COMMONWEALTH OF AUSTRALIA

Official Committee Hansard

SENATE

ECONOMICS LEGISLATION COMMITTEE

Consideration of Additional Estimates

WEDNESDAY, 13 MARCH 2002

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SENATE

ECONOMICS LEGISLATION COMMITTEE

Wednesday, 13 March 2002

Members: Senator Brandis *(Chair)*, Senator Collins (*Deputy Chair*), Senators Chapman, Murray, Schacht and Watson

Senators in attendance: Senator Brandis (*Chair*), Senators Cherry, Collins, Conroy, Mason, Murray, Sherry and Watson

Committee met at 9.06 a.m.

TREASURY PORTFOLIO

Consideration resumed from 22 February.

In Attendance

Senator Ian Campbell, Parliamentary Secretary to the Treasurer

Department of the Treasury
Dr Ken Henry, Secretary
Dr Martin Parkinson, Executive Director, Economic Group
Mr Blair Comley, General Manager, Macroeconomic Policy Division
Australian Office of Financial Management
Mr Michael Allen, Chief Executive Officer
Mr Peter McCray, Deputy Chief Officer
Mr Pat Raccosta, Chief Financial Officer
Mr Andrew Johnson
Australian Prudential Regulation Authority
Dr Darryl Roberts, General Manager, Central Region

CHAIR—I call the committee to order. This public hearing is being conducted today in accordance with the order of the Senate of Tuesday, 12 March, which requires the committee to reconvene for the consideration of additional estimates. The order of the Senate requires the committee to adjourn by 1 p.m. I should indicate that, because this hearing is taking place while the Senate is sitting, in the event that there are divisions or quorums in the Senate we will briefly suspend the hearings while we attend to our obligations in the chamber.

The committee is to hear further evidence from the minister representing the Treasurer and relevant officers concerning the responsibilities of the Australian Office of Financial Management. The Senate's resolution also directed that the minister ensure officers of the Australian Prudential Regulation Authority statistics unit would attend today to provide evidence on general industry insurance statistics.

I remind officers that the Senate has resolved that there are no areas in connection with the expenditure of public funds where any person has a discretion to withhold details of explanations from the parliament or its committees unless the parliament has expressly provided otherwise. However, I would also like to remind those present of the Senate's resolutions for the protection of witnesses. Resolution 1(9) lays out the chairman's responsibilities to ensure questions are relevant and states:

(9) A chairman of a committee shall take care to ensure that all questions put to witnesses are relevant to the committee's inquiry and that the information sought by those questions is necessary for the purpose of that inquiry. Where a member of a committee requests discussion of a ruling of the chairman on this matter, the committee shall deliberate in private session and determine whether any question which is the subject of the ruling is to be permitted.

Resolution 1(10) sets out the procedure to be followed if a witness objects to answering any question. It states:

(10) Where a witness objects to answering any question put to the witness on any ground, including the ground that the question is not relevant or that the answer may incriminate the witness, the witness shall be invited to state the ground upon which objection to answering the question is taken.

Unless the committee determines immediately that the question should not be pressed, the committee shall then consider in private session whether it will insist upon an answer to the question, having regard to the relevance of the question to the committee's inquiry and the importance to the inquiry of the information sought by the question.

Where a witness declines to answer a question to which a committee has required an answer, the committee shall report the facts to the Senate.

I also remind senators and officers that an officer shall not be asked to give opinions on matters of policy and shall be given reasonable opportunity to refer questions asked of the officer to superior officers or to a minister. Witnesses should note that the evidence given to the committee is protected by parliamentary privilege. The giving of false or misleading evidence to the committee may constitute contempt of the Senate.

I welcome to the table Senator Ian Campbell, the Parliamentary Secretary to the Treasurer; Dr Ken Henry, the Secretary to the Treasury; and other Treasury officers. I understand that Dr Martin Parkinson has a short opening statement.

Dr Parkinson—Thank you, Mr Chairman. First of all, I would like to thank the committee for the opportunity to provide further information on the operation of AOFM. We are happy to assist the committee with respect to all aspects of the operation of the AOFM. However, having considered the specific documents requested in Senator Conroy's motion, we thought it would be useful to provide some introductory comments on the nature and extent of the Commonwealth's foreign currency exposure and on the related issue of the operation of the domestic interest rate swap program and the use of foreign currency forwards, which have attracted a fair bit of commentary, especially in the media, in recent times.

Let me start by emphasising that it is not possible to manage debt in any way that escapes uncertainty and risk. This important point—and it is something I want to return to later—has a corollary. Effective debt management requires a long-term perspective. It is not sufficient to measure risk and return by looking at the costs incurred in any one year or even over a few years. Let me start with cross-currency swaps. The Commonwealth has a foreign currency exposure associated with our debt portfolio. Of course, we have a range of foreign currency assets and liabilities, including the RBA's foreign exchange reserves and the government's multiyear contractual arrangements.

Given the focus on AOFM, I am not going to deal with those matters now. But as you know—I think we may have discussed it last time—the Commonwealth has had a foreign currency exposure since at least the 1930s. This foreign currency exposure reflected the relative ease of raising debt finance in foreign currency rather than in domestic currency. Up until 1987, the foreign currency exposure was in the form of physical debt. By 'physical' I mean that we actually issued bonds denominated in foreign currency. By virtue of issuing the physical bond in a foreign currency, we undertook an obligation to repay in that currency.

As a result, the Australian dollar value of these repayments was subject to variations associated with changes in the currency. When the currency devalued, or depreciated, the Australian dollar value of the repayments rose. When the dollar was revalued, or appreciated, the Australian dollar value of the repayments fell. Through the period in which the Commonwealth issued foreign currency denominated debt, the value of the portfolio was significantly affected by changes in the value of the Australian dollar. For example, in 1984-85, the depreciation of the dollar resulted in an increase in the value of foreign currency debt of around $3.6 billion expressed in today's dollars. In 1985-86, the depreciation increased the value of the debt portfolio by around $5.1 billion in today's dollars. I do not recall the point ever having been made at the time, but some, in today's media at least, would say that on that basis Treasury lost $8.7 billion in a two-year period by gambling on foreign currency loans.

The issuing of foreign currency denominated bonds inevitably exposes government to foreign currency risk. In 1987, the then Treasurer decided to allocate proceeds from the budget to retiring foreign currency denominated debt. Shortly after he made that decision, he also decided to allow the Commonwealth to enter into cross-currency swaps. The first swap was entered into in March 1988. That transferred deutschmark exposure to US dollar exposure. The first that transferred Australian dollar to US dollar exposure was entered into in September 1991. Let me make that point clearly: in respect of foreign exchange risk exposure, there is absolutely no difference between issuing physical debt in foreign currency and entering into cross-currency swaps to achieve the same foreign currency exposure.

I would like to expand on the nature of swaps and in particular cross-currency swaps. A swap is a transaction where one party swaps their obligations with another, called a counterparty. An interest rate swap involves the counterparties exchanging a fixed interest rate obligation for a floating interest rate obligation. A cross-currency swap is an agreement where an obligation in one currency is swapped for an obligation in another. A highly simplified numerical example might assist the committee. Of course, actual swaps are going to be far more complex, but at least this example captures the essence of the transaction.

Imagine the Commonwealth had issued a physical bond with one year to maturity that required the Commonwealth to pay $A100 to the bond holder on maturity. Now suppose the counterparty, say bank A, had issued a physical bond with one year to maturity that required bank A to pay $US55 to the holder of the bond. The Commonwealth enters into a swap transaction and agrees to meet the $US55 obligation of bank A in return for the bank meeting the Commonwealth's obligation to pay $A100. The swap transaction effectively puts the Commonwealth in the same position as if the Commonwealth had issued the US denominated bond in the first place. As noted above, physical issuance and derivative transactions are equivalent. In practice, derivatives such as swaps are often preferred because they can have greater liquidity, greater price transparency and lower transaction costs. As a result, the use of derivatives allows a more flexible approach to portfolio management.

