STATEMENT 7: ASSET AND LIABILITY MANAGEMENT

The Australian Government's balance sheet remains amongst the strongest in the developed world. Australia recently received a AAA credit rating from all three major rating agencies for the first time in our history.

This strong balance sheet position continues to provide the Government with the capacity and flexibility to respond to unanticipated adverse events and longer-term challenges.

The strength of the Government's financial position and the return to surplus in 2012-13 allows the Government to further reduce its already very low levels of net debt as a share of GDP from 2012-13.

The Australian Government's net debt position remains very low by international standards, notwithstanding the further write-down to tax receipts and the fall in interest rates on Commonwealth Government Securities (CGS) contributing to an increase in net debt since the 2011-12 Budget. The average net debt position, as a per cent of GDP, of the major advanced economies (G7) is projected to reach around ten times the expected peak in Australia's net debt.

In this Budget, the Government maintains its commitment to a liquid and efficient CGS market.

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

STATEMENT 7: ASSET AND LIABILITY MANAGEMENT

OVERVIEW OF THE AUSTRALIAN GOVERNMENT'S BALANCE SHEET

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

The outlook for the Government's stocks of assets and liabilities — or the Government's balance sheet — over the forward estimates is based on a range of estimates and assumptions about those assets and liabilities. If the estimates or assumptions change, this is likely to affect the projected value of assets and liabilities, and hence change the projected path of the balance sheet measures outlined above.

The outlook for the Government's stocks of assets across the forward estimates is broadly similar to that at the 2011-12 Budget. Several factors, including the further write-down in tax receipts and the fall in interest rates on Commonwealth Government Securities (CGS) to some of the lowest levels seen in Australia's history, have resulted in an increase in the value of expected liabilities. These market value adjustments have contributed to higher estimates for net debt, and lower estimated net financial worth and net worth than was expected at the 2011-12 Budget.

However, Australia's net debt position remains very low by international standards, with Australia one of only eight countries to have a AAA credit rating with a stable outlook from all three major credit ratings agencies.

Delivering a budget surplus through the Government's ongoing commitment to fiscal discipline will sustain confidence in the strength of Australia's public finances, and provide a buffer against adverse global economic developments.

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

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 financial worth and net 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 the most 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 worth is the broadest measure of the Government's financial position. It is the net position of total assets and liabilities recorded on the balance sheet.

Net debt, net financial worth and net worth

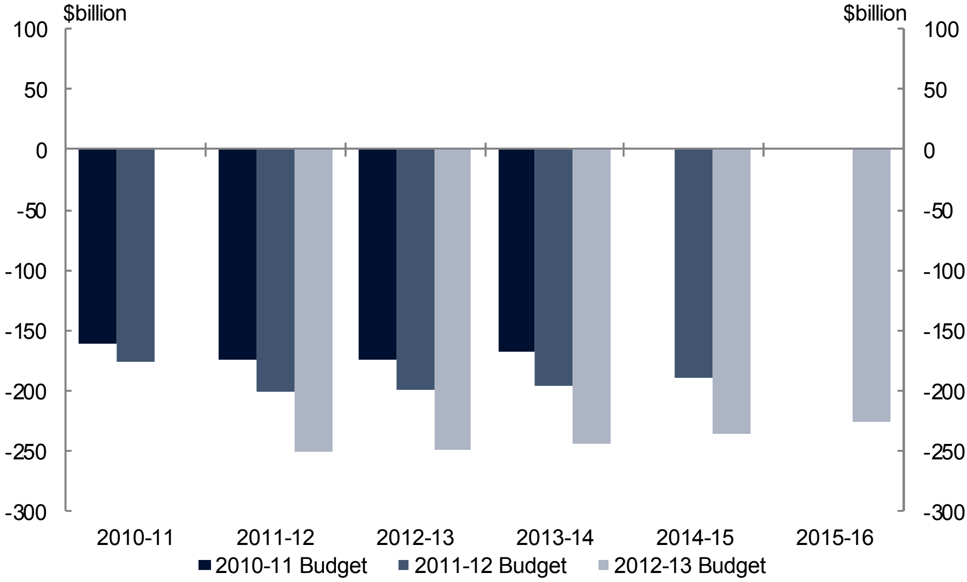
A range of factors, including the further write-down in tax receipts and the increase in the market value of CGS on issue, have contributed to a higher expected level of net debt, and lower expected net financial worth and net worth, than was forecast in the 2011-12 Budget. However, these estimates remain well below those expected during the global financial crisis— net debt, for example, was expected to peak at 13.8 per cent of GDP in 2013-14 in the 2009-10 Budget.

