7	635.5	137.4	-574.3	-436.9
1999–00	-226.7	-872.1	-1098.8	180.5	80.7	261.2
2000–01	-406.9	-1720.9	-2127.8	43.6	392.0	435.6
2001–02	-777.6	1935.6	1158.0	546.9	85.7	632.6
2002–03	166.8	1291.6	1458.4	388.5	1090.8	1479.3
2003–04	-226.3	383.7	157.4	323.6	-1098.8	-775.2
TOTAL	**84.9**	**-**	**84.9**	**1763.4**	**248.7**	**2012.1**

Source: ANAO analysis of AOFM data.

Note A: Comprises cross currency swaps, forward foreign exchange contracts, foreign exchange unwinds (see paragraphs 2.14 to 2.18) and spot currency transactions.

2.3 In addition to the direct economic returns, swap transaction cash flows involve indirect effects reflected in the extent to which they impact the Budget financing requirement and therefore change required debt issuance. The AOFM has reported that the overall economic gain over the life of the cross currency swaps program was $783.7 million.[19] This represents an average annual return of $46 million over the 17 years of the program.

2.4 Estimation of the economic gain involved certain assumptions about the indirect effects that the cash flows, arising from entering the swaps, had on the Commonwealth's borrowing program, as well as assumptions about the appropriate interest rates to use. In calculating the economic return, the AOFM has assumed that:

- all cash outflows were borrowed and all cash inflows were invested on the day that they occurred;
- each cash flow remained borrowed/invested until the program was wound up on 13 February 2004; and
- funds were borrowed/invested at the official RBA target cash rate, with interest compounded daily for 360 days per year. (The ANAO found that, when 365 days in the year is used, the reported economic gain falls by $11.9 million to $771.8 million).

2.5 In effect, these assumptions represent the economic contribution of one dollar borrowed or invested in May 1988 as being worth $3.35 in February 2004. Due to the effects of compounding interest, the methodology adopted by the AOFM amplifies the impact of the swaps conducted early in the life of the program.

2.6 In relation to Table 2.1, the AOFM commented in March 2005 that:

> The cross currency swap program provided positive cash inflows into the Government's bank accounts aggregating to around $2071 million by 1997–98. If there had been no cross currency swap program, Government net debt would have been higher by $2071 million by this time with an attendant higher public debt interest costs. Subsequent cash outflows only partially unwound this financing effect, producing a significant overall reduction in Government net debt.

[19] AOFM 2003–04 Annual Report, p.45.

2.7 The ANAO's 1999 audit included a series of findings and three recommendations relating to portfolio management activities. The recommendations were directed at:

- the target of seeking foreign currency exposure in the debt portfolio, and management of the related risk (Recommendations 1 and 6); and
- assessment and reporting of the cost and risk implications of departures from the portfolio benchmark (Recommendation 2).

Foreign currency exposure

2.8 Until 1988, the foreign currency exposure in the Commonwealth debt portfolio was all in the form of loans. From the early 1990s, domestic borrowings swapped into foreign currency (through the use of derivatives) became the dominant component.[20] The stated target was to maintain the exposure to foreign currency within the range of 10 to 15 per cent of the total debt portfolio.

Winding-up of the cross currency swaps program

2.9 The ANAO's 1999 audit report recommended that the AOFM continually evaluate the data and assumptions underlying the target of seeking US dollar exposures in the debt portfolio; re-examine the suitability of the benchmark portfolio targets; and obtain formal Ministerial endorsement of the targets.[21]

2.10 An internal review of the benchmark targets and underlying assumptions was completed by the AOFM in mid-November 1999. This review concluded that the existing target for US dollar exposures should be retained.

2.11 Around mid-October 2000, adherence to the benchmark limits was suspended when the then Treasury Secretary agreed to a request from the Governor of the RBA that the AOFM maintain its foreign currency exposure, on economic policy grounds. The concern was that substantial repayments of swaps required at that time to maintain the AOFM's foreign currency exposure within the benchmark limit of 15 per cent of the total debt portfolio would have added to the weakness of an already declining Australian dollar. This was because swaps repayments would have required sales of Australian dollars and purchases of US dollars. In addition, there were commercial considerations, as unwinding a large volume of swaps over a short period of

---

[20] ibid, p.39.

[21] op.cit., Recommendation No.1, p.60.

time, coinciding with a historically low exchange rate, could incur additional costs and could adversely impact the market.

2.12 In early December 2000, the Treasurer agreed to suspension of the benchmark target, pending its review.

2.13 In June 2001, the AOFM completed a review of the benchmark, which concluded that foreign currency exposure was no longer desirable for the Commonwealth debt portfolio. The AOFM found that:

- there was no longer an expected long-term cost saving through foreign currency exposure;
- there was large scope for adverse shorter-term cost outcomes; and
- foreign currency exposures generate large volatility in debt service costs.

2.14 The review recommended that there be an orderly and gradual reduction in the Commonwealth's foreign currency exposure, from its then-current level of about US$6.4 billion, to zero over a period not exceeding about seven years.[22] The Treasurer agreed to this recommendation in early September 2001.

2.15 The AOFM, Treasury and the RBA agreed to the operational approach to unwinding the swaps. This included a non-discretionary schedule to unwind a predetermined amount (in US dollars) per month, based on the average exchange rate prevailing over the previous month.[23] The unwinds commenced in October 2001. The scheduled amounts were subsequently increased from mid-March 2003 and again in July 2003, such that all foreign currency exposure was expected to be eliminated by February 2004 if the exchange rate remained above 65 US cents.[24]

2.16 Under the initial schedule, the rate of reduction in the foreign currency exposures was more gradual than that which would occur from simply allowing the existing cross currency swaps to mature as they fell due. In addition, the unwind process ultimately involved the early termination of some 31 cross currency swaps. In order to balance any differences these two

---

22 At that time, all existing US dollar exposure (excluding loans) was due to mature by November 2008.

23 The scheduled amounts ranged from US$75 million when the exchange rate was below 55 US cents, to US$250 million when the exchange rate exceeded 70 US cents.

24 The maximum period for unwinding the swaps under the original schedule was about seven years, assuming the exchange rate remained below 55 US cents.

factors caused with the contractual maturity profile of its cross currency swaps, the AOFM entered into a series of forward foreign exchange contracts through the RBA to sell US dollars (and buy Australian dollars), typically with settlement dates up to six months into the future.

Overall performance of the cross currency swaps program

2.17 The cross currency swaps program commenced on 1 March 1988 and was wound up on 13 February 2004. As a whole, the program and the subsequent activities to wind it up comprised of four elements, as shown in Table 2.2.

Table 2.2

Components of the cross currency swaps program

Transaction Type	Number	Dates	Net contribution $m [d]
Cross currency swap	210	Mar 1988 to Apr 2000 [a]	-280
Forward foreign exchange	154 [b]	Jul 1999 to Feb 2004	358
Foreign exchange unwind	26 [c]	Jul 2003 to Dec 2003	-5
Spot currency	34	Jul 2003 to Feb 2004	11

Source: ANAO analysis of AOFM data.

Note: a. The last cross currency swap was conducted on 18 April 2000, as a result of the repurchase of debt associated with the Federal Airports Corporation. This swap hedged the foreign exchange risk associated with the debt, rather than add to the AOFM's foreign currency exposure. This was the only cross currency swap conducted in 1999–2000.

b. These were recorded as forward foreign exchange transactions numbered F10 to F163.

c. These were recorded as six foreign exchange unwinds numbered FXR200307 to FXR200312, but actually comprised 26 individual transactions.

d. Figures have been rounded.

2.18 In February 2005, the AOFM advised the ANAO that, in relation to Table 2.2:

> The foreign exchange unwind schedule specified the amount of foreign currency exposure vested in cross currency derivatives to be unwound in a given period. Where cross currency swaps maturities within a given period were greater than the scheduled amount in that period, foreign exchange contracts were undertaken with the RBA to sell US dollars forward. These forward foreign exchange contracts were transacted in two components: an ongoing forward foreign exchange transaction to meet the unwind schedule beyond the immediate period; and another foreign exchange forward

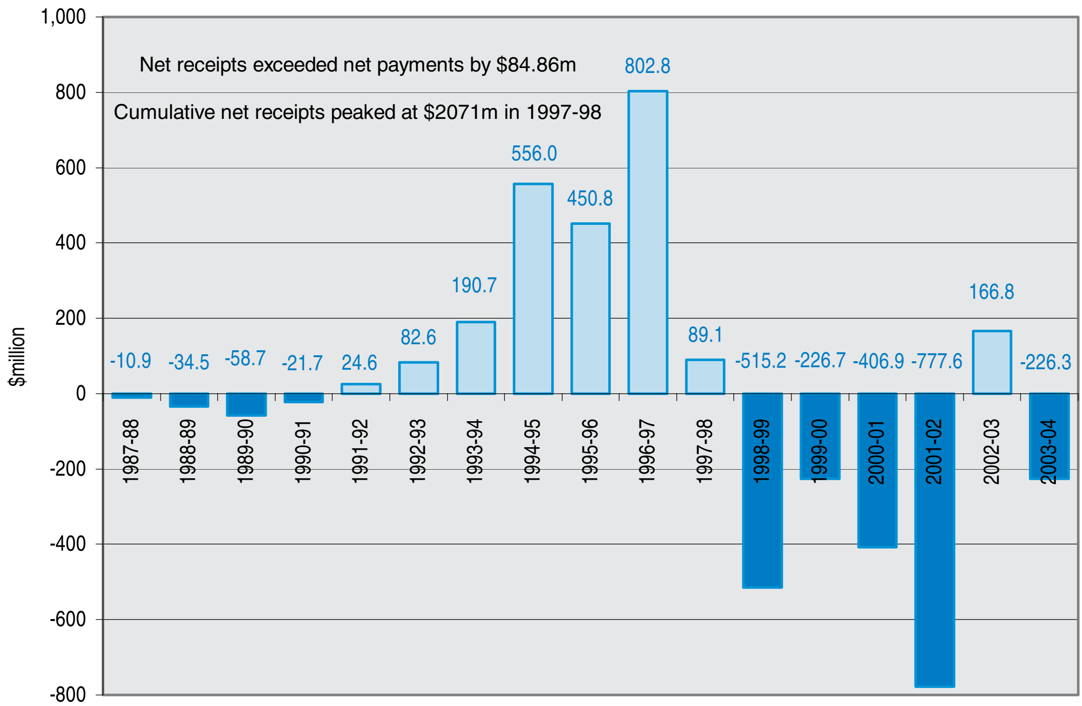
transaction with a short maturity date, to put into effect the reduction in foreign exchange derivative exposure required for that immediate period under the unwind schedule.

