Commonwealth Government's 1997-98 Budget Financing Program and Debt Management Strategy

The following is a speech to the Australian Financial Markets Association by Mr Tony Hinton, First Assistant Secretary, Investment and Debt Division, Treasury, in Sydney on 6 August 1997.

INTRODUCTION

It is a pleasure to be with you once more this evening to discuss the Commonwealth's debt management strategy and budget funding program. Treasury has been addressing AFMA on this topic for a number of years now and we very much value the opportunity that this gathering provides. Over the years, we have found this to be a particularly useful forum for communicating our thinking and explaining our actions to key market participants. We also find this event particularly useful for receiving your feedback and comments.

I would like to begin my presentation tonight by discussing one or two of the key risk management considerations that are integral to the broad strategic framework within which the debt management strategy and issue program are formulated. Following on from that, I will provide you with some greater detail than was possible at Budget time about the make-up of the planned debt issue program for 1997-98 and set out projections as to the Commonwealth's net borrowing requirement and stock of Commonwealth Government Securities on issue over coming years. I will conclude my presentation this evening with a few words on the current state of play with the Consultants' Review of Institutional and Resourcing Arrangements for Commonwealth Debt Management, an exercise with which many of you will be familiar.

COMMONWEALTH DEBT MANAGEMENT FRAMEWORK

In common with most entities with significant financial exposures in their balance sheet, the Commonwealth has been moving increasingly in recent years to conduct its debt management within a risk management framework. As managers of a debt portfolio in excess of $100 billion, charged explicitly with the task of minimising the cost of that portfolio over time, it is essential that we approach the management task cognisant of the full range of relevant risks to longer-term cost performance. It follows that we need to have the capacity to measure, monitor and manage those risks on a comprehensive basis.

As this style of financial risk management framework is one that will be familiar to many of you, I don't propose to cover the component risks in all their detail. However, I would like to address two of the key risks that impact most directly on the Commonwealth's portfolio management and debt funding activities, namely funding risk and market risk.

A couple of definitions to start with. From our perspective, funding risk is broadly the risk to a borrower's capacity to raise funds in an orderly manner, without penalty, when required. Market risk (sometimes referred to as portfolio risk) is the risk to the value of the debt portfolio from changes in financial prices.

Funding Risk

The Commonwealth's broad objective with respect to managing funding risk is to maintain on-going market access on continuing favourable terms, such that we can be confident of raising funds in a cost-effective manner whenever required. In managing its funding risk, the Commonwealth places a high priority on maintaining the liquidity and efficiency of the market for Commonwealth Government Securities (CGS).

Consistent with this, for a number of years now in our Treasury Bond programs we have concentrated issuance into a relatively small number of highly liquid benchmark lines. We have also sought to maintain the liquid curve out to 12 to 13 years, partially with an eye to maintaining a steady profile of stocks through the 10 year bond futures contract. We consider the maintenance of liquidity in key benchmark lines as absolutely integral to the continuing efficient management of the Commonwealth's funding risk.

The Government's program of ongoing fiscal consolidation is, of course, a highly desirable one from a whole variety of perspectives. Fiscal consolidation does, however, pose certain challenges to the Commonwealth's capacity to achieve the objective of efficient management of the Commonwealth's funding risk. With smaller debt issue programs, there is less scope to maintain liquidity in key Treasury Bond lines and less scope to maintain the length of the Commonwealth yield curve.

To underpin our capacity to better manage the Commonwealth's funding risk and to maintain liquidity across the curve, it was announced in the Budget that, as was the case in 1996-97, it was proposed to gross-up the aggregate new debt issue program in 1997-98 through the early retirement of select lines of Treasury Bonds. Of course, as any early redemptions would be financed by the issue of new stock, any such transactions would have no effect on the Commonwealth's net call on the market, nor on the stock of Commonwealth debt outstanding.

For the present, the intention is that any early repurchases would be undertaken from the Reserve Bank's portfolio of CGS and would be limited to stocks with no more than 12 to 18 months till maturity. Any such transactions between the Commonwealth and the Bank, would of course, be priced at prevailing market rates.

Looking further forward, it is possible that the option of conducting reverse tenders direct in the market for stocks further out on the curve might need to be considered, although the need for, and timing of, any such move is quite uncertain at this stage. Moreover, given that the primary objective of any such exercise would be to enhance the Commonwealth's capacity to build and enhance the liquidity of its key benchmarks, reverse tender stocks would need to be selected carefully. Stocks from those years where there are currently two benchmark lines on issue would be an obvious point to start such an exercise.