Let me just comment on the nature of the cost calculations that underpin swap transactions. The cost calculations seek to identify the cost to the Commonwealth of undertaking a particular course of action relative to another course of action. What the approach highlights—and it is something I agree with—is that there is no such thing as a riskless position. The J.P. Morgan analysis in 1989, for example, highlighted that maintaining a portfolio solely in Australian dollars risked forgoing potential benefits from maintaining a foreign currency exposure. As history shows, in the end we decided to adopt a portfolio that was a mix of Australian dollar and US dollar exposures.

Let me outline the chronology about the use of swaps. The decision to maintain a discretionary foreign currency exposure was recommended by J.P. Morgan in 1989. That strategy was based on analysis that suggested some foreign currency exposure would provide a long-term cost saving relative to a portfolio wholly comprised of Australian dollars. J.P. Morgan advised the Commonwealth that the optimal debt portfolio would include a foreign currency exposure to a maximum of 15 per cent. They also advised, though, that there were some risk reduction properties associated with the strategy. As noted earlier, the first cross-currency swap used to generate additional foreign exchange exposure was entered into in September 1991. In the absence of swaps, the overall foreign currency exposure would subsequently have fallen below the levels recommended by J.P. Morgan.

We move forward to 1996. A review by UBS supported the maintenance of that 15 per cent benchmark of foreign currency exposure. In 1997-98 there was a negative economic return of $2.2 billion in current terms. Both internal and external reviews, including by UBS, of the assumptions underlying the strategy were undertaken in 1998. Notwithstanding the negative returns, the reviews concluded that the assumptions remained sound and the strategy should be maintained. In the following year, 1998-99, the strategy generated a positive economic return of almost $600 million.

It was decided in 1999 not to replace maturing swaps because fiscal policy was delivering a sharp decline in the net debt portfolio. No swaps generating additional US dollar exposure have been entered into since February 1999. Indeed, between February 1999 and May 2000 the US dollar value of the swaps exposure fell by $US1.6 billion. Notwithstanding this, the Australian dollar value of the foreign currency share rose due to the decline in the Australian dollar over that period to May 2000, particularly during the six months to May 2000.

In 1999-2000 a negative economic return of around $1.1 billion was recorded. However, the cumulative net economic return still remained positive until around mid-2000. Despite the second negative economic return in three years, the strategy was maintained. This was because the behaviour of the exchange rate and interest rates remained consistent with the assumptions underlying the strategy. The assumptions had been subject to internal review in late 1999. That said, AOFM recognised that the environment may have changed and that there was a need for a more comprehensive review of the policy. An ongoing review was initiated following the appointment of the AOFM CEO in March 2000.

On 17 October 2000, in response to a request from the Governor of the RBA, the former Secretary to the Treasury agreed to a temporary breach of the foreign exchange benchmark. 9 November 2000 was the first time the Treasurer was advised there was a significant issue concerning the operation of the benchmark that required his attention. On 10 November 2000 the matter was discussed between the Treasurer, the Secretary to the Treasury and the Governor of the Reserve Bank of Australia. On 6 December 2000 the Treasurer agreed to suspend the benchmark and requested that AOFM conduct a review of the need for foreign currency debt and the level of any benchmark that might be adopted. AOFM was directed to report by June 2001. On 29 June 2001 the Treasurer was advised of the outcome of the review. On 4 September 2001 the Treasurer endorsed an ultimate target of zero foreign currency exposure and a phased rundown of the existing exposure.

Foreign exchange gains and losses from the cross-currency swaps have been reported to parliament annually in Treasury and AOFM annual reports. From 1994-95 the net impact of foreign exchange gains and losses have been reported in the Treasury annual report. From 1999-2000 AOFM's annual report has provided details on foreign exchange gains and losses, total carrying amounts and aggregate net fair value of the cross-currency swap portfolio. From

1996-97 the annual Commonwealth debt management reports, which are published, have also provided information on the market value of the aggregate swap portfolio. Let me make the following point clear: Treasury never advised the Treasurer of anything that was not on the public record. In doing so, though, we emphasised the long-term nature of the strategy and its continuing appropriateness. Indeed, we did not recommend any change to the underlying strategy until June 2001.

Let me turn to another derivative that AOFM utilises to achieve Commonwealth debt management objectives; that is, interest rate swaps. As I said earlier, the Commonwealth is subject to interest rate risk in respect of the debt portfolio. At least some part of this risk will always remain and cannot feasibly be eliminated. The value of the debt portfolio is measured in present value terms. This means that the value of all future payment obligations is discounted back to the present. You apply a discount rate to do that. That discount rate is the current market interest rate. This means that a change in the market interest rate will change the measured value of the portfolio, even if there are no changes in the Commonwealth's nominal payment obligation.

A simple numerical example might help you. Imagine we have a Commonwealth portfolio that has one bond and the Commonwealth was required to pay $150 in one year's time. The present value of the bond can be calculated by a simple formula—the amount you have to pay on maturity over one plus the interest rate, all raised to the number of years to maturity. So in our example it is $150 over one plus the interest rate. If the interest rate were 50 per cent, then the present value of the bond would be $100 expressed in today's dollars. If the interest rate rose to 100 per cent, the present value would be $75 in current dollars. This illustrates the fact that the present value of the bond changes with interest rate changes. In general, when interest rates rise the present value falls; that is, the market value of our debt outstanding falls and when interest rates fall the present value of our outstanding debt rises. The amount of risk that the Commonwealth is exposed to therefore depends on how much the value of the bond portfolio changes in response to interest rates. The sensitivity of the value of the debt portfolio to changes in interest rates depends on the time maturity of the portfolio.

I do not want to labour the point, but another example might help. Imagine our portfolio has only one bond but now has to be repaid in two years time. The required payment is $225. If the interest rate is still 50 per cent, then the present value is equal to $225 divided by one plus 0.5 squared—that is, one plus 0.5 for the first year times one plus 0.5 for the second year. That is equal to $225 over 2.25, or $100. The present value of the bond if the interest rate rises to 100 per cent becomes $225 over four or $56.25. So the longer to maturity, the greater the change in the value of the debt portfolio for any given change in interest rates.

The first example showed that with a bond of one year to maturity the present value changed from $100 to $75. In the second case it moves from $100 to $56.25 when you have got two years to maturity. The Commonwealth enters into interest rate swaps in order to reduce the overall risk to the portfolio; that is, it tries to reduce the extent to which the value of the portfolio moves in response to changes in interest rates.

An interest rate swap is nothing more than an agreement between two parties to exchange interest rate payments, based on some nominal amount of principal and over a certain period of time. One party pays a floating interest rate; the other pays a fixed interest rate. In order to reduce the interest rate sensitivity of the portfolio, the Commonwealth enters into swaps whereby it receives a fixed interest rate which offsets obligations on its long-dated bonds and in return takes an obligation to pay a floating rate. Such swaps have the same effect as a reduction in the average period to maturity of the debt in the portfolio. In other words, we are

issuing very long-dated debt. We are engaging in swaps. That is having the effect of reducing the average maturity of the portfolio.

Why would someone want to engage in this deal with us? The answer lies in the fact that either they have other assets and liabilities that can allow them to create a hedge or they require some sort of side payment—that is, they require some sort of favourable terms from us to compensate for the additional risk.