Net debt is now expected to peak, in nominal terms, at $144.9 billion in 2013-14 (8.9 per cent of GDP), falling to 7.3 per cent of GDP by the end of the forward estimates.

In 2012-13, net financial worth is estimated to be -$248.6 billion, compared to the 2011-12 Budget estimate of -$198.5 billion. Net financial worth is estimated to be -$225.8 billion by the end of the forward estimates.

Chart 1 shows the projected movements in net financial worth since the 2010-11 Budget.

Chart 1: Net financial worth comparison



Note: Net financial worth for 2014-15 was not projected in the 2010-11 Budget; net financial worth for 2015-16 was not projected in the 2011-12 Budget.

Net worth is currently estimated at -$137.8 billion for 2012-13, compared with -$83.4 billion estimated at the time of the 2011-12 Budget.

The Australian Government's financial position remains amongst the strongest in the developed world (Box 2) and is a key reason behind Australia's receiving a AAA credit rating from all three major rating agencies for the first time in our history. Indeed, Australia is now one of only eight countries to have a AAA rating with a stable outlook from all three agencies. In addition to the Government's adherence to a credible medium-term fiscal framework, other key factors underpinning Australia's credit rating are the strength and resilience of the economy, the stability of the financial system and the quality of policy and institutional arrangements, including independent monetary policy and strong financial regulation.

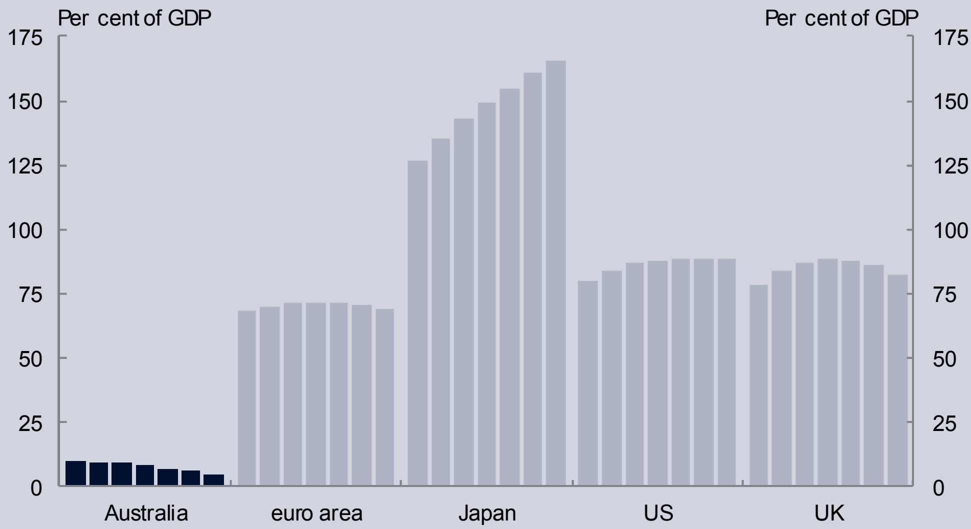
Box 2: The strength of the Australian Government's financial position

During 2011-12, many countries have faced profound financial and fiscal challenges as a result of the accumulation of large budget deficits and high levels of sovereign debt. Several governments have had to implement severe austerity measures in order to support more sustainable trajectories for government debt at a time when they also face the significant task of generating growth.