Another conclusion that can be drawn from this risk management focus on maintaining the liquidity of the Commonwealth curve is that the Bond issuance program for 1997-98 is likely to be weighted towards those parts of the curve where benchmarks tend currently to be least liquid. I will elaborate on that aspect in the debt issue program part of my presentation.

Market Risk

Managing market risk requires a portfolio approach. As I have outlined to this gathering in the past, the Commonwealth's approach to the management of market risk has focussed for a number of years now on the establishment of a carefully defined benchmark to serve as a target for the debt portfolio.

The benchmark portfolio is defined in terms of domestic currency and US dollar shares (around 10-15 per cent of the portfolio in the latter case), with precise duration objectives specified within each currency sector. In the domestic sector of the portfolio, the duration target is around 3¼ years.

The benchmark, which is the outcome of considerable research and modelling undertaken with the assistance of the Union Bank of Switzerland's Quantitative Finance Group in London over the past couple of years, reflects a portfolio composition that, ex ante, can be expected to minimise the cost of Commonwealth debt over the long-term, subject to an acceptable degree of volatility in annual debt service costs.

Although I think the point is well understood already, I nevertheless re-iterate that, in our portfolio management operations, we do not attempt to outperform this benchmark by taking short-term interest and exchange rate views. Such action could readily be viewed as signalling an 'official family' view on the direction of interest and exchange rates. Obviously, this would be inappropriate and unacceptable.

Rather than some kind of 'line in the sand' that we might seek to outperform through taking views, the benchmark is a target that we seek to achieve in relation to the actual composition of the portfolio. Of course, in practice, to keep the actual portfolio closely aligned with the target, we do need to take actions to deliberately manage its composition. But again, our portfolio management operations are designed purely to keep the portfolio in line with the fixed benchmark, not an attempt to add value by trying to outperform it.

For the past several years, normal debt issue and debt redemption activities have been the primary vehicle for maintaining the domestic component of the debt portfolio in line with the benchmark duration target. The size of aggregate borrowing programs has been such that through primary issuance we have had the capacity to meet both funding risk and portfolio management objectives. That is, to both maintain liquidity across the curve and to position the domestic portfolio in line with benchmark targets. This is no longer the case.

In view of the relatively small primary issuance programs this year and in prospect over coming years, and the targeting of this issuance to meet funding risk management objectives, the scope to manage the domestic component of the portfolio in line with the benchmark target through normal debt issue and debt redemption activities will be considerably reduced.

Indeed, on current indications for 1997-98 and without some other action being taken, it would not be possible to both maintain liquidity across the curve *and* achieve domestic portfolio duration objectives in line with the benchmark target. It is a classic instance of too few instruments chasing too many objectives.

Domestic Interest Rate Swaps

To provide the additional flexibility required to assist us in achieving both funding risk and market risk management objectives in 1997-98, it is proposed to utilise domestic interest rate swaps to maintain domestic portfolio duration in line with the benchmark target. As emphasised already, any domestic interest rate swaps undertaken by the Commonwealth will be executed solely for portfolio management purposes, to maintain domestic portfolio duration in line with the benchmark.

Any such transactions should not be read in any way, shape or form as signalling a Treasury view on the direction of interest rates. We will, of course, have in place a rigorous and prudent system for managing the counterparty credit risk exposures inherent in the swaps program — just as we have for our foreign currency swaps programs that have been operating for quite some years. I will comment on the proposed domestic interest rate swaps program for 1997-98 later in my presentation.

1997-98 DEBT ISSUE PROGRAM

Much of what I have covered so far sets the framework within which the 1997-98 borrowing program has been cast. I now turn to the borrowing program itself, which was briefly outlined in May in Statement 6 of Budget Paper No 1. An aggregate debt issue program of around $6½ billion to $7½ billion was indicated for 1997-98.

At this stage, no revisions have been made to the 1997-98 Budget figuring. However, the preliminary Budget outcome for 1996-97 is now available and details are attached to the copies of my presentation that will be distributed. As you know, the budget outcome for 1996-97 was somewhat better than expected. Several factors contributed to this outcome. However, the net result was a run-up in Commonwealth cash balances of approximately $3 billion at the end of 1996-97. This will, no doubt, have caused some of you to ponder possible implications for the 1997-98 borrowing program.

