

STATEMENT 7: ASSET AND LIABILITY MANAGEMENT

This statement discusses the Australian Government's financial position and covers the management of the major assets and liabilities on its balance sheet.

The Australian Government's balance sheet remains amongst the strongest in the developed world. This is a key reason behind the retention of the Australian Government's AAA credit rating.

This strong balance sheet position continues to provide the Government with the capacity and flexibility to respond to changes in economic circumstances as well as address longer term fiscal pressures.

The global financial crisis led to billions in tax receipts being written off the Government's budget position and drove the budget into deficit. The combined effects of a stronger economic outlook and fiscal discipline have delivered a significantly improved fiscal outlook and brought forward the projected return to surplus by three years.

As a result, the Australian Government's net debt position remains low by international standards. Improvements to the expected budget position mean that net debt is now expected to peak at 6.1 per cent of GDP in 2011-12.

Australian government net debt is expected to peak at levels less than a tenth of the average of the major advanced economies.

A detailed balance sheet for the Australian Government general government sector is provided in Statement 9: Budget Financial Statements.

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STATEMENT 7: ASSET AND LIABILITY MANAGEMENT

THE AUSTRALIAN GOVERNMENT'S MAJOR ASSETS AND LIABILITIES

The Government's balance sheet shows the stocks of all government assets and liabilities. Measures such as net debt, net worth and net financial worth are aggregates drawn from the balance sheet that provide an indication of the Government's financial strength (see Box 1).

The outlook for the Government's balance sheet, including the aggregates for net debt, net worth and net financial worth, are based on a range of assumptions. If the basis for these assumptions changes, it is likely to impact on the projected value of assets and liabilities, and hence change the projected path of net financial worth.

Statement 3: Fiscal Strategy and Outlook examines the impact of altering key economic assumptions on payments and receipts. Since the Budget outcome is one of the main drivers of the movement in the Government's asset and liability position, changes in the economic assumptions will also impact on net financial worth.

The Government reports on a range of other fiscal risks in Statement 8: Statement of Risks. These risks comprise general developments or specific events that may affect the fiscal outlook. Fiscal risks may affect expenses or revenue and, as a result, may contribute to variability in the Government's projected net debt, net worth and net financial worth position.

Measurement of the Government's financial position

Box 1: Net debt, net financial worth and net worth

Net debt is a commonly quoted measure of a government's financial strength. Historically, this was the only available stock measure for governments that were recording financial information in a cash-based accounting system. Net debt provides a useful measure for international comparisons, given most OECD countries report on it.

Net financial worth is used by the Government as the primary indicator of balance sheet sustainability because it provides a more effective and intuitive indicator of the sustainability of the Government's finances. It is a broader measure than net debt as it includes government borrowing, superannuation and all financial assets, but is narrower than net worth since it excludes non-financial assets. There are advantages to excluding non-financial assets since they are often illiquid and cannot easily be drawn upon to meet the Government's financing needs.

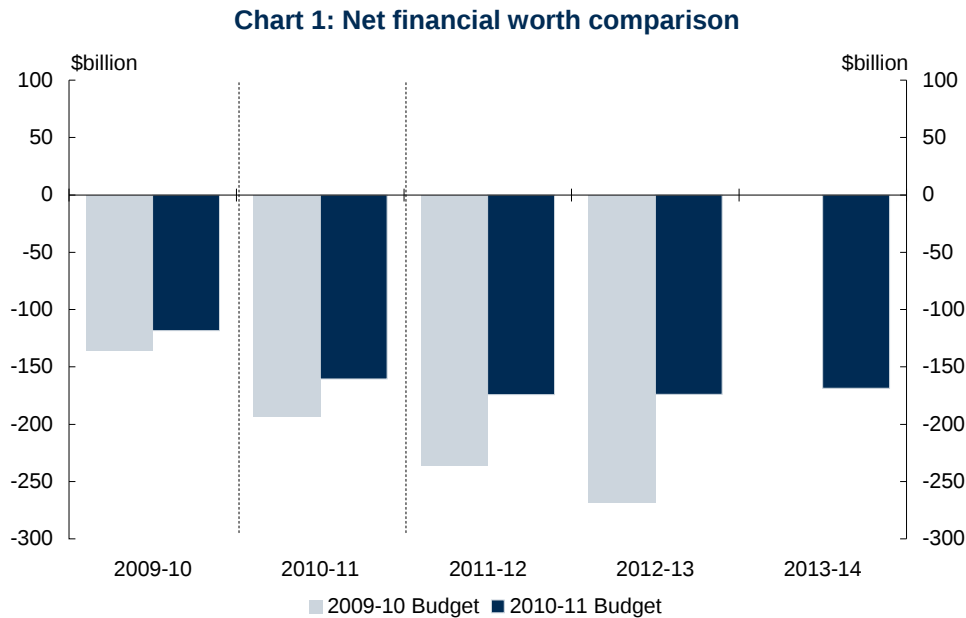
Net debt, net financial worth and net worth