In that case, we would pay a premium, and effectively we would be buying lower variability in the value of our debt portfolio with some slightly higher average debt servicing costs. The AOFM currently manages the portfolio within what is called a modified duration range of three to 3½. The mathematics are reasonably complex for today's purposes, so I will skip over that. But the way to think of duration is it is simply a summary measure that is closely related to the average time to maturity of the portfolio. In the absence of the swaps program, the duration would be longer, so we would not be able to target the three to 3½ modified duration range if we were only issuing debt out at the long end. So the decision to enter into swaps reflects the fact that the duration of the portfolio was increasing as the government was paying down debt and the fact that there are other means which you can use to reduce duration, but it was decided they were less attractive than engaging in swaps.

The two approaches which could have been adopted so we could alter duration without the need to engage in swaps are, first, we could have bought back long maturity bonds earlier than when they matured. The problem with that is that it undermines the liquidity of the Commonwealth government's securities market. Second, we could have issued short maturity bonds, that is, rather than issuing 10-year bonds we could have issued one, two or three-year bonds. This was not considered an appropriate policy given the government had no need to issue debt. All this is really coming back to the point that portfolio objectives can be achieved either by the use of derivatives or by issuing physicals. But in this case, and as in other cases, the use of derivatives can be more flexible.

The Commonwealth entered into its first interest rate swap for the purposes of managing the duration of the Australian dollar denominated debt portfolio in August 1997. While some swaps had been entered into in 1992-93 and 1994-95, that was as part of the foreign currency swap program. Since 1997 the size of the swaps program has increased. This has not reflected the change in the fundamental framework or the philosophy behind the approach to debt management; rather, it is a reflection of the increased duration of the portfolio. That is, the repayment of debt has made it harder for us to maintain the target benchmark without the use of swaps. On 19 February 2002, AOFM issued a press release announcing there was no intention to enter into further interest rate swaps for the remainder of the financial year on the basis that we did not need those to meet our portfolio objectives.

Let me briefly touch on forward contracts. It seems now that the mere mention of any foreign exchange contract causes some form of consternation. AOFM transacts forward exchange contracts with the Reserve Bank in order to maintain the existing stock of foreign currency liabilities. This was done over the period during which the benchmark was suspended, that is, from October 2000 to September 2001. Since then, since the decision to move towards a zero foreign currency exposure, as was agreed by the Treasurer in September 2001, AOFM has used forward foreign exchange contracts in order to manage the rundown of the foreign currency exposure in accordance with the schedule that was agreed with the Treasurer and the RBA.

Let me emphasise this. These forward contracts do not involve any additional foreign currency exposure. Indeed, the entire strategy involves a rundown in the exposure, and the forward contracts are simply a way of managing that process. Let me try to make it even clearer. The cross-currency swaps mature in a lumpy fashion. We feel that there is a limited capacity of the market to absorb the unwinding of swaps. So what we are doing is we are using the forward contracts to smooth the pattern of these lumpy maturities so that we can unwind in a smooth fashion the existing foreign currency exposure.

Let me make some comments by way of conclusion—and I thank the senators for the amount of time they have given me. Much of the commentary in recent weeks reflects the beauty of 20/20 hindsight. We do not yet know and, in fact, will not know for many years to come whether the policy of maintaining a portion of net debt in US dollars will end up saving the Commonwealth money compared with a policy that involved no foreign currency exposure. We cannot know this yet as we do not know the path of exchange rates and interest rates over the relevant period.

I am making this point acknowledging freely that there are numerous instant experts that have emerged in the last couple of weeks who have absolutely no difficulty coming to such judgments. In particular, there have been comments to the effect that cross-currency portfolios should have been wound up after the 20 August 1998 internal review of benchmark assumptions or following the release of the audit report on 12 October 1999. The inference is that the unrealised foreign exchange losses in 1999-2000 and 2000-01 could have been avoided if we had done so. To unwind the position on either date would have required the purchase of about $US8 billion in August 1998 or $US7 billion in October 1999. Currency trades of this magnitude may have influenced the Australian dollar. As a result, the unrealised economic returns that have been reported may not be substantially different from those that would have been achieved under any practical unwind strategy—to say nothing of the actual returns that may eventuate in the future.

Let me finally make a few comments about the rationale behind the cross-currency swaps policy. The policy was entered into with a long-term focus. You will recall that I said at the outset that if you are going to engage in debt management you had better have a long-term objective. From the beginning it was acknowledged that, in contrast to interest rate swaps, cross-currency swaps may produce greater short-term volatility in returns. Indeed, the policy had a negative economic return over the first four years it was in operation. From 1987-88 to 1990-91 it produced negative economic returns, but obviously the policy was not terminated. The policy was predicated on the assumption there was a systemic relationship between the Australian and US interest rates and the bilateral exchange rate.

As I noted earlier, adoption of the assumption was based on a range of external advice. If the assumptions were correct, then the expected long-term cost to the Commonwealth would have been lower as a result of adopting the policy than it would have been without having a foreign currency exposure. The alternative assumption may be that uncovered interest parity holds; that is, that there is not the systemic relationship that offered gains. The implication of this is that the expected long-term costs of the policy would be identical to the expected long-term costs of the Commonwealth having no foreign currency exposure. In other words, even if the assumptions on which the policy is predicated were incorrect, the average expected cost of the policy would be no different than without a foreign currency exposure.

This is not to say that we should be indifferent between the two policies. The higher short-term volatility of the portfolio with a foreign currency exposure is a relevant consideration when considering the overall desirability of the policy. At the time the policy commenced, the

expected long-term savings were considered sufficient to offset the possibility of higher short-term volatility. In contrast, when the policy was terminated last year greater weight was given to the importance of short-term volatility, particularly in the context of declining debt, because that increased the risk of the portfolio being out of the money at any point in time as the debt stock was being unwound. As I noted earlier, until June 2001 Treasury's position was to continue the use of cross-currency swaps to manage foreign exchange exposure in the Commonwealth's debt portfolio. At no stage before June 2001 did we recommend to any Treasurer anything to the contrary. It was only in June 2001, with the completion of the most recent AOFM review, that we recommended that we cease targeting a foreign currency exposure in the portfolio and that the existing exposure be wound down.

I would like to address the issue of whether Treasury has been taking a view on the level of the currency. We do not and have not taken a view on the level of the currency. This is why the entire policy was set in terms of a clear, long-term benchmark. That is not to say that the movement in the currency or the value of the currency has no effect on the cost of servicing the Commonwealth's debt. Of course it has. As I noted earlier, it is impossible to have a debt portfolio without changes in the exchange rate having an effect on either costs incurred or opportunities forgone.

Even if the entire portfolio is in Australian dollars, you are forgoing opportunities to have lower—or higher; and you have to work out what is likely to happen—cost. Finally, I have copies of the external consultants reports. I am happy to provide these to the committee. I noticed that Senator Conroy had sought a range of other documents in the motion yesterday. I hope the committee will accept that we believe it is inappropriate to release those additional documents given their nature. I really am thankful for the indulgence of the committee in letting me make this statement. My colleagues and I hope that we can be of assistance to you.

CHAIR—Thank you very much indeed, Dr Parkinson.