There are a number of options currently before us for dealing with that run-up in year-end cash balances. And, as noted earlier, in determining the size and make-up of the gross borrowing program, we take a variety of considerations into account, including the imperatives of managing the Commonwealth's funding risk. At this stage, we have no plans to amend the aggregate debt issue program announced in May. As indicated in the Budget, the 1997-98 debt issue program is expected to comprise the following elements:

- Treasury Fixed Coupon Bond issuance of around $5 billion to $6 billion;
- Treasury Indexed Bond issuance of around $500 million to $1 billion;
- Treasury Adjustable Rate Bond issuance of around $1 billion;
- on an end-year basis, no net change in the stock of Treasury Notes on issue.

I will now provide some detail on each of these program elements.

TREASURY FIXED COUPON BONDS

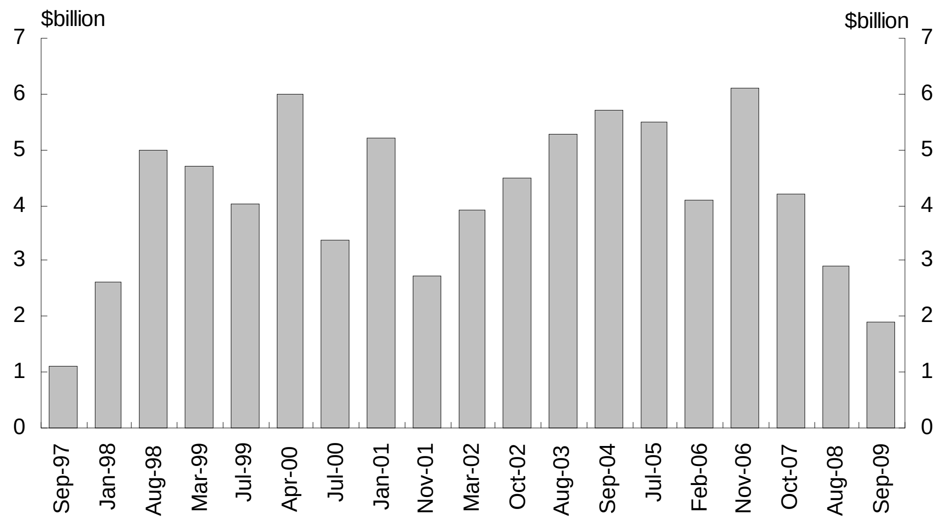
As noted, Treasury Fixed Coupon Bond issuance in 1997-98 is expected to be of the order of $5 billion to $6 billion. In planning the broad composition of the Bond program for 1997-98, we have put particular weight on the importance of building and maintaining liquidity in key benchmark lines and of maintaining an efficient and liquid curve out to the present 12-13 years.

Consistent with that, at this stage it is expected that Treasury Bond issuance in 1997-98 will be weighted towards stocks at the long end of the curve. We plan, at this stage, to introduce a new 2010 benchmark line to maintain the length of the yield curve and to ensure, in the longer term, that a smooth progression of stocks is available to move into the 10 year futures contract. With an eye to possible future borrowing programs implied by current forward estimates period projections, introducing a 2010 line this year should also allow time for the liquidity of the stock to be built up, prior to it becoming the 10 year benchmark in due course.

- We also recognise that liquidity in existing long-end Treasury Bond lines (specifically the October 2007, August 2008 and September 2009) needs to be built up further prior to the introduction of any new stock. Therefore, the proposed new 2010 line is not expected to be introduced until the second half of the financial year.
- At this stage, we would regard further issuance in 1997-98 into the November 2006 line as unlikely.

Chart 1 shows the face value currently on issue for each of the Commonwealth's benchmark Bonds.

Chart 1: Benchmark Bonds on Issue as at 6 August 1997



After consulting widely in the market, we have decided to stay with the practice of conducting tenders for Treasury Bonds at approximately four to six week intervals. Given the expected 1997-98 aggregate program, this means that the average tender size will be around $500 million to $600 million, somewhat smaller than the average in recent years. The consensus seems to be that smaller sized tenders, held on a more frequent basis, will better cater for the liquidity needs of the market than larger, more infrequent tenders.

Also, in recent years, the general practice has been to offer two or more stocks in each tender. In circumstances of a reduced issuance program, it is possible that, in future, some tenders may only have one stock on offer, particularly where we are looking quickly to build liquidity into particular lines.