As the foreign exchange forwards, foreign exchange spots and cross currency swaps were directed to meeting the same exposure target (that is, the foreign exchange derivative exposure level specified under the unwind schedule), a 'profit or loss' on any of these types of transactions in isolation does not represent further insight, as they were not managed separately and were not independent of each other.

2.19 In aggregate, net receipts over the life of the cross currency swaps program totalled $84.9 million. However, year-by-year results varied considerably, such that payments exceeded receipts in nine of the 17 years of operation of the program (see Figure 2.1).

Figure 2.1

Net cash flows for the cross currency swaps program, 1987–88 to 2003–04



Source: ANAO analysis of AOFM data.

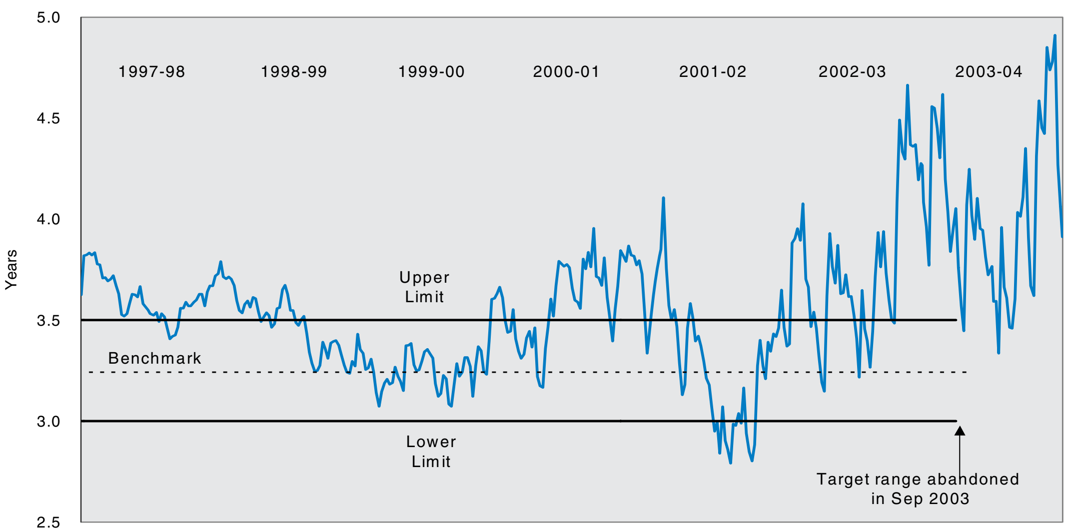
Domestic currency portfolio interest rate exposure

2.20 Portfolio duration (that is, the maturity profile of the portfolio) and interest rate exposure are intertwined. The longer the modified duration, the longer the period the Commonwealth is insulated against increases in interest rates. However, this also means that the Commonwealth has greater exposure to rates declining, resulting in the cost of the Commonwealth's debt exceeding market rates.

2.21 The AOFM's rationale for conducting interest rate swaps is to adjust the modified duration of the domestic currency portfolio to keep it within a specified target range. In 1997, in an environment of falling interest rates, the benchmark for the modified duration of the portfolio was set at 3.25 years, with a lower and upper target range of 3.0 and 3.5 years respectively.[25] Figure 2.2 shows that the modified duration has been outside the target range (either above 3.5 or, for brief periods, below 3.0 years) more often than it has been within the target range over the seven years since this target was adopted.[26]

Figure 2.2

Modified duration of domestic currency portfolio 1997–98 to 2003–04



Source: ANAO analysis of AOFM data.

---

25 In December 2004, the AOFM estimated that the modified duration of the long-term debt portfolio that would arise from issuance alone (that is, without swaps) would be around 4.0 to 4.5 years.

26 Modified duration was maintained within the target range for only 42 per cent of the time over the period of 328 weeks from when the target was adopted to when it was replaced by a new target (see paragraph 2.31).

2.22 In March 2005, the AOFM advised the ANAO that in relation to those periods when the modified duration of the portfolio was outside the target range:

> The main factors driving this result were increased volatility of within-year Budget cash flows, due to changes in taxation and expenditure patterns, and the increased relative importance of these flows as Budget surpluses and asset sales reduced the size of the net debt portfolio. These factors were recognised as structural and as requiring substantial changes to the debt management framework, including the establishment of a new book structure and the introduction of a new benchmark. These steps took time. In the meantime, it was decided it would be inappropriate to seek to offset fully the short-term swings in duration using available long-term instruments such as interest rate swaps. Offsetting these swings would have required large volumes of swaps to have been executed and then unwound within short periods of time, which would have been potentially disruptive to markets and may not have proven cost effective.

Costs of departures from the modified duration target range

2.23 The ANAO's 1999 audit report found that, up to the time the report was tabled, only one performance assessment had been completed to quantify the costs of departures from the modified duration benchmark.[27] The ANAO recommended that:

> The Australian Office of Financial Management enhance accountability for its debt management performance by regularly assessing the cost and risk implications of departures from the portfolio benchmark targets and reporting key performance indicators in its Annual Report.[28]

2.24 The AOFM and Treasury accepted this recommendation. Furthermore, the AOFM advised the JCPAA that a framework for reporting against benchmark would be introduced in 2000–01.[29] However, in this current audit, the ANAO found that, more than five years after this matter was raised, the AOFM has still not quantified in its Annual Reports the costs of its departures from the modified duration target range.

2.25 The ANAO noted that an internal report to the AOFM Advisory Board in August 2002 indicated that the departures from the benchmark during 2001–02 cost about $175 million. However, no analyses for prior or subsequent years were located during the audit.

---

27 This was a consultant's performance assessment of portfolio management operations in 1997–98 relative to the benchmark. It concluded that the departures from the benchmark during that year added some $423.2 million to debt costs.

28 op.cit., Recommendation No.2, p.65.

29 AOFM Action Report to Joint Committee of Public Accounts and Audit, May 2000.

2.26 In February 2005, the AOFM advised the ANAO as follows:

> Initially, the AOFM prepared internal reports on the performance of the portfolio, including relative to the benchmark, but found that resulting information was of limited value because of the increasing volatility of the portfolio. A major driver of this increased volatility was the growing size of within-year cash management flows relative to the contracting size of the total portfolio. It was concluded that efforts should be directed first to dealing with the problems created by within-year financing swings, establishing a new book structure and reviewing the benchmark. New database, recording and analytical systems were also required. These were major tasks but they have been completed and have allowed improvements in the reporting of portfolio performance to be introduced.
>
> In the 2003–04 Annual Report, the AOFM reported on accrual cost outcomes for the net Commonwealth Government Securities debt portfolio, both as a whole and for the constituent sub-portfolios. These key performance indicators relate directly to our objective of managing the portfolio at least cost over the medium term. While relative performance measures are also relevant, the AOFM is ultimately responsible for the overall performance outcomes of its debt management activities. The AOFM is both a consultant (advising on the appropriate benchmark) and manager (meeting that benchmark). Consequently, absolute cost measures provide the most relevant key performance indicators.
>
> Within the benchmark reviews, now conducted annually, the expected long run costs of deviations from the benchmark are explicitly assessed, in an ex ante sense. Costing ex post deviations from benchmark on an accrual basis makes large demands on data systems which we have been working to meet and are now close to completing. Producing relative performance data in an accrual paradigm is more relevant to our cost reduction objective than in a mark-to-market paradigm. Indeed mark-to-market cost measurement is not the standard among sovereign debt managers, although it may be more relevant in other industries for market participants with relatively short horizons.
>
> In any case, in order to be able to measure performance against the benchmark, a new benchmark had to be developed, as did a methodology for removing the noise created by the significant within-year fluctuations in the net funding task.
>
> Overall, while further work is required to enable the reporting of relative cost outcomes, this is near completion. Furthermore, substantial areas covered by the 1999 recommendation, such as the reporting of the key performance indicators of absolute cost and ex-ante costing of deviations, have been implemented.

2.27 The ANAO understands that industry practice is to use a mark-to-market cost of funds measurement. A major advantage of this method is that it effectively removes the effects of all prior years' decisions from the current year's performance measurement. It also allows the cost of funds of the benchmark portfolio to be simulated and directly compared with the costs of funds achieved by the actual portfolio.

2.28 However, as indicated above and in its 2003–04 Annual Report, the AOFM considers that the inclusion of unrealised gains and losses when measuring debt service costs under this approach may result in greater year-by-year volatility in reported debt service costs.[30] In March 2005, the AOFM advised the ANAO that:

> As a sovereign debt manager, the AOFM is focused on longer-term results and does not take trading positions based on views on likely movements in interest rates. The debt it issues and the financial assets and derivatives it holds are intended to remain on issue, or be held, until maturity and there is little likelihood, in normal circumstances, that unrealised market value gains and losses will be realised.
>
> The AOFM gives priority to realised (accrual) debt service cost as the most relevant measure of cost. The AOFM also takes account of market value measures, which are particularly relevant when marked changes in the portfolio are in prospect. It has reported on the net fair value of the portfolio and its components since 1999–00, specifically identifying the net fair value of interest rate swaps since 2002–03 in the notes to the financial statements in its annual reports.

2.29 Nonetheless, the ANAO considers that, without the mark-to-market approach, performance measurement is constrained, because the reported performance of the portfolio would contain an inseparable mix of results arising from decisions made in the current year and previous years.[31]

---

30 See AOFM 2003–04 Annual Report, pp.24-25.

31 This is evident, for example, in the AOFM's explanation of the cost of funds during 2003–04, which highlights that the Treasury bonds outstanding at 30 June 2004 had been issued over the preceding 12 years and that half of these bonds had been issued in the five years up to February 1997, when interest rates were higher than current levels. (See AOFM 2003–04 Annual Report, p.31.)

2.30 The ANAO considers that the AOFM should report on the cost and risk implications of departures from the portfolio benchmark targets in its next Annual Report. If this is not possible, the AOFM should report on its progress towards implementing Recommendation No.2 of the 1999 audit. The AOFM should also report clearly on the extent to which actual conditions experienced in the year under review aligned with the key assumptions underpinning selection of the benchmark (the most important assumption is the estimated term premium).[32]

New benchmark

2.31 In recognition of the increasing difficulties in maintaining the modified duration target range, the AOFM recommended to the Treasurer in late June 2003 that a new benchmark be adopted. The Treasurer approved a new benchmark portfolio in September 2003.