Senator WATSON—Dr Parkinson—and maybe Dr Henry—I take you back to a Senate estimates hearing in 1992, when I, among a number of other colleagues, was expressing some concern about the use of swaps and the practice of using derivatives. After all, a swap is a derivative product, which means that there is some leverage there and some risk. But the Senate in a sense was given some assurances by Mr Hyden and Mr Waterman. So in 1992, when some of us had these concerns about the safety and security of the use of derivatives by the Commonwealth, particularly given, as you acknowledge now, Dr Parkinson, some reference to early negativity in the program, were we misled by Mr Waterman when he told the Senate that swaps, as used by the Commonwealth, were basically a means of reducing the risks? We all know that, with any derivative product, being a leverage product, if it goes well, you make a lot of money. But if the terms move against you, you have the potential to lose a lot of money. So I ask: was the Senate misled or given a false sense of security in 1992, in those early days, given the early experience? I think that in 1992 you were possibly making a little bit of money on the swaps program, but prior to that there had been some negativity. Is that right?

Dr Parkinson—As I noted in my statement, J.P, Morgan advised that there were risk reduction properties associated with the use of cross-currency swaps.

Senator WATSON—If you get it right.

Dr Parkinson—When you say, `If you get it right,' what you are trying to do at any point in time is set up a strategy that helps you deal with unknown developments in the future. At any point in time—and this is why we emphasise the long-term nature of the portfolio—you

may be getting a positive or a negative return. The question is whether you conclude that the strategy was right on the basis of one year's results or whether you look over a long time period.

Senator Ian Campbell—Isn't the answer partly that if you have all your eggs in the one basket, in other words, if you have all of your risk in one currency, all of your exposure to one currency, investment philosophy would say that, as a whole, your risk is higher than if you spread it across two? Obviously, if you spread it across a few more, you are reducing the overall risk. That is the real point. That is clearly why Mr Keating and the Treasury at that time made a decision to move to buying these swaps as opposed to having exposure to the yen, as it was at the time, the deutschmark—

Senator WATSON—Yes, that is true. They moved out of the so-called hard currencies.

Senator Ian Campbell—and actually issuing bonds in those markets as opposed to buying swaps, which are a more efficient transaction cost-wise.

Senator WATSON—But they moved out of the hard currencies of the day, European currencies, they moved out of the yen, and they further locked us in more to the US dollar. That is our problem now, because nothing appears to have been done to try to extricate ourselves from the problems of the weakening of the Australian dollar vis-a-vis the hardening of the US dollar. So obviously you have got it wrong. But you have not answered my question: were we misled?

Dr Parkinson—No, I do not believe that you were.

Senator WATSON—About risks?

Dr Parkinson—I think that I have the reference to Mr Waterman that you are referring to. You asked, 'What is the estimate of the saving as a result of this practice?' Mr Waterman said: 'I do not know'—

Senator CONROY—You found that quote very quickly, Dr Parkinson.

Dr Parkinson—No, actually I did not; my colleague found it for me.

Senator CONROY—Remarkably quickly—a 10 years old *Hansard*. Do you keep them handy, Mr Allen?

CHAIR—Senator Conroy, Senator Watson has the floor. Let the witness proceed with his answer.

Senator CONROY—Does the AOFM have all of the *Hansards* for the last 10 years?

CHAIR—Senator Conroy, let the witness proceed with his answer, please.

Dr Parkinson—Let me give you the quote that Mr Waterman made:

I do not know whether we can provide a precise estimate of the savings. It is basically a means of giving us greater diversification and reducing the risks associated with the portfolio. A number of people have done analytical work for us and they have all concluded that we should retain a small proportion of foreign currency debt in the portfolio.

Senator WATSON—Can I also quote from Mr Hyden, as you have the reference before you—

Senator CONROY—What a coincidence!

Senator WATSON—where he says that the analysis is because the risk of that is relatively low because of the correlation between movements in the US dollar and exchange rates and those of the Australian currency. That is why I say we are getting a confused position.

Senator CONROY—You voted against this meeting.

Senator WATSON—We were seeking assurances from Treasury in those days about moving to a program which was relatively new and I, for one, was—naively—quite satisfied because of what was told to us in 1992.

Dr Parkinson—I have no reason to disagree with what you were told in 1992.

Dr Henry—My view is that in no sense was the Senate misled on that occasion, and as Dr Parkinson—

Senator WATSON—Given a false sense of security.

CHAIR—Senator Watson, let Dr Henry finish his answer. I am not going to have this interruption of witnesses.

Dr Henry—As Dr Parkinson noted in his opening statement, this strategy has been subject to numerous reviews over a long period of time, including prior to the Senate estimates hearing in 1992 to which you refer, and certainly subsequently. As Dr Parkinson also said, nobody involved in that analysis and nobody external to that analysis ever urged the Treasury to do something different—ever urged the Treasury to exit the swaps strategy. In fact, we, the Treasury, did not come to that view ourselves until June last year, on the basis of all the advice that was available to us and on the basis of our own observation of the behaviour of the portfolio.

I accept that it is easy in hindsight to look back and say, as some have done in recent weeks, that the Treasury should have taken a position on the currency when the value of the swaps was well into the money—in fact, at their peak in terms of economic return. Someone said that, and it is easy to say in hindsight, but I would want the committee to understand that the whole point of this strategy, the way it was set up, was to avoid taking a position on the currency. This was not about taking a gamble on the dollar and finding the best time at which to transact swaps or indeed any other instrument in order to seek to maximise some short-term gain for the balance sheet. It was not about that. If senators or anybody else want to suggest that that is what the Treasury should be doing, then let them suggest it. But it has never been our view that the Treasury should be speculating on the Australian dollar.

When we went into this strategy, we accepted that this was a long-term strategy. We established benchmarks to guide our performance in the execution of this strategy. The original debt management office that existed in the Treasury, and subsequently the Australian Office of Financial Management, an executive agency in the Treasury portfolio, were instructed to manage to that benchmark. They were instructed explicitly to avoid taking a speculative position on the value of the Australian dollar. It is important that that be understood.

Senator WATSON—Do you not use your swaps program to minimise your risk when you have an approaching contract termination?

Dr Parkinson—Sorry, Senator, would you clarify the point?

Senator WATSON—You have a lot of debt maturing at different times and obviously some of that timing can be embarrassing, given the nature of the exchange rates and the interest rates pertaining at a point in time.

Senator CONROY—I think you are saying that—

Senator WATSON—I thought that was the use of some of the swaps programs, to try to minimise that.

Dr Henry—No, Senator. I think as Dr Parkinson may have referred to earlier, we have used foreign exchange forward contracts in order to prevent lumpy maturities on swaps being passed through the foreign exchange market. We have done that. I stand to be corrected, but I do not think we have executed swaps in order to avoid impacts on the exchange rate.

Senator WATSON—I know, because the Reserve Bank would not let you. Let's face it.

Dr Henry—No, but seriously—

Senator WATSON—What comes first?

Dr Henry—Yes, we have recently used forward contracts in order to smooth the impact on the foreign exchange market of our exit from the swaps strategy, but I do not see that as taking a position—a short-term or a long-term position—on the currency in any way. It is just that, once you take a decision to exit the strategy, you have to find some orderly way of managing a stock down. We have taken a decision on the basis of advice from the Reserve Bank of Australia. In fact, a decision was taken by the Treasurer about the pace at which it would be prudent to unwind this strategy. In order to manage that pace of unwinding, we have entered into forward foreign currency.

Senator CONROY—You have also rolled swaps to avoid an embarrassing impact on the currency. That is why the Reserve Bank intervened and said, 'Don't do it.' The swaps were not just as part of the forwards.