This stands in sharp contrast to the strength and resilience of the Australian Government's financial position and the domestic economy, forecast to grow around trend.

Australia's level of net debt remains very low by international standards (Chart A). Australian Government net debt is expected to peak at 9.6 per cent of GDP in 2011–12, compared to the expected average net debt position of the major advanced economies of around 93 per cent of GDP in 2016 and 2017.

Chart A: Comparison of Government net debt for selected economies, 2011-2017

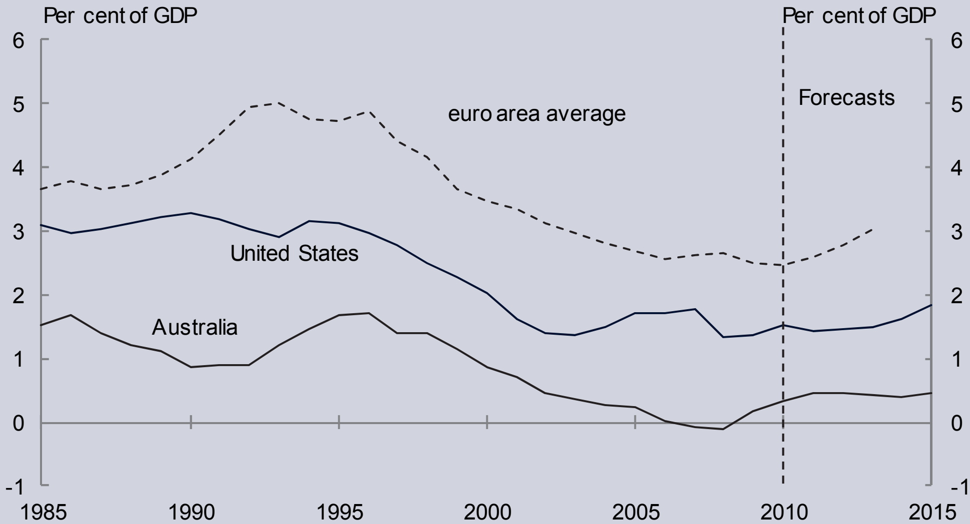


Note: Australian data are for the Australian Government general government sector and refer to financial years beginning 2011-12. Data for all other economies are total government and refer to calendar years beginning 2011.
Source: IMF *Fiscal Monitor* April 2012 and Treasury.

Box 2: The strength of the Australian Government's financial position (continued)

Similarly, Australia's net interest payments are very low by international comparison (Chart B).

Chart B: Net interest payments for Australia, the US and the euro area



Note: Net interest payments are equal to the difference between interest paid and interest receipts on government assets and liabilities. Australian and US data are federal government data. Australian data refer to financial years beginning 1985-86. US data refer to US fiscal years beginning October 1985. Euro area data are total government and refer to calendar years beginning 1985.
Source: United States Congressional Budget Office *The Budget and Economic Outlook* January 2012 and *Updated Budget Projections* March 2012, OECD *Economic Outlook 90* November 2011, Thomson Reuters and Treasury.

Not only are the Government's debt levels very low by international comparison, the return to budget surplus in 2012-13 and beyond means that the Government is well placed to reduce net debt from its already modest level.

Returning the budget to surplus and having those surpluses growing over time will strengthen the balance sheet further. This will ensure Australia continues to have the flexibility to respond to any unanticipated adverse future events that have a fiscal impact and to other longer-term challenges.

THE AUSTRALIAN GOVERNMENT'S MAJOR ASSETS AND LIABILITIES

Assets

The Government's total stock of assets is estimated to be around $325.8 billion at 30 June 2012, increasing to $349.4 billion in 2012-13 and $397.4 billion by the end of the forward estimates.