2.32 The transition from the existing portfolio to the new benchmark is to be accomplished over two to three years. Unlike the previous benchmark, which was applicable to the entire Australian dollar debt portfolio, the new benchmark excludes the indexed debt component of the portfolio.[33] In splitting off the indexed debt, the AOFM calls the residual to which the new benchmark applies the 'nominal component of the Australian dollar long-term debt portfolio'.[34] In addition to modified duration, the benchmark now also measures the short-dated exposure of the portfolio.[35]

---

[32] A lower term premium estimate reduces the attractiveness of having a portfolio with a shorter duration than the one that arises from the AOFM's debt issuance pattern alone. The AOFM's 2003–04 interest rate swap activities achieved significantly less savings than those expected, as actual market conditions were less favourable than the long run assumptions adopted in the modelling conducted by the AOFM, which are based on an estimated term premium of 90 basis points. In October 2004, the AOFM estimated that the average term premium was 75 basis points (see AOFM 2003–04 Annual Report, p.25).

[33] Some $6.55 billion in Treasury Indexed Bonds were outstanding at 30 June 2004.

[34] There is no longer any benchmark applicable to the indexed debt component of the portfolio.

[35] Short-dated exposure is a measure of the proportion of the portfolio subject to immediate repricing. In a rising interest rate environment, a portfolio with higher short-dated exposure will generate increasing debt service costs sooner than a portfolio with lower short-dated exposure and the same modified duration. Source: AOFM Annual Report 2002-03, p.17.

2.33 The previous benchmark aimed for a modified duration of 3.25 years, whereas this has been shortened to 2.0 years under the new benchmark. In February 2005, the AOFM advised the ANAO as follows:

> The new benchmark's target of 2.0 on nominal debt corresponds to 2.9 under the old measure. When measured on a like for like basis, the reduction is much smaller than the raw figures suggest. [In addition,] the cost/risk simulations conducted in reviewing the benchmark take the current level of inflation-linked debt into consideration, so that the benchmark continues to be set taking account of the whole portfolio including inflation-linked debt.
>
> The AOFM expects the shorter duration to lower the cost of Commonwealth debt over time, without introducing unacceptable volatility in debt service costs at current low levels of debt.[36]

2.34 One benefit of a shorter duration portfolio is that interest costs would be less, should interest rates fall, than would be incurred with a longer duration portfolio. A disadvantage of a shorter duration portfolio is that interest costs would be higher than would be incurred with a longer duration portfolio, in the event that interest rates rose in the future.

2.35 In relation to paragraph 2.34, the AOFM commented in March 2004 that:

> As we see it, the savings generated from a portfolio with a shorter duration do not come from expectations about future interest rate movements, which the AOFM does not seek to predict, but from the lower cost of shorter duration debt due to the term premium.Market value of the swap portfolio

2.36 The 1999 audit found that, when the AOFM commenced operations on 1 July 1999, the market value of the swap portfolio was $1297 million 'out of the money'(see Glossary).[37] This meant that there was an unrealised loss on the swaps outstanding. In the current audit, the ANAO observed that the market value of the swaps portfolio continued to decline, reaching a low of $3708 million 'out of the money' on 27 October 2000. It then improved to break even in early 2003. The maximum market value for the portfolio peaked at $1241 million 'in the money' (see Glossary) on 13 June 2003 (see Figure 2.3).

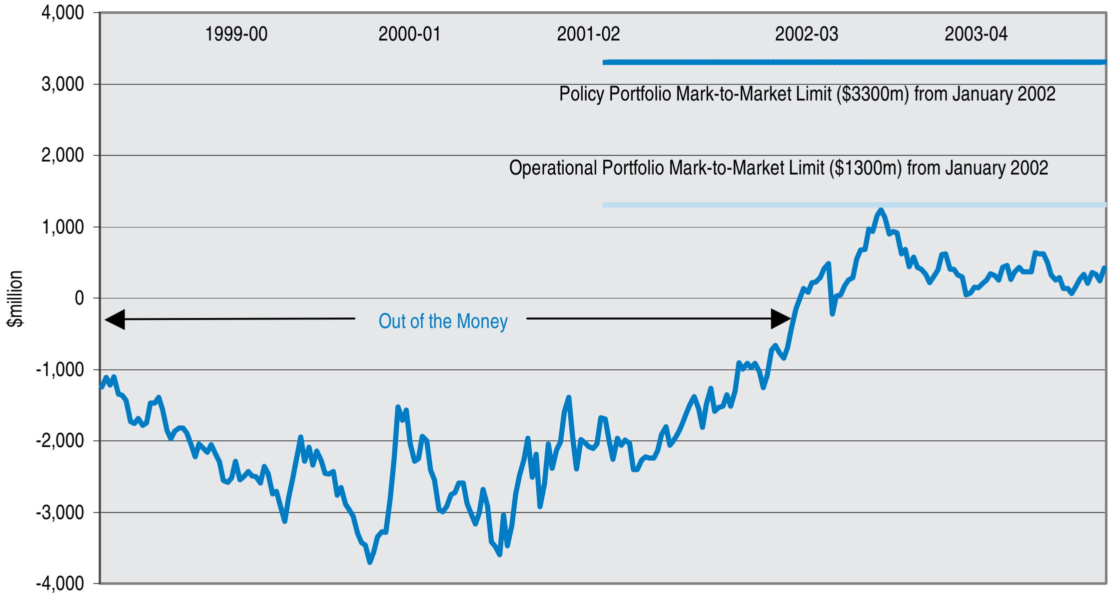
---

[36] See AOFM 2003–04 Annual Report, p.xv.

[37] op.cit., see paragraph 5.56, p.99.

Figure 2.3

Swap portfolio market value 1999–00 to 2003–04



Source: ANAO analysis of AOFM data.

2.37 In January 2002, the AOFM set policy and operational limits for the maximum market value of the portfolio. However, it has not established any boundaries regarding the extent that it remains comfortable when the swap portfolio goes significantly 'out of the money' (that is, the maximum level of unrealised losses that the AOFM deems to be an acceptable risk).

2.38 The ANAO's 1999 report recommended that the AOFM Advisory Board ensure that the Treasurer is consulted on matters of significance which may affect government decisions on financial exposures.[38] In this current audit, the ANAO observed that the Treasurer was consulted about significant matters and, in particular, was regularly briefed by the AOFM on progress following the decision to wind-up the cross currency swaps program. However, the ANAO considers that there is scope for improving advice to the Treasurer about the level of unrealised losses when the interest rate swaps portfolio is significantly 'out of the money'.[39]

---

38 op.cit., Recommendation No.6, part d, p.107.

39 To date, there has been no change in the AOFM's policy of allowing 'out of the money' swaps to run to maturity, irrespective of the potential losses or actual losses that may be incurred. This contrasts with its approach for adjusting profitable ('in the money') swaps. See 1999 audit report, op.cit., pp.105-6.

2.39 On this issue, the AOFM commented to the ANAO in February 2005, as follows:

> The focus on the market value of the interest rate swap portfolio in isolation seems to overlook the point that these instruments are used to achieve a desired overall portfolio profile. Swaps need to be used towards this end because the Government has committed to a nominal bond issuance pattern that supports the bond futures market rather than to meet ongoing funding needs. Without this decision, varying the issuance profile could in principle be used to achieve a desired benchmark portfolio profile.
>
> When the interest rate swap book falls in value, so too will the market value of physical debt, and the Government's net worth will rise. Currently the sensitivity of the market value (delta) of the interest rate swap portfolio is approximately -$10 million per basis point, while the delta of nominal physical debt is in the order of +$20 million. An increase in interest rates that causes a fall in the mark-to-market value of the interest rate swap portfolio will thus lead to an increase in net worth. It is therefore desirable to look at changes in the value of swaps in the context of the overall portfolio, and possible changes in the swap program need to be considered in terms of the repercussions they would have for the achievement of benchmark targets or breaches of operational and policy limits.
>
> Placing hard limits on the unrealised value of the interest rate swap portfolio in isolation would be dangerous, as remedial action taken under the pressure of such limits could move markets against the Government and possibly seriously destabilise them. We would not support the introduction of such limits.

Recommendation No.1

2.40 The ANAO recommends that the AOFM establish a reporting trigger to inform the Treasurer and Treasury Secretary when the swap portfolio has significant unrealised losses.

AOFM response

2.41 Agreed with qualification. The AOFM accepts that there would be advantage in expanding its reporting to stakeholders in this area. However, it considers that reporting should apply to the physical net debt portfolio as well as to swaps, since both generate interest rate risk exposures and should be considered together. It is considering whether reporting should be done on a regular basis or using a trigger.

Reporting of swap exposures

2.42 The ANAO's 1999 audit report recommended that the AOFM Advisory Board require the timely review and reporting of significant movements in the net exposures around the mid-point of the relevant benchmark ranges for cross currency and interest rate swaps.[40] In 2001, the AOFM advised the JCPAA that:

> The reporting of exposures around the mid-point of the relevant benchmark will be reflected as part of the broader exercise of enhancing portfolio performance reporting around benchmark. Limits will be established for departures from benchmark targets.[41]

2.43 The ANAO noted that, following the 1999 audit, the net exposures for the entire swaps portfolio (that is, the combined net results for interest rate and cross currency swaps) were regularly reported to the AOFM's Liabilities Management Committee and the AOFM Advisory Board. However, from June 2003, this practice ceased. Reports since then have indicated the current exposures against each counterparty's operational limits, but the overall level of net exposure for the portfolio has not been reported.[42] This was partially redressed in June 2004, when the AOFM formalised a policy of reporting net exposures to its Advisory Board at six monthly intervals.

2.44 In February 2005, the AOFM advised the ANAO as follows:

> The AOFM maintains extensive processes for regularly reviewing its key market risk exposure measures, namely modified duration and short-dated exposures, and reporting on them to the [Liabilities Management Committee] and Advisory Board and in its Annual Report. Daily reports are provided to the [Chief Executive Officer] and other office staff. The measures are compared with both the operational limits and the central benchmark targets. As such, the recommendation has been fully implemented.

---

40 op.cit., Recommendation No.6, part c.

41 The Treasurer, *Government Response to JCPAA Report 378*, 8 June 2001, p.6.

42 However, the aggregate market value of the swaps portfolio was included in an Advisory Board paper dated 17 December 2004 seeking approval of a revised Credit Policy.

3. Internal Controls

This chapter discusses selected aspects of the AOFM's control framework for managing the Commonwealth debt portfolio.