TREASURY INDEXED BONDS

The indexed bond market has continued to develop apace over the past twelve months. Last financial year saw the successful launch of a new 2020 capital indexed bond line via a $250 million tender. We have also seen very healthy bidding interest in indexed bond tenders over the past twelve months. This allowed the average size of indexed tenders to be increased in 1996-97, compared with the average tender size of recent years.

For the past couple of years, issuance of indexed bonds has been deliberately targeted to meet identified market demand, in the interests of broad market development objectives. This approach has been successful in contributing to a growing confidence in the sector from intermediaries and investors alike.

Our market soundings indicate that, with the further development of the market, some change to the present issuance arrangements is now warranted. In particular, feedback from market participants suggests that greater certainty as to the timing of TIBs tenders would now be beneficial in terms of the further development of the indexed bond market.

Having carefully weighed the pros and cons of amending the present issuance arrangements, we have decided to move to an approach of conducting TIBs tenders on a regular six to eight week cycle. The volume and stock offered in each tender will depend on market demand and feedback. We are confident that this further commitment by the Commonwealth to the indexed market will be matched by continuing support for the sector from intermediaries and investors alike.

A TIBs issue program of around $500 million to $1 billion is envisaged for 1997-98. In 1996-97 priority was given to building up the liquidity of the new 2020 line. In 1997-98 issuance will initially continue to be targeted towards this line. However, we also plan to continue to issue the 2015 line as demand and circumstances permit. More than one stock could be offered in future tenders (eg, both the 2015 and 2020 lines could be offered in the same tender) depending on demand and market feedback. At this stage, we anticipate that the first tender of the 1997-98 TIBs issue program will be conducted prior to the end of this month.

TREASURY ADJUSTABLE RATE BONDS

As noted earlier, TABs issuance of around $1 billion is envisaged for 1997-98. As you would appreciate, we shall be carefully assessing the impact on the TABs market of the recent changes to PAR requirements before coming to any firm views on the precise make-up of the 1997-98 program. Accordingly, the first TABs tender for 1997-98 is not expected to be held until the December quarter.

Subject to market demand, we will be looking to the possibility of launching a new TABs line during the year, given that the original March 1998 line matures this financial year and with the existing October 2000 line now having shortened to close to three years and with some $4.3 billion already on issue. At this stage, our thinking is that any new TABs line would probably have a maturity of around five years. However, we will looking to market input prior to making any final decision.

TREASURY NOTES

In 1997-98, as in the past, Treasury Notes will be issued primarily to fund within-year mismatches in expenditure and receipts. The volume of Treasury Notes currently on issue is around $12½ billion, compared with $13.3 billion as at end-June 1997. Note outstandings are expected to peak at around $18 billion later this calendar year and then, on current Budget figuring, fall back to around $13 billion by end-June 1998.

DERIVATIVES PROGRAM

Foreign Currency Swaps

The benchmark analysis continues to indicate a valuable cost and risk reducing role for a small, core holding of $US in the portfolio. The Commonwealth routinely monitors and assesses a range of options to acquire this exposure. For a number of years now, a strategy of obtaining desired new foreign currency exposure through a combination of domestic issue and foreign currency swaps has offered cost advantages over various offshore issuance options, though this will not necessarily hold true in all circumstances. Of course, potential savings from any direct offshore issue that did occur would need to be set against domestic market liquidity considerations.

Maintenance of the Commonwealth's portfolio at the benchmark target in 1997-98 will require the acquisition of new $US exposure of the equivalent of around $A3 billion, after allowance for scheduled maturities. At this stage, the intention is that this exposure will be acquired via the standard domestic issue and foreign currency swap approach employed in recent years.

Domestic Interest Rate Swaps

It is difficult to be too precise at this stage as to the likely size of the program of domestic interest rate swaps to be undertaken by the Commonwealth in 1997-98. This is because, as I indicated earlier, we will be using domestic swaps on a needs basis, to maintain the actual portfolio in line with the benchmark duration target. Though actual portfolio duration at the start of the new financial year is broadly in line with the benchmark target, the size, composition and timing of the domestic issue program, movements in market rates and time decay itself will all bear on portfolio duration through the course of the year and, hence, on the need to undertake domestic interest rate swap transactions for portfolio management purposes.

As the Bond issue program in 1997-98 is likely to be weighted towards longer-dated stocks, at this stage it would seem sensible to anticipate a reasonably sizeable program of domestic interest rate swaps through the course of the year. For the purposes of a very broad indication, I note that a program perhaps in the order of $2 billion to $3 billion might be anticipated.