The Government's financial assets are estimated to be $216.3 billion at 30 June 2012, increasing to $238.5 billion in 2012-13 and $283.4 billion by the end of the forward estimates.

The Government's non-financial assets are estimated to be $109.5 billion at 30 June 2012, increasing to $110.9 billion in 2012-13 and $114.0 billion by the end of the forward estimates.

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.

The Treasurer and the Minister for Finance and Deregulation set the Investment Mandate for the Future Fund, which, since the Fund's establishment, has set 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 gives guidance to the Future Fund Board of Guardians (the Board) in relation to its investment strategy. The Board is independently responsible for the investment decisions of the Fund. 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. Returns have also been affected by the difficult investment climate, although the Fund's performance compared favourably with institutional investors generally during this period.

Since the effective start of the investment program on 1 July 2007, the Future Fund has generated a nominal return of 4.6 per cent. Since the first contribution to the Future Fund on 5 May 2006, the return has been 4.9 per cent per annum.

At 31 March 2012, the Future Fund's return for the financial year to date was 2.2 per cent.

The Future Fund was valued at $77.0 billion at 31 March 2012. Table 1 shows changes in the asset allocation of the Future Fund over 2011-12.

Table 1: Asset allocation of the Future Fund

Asset class	30 June 2011 $m	31 March 2012 $m
Australian equities	8,278	8,478
Global equities	19,604	17,953
Private equity	2,896	4,294
Property	4,801	4,699
Infrastructure	3,911	4,311
Debt securities	14,403	14,301
Alternative assets	13,768	14,475
Cash	6,552	8,537
Telstra holding	939	*
Total Future Fund assets	75,152	77,049

*Note: In August 2011 the Future Fund Board of Guardians announced that it had achieved market weight in its Telstra holding following the completion of its portfolio rebalancing activity and that it would no longer report its Telstra holding separately from the rest of the portfolio.

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 Investment Mandates for the Nation-building Funds, which are set by the Treasurer and the Minister for Finance and Deregulation, give guidance to the Board, which has responsibility for managing the investments of the BAF, EIF and HHF. The Board is responsible for the investment decisions of 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 (5.2 per cent for the year to 31 March 2012). 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.

Over the 12 months to 31 March 2012, the BAF and EIF each returned 5.4 per cent, while the HHF returned 5.3 per cent, exceeding the mandated benchmark return of 5.2 per cent.

At the end of the March quarter 2012, the value of the BAF was $6.7 billion, the EIF was $4.6 billion and the HHF stood at $3.9 billion.

The estimated uncommitted balance of funds at 31 March 2012 was $1.7 billion for the BAF, $2.8 billion for the EIF and $0.7 billion for the HHF. These figures are the amounts available for new eligible projects and include net investment earnings up to 31 March 2012.

The Nation-building Funds are financial asset funds, consisting of cash and investments in debt instruments. When cash is drawn down from the Funds to fund projects, this reduces the size of the Funds on the balance sheet. In addition, decisions which commit to future spending from the uncommitted balances of the Funds will impact on the underlying cash balance estimates at the time those decisions are taken.

Residential mortgage-backed securities

The global financial crisis led to the profound dislocation of the securitisation market globally, including the Australian residential mortgage backed securities (RMBS) market. In view of these developments, during 2008 and 2009 the Government directed the Australian Office of Financial Management (AOFM) to invest $16 billion in high quality, AAA-rated Australian securities to support competition from smaller lenders in the residential mortgage and small business lending markets.

In December 2010, as part of its Competitive and Sustainable Banking System package, the Government announced a further $4 billion of investment in the RMBS market, with an additional objective of transitioning to a sustainable market, bringing the Government's total investment commitment to $20 billion.

As at 1 May 2012, the AOFM had invested $14.9 billion of these funds, with $5.1 billion remaining within the AOFM's mandate to invest in future high-quality RMBS. The program has so far supported 58 securitisation deals to raise over $39.2 billion, assisting 20 smaller mortgage lenders to continue lending to the retail market.