Introduction

3.1 In addition to market risk (discussed in Chapter 2), the Commonwealth is exposed to credit risks, legal risks and operational risks in undertaking its day-to-day debt management operations. The complexity of the AOFM's operations, coupled with the magnitude of its financial transactions,[43] further emphasises the importance of establishing and maintaining sufficient and effective internal controls to manage risks.

3.2 The 1999 audit made three recommendations relating to improving controls over the use of derivatives. These were directed at:

- the conduct of periodic internal audits and external reviews;
- management of legal risk in contractual documentation; and
- the swap tender process.

Conduct of swap tenders

3.3 An interest rate swap is a financial contract between two parties to exchange interest payments. The Commonwealth Procurement Guidelines (CPGs) encompass the whole process of acquiring property or services. The CPGs define property as referring to every type of right, interest or thing that is legally capable of being owned.[44] This includes, but is not restricted to, physical goods and real property, as well as intangibles such as intellectual property, contract options and goodwill.[45]

3.4 Swaps have played an increasingly important role in the AOFM's debt portfolio management activities over the last five years. The ANAO found that the proportion of the net debt portfolio that is swapped grew from about 20 per cent as at 30 June 1999 to over 80 per cent as at 30 June 2004. This trend is anticipated to continue, at least in the short-term, as the AOFM expects to

---

43 For example, the AOFM's appropriation draw downs totalled more than $166 billion during 2003–04.

44 Department of Finance and Administration, *Commonwealth Procurement Guidelines—January 2005*, Financial Management Guidance No.1, paragraph 2.2.

45 ibid.

conduct about $6 billion in interest rate swaps during 2004–05,[46] bringing the total notional principal value of swaps outstanding to some $38 billion by 30 June 2005.

3.5 The largest single interest rate swap conducted by the AOFM had a notional principal value of $1 billion. Most of the AOFM's swaps have principal values in the hundreds of millions of dollars.

3.6 When it wishes to conduct an interest rate swap,[47] the AOFM procedure is to invite three counterparties to tender.[48] The tenderers are selected on a rotational basis from the AOFM's list of eligible and approved institutions with which it has entered an International Swap and Derivatives Association (ISDA) Master Agreement.[49]

3.7 Under its Swap Counterparty Credit Policy, the AOFM may only undertake swap transactions with counterparties that satisfy a minimum credit rating, with counterparty credit limits assigned for those parties that meet the minimum standard. The counterparty credit limits are scaled according to the counterparty's credit rating: the more highly rated the counterparty, the larger is the credit limit. The Approved Counterparty Listing was not developed as the result of either an open or a select tender, but has evolved over a long period of time.

3.8 In January 2005, the CPGs were revised as a result of changes in the Government's procurement policy. The revision included new mandatory procedures for certain procurement processes. Among other things, these mandatory procedures provide for procurement actions that are consistent with the Australian Government's international agreements, particularly the recently completed Australia—United States Free Trade Agreement.

3.9 The intended dominant impact of the revised CPGs is that it will increase the number and scope of procurement activities offered to the full market.[50] To this end, the revised CPGs include mandatory procurement procedures that require the conduct of open tendering (or select tendering in certain circumstances) for procurements, other than for construction services,

---

46 As the AOFM continues to work towards a modified duration of two years for the domestic currency portfolio.

47 Cross currency swaps are no longer conducted by the AOFM.

48 Swap activity was suspended from 12 December 2001 to 9 October 2003. This procedure applies to swaps conducted since the resumption of the AOFM's swap activity in October 2003.

49 As at 30 June 2004, there were 13 counterparties on the AOFM's Approved Counterparty Listing that were eligible to tender for interest rate swap transactions with the AOFM.

50 The Hon. Dr Sharman Stone MP, Parliamentary Secretary to the Minister for Finance and Administration, *$200 billion US procurement market open to Australian suppliers from January 1, 2005*, Media Release 04/2004, 31 December 2004.

by agencies subject to the *Financial Management and Accountability Act 1997* (FMA Act), where the estimated value of the property or services being procured is above the threshold of $80 000.[51]

3.10 There are some exceptions to the mandatory procurement procedures. For the AOFM, this includes:

> Acquisition of fiscal agency or depository services, liquidation and management services for regulated financial institutions, and sale and distribution services for Government debt.[52]

3.11 In February 2005, the ANAO and the AOFM consulted with the Department of Finance and Administration (Finance) to clarify the extent to which the AOFM's interest rate swap activities are governed by the revised CPGs.

3.12 In March 2005, Finance advised the ANAO that it considers that interest rate swap activities are a 'procurement' as defined in the CPGs, and as such are governed by the CPGs. However, for the purposes of the CPGs, Finance considers that the AOFM's swap activities fall within the intended scope of 'sale and distribution services of Government debt' (Exemption 10 of Annex B of the CPGs) and are therefore exempted from the mandatory procurement procedures set out in Division 2 of the CPGs.

Recording of swap tenders conducted by telephone

3.13 In its 1999 audit report, the ANAO recommended that the AOFM enhance the swap tender process by electronically recording swap tenders.[53] In December 2000, the AOFM installed a telephone recording system.[54] However, until suggested by the ANAO during the current audit, this system was not regularly tested. The ANAO also suggested that the AOFM's procedures for accessing these telephone recordings should explicitly recognise the role of internal/external audit,[55] and that the system clock be adjusted for the start/end of daylight saving.

---

51 Department of Finance and Administration, op.cit., p.26.

52 ibid, p.46.

53 op.cit., Recommendation No.5, p.94.

54 However, the first swap tender to be electronically recorded was conducted on 21 February 2001.

55 The AOFM's procedures state that: 'the replay of a taped conversation can only occur with the knowledge and consent of the AOFM officer(s) who were a party to the conversation.' In practice, this imposes an unnecessary constraint, for example, when the officer is no longer employed by the AOFM.

3.14 In March 2005, the AOFM advised the ANAO that the procedures for accessing telephone recordings of swap tenders will be reviewed to ensure they meet likely needs, including those of internal and external audit.

The one billion dollar swap

3.15 The first swap conducted by the AOFM (as opposed to earlier swaps conducted by Treasury) was an interest rate swap for $1 billion conducted on 26 July 1999. This was by far the largest swap conducted by the AOFM. It was also the sole two-year swap conducted by the AOFM until October 2004 and the only swap conducted in 1999–00 that lost money.

3.16 The counterparties invited to tender for the swaps were each asked to indicate whether they were prepared to deal for an amount greater than $100 million. The unsuccessful counterparties offered swaps of $150 million and $200 million. However, the ANAO considers that, if the Commonwealth wished to conduct a $1 billion swap, it may have been more equitable to make this clear to all parties at the outset.

3.17 This swap also raises the question of whether there should be an upper limit on the delegated power from the Treasurer for various AOFM staff to enter swaps on behalf of the Commonwealth. At present, there is no limit on the notional principal value that can be exchanged in a single swap, while ever the annual program approved by the Treasurer is not exceeded.

3.18 In February 2005, the AOFM advised the ANAO as follows:

> Before returning to the interest rate swap market in late 2003, internal controls were reviewed to provide for the CEO [Chief Executive Officer] to approve a schedule of swaps to be undertaken consistent with the annual remit approved by the Treasurer. The schedule specifies the size and timing of swaps, with flexibility to be ahead or behind the schedule at any point in time limited to $200 million in the case of long-dated swaps and $400 million in the case of short-dated swaps. These controls are reinforced by the daily reporting to the CEO of any swap transactions undertaken.
>
> These controls effectively limit the size of individual transactions undertaken.

Operational error in swap 478

3.19 The AOFM conducted a tender for interest rate swaps 477 and 478 on 23 October 2003. Swap 477 invited bids from three counterparties for a nine year $100 million swap in which the Commonwealth would receive a fixed interest rate and pay floating rates. Swap 478 invited bids for a two year $200 million swap in which the Commonwealth would pay floating interest rates and receive a fixed interest rate. Due to a transcription error by the AOFM in recording the telephone bids from one of the counterparties, Swap 478 was transacted on terms that were less favourable to the Commonwealth than would have been received had the best bid been accepted.[56] This error was not detected until after the swap was dealt. The ANAO estimated that this error cost the Commonwealth some $52 000.[57]

3.20 The AOFM's procedures have been revised to prevent a recurrence of errors of this nature. In addition, a report on the circumstances surrounding this error was prepared for the AOFM's senior management.

3.21 The unsuccessful tenderer that should have won the swap was advised that it did not win because the combination of bids from another counterparty for both swaps was more competitive. The AOFM decided that both the counterparty that should have won the swap, and the counterparty that was incorrectly awarded the swap, should not be advised of the error. It also appears that the error was not reported at the time to the AOFM Advisory Board, the Treasury Secretary, or the AOFM's internal auditors.

3.22 In arriving at its decision not to inform the counterparties, the AOFM recognised that not acknowledging the error ran counter to the Commonwealth's intention of being transparent with all counterparties as to the result of the interest rate swap process. The AOFM considered that this was outweighed by the risk that acknowledging the error may damage confidence in the Commonwealth's tender process, either with the affected counterparty or the financial markets more generally.

---

[56] ANAO notes that the AOFM advised the JCPAA that: '… the number of officers involved in the execution of swaps and the confirmation process prior to acceptance of the best bid provide a high level of assurance that the best bids are accepted.' Source: JCPAA Report 378, op.cit., p.29.

[57] The bid was 5.53 per cent, but was transcribed as 5.553 per cent, a 2.3 basis point error. The incorrectly selected bid was 5.543 per cent, being 1.3 basis points higher than the lowest bid. ANAO therefore calculated the additional payments required as $200 million at 0.00013 per cent for a period of two years.

3.23 In February 2005, the AOFM advised the ANAO as follows:

> We accept that an error occurred and that the advice given to the unsuccessful tenderer was incomplete. However, the procedures for conduct of swap tenders have been changed to ensure that such errors will not occur in future; these new procedures are working effectively. The officer in charge of the swap transaction acted promptly and properly to alert senior management to the error as soon as he discovered it. Although the transaction was in error, there was no scope to change it as the deal had been committed: under the AFMA Codes, transactions entered into in error still need to be honoured, unless there has been a clear misquote, which was not the case on this occasion.