The stronger economic outlook and fiscal discipline has contributed to lower estimated net debt across the forward estimates. The level of net debt in 2010-11 is estimated to be \$78.5 billion, which is \$33.7 billion lower than estimated in the 2009-10 Budget. By the end of the forward estimates, net debt is expected to be around \$90.8 billion (5.5 per cent of GDP) in 2013-14.

Net debt is now expected to peak at 6.1 per cent of GDP in 2011-12. This peak in net debt is at levels less than a tenth of the average of the major advanced economies.

Net financial worth for the Australian Government general government sector has also improved compared with the 2009-10 Budget. In 2010-11, net financial worth is estimated to be -\$160.6 billion, compared to the 2009-10 Budget estimate of -\$193.1 billion. Net financial worth is estimated to be -\$168.5 billion by the end of the forward estimates.

Chart 1 shows the projected movements in net financial worth since the 2009-10 Budget.



Note: Net financial worth for 2013-14 was not projected in the 2009-10 Budget.

Net worth is currently estimated at -\$56.5 billion for 2010-11 compared with around -\$90.0 billion estimated at the time of the 2009-10 Budget.

The improvements in the outlook for net debt, net worth and net financial worth since the 2009-10 Budget are primarily the result of a lower borrowing requirement across the forward estimates.

The lower borrowing requirement is driven by a significantly improved fiscal outlook reflecting both the stronger economic outlook as well as the Government's budget discipline. The small size of Australia's borrowing program relative to the major advanced economies leaves the Government well placed to pay down debt quickly as the economy improves and the budget returns to surplus.

Assets

The Government's financial assets are expected to increase by around \$16 billion over the Budget year and, across the forward estimates, by \$29 billion.

Future Fund

The Future Fund was established in 2006 to accumulate financial assets and invest them on behalf of the Australian Government to address the Government's unfunded superannuation liability.

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The Investment Mandate for the Future Fund gives guidance to the Future Fund Board of Guardians in relation to its investment strategy. The Investment Mandate sets a benchmark return of at least the CPI plus 4.5 per cent to 5.5 per cent per annum over the long term. The Investment Mandate also requires the Board to take an acceptable but not excessive level of risk for the Fund, measured in terms such as the probability of losses in a particular year.

During the initial transition period of the Future Fund, it was envisaged that returns would be lower while investments were built in line with the long-term strategic asset allocation. Since inception, returns have reflected this situation. Since the effective start of the investment program on 1 July 2007, the Future Fund has generated a nominal return of 3.1 per cent (excluding its Telstra holdings). Since the first contribution to the Future Fund on 5 May 2006, the return has been 4 per cent per annum.

At 31 March 2010 the Future Fund's return for the financial year to date was 11.8 per cent (excluding its Telstra holdings). The Future Fund's Telstra portfolio returned -7.1 per cent for the March 2010 quarter and -1.8 per cent for the financial year to 31 March 2010.

In August 2009, consistent with its strategic asset allocation, the Board reduced the Future Fund portfolio's holding in Telstra from 16.4 per cent of the company to 10.9 per cent through an underwritten sale to institutional investors of 684.4 million Telstra shares at a price of \$3.47 per share.

The Future Fund was valued at \$67.6 billion at 31 March 2010. Table 1 shows changes in the asset allocation of the Future Fund over 2009-10.

Table 1: Asset allocation of the Future Fund

Asset class	30 June 2009	31 March 2010
	\$m	\$m
Australian equities	4,494	8,145
Global equities	9,001	17,159
Private equity	1,240	1,482
Property	757	2,538
Infrastructure	1,178	2,066
Debt securities	12,489	13,985
Alternative assets	2,694	7,832
Cash	22,262	10,484
Total (excluding Telstra holdings)	54,115	63,692
Telstra holdings	6,925	3,930
Total Future Fund assets	61,040	67,622

Nation-building funds

The Building Australia Fund (BAF), the Education Investment Fund (EIF) and the Health and Hospitals Fund (HHF) were established on 1 January 2009. These Nation-building funds were established to finance investment in transport, communications, broadband, energy, water, higher education, research, vocational education and training, and health infrastructure.