The Government's securitisation program continues to be successful in supporting smaller lenders access funding to compete in the retail mortgage and business lending markets.

Since 2008, it is estimated that the program has assisted smaller lenders fund over 211,000 home loans and more than $2.4 billion worth of loans to small businesses. Within the banking sector, non-major Australian-owned banks have increased their market share by 1.0 percentage point in the year to March 2012.

The AOFM and the Treasury will continue to monitor conditions in the RMBS market closely.

National Broadband Network

NBN Co Limited (NBN Co) was created in April 2009 to build and operate the National Broadband Network (NBN), the single largest infrastructure project in Australian history. NBN Co is a wholly owned Australian Government company that has been prescribed as a Government Business Enterprise.

There have been some delays to the rollout of the NBN over the course of 2011-12, owing to the delay in finalising the Definitive Agreements between NBN Co and Telstra and in NBN Co negotiating better value construction contracts. As a result, NBN Co's equity requirement from Government in 2011-12 has decreased to reflect these delays from $3.4 billion to $2.1 billion. The Government will provide $20.1 billion in equity to NBN Co over four years from 2012-13.

The NBN rollout is expected to accelerate in 2012-13 following the Definitive Agreements coming into force on 7 March 2012. On 29 March 2012, NBN Co announced the three year rollout plan for the NBN, which will see construction of the fibre optic network underway or complete in areas containing over 3.5 million premises in 1500 communities in every State and Territory — up to one third of Australia's homes and businesses.

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 $17.6 billion at 30 June 2012, which is $0.3 billion higher than projected in the 2011-12 Budget. The value of HELP is projected to grow to around $20.3 billion over 2012-13 and $30.6 billion by the end of the forward estimates.

This growth is largely due to the estimated increase in university commencements over the forward estimates, principally the result of the uncapping of Commonwealth Support Places for Undergraduate courses from 1 January 2012 and the expansion of access to the Vocational Education and Training FEE-HELP scheme.

Clean Energy Finance Corporation

On 10 July 2011, the Government announced it would provide $2 billion a year for five years from 2013-14 to the Clean Energy Finance Corporation (CEFC). The CEFC will apply its capital through a commercial filter to increase flows of finance to the clean energy sector. It will invest in the later-stage development of renewable energy, low-emissions technology and energy efficiency. It will also invest in manufacturing businesses that provide inputs for these sectors. The CEFC will use a range of financial instruments to make these investments, including loans on commercial and concessional terms, loans guarantees and equity.

The CEFC will be established by legislation and will operate as a Commonwealth authority. Investment decisions will be made by an independent Board, consistent with a high-level investment mandate set by the Government.

Further information can be found in the measure: *Clean Energy Finance Corporation* detailed in the 2011-12 Mid-Year Economic and Fiscal Outlook.

Liabilities

The Government's total liabilities are estimated to be $467.6 billion at 30 June 2012, increasing to $487.2 billion in 2012-13 and $509.1 billion by the end of the forward estimates.

Public sector employee superannuation liabilities

Public sector employee superannuation entitlements relating to past and present civilian employees and military personnel are a financial liability on the Government's balance sheet. The Government's superannuation liability is estimated to be around $138.5 billion at 30 June 2012.

The Australian Government has never fully funded its superannuation liabilities. The Commonwealth Sector Superannuation (CSS) Scheme and the Public Sector Superannuation (PSS) 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 $159.7 billion by the end of the forward estimates. This is the result of growth in the membership of the Military Superannuation and Benefits Scheme (MSBS), 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 estimate the present value of future unfunded superannuation benefits. While recent yields on government bonds have been lower than average, the long-term nature of the unfunded superannuation liability requires the use of a longer-term discount rate. The value recorded on the balance sheet is highly sensitive to the discount rate used. Consistent with the latest Long Term Cost Reports for the civilian and military schemes, the discount rate currently applied is 6.0 per cent per annum.