Swap margins to market rates

3.24 An indication of the efficiency of a swap transaction is the margin to the 10.00am AFMA mid-market rate on the day the swap was conducted.[58] Since July 2001, the AOFM has measured the efficiency of its swaps executed by reference to the AFMA mid-market rate after adjustment for the movements in the interest rate futures market between the 10.00am fix by AFMA and the actual time the swap was conducted by the AOFM.[59]

3.25 To maintain the debt portfolio within the benchmark target ranges, the AOFM conducts both long-dated and short-dated swaps. The average margin for the 54 long-dated receive swaps conducted by the AOFM between 1 July 2001 and 30 June 2004 was negative 0.6 basis points.[60] Margins averaged negative 0.7 basis points during 2000–01 and, for individual swaps, these margins ranged more widely than during 2003–04, when they averaged negative 0.5 basis points. For six of the swaps conducted over this period, the AOFM achieved a higher than market rate in its swap tender (a good result). The worst margin was negative 2.25 basis points for a swap conducted in August 2001[61] (see Figure 3.1).

---

58 The mid-market rate is the middle of the bid and offer rates at 10.00am for an equivalent swap transaction, as published by AFMA.

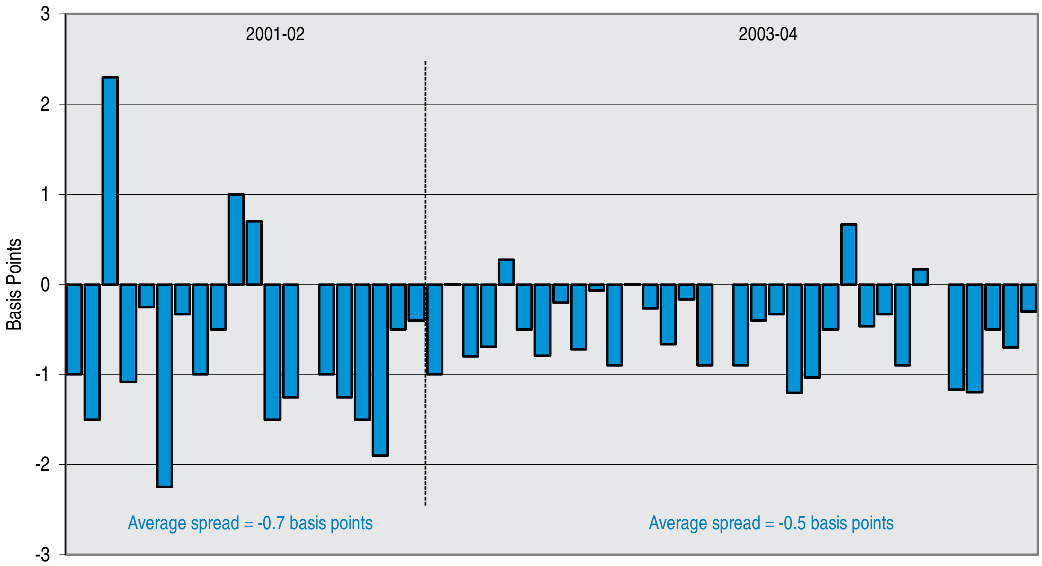
59 Before this, the AOFM collected data on the margin to the Bank Bill Swap Rate.

60 This means that, on average, the AOFM would have received $3.22 million more in interest over the life of these swaps if the swaps had been conducted at the then market rates.

61 This means that the AOFM would have received $225 000 more in interest revenue on this ten-year $100 million swap if it had been conducted at the then market rate.

Figure 3.1

Interest rate long-dated receive swaps—margin to adjusted AFMA mid-market rates



Source: ANAO analysis of AOFM data.

Note: Interest rate swap margins not available for swaps conducted before 1 July 2001.

Swap activity was suspended from 12 December 2001 to 9 October 2003.

These long-dated swaps were for periods ranging from four years to 11 years.

Receive swaps means that the AOFM receives fixed interest and pays floating interest for the life of the swap.

3.26 The average margin for the 19 short-dated pay swaps conducted by the AOFM between 10 October 2003 and 30 June 2004 was 0.8 basis points.[62] In two of these swaps, the AOFM achieved a lower than market rate in its swap tender (a good result). The worst margin was two basis points above market rates[63] (see Figure 3.2). In conducting its swaps, the AOFM has the option of not proceeding with the transaction if the best bid received exceeds the margin to the adjusted AFMA mid-market rate by more than a specified number of basis points.[64]

---

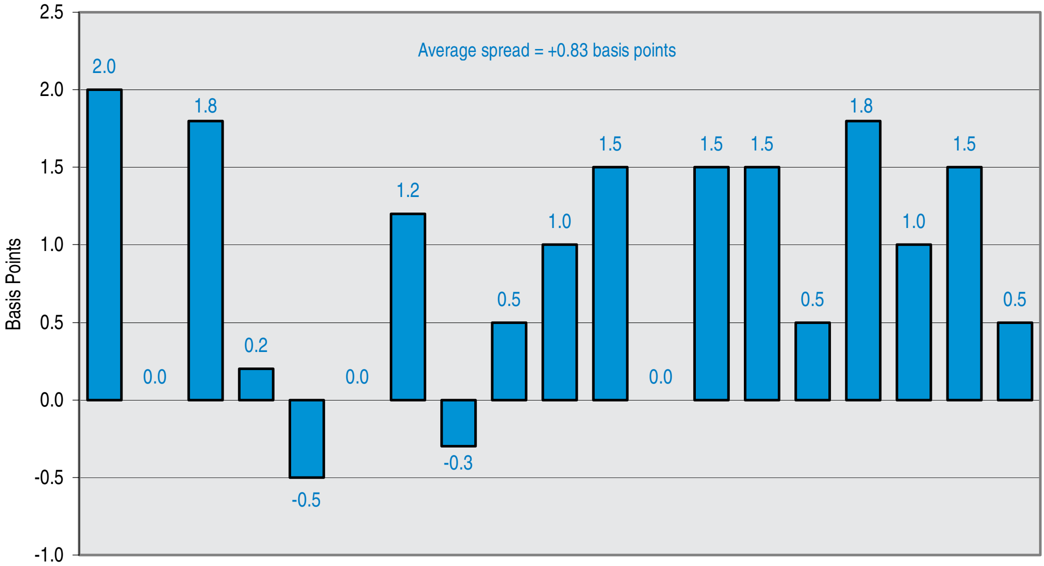
62 This means that, on average, the AOFM paid $528 000 more in interest over the life of these swaps than if the swaps had been conducted at the then market rates.

63 This was the first swap conducted when swap activity resumed in October 2003.

64 The ANAO noted that, at the time of the audit fieldwork, this had occurred in only one swap tender in the period since the AOFM resumed its swap program in October 2003. This was the tender for an 11-year swap conducted on 8 October 2004.

Figure 3.2

Interest rate short-dated pay swaps – margin to adjusted AFMA mid-market rates



Source: ANAO analysis of AOFM data.

Note: These short-dated swaps were for a period of two years and were conducted during 2003–04.

Pay swaps means that the AOFM pays fixed interest and receives floating interest for the life of the swap.

3.27 In March 2005, the AOFM commented that, in relation to the swap margins achieved, it considers that the data indicate that the rates obtained have been favourable for the Commonwealth, taking account of the size of the transactions involved, which are larger than average in the market.

3.28 The ANAO noted that the AOFM reported on the average margin for its interest rate swaps in its 2001–02 Annual Report.[65] However, its previous and subsequent Annual Reports have not contained this information.

Recommendation No.2

3.29 The ANAO recommends that, to improve transparency and accountability, the AOFM report more comprehensively and consistently on the efficiency of its swap dealings in future Annual Reports.

[65] AOFM 2001-02 Annual Report, p.20.

AOFM response

3.30 Agreed. The AOFM is considering how, in practical terms, reporting on the efficiency of swap transactions might best be developed.

Delays in finalisation of swap confirmations

3.31 In the 1999 audit, the ANAO found that about one-third of the 87 swaps sampled were confirmed by the relevant counterparty one week or longer after the trade date.[66]

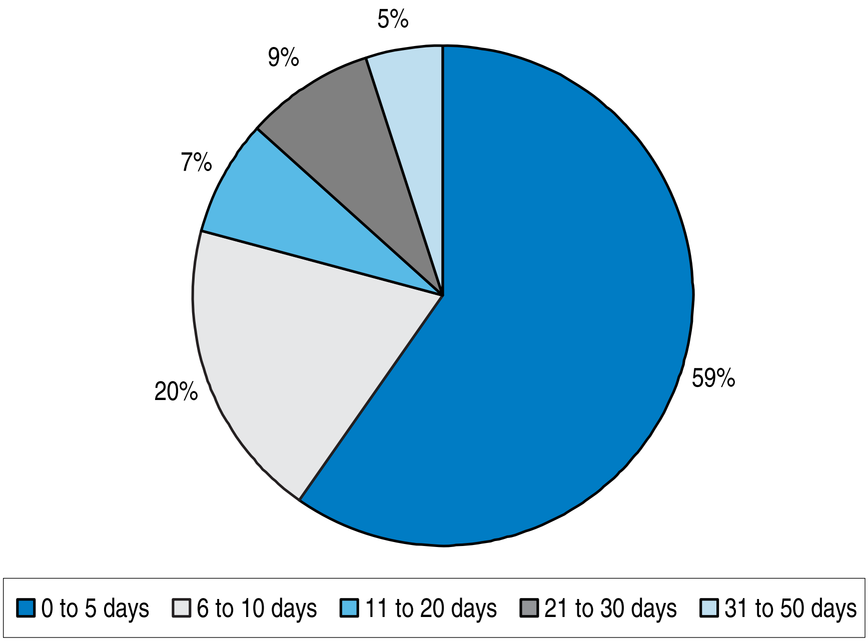
3.32 In February 2005, the AOFM advised the ANAO that it requires a much stricter standard of confirmation compliance than any of its counterparties (which include a number of major international banks). It stated that confirmations that are not received immediately or that contain discrepancies are subject to immediate follow up via compliance, trading staff and management. It noted that many delays arise in the resolution of discrepancies, which inevitably takes some time. The AOFM further advised that the Chief Operating Officer is informed on a weekly basis and all outstanding confirmations are reported to the regular Liabilities Management Committee meetings, where follow-up action is discussed and prioritised.

3.33 In the current audit, the ANAO's examination of the 82 swaps conducted by the AOFM from 8 October 2003 to 23 September 2004 revealed that there has been no noticeable reduction in confirmation delays. Some 29 of the 82 swaps (35 per cent) were confirmed one week or longer after the trade date (see Figure 3.3). One confirmation was received 50 days after the trade date. This data suggests that, to satisfactorily address this issue, the AOFM may need to revise its approach to facilitate obtaining more timely confirmations.