The Future Fund Board of Guardians has responsibility for managing the investments of the BAF, EIF and HHF. The Investment Mandates for the Nation-building funds give guidance to the Board in relation to its investment strategy for the funds.

The Investment Mandates set a benchmark return on the Nation-building funds of the Australian three-month bank bill swap rate plus 0.3 per cent per annum calculated on a rolling 12-month basis. The Investment Mandates require that investments minimise the probability of capital losses over a 12-month horizon. Consistent with these requirements, the assets of the three funds are invested in combinations of short-term and medium-term debt instruments.

The March quarter 2010 return for each of the funds was 1.3 per cent. Since the inception of the funds, the BAF and the HHF have returned 4.1 per cent per annum while the EIF has returned 4.2 per cent per annum.

At the end of the March quarter 2010, the value of the BAF was \$10.1 billion, the EIF was \$5.9 billion and the HHF stood at \$4.9 billion.

The estimated uncommitted balance of funds at 31 March 2010 was \$0.7 billion for the BAF, \$2.7 billion for the EIF and \$2.0 billion for the HHF. These figures include net investment earnings up to 31 March 2010.

Residential mortgage-backed securities

Developments in international capital markets since mid-2007 led to the dislocation of the Australian residential mortgage-backed securities (RMBS) market. In view of these developments, in October 2008 the Government directed the Australian Office of Financial Management (AOFM) to invest \$8 billion in high-quality AAA-rated Australian RMBS to support competition in residential mortgage lending from smaller lenders.

In October 2009, the Treasurer announced that the Government would extend the program to invest an additional \$8 billion to support competition in the mortgage market.

The objectives of the program were also extended to include support for lending to small business. As a result, lenders who seek support under the RMBS program are encouraged to outline their lending activities to small business and to allocate part of

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the proceeds to these loans. It is expected that about 10 per cent of the funds raised by lenders so far during this second investment phase will be lent to small business.

Investor sentiment towards investment in RMBS improved over the course of 2009 and the first quarter of 2010. The private sector's contribution to RMBS transactions supported by the Government increased from around 20 per cent towards the end of 2008 to around 80 per cent in the first quarter of 2010.

However, the RMBS market continues to be affected by the fallout from the global financial crisis. The Government will continue to monitor market conditions and the impact of the program in assessing whether further support is required.

National Broadband Network

NBN Co was created in April 2009 to build and operate a new high-speed National Broadband Network (NBN). NBN Co is a wholly-owned Australian Government company that has been prescribed as a Government Business Enterprise (GBE).

In August 2009, the Government commissioned McKinsey/KPMG to conduct an implementation study examining a range of issues relating to the NBN, including operating and governance arrangements for NBN Co, network design, ownership caps, and scope for private sector investment.

The implementation study concluded that the NBN can be constructed within the \$43 billion envelope identified by the Government in April 2009, even assuming the NBN does not have access to existing infrastructure. The study also indicates that NBN Co will have a positive business case, and that NBN Co can expect to generate a rate of return that allows the Government to cover its cost of capital.

The implementation study recommends that private equity should not be introduced prior to privatisation. This will allow the Government to retain policy and regulatory flexibility before introducing private sector equity investment.

The Government has made appropriate provision in the Budget for the roll-out of the NBN, subject to a final response on the implementation study.

Higher Education Loan Program

The Higher Education Loan Program (HELP) comprises concessional loans to students that enable them to meet their education costs prior to earning an income above a certain level. The value of HELP is estimated to be around \$12 billion at 30 June 2010 and is estimated to grow to around \$16 billion by 2013-14. This is due to the estimated increase in university commencements over the forward estimates, principally due to the Government's Bradley reforms which lifted the over-enrolment cap from 5 per cent to 10 per cent in 2010 and 2011 and will uncap Commonwealth supported places from 2012.

Liabilities

The Government's total liabilities are expected to increase by around \$59 billion over the Budget year and, across the forward estimates, by \$79 billion.

Public sector employee superannuation liabilities

Public sector employee superannuation entitlements relating to past and present civilian employees and military personnel is a financial liability on the Government's balance sheet. The Government's superannuation liability is estimated to be around \$123 billion at 30 June 2010.