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

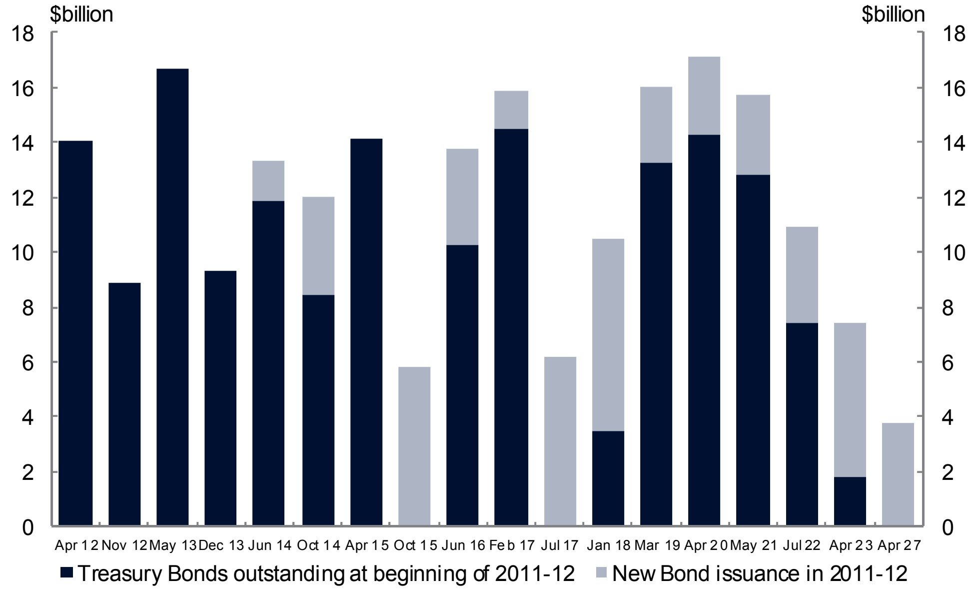
The face value of the total stock of Commonwealth Government Securities (CGS) on issue at 30 June 2012 is expected to be $235 billion. The face value of Treasury Bonds and Notes represents the amount that the Government pays back at maturity and is independent of fluctuations in market value.

CGS are reported on the balance sheet in market value terms, consistent with relevant accounting standards. The market value of CGS reflects bond prices in the secondary market, which are constantly changing with market conditions.

Treasury Bonds

Chart 2 shows the face value of Treasury Bonds outstanding at 30 June 2011 and new issuance in 2011-12. Three new Treasury Bond lines were issued in 2011-12.

Chart 2: Treasury Bonds on issue



Note: New issuance in 2011-12 is to 8 May 2012.

The face value of Treasury Bonds on issue at 30 June 2012 is projected to be around $205 billion, and around $214 billion at 30 June 2013.