[66] op.cit., Paragraph 5.39, p.93.

Figure 3.3

Days to receive counterparty confirmations – Oct 2003 to Oct 2004



Source: ANAO analysis of AOFM data.

3.34 The ANAO's examination of relevant swap files revealed that there was no evidence of follow-up by the AOFM of outstanding swap confirmations.[67] The ANAO suggests that the AOFM's efforts, if any, to pursue the receipt of outstanding confirmations from counterparties be adequately documented. Amendment to the AOFM's Swap Confirmation Procedures in this regard is also suggested.

3.35 In February 2005, the AOFM advised the ANAO that a central record of action taken is now maintained. In March 2005, it also advised that:

> While confirmations are being finalised, the Commonwealth has the protection that the terms of the transaction concerned are set out in the AOFM's email notifying the tender and in the telephone recording of the tender.

3.36 The ANAO's 1999 audit report also recommended that the AOFM formally check swap confirmations against lists of authorised signatories supported by resolutions of the counterparty.[68] The AOFM accepted this

---

[67] However, details of outstanding swap confirmations are regularly reported to the Liabilities Management Committee.

[68] op.cit., Paragraphs 5.41-43, pp.93-94.

recommendation and amended its swap confirmation procedures accordingly. The ANAO noted, however, that some counterparties have recently implemented the practice of faxing unsigned confirmations to the AOFM. In such cases, the AOFM attaches a pro forma to the relevant swap file indicating that no signature verification was possible, rather than requesting signatures.[69]

3.37 The ANAO also noted that, where signed confirmations are received, these are verified against photocopies of the authorised signatories lists kept in a folder that is accessible to all AOFM staff. The ANAO suggests that the checks be conducted by reference to the original specimen signatures. Alternatively, access to the photocopied lists should be restricted.

3.38 The ANAO acknowledges that, in addition to the above detailed confirmations, the AOFM introduced a regime of seeking quarterly confirmations aimed at ensuring 'the completeness and accuracy of trades executed with each counterparty.' This commenced with the confirmation of all unexpired swaps as at 31 December 2003.

3.39 In March 2005, the AOFM advised the ANAO that:

> The use of computer generated confirmations without signature is becoming more prevalent and may become standard market practice. In the meantime, the AOFM has applied measures to further restrict access to signature lists.

Master agreements

3.40 Legal risk arises when contracts are not legally enforceable or documented correctly. Legal risks associated with derivatives are typically managed through the use of Master Agreements, which establish standard terms and conditions applicable to derivative transactions between two parties.

3.41 The ANAO's 1999 audit report found that some Master Agreements were then quite dated, including those for counterparties with which Treasury had significant exposures.[70] It also recommended that the AOFM identify opportunities to increase the number of Master Agreements that are subject to Australian governing law.[71]

3.42 During the current audit, the ANAO found that the AOFM had updated all Master Agreements (except one)[72] to the ISDA 1992 version[73] and

---

69 Unsigned confirmations are included in the analysis presented in Figure 3.3.

70 op.cit., p.17.

71 ibid, p.23.

72 The AOFM advised the ANAO in February 2005 that this is an inactive counterparty, which is closing down its Australian operations and to which the AOFM has very minor exposure.

had successfully negotiated to increase the number of contractual relationships that are subject to Australian law. A requirement for Australian governing law is the AOFM's preferred position in negotiating Master Agreements. However, the counterparties are unable to negotiate on the question of jurisdiction in those remaining Master Agreements that are not governed by Australian law.

3.43 In 2002, the ISDA published a revised version of its Master Agreement, which offers several new beneficial provisions compared to the 1992 agreement. An AOFM internal Minute dated 31 May 2004 listed these as:

- a single measure of damages provision;
- introduction of a new 'close-out amount' payment measure, in place of market quotation and loss; and
- amendments to several of the Events of Default and Termination Events, including:
  - a new Termination Event for consolidations and mergers;
  - a Force Majeure Event, aimed at covering events such as natural or man-made disasters, riots, acts of terrorism and other unanticipated events that prevent the performance of a party's obligations;
  - a set-off provision to allow netting of payments between parties;
  - consolidated interest and compensation provisions; and
  - amended jurisdiction provisions.

3.44 At the time of the audit fieldwork, the AOFM had not sought to adopt this new version for its swap dealings with its counterparties, as the AOFM considers there is mutual satisfaction with the contents of the existing Master Agreements.[74]

---

[73] The ISDA Master Agreement was originally published in 1987 and a revised version was published in 1992 to accommodate its adoption in markets other than New York and London.

[74] However, an AOFM internal Minute dated 30 March 2004 stated that:

> Although considered good corporate practice to implement the most up-to-date legal documentation, continuing to apply the 1992 Agreement and associated definitions does not reduce the AOFM's future ability to enforce legal obligations over derivative contracts. However, the AOFM may not be applying best market practice by not applying the new form of agreement.

3.45 In February 2005, the AOFM advised the ANAO that version upgrades would be made over time, as and when documents might need amendment or upon requests from counterparties. The AOFM considers that this is consistent with the approach adopted by many of its counterparties which stated to the AOFM that they will update to the 2002 agreement when new documentation or amendments are required but are not planning to update all their existing 1992 agreements in the short term.

Credit risk

3.46 The Commonwealth assumes credit risk when it enters into a swap agreement: that is, the risk of the counterparty defaulting on its financial obligations under the swap agreement. As interest and exchange rates move over time, the market value of the swap agreement will also change. Where the market value of the swap has increased from the Commonwealth's perspective, any default by the counterparty would result in the Commonwealth suffering a financial detriment through the opportunity cost of being unable to exercise the swap and realise the gain[75] it has made from hedging its market price exposure. It is therefore important that this risk be appropriately managed to realise the benefits of market activities.[76]

3.47 The number and market value of swaps for each of the 20 counterparties with which the AOFM had outstanding interest rate swaps as at 30 June 2004 is shown in Figure 3.4. The AOFM had market exposure to all but two counterparties as at that date.

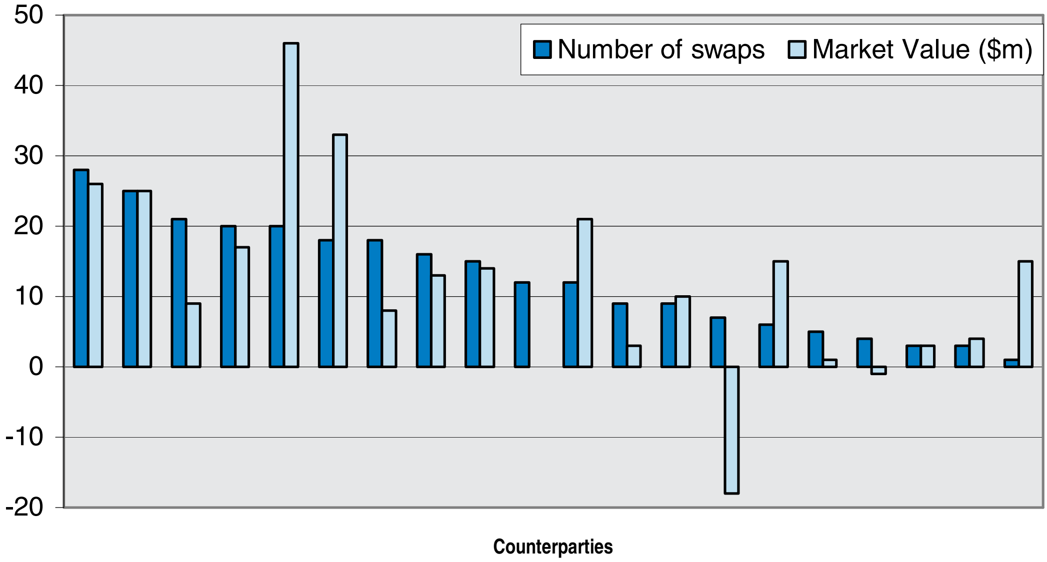
---

[75] That is, the AOFM is not exposed for the full face value of the swap contracts. Instead, the amount at risk is restricted to the potential cost of replacing the cash flow on contracts showing a positive value.

[76] There is counterparty risk even when the swap has a negative market value because of the possibility of future price movements leading to a positive market value.

Figure 3.4

Number and value of swaps outstanding at 30 June 2004, by counterparty



Source: ANAO analysis of AOFM data.

3.48 The ANAO found that the number and proportion of outstanding swaps with highly rated counterparties has declined over the three years to 30 June 2004 (see Table 3.1). As at 30 June 2002, some 56 per cent of swaps outstanding were with counterparties holding the top three credit ratings (AAA, AA+ or AA), whereas this had more than halved to around 24 per cent by 30 June 2004. Over this period, the AOFM has also significantly increased the credit limits applicable to each rating. However, the ANAO noted that collaterisation arrangements were being developed by the AOFM at the time of the audit fieldwork, which would assist in managing the increased risk.[77]

---

[77] The planned arrangements involve the holding by the AOFM of cash paid by a counterparty as security when the market value of outstanding swaps moves in the AOFM's favour above a pre-defined threshold level and minimum transfer amount.

Table 3.1

Number of outstanding swaps by counterparty credit rating as at 30 June

	AAA		AA+		AA		AA-		A+		A		A-	
Year	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%
2002	27	9	31	10	109	37	118	40	-	4	-	-	12	4
2003	26	10	27	10	43	16	131	49	31	12	9	3	-	-
2004	18	7	20	8	22	9	161	64	24	10	7	3	-	-

Source: ANAO analysis of AOFM data.

Note: These are Standard and Poor's ratings. Equivalent Moody's ratings are Aaa, Aa1, Aa2, Aa3, A1, A2 and A3 respectively. The AOFM uses the lower rating when counterparties are not equivalently rated by both ratings agencies.

3.49 In March 2005, the AOFM commented that the decline in the number and proportion of outstanding swaps with highly rated counterparties is not unique to the AOFM but a trend in the market more generally.

Legal enforceability

3.50 The ANAO's 1999 audit report recommended also that the AOFM obtain greater assurance about the power, capacity and due authorisation of counterparties to enter into swap transactions.[78] The report suggested that consideration be given, on a risk management basis, to obtaining independent legal advice in relation to those counterparties that the AOFM regularly transacts with and/or counterparties with which the AOFM has significant credit exposures.