Dr Henry—Senator, you are referring there to an earlier decision, a decision taken towards the end of the previous year, the year 2000, to initially breach for two months and then to temporarily suspend the operation of the benchmark. The point there is the way the benchmark applies or operates. There will be circumstances in which we would be unwinding swap positions, say, selling Australian dollars in the context of the declining value of the Australian dollar. If we have swaps which, in Australian dollar terms, are worth 15 per cent of the portfolio and the Australian dollar depreciates, then other things equal to that 15 per cent benchmark would be breached, and the AOFM would be obliged to go into the market to sell Australian dollars in order to unwind some part of its swaps portfolio in order to keep within the 15 per cent limit. Toward the end of the year 2000, a decision was taken that it would be unhelpful, for broader macro-economic reasons, to allow the AOFM to unwind some part of its swaps position in order to stay below the 15 per cent upper boundary of the benchmark. Now that decision was taken, as I have indicated, for broader macro-economic reasons.

Senator CONROY—The Reserve Bank said you were destabilising the dollar.

Senator Ian Campbell—Mr Chair, I think one of the points that should be recorded by the committee is that the pressure on the benchmark was caused by a couple of factors. One of the biggest ones was in fact the reduction in the Commonwealth's net debt. If the benchmark is 15 per cent of the overall portfolio and the government, by sound financial management, sound economic management, privatisation and repatriation—

Senator CONROY—Any money to flog an asset and retire debt.

CHAIR—Senator Conroy, let the witness finish his statement.

Senator CONROY—Sorry. The witness interjected over the top of Dr Henry actually, and I did not notice you intervening.

CHAIR—Senator Campbell.

Senator Ian Campbell—The point that should be made is that if you have $100 billion worth of debt and 15 per cent is what you are targeting for US currency exposure, you will have about $US15 billion. If you reduce the debt from $100 billion down to $50 billion, all of a sudden the $15 billion becomes a larger portion of your debt, and that is unhelpful for the Labor Party. Between 1991 and 1992, or in fiscal year 1991, Australia's net debt was $16.9 billion. The reason it became a real issue, Senator Watson, is that back then, when Mr Keating entered into the policy for what at the time—I think we have all agreed—were good reasons, the debt was $16.9 billion. When you were asking questions at estimates in 1992, that debt had nearly doubled to $31.1 billion. The stress occurred over the next very short period when people like Mr John Edwards and HSBC were actually advising Mr Keating. He was getting advice from people like the then Senator McMullan, who said to your committee, 'I don't know about this. I hope someone else knows about it.' That is the advice he was getting. During that period of economic vandalism in Australia's history, the debt that had to be managed literally tripled. It went from $16 billion to $31 billion in one financial year, and then it went to $96 billion. So you have tripled the size of the debt management task and the ironic—

Senator CONROY—Mr Chair, can I just take a point of order?

CHAIR—Senator Campbell, there is a point of order.

Senator Ian Campbell—The ironical thing is that—

CHAIR—Sorry, Senator Campbell.

Senator Ian Campbell—The stress on the benchmark, and I will conclude—

CHAIR—Senator Campbell, there is a point of order. Senator Conroy.

Senator CONROY—I am just wondering what question Senator Campbell is answering.

CHAIR—Senator Campbell is answering the question that was put to you initially by Dr Henry, and he is elaborating upon it.

Senator CONROY—Sorry?

CHAIR—Senator Campbell.

Senator Ian Campbell—We are focusing on the issue—

Senator CONROY—Mr Chair, can I take a point of order on relevance to the question I asked?

Senator Ian Campbell—of the benchmark, the suspension of the benchmark and the pressure that comes on the benchmark. There are two factors. There is the change in the strength of the American dollar against the Australian dollar. That is one crucial factor and, of course, that was a significant factor in the year 2000. The other incredibly significant factor was that, because of sound economic management, Australia's net government debt was significantly reduced, therefore ensuring that the 15 per cent benchmark became a serious issue. Now if we actually wiped out all of Australia's debt, if we got rid of all of Labor's debt, then of course 15 per cent would actually be zero: 15 per cent of zero is zero. You would have an even more severe issue in relation to how you repatriate the US denominated debt.

Senator WATSON—Dr Henry, in terms of the use of swaps, what are the differences in practice and procedure between the government's use of the swaps program and the private sector's use, because it has been suggested that swaps is best left to the private sector?

Dr Henry—It may be that Mr Allen will want to add to this. Can I just note again, as Dr Parkinson indicated in his opening statement, that the Commonwealth has had a foreign currency exposure in its debt portfolio since at least the 1930s and probably the 1920s. That is not by any means new. However, more recently—that is, since 1988—the Commonwealth has taken a view that it may be more efficient to achieve that foreign currency exposure not through the issuance of physical debt denominated in foreign currencies but, rather, through the issuance of physical debt denominated in Australian dollars and then using swaps in order to convert that Australian dollar exposure into a foreign currency exposure. That is why the Commonwealth has made use of swaps.

I can only speak for the Commonwealth. But since the net effect of the use of swaps is absolutely identical in terms of foreign currency exposure to having issued in foreign currency in the first place, I do not see that there is a particular issue there concerning the use of swaps. For heaven's sake, our analysis shows that in most circumstances if you want to achieve a foreign currency exposure it is cheaper, and certainly more flexible, for the Commonwealth to issue in Australian dollars and to swap into foreign currency exposure. I have not seen anybody suggest that that is not the case, but I cannot speak for the private sector.

Senator WATSON—Maybe you might look at the use of an underlying or alternative asset in terms of providing a sense of security. Are you swapping just the interest program or the debt itself?

Mr Allen—In terms of the issue of using swaps in our portfolio, I think as Dr Henry has just outlined, which was reinforcing the point that Dr Parkinson was making, what we have is a portfolio of risks by definition of having a debt portfolio. We then assess the risks of that portfolio and, in the context of seeking independent advice from external consultants in terms of the range of risks that we have within that portfolio, we make an assessment about whether those risks are the ones that are desired to achieve our portfolio management objectives. When we engage in swap transactions, what we are doing is changing the nature of the existing cash flow profile on our portfolio and repositioning that into our desired set of cash flows. Whilst that is a transaction that could also be undertaken by the private sector, that particular transaction in the private sector is often taken by market participants who may be seeking to take a trading view. A trading view is one where they do not have the set of underlying risk exposures in their portfolio, and they are actually not looking to reposition those risks into a desired optimal portfolio structure. They are just starting effectively with a blank sheet of paper and taking a particular view on the cash flow profile that is inherent within the swap transaction and, depending upon the future path of either interest rates or currency rates, their pay-off profile will be determined by that particular outcome.

In our case we are different to that example. As I explained, we start with an underlying portfolio which has a set of cash flows, a set of risks attached to that underlying portfolio. Through the use of swap transactions we are looking to reposition those cash flows consistent with what we feel is the optimal portfolio structure.

Senator WATSON—Which was into US dollars.

Dr Parkinson—Just to reinforce that point, the reason why we engage in portfolio management is because we have Commonwealth debt. The private sector, particularly those people taking trading positions, do not start from having to manage a portfolio of debt. We have to. If we did not have any debt, we would not have anything to have to manage. As I

said earlier, once you have debt you have risk. This is just one way of helping us manage some of those risks.

Senator WATSON—In your repayment of this approximately $50 billion that Senator Campbell referred to of Labor's debt by the current document, did you give any priority to trying to minimise or to focus on reducing the impact of the swaps program?

Dr Parkinson—The swaps program was aiming to maintain a foreign currency exposure of around 15 per cent of the entire portfolio. So as debt was repaid, as the net debt shrunk, the actual amount of the swap portfolio shrunk commensurately. Were we to have tried, for example, to unwind the swaps portfolio, that would have actually breached us, and from the benchmark in the other direction we would have been engaging in abandoning the policy of having 10 per cent to 15 per cent exposure—

Senator WATSON—Surely there is no breach in being below the maximum?