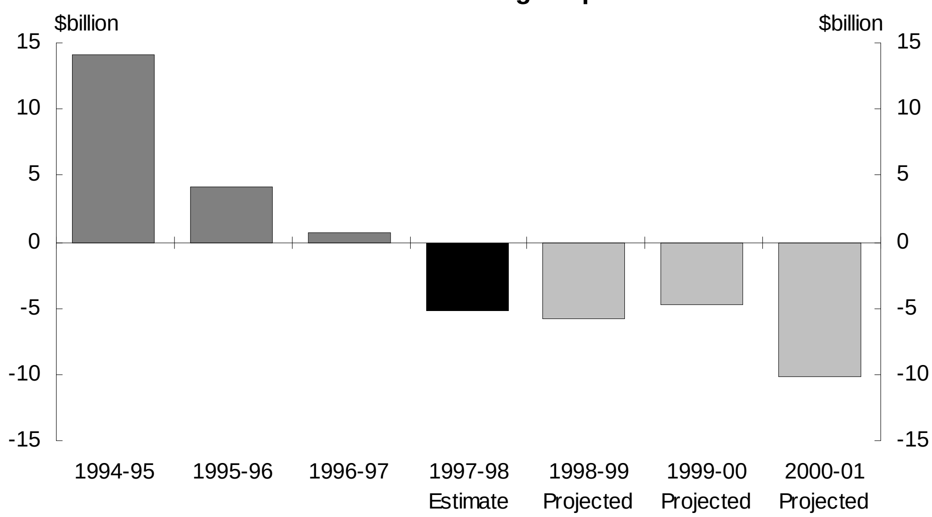
NET BORROWING REQUIREMENT FOR 1997-98 AND THE OUT-YEARS

The Government's program of fiscal consolidation generates the particular benefit of the Commonwealth repaying a significant amount of debt in net terms over the next few years. The Commonwealth's net borrowing requirement for 1997-98 was estimated in the Budget to be negative $5.2 billion. That is, the value of Commonwealth debt repayments was projected to be $5.2 billion greater than the value of new debt issued. This reflected:

- an estimated headline budget surplus of $6.4 billion, offset in part by
- an estimated $1.2 billion in payments associated with Commonwealth public trading enterprise superannuation.

Consistent with the Budget-time figuring, Chart 2 depicts the net borrowing requirement out to 2000-01, as well as actual net borrowings for the three years to 1996-97.

Chart 2: Net Borrowing Requirement

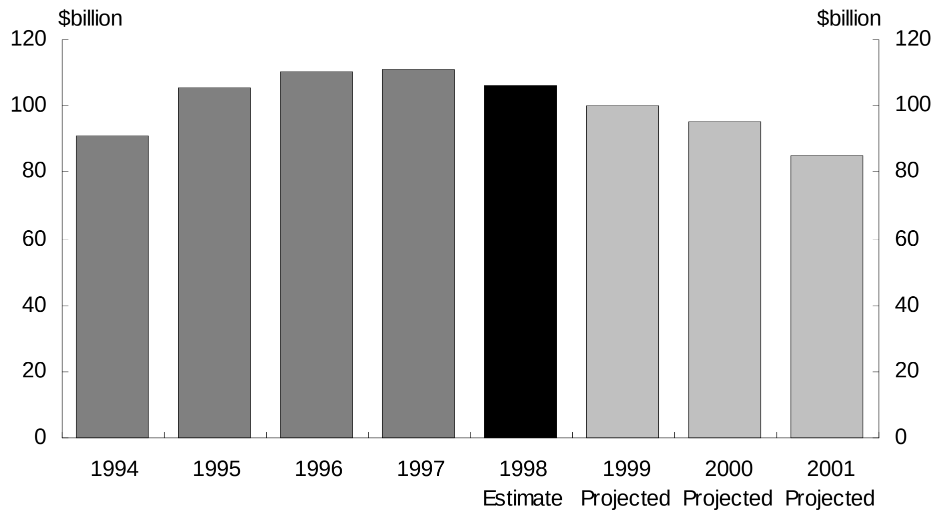


- The net borrowing requirement is projected to remain negative for each of the out-years. On current figuring, the negative net borrowing requirements for 1998-99, 1999-00 and 2000-01 are projected to be $5.8 billion, $4.8 billion and $10.1 billion respectively.