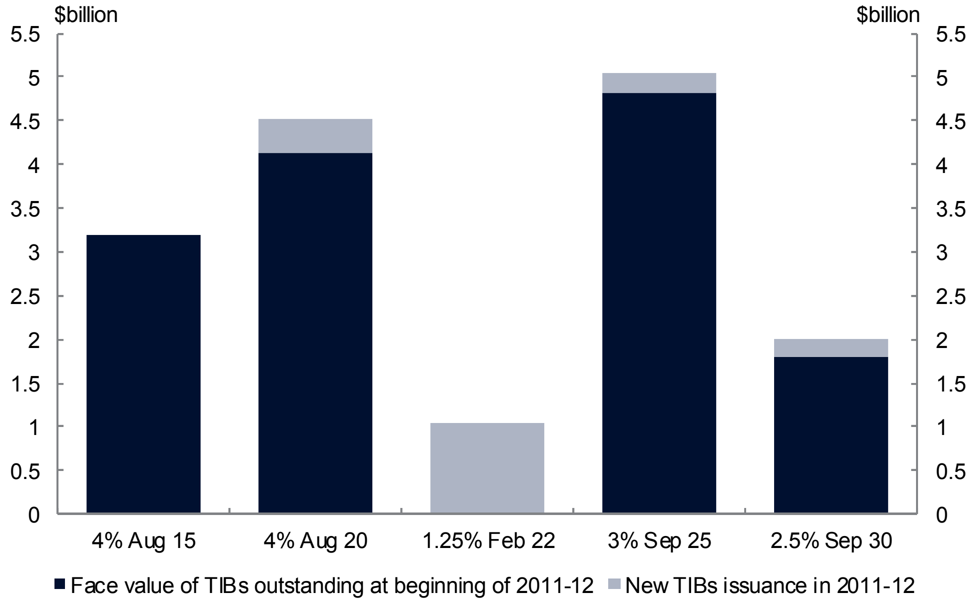
Treasury Indexed Bonds

Treasury Indexed Bonds (TIBs) 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. The Australian Government recommenced the issuance of TIBs in 2009-10.

TIBs 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 TIBs outstanding at 30 June 2011 and new issuance in 2011-12.

Chart 3: Treasury Indexed Bonds on issue



Note: New issuance in 2011-12 is to 8 May 2012.

The face value of TIBs on issue at 30 June 2012 is projected to be around $16 billion, and around $18 billion at 30 June 2013.

Interest payments made on TIBs are reflected in the Government's cash flow statements, with the adjusted capital value paid in the year which the bond matures. In 2015-16 there is an increase in interest paid as a result of the August 2015 TIB maturing.

Treasury Notes

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 at least $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 2012 is projected to be around $15 billion.

Aussie Infrastructure Bonds

In April 2009, the Government announced that its investment in NBN Co would be partly funded through the issuance of Aussie Infrastructure Bonds (AIBs).

AIBs were not required prior to 2011-12, as the Government's equity contributions were met in full with funds from the Building Australia Fund. In 2011-12, it is expected that around \$1.7 billion of the Government's \$2.1 billion equity investment in the National Broadband Network will be financed by AIBs, through wholesale issuance of CGS as part of the AOFM's overall debt issuance program.

From 2012-13, all of the Government's equity contributions to NBN Co will be funded through AIBs. In 2012-13, this is expected to be around \$5.8 billion.

THE COMMONWEALTH GOVERNMENT SECURITIES MARKET

In the 2011-12 Budget, the Government reaffirmed that its primary objective for the future of the Commonwealth Government Securities (CGS) market is to maintain liquidity to support the three- and ten-year bond futures market. The experience of the global financial crisis underscored the value in maintaining a liquid and efficient CGS market of sufficient size to support the long-term stability of the financial markets.

In considering the future of the CGS market, including the size needed to ensure liquidity, the Government's deliberations were informed by discussion with a panel of financial market participants and financial regulators. The panel considered the impact of the global financial crisis, the new global liquidity standards and the changing composition of the CGS investor base on the CGS market.

Since the 2011-12 Budget there have been significant developments in world financial markets that have had implications for the CGS market, in particular the growing demand from international investors for Australian dollar denominated securities, including CGS, against a backdrop of global economic volatility and persistently weak sovereign balance sheets in many other advanced economies.

The strength of Australia's economy and public finances, which is reinforced by the Government returning the budget to surplus, stands in stark contrast to many other sovereigns facing a significant task of generating growth and placing public finances on a sustainable footing. Australia is one of only eight countries to have a AAA credit rating with a stable outlook from all three major rating agencies.

Since the last Budget, a number of factors have influenced the fall in yields on bonds of all maturities (see Box 3). The benchmark borrowing rate for the 10-year Treasury Bond has fallen to some of the lowest levels in Australia's history.