Dr Parkinson—It is a target. It is a 10 per cent to 15 per cent range. The objective was to have foreign currency exposure within that amount. Otherwise you could have just said, 'We'll have foreign currency exposure of zero.' But it is—

Senator WATSON—So just because somebody said that it is a good idea that you go to a maximum of 15 per cent or 10 per cent you said, 'We'll stick to this,' even though the conditions may be that you have the opportunity to wind it back? Given the history of what happened, does it make sense?

Dr Parkinson—The reason why you are engaging in it is because you believe from a long-term perspective it will generate you some savings.

Senator WATSON—But your short-term history was negative, particularly during this period—1997—when you accelerated your program?

Dr Parkinson—It was negative for the first four years the policy was in place.

Senator WATSON—That is why I asked whether there were any questions. That is why I sought those assurances.

Senator CONROY—Back in 1992.

Senator WATSON—I find it incredible that you have a maximum and that you believed you had to stick to your maximum even though you were making massive repayments. I would have thought that would be the environment where you would try to get it down and reduce your limit.

Dr Parkinson—Let me be completely blunt about this. What you are telling us is, with the benefit of hindsight, the Australian Treasury should have gone and—

Senator WATSON—Sound business commonsense.

CHAIR—Senator Watson, let the witness finish his answer. Dr Parkinson.

Dr Parkinson—If you had said to us that when the swaps portfolio was in the money we should have attempted to unwind that—pocket that—then you are telling us to act in an analogous fashion to private sector. The problem is we are a very large player in that market. We could not unwind that position even if it was consistent with our strategy, and it was not consistent with strategy. The strategy was basically a holding one, where you took a long-term perspective on the basis of the analytical work undertaken internally and externally. With the benefit of hindsight, you can question that work, but that was the best possible work that could be done at the time. We had external advice from a number of consultants. We had our

own internal work. We decided it was an appropriate strategy to have 10 per cent to 15 per cent of the portfolio with a foreign currency exposure. If you are saying that we should have managed out of the swaps book at any particular point in time, you are telling Treasury to engage in speculation about the currency and interest rates.

Senator WATSON—No, commonsense. Those are all my questions.

Senator Ian Campbell—My view is that if someone advocates that you do that now you are speculating on what will happen between now and the end of this decade.

Senator CONROY—That is what you have decided to do.

CHAIR—Do you have any further questions?

Senator WATSON—No.

Senator Ian Campbell—If you got rid of all the exposure now, you would be speculating on what is going to happen over the next eight years.

Senator CONROY—That is what you are doing. You are managing out.

Senator Ian Campbell—That is right, managing out.

Senator CONROY—Is that your current policy?

Senator Ian Campbell—Our current policy is to actually repay all of the Labor debt. Our policy is to get rid of Commonwealth debt.

Senator CONROY—No. You are now confused between two different things.

Senator Ian Campbell—Labor's policy was to run the debt up at the rate of $13 billion—

Senator CONROY—Dr Henry, are you speculating?

Senator Ian Campbell—The Labor policy was to run the debt up at $13 billion a year and the Labor policy was to then go and get $1.95 billion a year in US debt. That was the policy supported by John Edwards of HSBC. That was the policy supported by then Senator McMullan. That was the policy supported by John Kerin, Ralph Willis, P.J. Keating—

Senator CONROY—Peter Costello.

Senator Ian Campbell—No. We are talking about a policy of running up debt at $13 billion a year. Our policy has been to actually pay down debt. We started off with $96.28 billion inherited from Keating, Willis and John Edwards of HSBC.

Senator CONROY—Any mug can sell an asset.

Senator Ian Campbell—We inherited that from that bunch of economic gurus.

Senator CONROY—Do you know if you sold your house you would not have a mortgage, Ian?

Senator Ian Campbell—And as we speak, Senator Conroy, we have paid down the debt to roughly $35.5 billion in this fiscal year. You ran it up.

Senator CONROY—If you sold your house you would not have a mortgage.

Senator Ian Campbell—You ran it up to $96.28 billion. You spent $13 billion a year more than you earned. We have been paying back the debt. The problem that the Commonwealth has in terms of managing debt is—

Senator CONROY—But you lost $5 billion.

Senator Ian Campbell—a problem that was created by Paul Keating and his economic advisers in John Edwards and Mr McMullan. I think it is the ultimate irony that you still have Mr McMullan as the Treasury spokesman. It says a lot about the Labor Party learning the lessons of economic—

Senator CONROY—What about a Treasurer who has just lost $5 billion?

CHAIR—We will go to your questions—Senator Conroy—

Senator CONROY—It is only an hour and 10 minutes since we started.

CHAIR—Senator Watson has been asking questions and Dr Parkinson has been making an opening statement.

Senator CONROY—He voted against even turning up.

CHAIR—Senator Conroy, the estimates committee has been reconvened and Senator Watson is perfectly entitled to ask questions—

Senator CONROY—But he did vote against reconvening—

CHAIR—as he has been doing. There are a couple of housekeeping matters. First of all, Dr Parkinson, you had some documents that you wished to produce to the committee. May they be handed to the officer now, please, so that they can be copied for the members of the committee fairly promptly? Thank you. Senator Conroy.

Senator CONROY—I just wanted to run through the list of the documents that you have provided and the ones that you have not. Have you got a copy of the Senate resolution?

Dr Parkinson—Yes, I have.

Senator CONROY—Could you just take me down which ones you have supplied to the committee?

Dr Parkinson—I am assuming that your copy is exactly the same as mine.

Senator CONROY—Hopefully.

Dr Parkinson—Under item (c) of your motion, under point (i) we have provided you with documents listed at (B), (C) and (G). They are the UBS 1996, UBS 1998 and the Bankers Trust, Carmichael Consulting and Coopers and Lybrand 1997 reports.

Senator CONROY—And item (A), the AOFM review of foreign currency exposure—is that a state secret?

Dr Parkinson—We have taken the view that—and this is not a new view; the Treasury has taken this view for a very long time—it is inappropriate to provide documents that go to the matter of advice of the deliberative process for us preparing policy advice. We have taken the view that the AOFM review which you refer to under item (A) falls into that category.

Senator CONROY—So all of the other files fall into the category of—

Dr Parkinson—All of the other items that are under (c) (i) plus the files that are listed.

Senator CONROY—And (ii) down to (xvii)?

Dr Parkinson—Yes.

Senator CONROY—Are any of those the actual reports that you supplied in terms of the actual advice to the Treasurer?

Dr Parkinson—I am sorry?

Senator CONROY—Are any of those ones—

Dr Parkinson—Of the three that we supplied?

Senator CONROY—No, of the ones you have not supplied, are any of them the actual advice that went to the Treasurer, or are they background documents?

Dr Parkinson—They are part of our policy development process. Let me go back to something that I said in my opening statement, which is that we have not advised the Treasurer of anything that is not on the public record in this matter.

Senator CONROY—I am not disputing that that is the case. I am just seeking to confirm that none of the documents that you are not supplying are actual advice. I understand the convention that we can ask for them but fundamentally the departmental officers will always say, 'We cannot tell you what is our advice,' but none of these documents are the actual advice?

Dr Parkinson—As you know, the position that we have taken for very many years is that—

Senator Ian Campbell—It is not only Treasury—

Senator CONROY—No, I said departmental officers, which was covering a broader area.

Senator Ian Campbell—All government departments under all previous administrations as well.

Dr Parkinson—We are trying to be helpful. That is why we were happy to provide the external consultants' reports, but the others go to matters in the nature of advice or recommendations to the minister or to the development of policy.

Senator CONROY—Not the actual advice?