3.51 In June 2001, the AOFM advised the JCPAA that:

> It is now standard procedure to seek documented assurance concerning the power, capacity and due authorisation of counterparties to enter into swap transactions.[79]

3.52 However, the ANAO found no references to this in AOFM's procedural documentation. Further, the ANAO found that, although the AOFM considered and accepted the ANAO recommendation, there had been no instances since the previous audit in which the AOFM determined that obtaining such independent legal advice was warranted, based on its assessment of the costs and risks involved.

---

[78] op.cit., pp.90-91.

[79] The Treasurer, Government Response to JCPAA Report 378, 8 June 2001, p.4.

3.53 In February 2005, the AOFM advised the ANAO as follows:

> It remains our standard practice to comprehensively assess the power and authority for counterparties to enter into and sign the ISDA master agreements and accompanying schedules. Details may vary depending on the exact nature of the entity involved, but the process normally takes the form of sighting the relevant power of attorney. Independent legal advice would be sought if it were considered that any doubt existed as to the capacity of a counterparty to undertake the agreement. For the agreements signed over the last few years, the legal capacity of the counterparties has been straightforward and easily confirmed.

AOFM internal audits and external reviews

3.54 The ANAO's 1999 audit report noted that no internal audits or independent reviews of the controls associated with Treasury's use of financial derivatives had been conducted. This was the case notwithstanding that, as early as 1995, Treasury had recognised the need to conduct random audits.[80] Given the significant risks that are involved in derivative transactions, the ANAO recommended in 1999 that the AOFM undertake periodic reviews of the application and effectiveness of the control framework for its use of these instruments.[81]

3.55 The AOFM accepted this recommendation and established an Audit Committee in May 2000. However, its internal auditor (contracted provider) was not appointed until January 2002. Internal audits of the controls over derivative transactions were subsequently completed in January 2003 and January 2004, as part of the internal audit reviews of general controls.

AOFM policies and procedures

3.56 The ANAO's 1999 audit report recommended that the AOFM enhance existing documentation of its risk management policies and procedures in a comprehensive procedures manual.[82]

3.57 In the current audit, the ANAO found that the AOFM had made a concerted effort, especially during 2004, to document and/or update its

---

80 See 1999 Audit Report, op.cit., paragraph 5.61, p.102.

81 op.cit., Recommendation No.3, p.86.

82 op.cit., Recommendation No.6, p.107. The lack of a comprehensive, consolidated policies and procedures manual was first raised in a September 1997 consultancy report commissioned by the Treasury (see 1999 Audit Report, p.85).

policies and operational procedures.[83] At the time of the audit fieldwork there were numerous procedures to be completed. However, as at early January 2005, one procedure identified as being required under this project was still to be documented. This related to the Quantum Server Installation. The procedure was originally scheduled for completion by mid-June 2004, then re-scheduled for completion by end-February 2005.

3.58 In February 2005, the AOFM advised that the process of procedure documentation is ongoing, with procedural refinements expected over coming years to reflect process improvements, new products and initiatives.

Canberra ACT	Ian McPhee
19 April 2005	Auditor-General

[83] The AOFM 2003–04 Annual Report at page 34 stated that 'the task of fully documenting business critical processes was substantially completed' and 'work began on the development of a formal operational risk framework, including an operational risk charter and a more detailed and systematic approach to operational risk management.'

Appendices

Appendix 1: AOFM Status Report to JCPAA on progress with implementing ANAO recommendations as at end April 2000

	1999 audit report recommendation	AOFM Action Report
1.	Consistent with its increasing focus on risk management and having regard to the changed economic circumstances since its original analysis and the planned reduction in Commonwealth net debt, the AOFM:	
	(a) as part of its ongoing portfolio management activities, continue to evaluate the data and assumptions underlying the target of seeking United States dollar exposures in the debt portfolio;	Benchmark assumptions relating to long-term US dollar exposure were reviewed in November 1999. Further reviews (and their nature) will depend upon the general benchmark review currently underway.
	(b) re-examine the benchmark portfolio targets as part of its next portfolio management consultancy; and	All benchmark targets are currently being reviewed.
	(c) obtain formal Ministerial endorsement of the portfolio benchmark targets.	The AOFM will seek the Treasurer's approval of the benchmark targets following the internal review.
2.	AOFM enhance accountability for its debt management performance by regularly assessing the cost and risk implications of departures from the portfolio benchmark targets and reporting key performance indicators in its Annual Report.	Framework for reporting against benchmark is being developed for introduction in 2000–01. Work on systems design is to commence once benchmark targets are finalised.
3.	Given the significant risks involved in derivative transactions, the AOFM undertake periodic internal audits and commission external reviews of the application and effectiveness of the control framework for its use of financial derivatives and take appropriate action if necessary.	The nature and timing of the recommended audits and reviews is to be considered by the AOFM Audit Committee.
4.	AOFM improve its management of legal risk associated with derivative transactions by:	
	(a) prioritising the periodic update of Master Agreements with its major counterparties through amendment agreements or negotiating new Master Agreements;	Counterparties have been advised that an updated Master Agreement is a pre requisite for new business post 30 June 2000.
	(b) identifying opportunities to increase the number of Master Agreements that are subject to Australian governing law; and	A requirement for Australian governing law is the AOFM's opening stance in negotiation.
	(c) obtaining greater assurance concerning the power, capacity and due authorisation of counterparties to enter into swap transactions.	Assurances are now sought as part of standard procedures.

1999 audit report recommendation			AOFM Action Report
5.	AOFM enhance the swap tender process by:		
	(a)	electronically recording swap tenders in order to assist resolution of any disagreements with counterparties over swap terms and/or assist enforcement of any undocumented trades;	The AOFM is scheduled to move into new accommodation in January 2001 and at that time will install equipment which electronically records swap tenders. In the interim the best telephone bid is confirmed by two AOFM officers and all bidders are required to confirm telephone bids by facsimile.
	(b)	prioritising its follow-up of outstanding counterparty confirmations according to the age of the transaction, the amount of time before a payment is due, and whether the transaction involves a credit exposure for the Commonwealth; and	Implemented.
	(c)	as part of its swap confirmation process, formally checking swap confirmations against lists of authorised signatories supported by resolutions of the counterparty.	Checks are undertaken against signatory lists. Active counterparties have been requested to advise lists and changes thereto.
6.	Having regard to the significant unanticipated financial losses that can occur due to market risk involving derivatives, the Board of the AOFM:		
	(a)	enhance existing documentation of the AOFM's risk management policies and procedures in a comprehensive procedures manual;	Existing documentation on AOFM risk management policy is to be revisited once the internal review of the benchmark is completed.
	(b)	ensure that internal controls are periodically independently reviewed;	This is to be addressed by the AOFM Audit Committee.
	(c)	consistent with the objective of seeking long-term cost savings subject to acceptable short-term cost volatility, require the timely review and reporting of significant movements in the net exposures around the mid-point of the relevant benchmark ranges for cross-currency and interest rate swaps; and	This will be incorporated as part of the reporting of performance against benchmark. There will be limits established for the exposure associated with departures from the benchmark targets.
	(d)	ensure that the Treasurer is consulted on matters of significance which may affect Government decisions on financial exposures.	The Treasurer's approval of the benchmark targets will be sought. More generally, significant financial exposures beyond approved limits would be reported to the Treasurer through the Governing Board.

Source: AOFM Submission No.3 to JCPAA Review of Auditor-General's Reports – Second Quarter 1999–00, 31 May 2000.

Appendix 2: AOFM's response to the audit[84]

The Report indicates that the ANAO considers that most of the recommendations in the 1999 performance audit have been implemented, or satisfactory progress made. The Report quotes comments by the AOFM on various points and the AOFM broadly accepts the two new recommendations in the Report. However, there are some issues on which we have further comments.

Portfolio Management

Performance of Derivative Programs

In depicting the performance of the cross-currency derivatives and interest rate swap programs, Table 2.1 of the Report (page 24) shows only direct benefits and excludes the financing costs and savings resulting from the cash flows under these programs. These financing effects are important:

- The cross currency swap program provided positive cash inflows into the Government's bank accounts aggregating to around $2071 million by 1997–98. If there had been no cross currency swap program, Government net debt would have been higher by $2071 million by this time with an attendant higher public debt interest costs. Subsequent cash outflows only partially unwound this financing effect, producing a significant overall reduction in Government net debt.
- The ANAO has recognised similar financing effects in performance audits of other Commonwealth programs such as cash management and the sale of Sydney airports *(Cash Management in Commonwealth Government Departments*, ANAO Audit Report No. 10, 1994–95 page 34 and *The Sale of Sydney (Kingsford Smith) Airport*, ANAO Audit Report No. 43, 2002–03 page 15.)[85]

[84] To the extent considered appropriate, the AOFM's comments have also been included in the body of the report.

[85] ANAO Comment: With regard to this reference, the ANAO considers that the two Audit Reports mentioned do not support this view, as the first report discussed savings from faster receipting and delayed due dates for Commonwealth receipts and payments, whereas the second report discussed how the proceeds from the airport sale were applied both to finance maturing debt and invested in deposits with the RBA.

Domestic currency portfolio interest rate exposure

Paragraph 2.21 of the Report and Figure 2.2 indicate that there were periods in the six years to September 2003 when the modified duration of the portfolio was outside the target range. The main factors driving this result were increased volatility of within-year Budget cash flows, due to changes in taxation and expenditure patterns, and the increased relative importance of these flows as Budget surpluses and asset sales reduced the size of the net debt portfolio. These factors were recognised as structural and as requiring substantial changes to the debt management framework, including the establishment of a new book structure and the introduction of a new benchmark. These steps took time. In the meantime, it was decided it would be inappropriate to seek to offset fully the short-term swings in duration using available long-term instruments such as interest rate swaps. Offsetting these swings would have required large volumes of swaps to have been executed and then unwound within short periods of time, which would have been potentially disruptive to markets and may not have proven cost effective.

Appropriate cost measure

The Report advocates the use of a mark-to-market measure of costs on the grounds that it:

(a) effectively removes the effects of all prior years' decisions from the current year's performance measurement; and

(b) allows the cost of funds of the benchmark portfolio to be simulated and directly compared with the costs of funds achieved by the actual portfolio (paragraph 2.27).