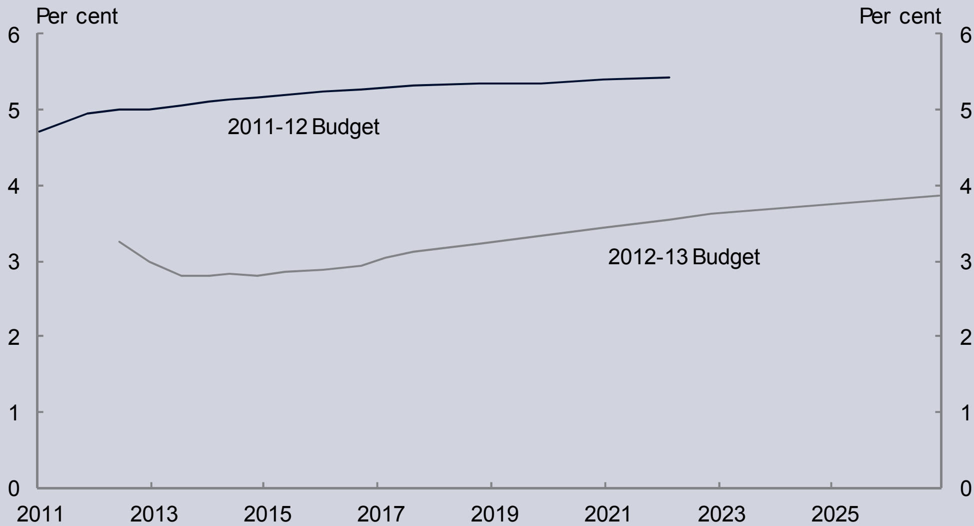
Box 3: Increased demand for Australia's sovereign debt

In the year since the last Budget, CGS yields have fallen substantially across the yield curve, (Chart A) resulting in lower borrowing rates for the Government.

The movement in the Australian yield curve reflects a range of factors. The weak and fragile global economy has put downward pressure on benchmark global long-term bond yields. This weak global economy has also driven investors into high quality government debt. As a result, Australia is reaping the benefits of a deep and liquid AAA-rated CGS market, increasing the diversity of the buyers of government debt. Shorter-term bond yields have also moved, primarily owing to the changed stance of monetary policy.

As a result of this fall in yields, the market value of CGS outstanding has increased while the face value is not affected.

Chart A: Yield curve for Treasury Bonds



Note: Yields are indicative mid-rates of CGS. Data for the 2011-12 Budget and 2012-13 Budget refer to yields on 10 May 2011 and on 1 May 2012 respectively.
Source: RBA.

CGS on issue subject to the current legislative limit is projected to be below $250 billion at the end of each financial year across the forward estimates. The volume of CGS on issue at various times throughout the year is projected to exceed this level due to within-year fluctuations of CGS on issue. Within-year fluctuations of CGS on issue are a normal feature of the annual financing task.

The two key drivers of within-year fluctuations of CGS on issue are: the difference in timing between Government outlays and revenue collections throughout the financial year; and the timing of bond maturities. Treasury Note issuance is the most efficient and effective means of managing within-year financing requirements.

Government payments occur relatively evenly across the financial year whereas tax collections in the last quarter of the financial year tend to be higher than in other quarters. As a consequence year-to-date expenditure exceeds year-to-date receipts for the majority of the year. The Australian Office of Financial Management (AOFM) manages this timing difference principally by issuing Treasury Notes.

In advance of bond lines maturing, the AOFM accumulates sufficient funds, including through Treasury Note issuance, to repay these bonds. This means that in the lead up to the maturity of a bond line there is a temporary increase in the amount of total CGS on issue owing to the combined value of the Treasury Notes and the maturing bond on issue. The volume of CGS on issue falls on the maturity date of the bond by the face value amount of that bond.

To ensure flexibility in meeting the Government's objective of maintaining a deep and liquid CGS market, and to manage most efficiently the normal within-year financing task, an amendment will be sought to the *Commonwealth Inscribed Stock Act 1911* to increase the legislative limit on CGS to $300 billion.