Dr Parkinson—The development of policy.

Senator CONROY—Are you aware that from time to time the Senate does ask for information and documents like this and, on occasions, the government and the departments do supply this information? It is not like there is a blanket 'No'. The Senate has passed resolutions that have been followed by departments and they have supplied information—I think they are called return to orders.

Dr Parkinson—I am aware of that.

Senator CONROY—So material that would fall into the description of these documents has been supplied to the parliament before.

Dr Parkinson—I am aware of that, but not by the Department of the Treasury.

Senator CONROY—You have never complied with a return to order, or you have never supplied a document that might be helpful?

Dr Parkinson—The latter is in the eye of the beholder. The issue is that we have never provided documents which we believed to be part of the deliberative process.

Senator CONROY—Even after a return to order?

Dr Parkinson—I would have to check exactly what returns to order we have ever been subject to, but I would be very surprised were that to be the case.

Senator JACINTA COLLINS—Are you making a distinction, though, between you providing it as opposed to the minister choosing to provide it?

Dr Parkinson—The Treasurer can choose to provide it.

Senator JACINTA COLLINS—And has done so?

Dr Parkinson—If the Treasurer chooses to provide it, that is a matter for the Treasurer. As far as the department is concerned, the department's position has always been that we will not provide material that goes to the deliberative process.

Senator Ian Campbell—A former Treasurer, some of us might recall, when asked to appear or send officers to a Senate committee, made a very famous statement about slumming it before Senate committees. I think you will find that this Treasurer is far more cooperative with the processes.

Senator JACINTA COLLINS—I do not think it is an issue that—

Senator Ian Campbell—The previous Treasurer refused to let anyone appear before Senate committees.

Senator CONROY—I would just like to start where we finished last time, Dr Parkinson. Thank you for that extra information that you supplied to us in the form of your 22 February letter and graph.

Dr Parkinson—Can I just get the letter?

Senator CONROY—Mr Allen did not have it for you? He had everything else, it seems—10 years of Hansard records.

Dr Parkinson—I can bring my own records, thank you, Senator.

Senator CONROY—I just wanted to go through the years from inception to 1996-97. The cumulative economic gain from the commencement of the program to 1996-97 was roughly $3 billion. Is that correct?

Dr Parkinson—The economic return of the portfolio—and, as the letter notes, this is both the realised and unrealised returns to the portfolio and includes the impact of changes in interest rates on the market values, swaps. Was 1996-97 the year that you were pointing to?

Senator CONROY—Yes.

Dr Parkinson—From eyeballing the chart it looks to be a number that is like $3 billion.

Senator CONROY—So you would agree with the Treasurer's comments on the *7.30 Report* when he was asked about the program? He said, 'I think it is fair to point out that the policy commenced under the Labor Party and the Treasury position was that it was actually a profitable position.'

CHAIR—Senator Conroy, I suspect that question probably violates the prohibition on asking officers to comment on policy.

Senator CONROY—I am just asking him to confirm that the Treasurer has stated that this was what the Treasury was saying.

CHAIR—You are reading from a transcript of a media interview. You are not permitted to ask a question inviting an officer to comment on policy.

Senator CONROY—I am asking him to comment on whether he agreed with the Treasurer's statement about Treasury's views.

CHAIR—Just put your question again, Senator Conroy.

Senator CONROY—The Treasurer's comment is:

It's fair to point out that the policy commenced under the Labor Party. The Treasury position was—

so he has referred to the Treasury position—

that it was actually a profitable position.

CHAIR—What is the question?

Senator CONROY—I am just asking Dr Parkinson to confirm that that is the Treasurer's statement. He would agree with that?

Senator Ian Campbell—Could we get a copy of the whole transcript? The oldest trick in the game is to quote a small piece of a transcript. Let us have a look at the whole transcript.

CHAIR—I think Senator Watson is trying to take a point of order.

Senator WATSON—My point of order is that it is improper, because it impinges on policy, to ask a Treasury officer—

Senator CONROY—It is not a point of order.

CHAIR—Let him state his point of order.

Senator WATSON—about a statement made by the Treasurer as to whether he believes it confirms the Treasury view or whether it is correct. I do not think you can accept the question. It is improper for Treasury to speculate on these sorts of issues.

Senator CONROY—I am asking him to confirm whether what the Treasurer said is accurate.

CHAIR—It seems to me there are two issues here. One, Senator Watson's point of order is whether or not in form the question is asking the witness to comment on policy. In the form in which the question has most recently been put I do not think it does. The other question is the question of fairness to the witness; that is, asking the witness, sight unseen, from a selected quotation from a media transcript to confirm or adopt what the Treasurer may have said. I do not think, in fairness to the witness, he can be asked a question like that from an isolated quotation from a transcript he has not seen. You can put a proposition to the witness, Senator Conroy—

Senator CONROY—I am asking him to comment.

CHAIR—You can put a proposition to the witness and you can ask him to comment upon that proposition, as long as that is not inviting him to comment on policy.

Senator CONROY—I am just asking him to confirm that the Treasurer agrees that when Labor ran the program we made a profit. That is what the Treasurer said. I am just asking him to confirm his own figures. When Labor ran the program it was $3 billion in surplus.

CHAIR—I do not think you could ask him to confirm what the Treasurer said or did not say on a particular occasion when he has not seen the transcript. If you want to put a proposition to him and ask him to confirm facts or figures that is fine, subject to the bounds of relevancy. So proceed in that way, Senator Conroy.

Senator CONROY—I am happy to give him a copy, but I am also happy to move on.

CHAIR—Dr Henry wants to respond.

Dr Henry—I just want to make the point that it is very difficult and a little dangerous to make judgments about profits that may or may not have been achieved at any particular point in time. It would be prudent to await the realisation of positions before making such judgments. Certainly if the judgment that is being made is that at a particular point in the past

we were sitting on a substantial profit, I would ask you to bear in mind that we will not know what the return on those swap positions is until they are finally exited. We will not actually know. The same is true, obviously, with respect to the swaps that we presently have in the portfolios. It will be about eight years—maybe even longer—before we know what the final outcome is and what the final return on those swaps is. That proposition holds obviously with respect to the existing stock of swaps on the books, but that same proposition held at every point in the past. That is, simply looking at the stock of swaps on the books at a particular point in time and making some judgment about their economic value at that time does not provide terribly good guidance as to what will be the eventual outcome of those swap transactions.

Senator CONROY—It is, notwithstanding Dr Henry's comments, correct that by the end of the year 2000-01 the cumulative position was negative and the difference between 1996-97 and 2000-01 is net roughly $5 billion in terms of the economic gain/loss. So there is a $4.85 billion change in the position on the cumulative, rolling graph that you supplied to us.

Dr Parkinson—Let me go back and remind you what this chart is showing. It is a combination of the realised gains or losses in any given year and the market value—essentially the liquidation value of the portfolio. That is calculated on the assumption that you could actually liquidate. As I made clear in my introductory comments, if you had attempted to liquidate in, say, August 1998 or October 1999 you would have needed to have liquidated between $US8 billion or $US7 billion at any point in time. It is very difficult to comprehend, or to believe, that you could have unwound those and actually generated the positive liquidation values or the negative liquidation values that are reported. It is almost certain that you would have had some impact on the foreign exchange market. As I said earlier, we are a big player in this. So what you are asking is: on the assumption that you could have liquidated the entire portfolio, and including the realised gains or losses in that year, would you have then picked up a positive figure in 1996-97 and a negative figure in 2000-01? That is correct, but I go back to the point that it is predicated on the assumption that the prices that are ruling in the market on 30 June of those years could actually be maintained when the Commonwealth got out of its position. Frankly, I wonder why we calculate these numbers—

Senator CONROY—It is called accrual accounting. It was introduced by this government.