The Australian Government has never fully funded its superannuation liabilities. The Commonwealth Sector Superannuation Scheme and the Public Sector Superannuation Scheme were closed to new members in 1990 and 2005 respectively. The Public Sector Superannuation Accumulation Plan was introduced from 1 July 2005 and provides fully funded accumulation benefits for new civilian employees.

Despite these reforms, the value of the Government's existing superannuation liability is projected to continue growing (in nominal terms) into the future, reaching \$140 billion by the end of the forward estimates. This is the result of growth in the membership of the Military Superannuation and Benefits Scheme, which remains open to new military personnel, and continued growth of entitlements accruing to existing members of the closed civilian and military schemes.

An actuarially determined discount rate is used to value the nominal amounts of the future superannuation liability to today's dollars. Owing to the long-term nature of the unfunded superannuation liability, the value recorded on the balance sheet is highly sensitive to the discount rate used. As the superannuation liability is included in the Government's net worth and net financial worth aggregates, revaluations of the liability have an impact on these aggregates (see Note 1 in Budget Statement 9).

Commonwealth Government Securities

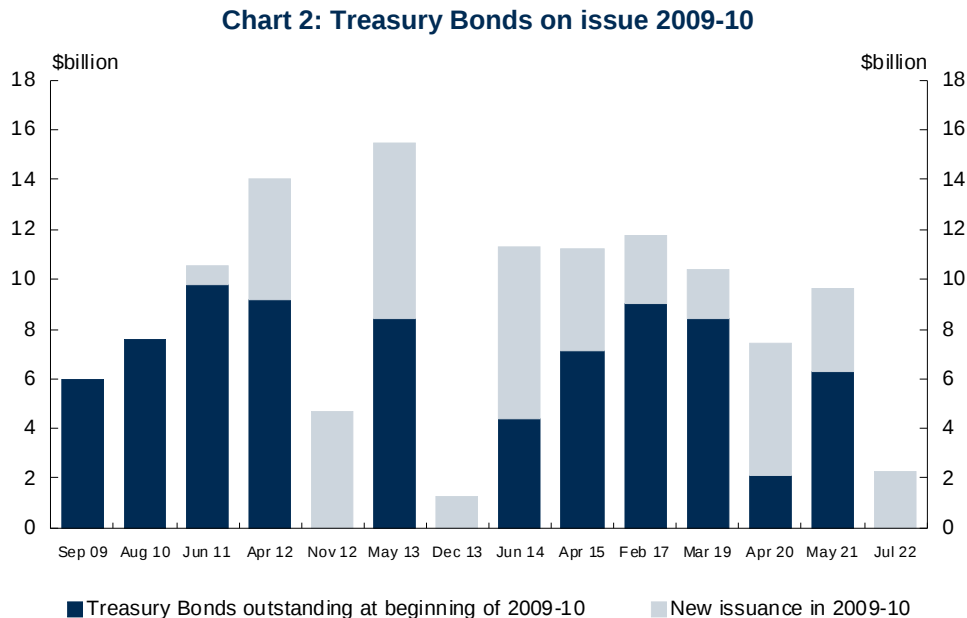
The total stock of Commonwealth Government Securities (CGS) on issue at 30 June 2010 is expected to be \$154 billion.

Net issuance of CGS in 2010-11 is expected to be around \$55 billion.

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Treasury Bonds

Chart 2 shows Treasury Bonds outstanding at 30 June 2009 and new issuance in 2009-10. Three new Treasury Bond lines were issued in 2009-10.



Note: New issuance in 2009-10 is to 11 May 2010.