STOCK OF COMMONWEALTH GOVERNMENT SECURITIES (CGS) ON ISSUE

Forward estimates period projections as to the stock of CGS on issue were provided in Statement 6 at Budget time, though these are now a little out of date in light of the preliminary Budget outcome for 1996-97. Chart 3 shows the stock of CGS on issue, at end-June 1994 to 1997, and the latest projections for the period to end-June 2001, consistent with the 1996-97 preliminary Budget outcome and budget time figuring for later years.

Chart 3: Stock of Commonwealth Government Securities on Issue as at 30 June



At end-June 1997, the face value of CGS on issue was just over $111 billion, or around 22 per cent of GDP. The estimated negative net borrowing requirement for 1997-98 implies a reduction in the stock of CGS on issue over 1997-98. At end-June 1998, the face value of CGS on issue is estimated to be around $106 billion or around 19 per cent of GDP.

- Further reductions in the stock of CGS on issue are projected in the out-years in line with the negative net borrowing requirements in these years. Between end-June 1998 and end-June 2001, the volume of CGS on issue is expected to fall by around $20 billion to around $85 billion or to about 13 per cent of GDP, well down on the 22 per cent at end-June this year.

DEBT MANAGEMENT REVIEW

In my presentation to AFMA last year, I noted that Treasury had retained a consultancy team consisting of Coopers and Lybrand Consultants, BT Risk Management Advisory Pty Ltd and Dr Jeffrey Carmichael of Carmichael Consulting to undertake a Review of Institutional Arrangements and Resourcing for Commonwealth Debt Management. The consultants were to review the Commonwealth’s existing operational approach to its debt management, assess the adequacy and suitability of existing institutional arrangements and resourcing and, if necessary, consider alternative options for institutional arrangements and resourcing consistent with the preferred operational approach.

As many of you will be aware, during the course of the Review, the consultants met with a wide range of interests across the domestic financial markets and also travelled overseas in order to obtain information on the operations and experiences of a diverse range of sovereign debt managers. A wide range of views were put to the consultants.

The Review is now close to completion and will be considered within Treasury at an early date. The process for handling the Review’s conclusions will form part of Treasury’s consideration. We are conscious of considerable interest in the Review in the market, both domestically and overseas, and from other sovereigns.

At this stage it is, of course, too early to say anything concrete as to the outcome of the Review. I can say, though, that the Review will present for consideration a range of options for institutional and resourcing arrangements, depending on the preferred objectives and philosophies of the sovereign debt manager. We consider the Review to be a very valuable input into the Commonwealth’s debt management and issuance activities. We hope to be in a position to make some further comment on the Review a little later in the year.

CONCLUSION

I conclude my presentation tonight by thanking you for your continuing interest in the Commonwealth’s debt management and issuance activities. I would be pleased to respond to questions and comments.

PRELIMINARY OUTCOME FOR 1996-97

The preliminary Budget outcome for 1996-97 was released on 23 July 1997. Table 1 provides details of the preliminary net and gross borrowing requirement and associated debt issue program for 1996-97.

Table 1: 1996-97 Borrowing Requirement and Debt Issue Program[(a)]

	1996-97 Outcome $m
Headline Budget Surplus[(b)]	-2514
PTE Superannuation Financing	928
Other Financing[(c)]	-814
Change in Cash Balances[(d)]	3026
Net Borrowing Requirement	626
Plus:	
Domestic Debt Repayments[(e)]	5332
Overseas Debt Repayments[(f)]	783
Gross Borrowing Requirement	6741
Financed as follows:	
Treasury Fixed Coupon Bond Issuance	7014
Treasury Indexed Bond Issuance	822
Treasury Adjustable Rate Bond Issuance	900
Treasury Notes (Net Issuance)	-1995
Total Debt Issue Program	6741

(a) Based on the face value of securities.
(b) Surpluses reduce the borrowing requirement.
(c) Includes difference between face value of securities and proceeds, net subscriptions to the International Monetary Fund, proceeds and payments relating to swap transactions classified as financing transactions and other financing transactions not elsewhere identified.
(d) Change in cash balances held by the Commonwealth at the Reserve Bank. An increase in cash balances increases the borrowing requirement.
(e) Excludes the refinancing of Treasury Notes.
(f) $A equivalent at exchange rate at time of transaction.

Full details of the Commonwealth's debt and portfolio management operations in 1996-97, as well as historical data on debt issuance and portfolio composition in previous years, will be presented in the *Commonwealth Debt Management Report* for 1996-97, which is expected to be published in September. Copies will be available from Government bookshop outlets.