The first point [(a) above] may be relevant for organisations that are focused on short term trading outcomes. As a sovereign debt manager, the AOFM is focused on longer-term results and does not take trading positions based on views on likely movements in interest rates. The debt it issues and the financial assets and derivatives it holds are intended to remain on issue, or be held, until maturity and there is little likelihood, in normal circumstances, that unrealised market value gains and losses will be realised. In these circumstances, the inclusion of unrealised market value gains and losses would add a misleading level of volatility to debt service cost measurement. Accordingly, the AOFM gives priority to realised (accrual) debt service cost as the most relevant measure of cost. The AOFM also takes account of market value measures, which are particularly relevant when marked changes in the portfolio are in prospect. It has reported on the net fair value of the portfolio and its components since 1999–00, specifically identifying the net fair value of interest rate swaps since 2002–03 in the notes to the financial statements in its annual reports.

The second point [(b) above] applies also to other measures of cost, including realised accrual cost, and is not unique to mark-to-market measures.

Market value of the swap portfolio

The Report asserts that the AOFM has set limits for the maximum market value of the swaps portfolio but not for unrealised losses (paragraph 2.37). The existing limits are credit limits under the AOFM's credit policy. Credit exposures arise only when swaps are in the money to the Commonwealth; there is therefore no corresponding minimum limit under this policy. The credit limits <u>indirectly</u> limit the overall market value of swaps, but the relation is not exact and may cease to apply in future with the introduction of collateral.

The Report recommends that the AOFM establish a reporting trigger to inform the Treasurer and Treasury Secretary when the swap portfolio has significant unrealised losses (paragraph 2.40). The AOFM accepts that there would be advantage in expanding its reporting to stakeholders in this area. However, it considers that reporting should apply to the physical net debt portfolio as well as to swaps, since both generate interest rate risk exposures and should be considered together. It is considering whether reporting should be done on a regular basis or using a trigger.

Internal Controls

Conduct of swap tenders

The Report refers to changes made in January 2005 to the Commonwealth Procurement Guidelines, issued by the Department of Finance and Administration, which were designed to increase the extent to which procurement activities are open to the full market (paragraph 3.8). The AOFM understands that the Procurement Guidelines do not apply to swap tenders. However, it considers that existing arrangements for tenders provide ample opportunity for financial institutions that meet the minimum credit standards and are prepared to enter the required contractual arrangements to be accepted as eligible counterparties.

The procedures for accessing telephone recordings of swap tenders will be reviewed to ensure they meet likely needs, including those of internal and external audit (paragraph 3.13).

Efficiency of swap dealings

The Report includes information on margins between the rates at which swaps have been dealt and mid-market rates as reported by AFMA (paragraphs 3.24-3.26 and Figures 3.1 and 3.2). The AOFM considers that the data indicate that the rates obtained have been favourable for the Commonwealth, taking account of the size of the transactions involved, which are larger than average in the market. The Report recommends that the AOFM report more comprehensively and consistently on the efficiency of its swap dealings in future Annual Reports (paragraph 3.29). The AOFM accepts this recommendation and is considering how, in practical terms, such reporting might best be developed.

Swap confirmations

The Report refers to the AOFM's experience with delays in swap confirmations (paragraph 3.31). It is important in this regard to distinguish between the receipt of confirmations and their finalisation. Confirmations are almost always received from counterparties within one working day; delays in their finalisation occur when discrepancies are identified that need to be resolved. Such discrepancies are generally of a relatively minor character. Confirmations that are not received immediately or that contain discrepancies are subject to immediate follow up and are closely monitored. A central record of follow up action is now maintained.

While confirmations are being finalised, the Commonwealth has the protection that the terms of the transaction concerned are set out in the AOFM's email notifying the tender and in the telephone recording of the tender.

The Report considers that further progress is required in reducing the time taken to finalise confirmations. The AOFM will take any opportunities it reasonably can in this regard but considers its existing practice to be much stricter than applied by its counterparties. It believes that the system of quarterly confirmations it has introduced (paragraph 3.38) will provide improved protection in relation to confirmation authenticity and accuracy on an ongoing basis.

The use of computer generated confirmations without signature (paragraph 3.36) is becoming more prevalent and may become standard market practice. In the meantime, the AOFM has applied measures to further restrict access to signature lists (paragraph 3.37).

Credit risk

The Report notes a decline in the proportion of its swaps that are undertaken with highly rated counterparties (paragraph 3.48). This experience is not unique to the AOFM but a trend in the market more generally.

Index

T

U

Series Titles

Audit Report No.41 Protective Security Audit
Administration of Security Incidents, including the Conduct of Security Investigations

Audit Report No.40 Performance Audit
The Edge Project

Audit Report No.39 Performance Audit
The Australian Taxation Office's Administration of the Superannuation Contributions Surcharge

Audit Report No.38 Performance Audit
Payments of Good and Services Tax to the States and Territories

Audit Report No.37 Business Support Process Audit
Management of Business Support Service Contracts

Audit Report No.36 Performance Audit
Centrelink's Value Creation Program

Audit Report No.35 Performance Audit
Centrelink's Review and Appeals System

Audit Report No.34 Performance Audit
Centrelink's Complaints Handling System

Audit Report No.33 Performance Audit
Centrelink's Customer Satisfaction Surveys

Audit Report No.32 Performance Audit
Centrelink's Customer Charter and Community Consultation Program

Audit Report No.31 Performance Audit
Centrelink's Customer Feedback Systems—Summary Report

Audit Report No.30 Performance Audit
Regulation of Commonwealth Radiation and Nuclear Activities
Australian Radiation Protection and Nuclear Safety Agency

Audit Report No.29 Performance Audit
The Armidale Class Patrol Boat Project: Project Management
Department of Defence

Audit Report No.28 Performance Audit
Protecting Australians and Staff Overseas
Department of Foreign Affairs and Trade
Australian Trade Commission

Audit Report No.27 Performance Audit
Management of the Conversion to Digital Broadcasting
Australian Broadcasting Corporation
Special Broadcasting Service Corporation

Audit Report No.26 Performance Audit
Measuring the Efficiency and Effectiveness of E-Government

Audit Report No.25 Performance Audit
Army Capability Assurance Processes
Department of Defence

Audit Report No.24 Performance Audit
Integrity of Medicare Enrolment Data
Health Insurance Commission

Audit Report No.23 Performance Audit
Audit Activity Report: July to December 2004
Summary of Results

Audit Report No.22 Performance Audit
Investment of Public Funds

Audit Report No.21 Financial Statement Audit
Audits of the Financial Statements of Australian Government Entities for the Period Ended 30 June 2004

Audit Report No.20 Performance Audit
The Australian Taxation Office's Management of the Energy Grants (Credits) Scheme

Audit Report No.19 Performance Audit
Taxpayers' Charter
Australian Taxation Office

Audit Report No.18 Performance Audit
Regulation of Non-prescription Medicinal Products
Department of Health and Ageing
Therapeutic Goods Administration

Audit Report No.17 Performance Audit
The Administration of the National Action Plan for Salinity and Water Quality
Department of Agriculture, Fisheries and Forestry
Department of the Environment and Heritage

Audit Report No.16 Performance Audit
Container Examination Facilities
Australian Customs Service

Audit Report No.15 Performance Audit
Financial Management of Special Appropriations

Audit Report No.14 Performance Audit
Management and Promotion of Citizenship Services
Department of Immigration and Multicultural and Indigenous Affairs

Audit Report No.13 Business Support Process Audit
Superannuation Payments for Independent Contractors working for the Australian Government

Audit Report No.12 Performance Audit
Research Project Management Follow-up audit
Commonwealth Scientific and Industrial Research Organisation (CSIRO)

Audit Report No.11 Performance Audit
Commonwealth Entities' Foreign Exchange Risk Management
Department of Finance and Administration

Audit Report No.10 Business Support Process Audit
The Senate Order for Departmental and Agency Contracts (Calendar Year 2003 Compliance)

Audit Report No.9 Performance Audit
Assistance Provided to Personnel Leaving the ADF
Department of Defence
Department of Veterans' Affairs

Audit Report No.8 Performance Audit
Management of Bilateral Relations with Selected Countries
Department of Foreign Affairs and Trade

Audit Report No.7 Performance Audit
Administration of Taxation Rulings Follow-up Audit
Australian Taxation Office

Audit Report No.6 Performance Audit
Performance Management in the Australian Public Service

Audit Report No.5 Performance Audit
Management of the Standard Defence Supply System Upgrade
Department of Defence

Audit Report No.4 Performance Audit
Management of Customer Debt
Centrelink

Audit Report No.3 Business Support Process Audit
Management of Internal Audit in Commonwealth Organisations

Audit Report No.2 Performance Audit
Onshore Compliance—Visa Overstayers and Non-citizens Working Illegally
Department of Immigration and Multicultural and Indigenous Affairs

Audit Report No.1 Performance Audit
Sale and Leaseback of the Australian Defence College Weston Creek
Department of Defence

Better Practice Guides

Public Sector Audit Committees	Feb 2005
Fraud Control in Australian Government Agencies	Aug 2004
Security and Control Update for SAP R/3	June 2004
AMODEL Illustrative Financial Statements 2004	May 2004
Better Practice in Annual Performance Reporting	Apr 2004
Management of Scientific Research and Development Projects in Commonwealth Agencies	Dec 2003
Public Sector Governance	July 2003
Goods and Services Tax (GST) Administration	May 2003
Managing Parliamentary Workflow	Apr 2003
Building Capability—A framework for managing learning and development in the APS	Apr 2003
Internal Budgeting	Feb 2003
Administration of Grants	May 2002
Performance Information in Portfolio Budget Statements	May 2002
Life-Cycle Costing	Dec 2001
Some Better Practice Principles for Developing Policy Advice	Nov 2001
Rehabilitation: Managing Return to Work	June 2001
Internet Delivery Decisions	Apr 2001
Planning for the Workforce of the Future	Mar 2001
Contract Management	Feb 2001
Business Continuity Management	Jan 2000
Building a Better Financial Management Framework	Nov 1999
Building Better Financial Management Support	Nov 1999
Managing APS Staff Reductions (in Audit Report No.49 1998–99)	June 1999
Commonwealth Agency Energy Management	June 1999

Cash Management	Mar 1999
Security and Control for SAP R/3	Oct 1998
Selecting Suppliers: Managing the Risk	Oct 1998
New Directions in Internal Audit	July 1998
Controlling Performance and Outcomes	Dec 1997
Management of Accounts Receivable	Dec 1997
Protective Security Principles (in Audit Report No.21 1997–98)	Dec 1997
Public Sector Travel	Dec 1997
Audit Committees	July 1997
Management of Corporate Sponsorship	Apr 1997
Telephone Call Centres Handbook	Dec 1996
Paying Accounts	Nov 1996
Asset Management Handbook	June 1996