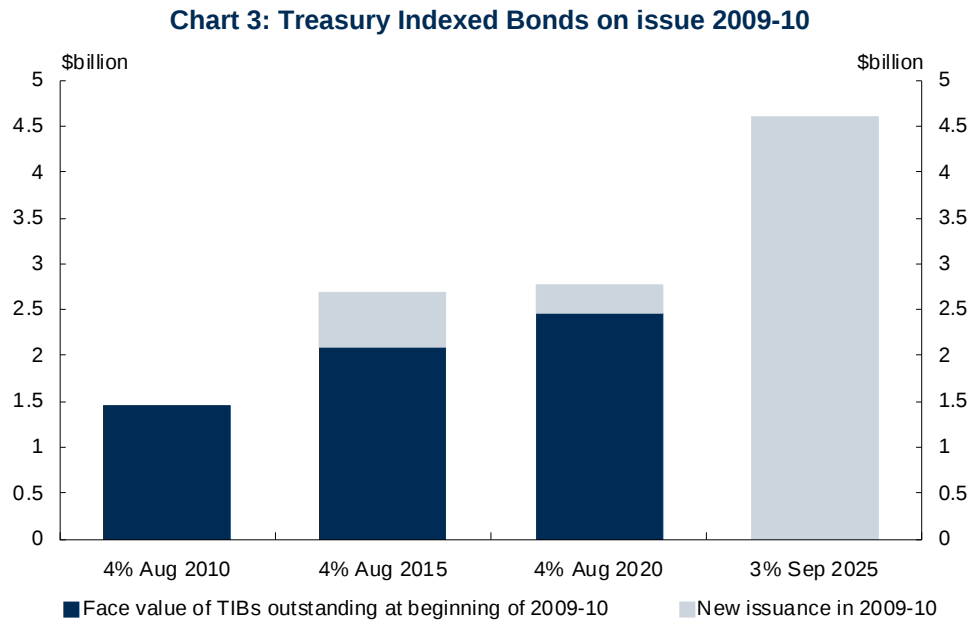
The face value of Treasury Bonds on issue at 30 June 2010 is projected to be around \$125 billion. Treasury Bond issuance in 2010-11 is expected to be around \$56 billion.

Treasury Indexed Bonds

Following consultations with a wide range of financial market participants, the Government recommenced the issuance of Treasury Indexed Bonds in 2009-10. Treasury Indexed Bonds are medium-term to long-term securities that have a capital value which is adjusted for movements in the CPI. Interest is paid quarterly, at a fixed rate, on the adjusted capital value. At maturity, investors receive the adjusted capital value of the security.

Treasury Indexed Bonds contribute to the management of Australian Government debt by widening the range of available debt instruments, diversifying risk and tapping additional sources of investor demand.

Chart 3 shows Treasury Indexed Bonds outstanding at 30 June 2009 and new issuance in 2009-10.



Note: New issuance in 2009-10 is to 11 May 2010.

The face value of Treasury Indexed Bonds on issue at 30 June 2010 is projected to be around \$11 billion. Treasury Indexed Bonds issuance in 2010-11 is expected to be around \$4 billion.

Treasury Notes

The Government recommenced the issuance of Treasury Notes in early 2009. Treasury Notes are short-term debt securities used primarily to meet within-year financing requirements resulting from differences in the timing of receipts and payments.

The volume of Treasury Notes on issue will vary over the course of the year, depending on the size and profile of the within-year funding flows. It is anticipated that approximately \$10 billion of Treasury Notes will be kept on issue at all times to maintain a liquid market in Treasury Notes.

The face value of Treasury Notes on issue at 30 June 2010 is projected to be around \$11 billion.

Aussie Infrastructure Bonds

On 7 April 2009, the Government announced that its investment in NBN Co would be partly funded through the issuance of Aussie Infrastructure Bonds to both household and institutional investors. In 2010-11, \$300 million of this investment will be financed by Aussie Infrastructure Bonds.

The component of this funding to be provided by institutional and other wholesale investors will be through the issue of CGS as part of the Government's overall debt issuance program. These bonds will not be separately identified from other CGS at the time of issue, but will be reported in the annual budget statements.

Consideration is currently being given to offerings of Aussie Infrastructure Bonds for household investors.

FUTURE OF THE BOND MARKET

The Government is committed to ensuring the effective operation of Australia's financial markets. The existence of an active and efficient bond market alongside the banking system strengthens the robustness of Australia's financial system and reduces its vulnerability to adverse shocks. The Government maintains an efficient and liquid CGS market that supports the three-year and ten-year Treasury Bond futures markets.

In 2008 the Treasurer directed the AOFM to increase the amount of CGS on issue, in response to market demand for Australian Government Treasury Bonds in the wake of the global financial crisis. The additional issuance assisted the Treasury Bond futures market to continue to operate in an efficient and effective manner.

As part of its debt management strategy, the AOFM launched a 2025 Treasury Indexed Bond in 2009-10 and new Treasury Bond lines that mature in 2012, 2013 and 2022 respectively. The term-to-maturity of Treasury Bonds currently extends out to 12 years and that of Treasury Indexed Bonds to 15 years.

The volume and maturity structure of bond issuance will continue to be set to meet the Government's financing task and portfolio management needs. In the longer term, the Government will aim to maintain a liquid CGS market to provide a sound foundation for Australia's financial system.