CHAIR—Senator Conroy, I do not think Dr Parkinson was finished his answer.

Senator CONROY—He was just wondering why—

CHAIR—Senator Conroy, I am not going to have discourtesy to senior officers of the Treasury. Dr Parkinson.

Dr Parkinson—Thank you, Chairman. Senator, what I was about to say does not reflect in any way on accrual accounting. What I am saying is that I do not see why anyone would calculate these and think that you could end up actually realising these gains or losses. Whatever happens, there will be some movement that takes you away from the numbers that are here.

Dr Henry—Could I just add to that? I think an interpretation has been placed on these numbers that is not warranted. This goes to Dr Parkinson's remarks. There is a temptation in looking at this graph to say, 'What would we have crystallised had we liquidated at a point in time?' That interpretation is entirely unwarranted because it was never anybody's idea, never anybody's proposition—and in fact it is entirely inconsistent with the whole strategy—that the portfolio be liquidated at any point in time.

A better question to ask—these figures do not answer this question—would be this. Let us take August 1998, any particular time, and let us ask the question: by the time we have unwound this entire portfolio over the next 10 years, what gains or what losses might we eventually realise? That would be a better question to ask. That is the sort of question that I think Senator Conroy is getting to.

This chart does not show that. This chart does not say that in 1996-97 our view was that over the next 10 years, as the swaps matured, we were going to crystallise a gain of $3 billion. The chart most certainly does not show that. In order to make that judgment, one would have to know the value of the exchange rate on every day for the whole 10 years subsequent to that point in time, just as, and I was making this point earlier, in order to make a judgment right now as to the eventual outcome in financial terms of the execution of the swaps strategy, one would have to make a judgment about the value of the exchange rate—and interest rates, incidentally, both in Australia and the US—between now and some point about eight, nine or perhaps even 10 years hence. It is very misleading to conclude from this chart—in fact quite inappropriate—that the difference between the value of the program in 1996-97 and the value of the program now is $5 billion, because this chart most assuredly does not answer the question that you would need to answer in order to make that judgment.

Senator CONROY—That is a very entertaining—

CHAIR—Sorry, Senator Watson wants to interpose a question. Senator Watson.

Senator WATSON—Following your line of argument, Dr Henry, it is against the—

Senator CONROY—You are not serious. If a Liberal wants to ask a question, they just get to butt in, do they?

CHAIR—Senator Conroy, just behave yourself.

Senator CONROY—I just want to know whether you are going to chair this impartially or not.

CHAIR—Yes, I am, Senator Conroy. I let you interpose a question into Senator Watson's line of questioning because it seemed to be relevant specifically to the issue. Senator Watson is asking for the same courtesy, and I am going to afford it to him. Senator Watson.

Senator WATSON—Dr Henry, your argument suggests that perhaps we should not be using accrual accounting, because by virtue of using accrual accounting people will inevitably make judgments, because by virtue of accrual accounting you do bring account at a point of time of a position as it is now.

Dr Henry—That depends. It raises a very good point, and the very good point that it raises is that, if you are going to use accrual accounting, be aware of its strengths and be aware of its weaknesses. A lot of people are aware of its strengths and prefer to ignore its weaknesses.

Senator CONROY—Did you have that conversation with Dr Boxall?

Dr Henry—It has been said quite often, in respect of funds management in particular, that one of the risks posed by accrual accounting is that people do not understand its limitations and report short-term gains and losses which encourage excessive volatility. That point has been made many times over. With respect to this committee, that is the sort of point that is being made here this morning.

CHAIR—Senator Conroy.

Senator CONROY—Is it fair to say the policy was profitable in the first period because the interest rate differential generated savings in debt servicing costs that compensated for any movement in the exchange rate? That was the fundamental philosophy behind it according to the strategy that was outlined I think by Dr Parkinson earlier. They are the balances that you weigh up.

Mr Allen—The strategy—

Senator CONROY—Mr Allen, you were going to answer my question. Mr Allen?

CHAIR—The witness is entitled to consider the answer.

Senator Ian Campbell—I would ask the senator to repeat the question.

Senator CONROY—I was asking about the basis of the policy and talking about the interest rate differential that generated savings in debt servicing costs that more than compensated for any movement in the exchange rate during the first period. That was the rationale. I was asking him to comment that that was the positive rationale for going ahead and that in the first period it was profitable while there was the differential.

Mr Allen—That was one of the factors that was underpinning the strategy. I do not have the precise breakdown of the particular impacts, but that was within the context of the objectives of the strategy.

Senator CONROY—So while there was a wide differential in interest rates, that could be a net positive for us? That was the theory behind it?

Mr Allen—That is right. That was one of the objectives included within that underpinning.

Senator CONROY—So in the latter period when the differential had disappeared, the liabilities bore the full brunt of the fall in the exchange rate. Is that a reasonable way to describe it? Don't let them put pressure on you, Mr Allen.

Senator Ian Campbell—It is actually not a question; it is a proposition.

CHAIR—Any senator is, subject to the bounds of relevance and the prohibition of commenting on policy, entitled to put a proposition to a witness and invite comment, which is what I think Senator Conroy has done. So I will allow the question.

Senator Ian Campbell—Senator Conroy said the interest rate differential between the US and Australia has changed.

Senator CONROY—Went to zero.

CHAIR—Rather than try to deconstruct Senator Conroy's question, Senator Conroy can you reput the question, please.

Senator CONROY—I think Mr Allen is okay. He has had his briefing from Dr Parkinson now.

CHAIR—I am not quite sure where we are. Do you have anything to add to Senator Conroy's question?

Senator CONROY—Mr Allen has not started his answer yet.

Senator Ian Campbell—Would you like to turn it into a question and then answer it?

CHAIR—Do you understand what is being asked of you? Perhaps it might be best to repeat the question.

Senator Ian Campbell—It was not a question; it was a proposition.

Senator CONROY—What I was asking was in the period when the interest rate differential moved to zero—and at one point it actually went the other way—the liabilities bore the full brunt of the fall in the exchange rate. That was in the latter period which I am defining as after 1996-97.

Senator WATSON—But that is not the case.

Senator CONROY—It is the case if you actually have a look at the chart.

CHAIR—What is the question?

Senator CONROY—Is that what happened, that the liabilities were being borne purely on the exchange rate movements because the differential was gone?

Mr Allen—I would not say purely on the basis of—

Senator CONROY—It does not have to be 100 per cent—

CHAIR—Let him finish. Yes, Mr Allen?

Mr Allen—I would not say it was purely driven by currency impacts.

Senator CONROY—But the larger majority? I am not asking you to put a percentage on it, but that was the most significant factor once the interest rate differential closed?

Mr Allen—There are other factors impacting on that particular outcome, including changes in markets assessment of risk premium. That obviously had an impact on the outcome.

Senator CONROY—But the most significant factor would have to be the exchange rate once that differential closed. I am not asking you to say up to 100 per cent. I accept your qualification and I accept 'not purely'.

CHAIR—Mr Allen, Hansard cannot record a nod.

Mr Allen—I am sorry.

Senator CONROY—I saw Dr Parkinson give you permission to answer it, so you can speak up now.

CHAIR—Senator Conroy, no editorial comments, please. This is very undignified. Mr Allen, do you agree with what Senator Conroy put to you or do you not?

Mr Allen—There were a range of factors impacting on the movement in the economic value of the portfolio.

CHAIR—But what you were asked is whether what Senator Conroy put to you was the most important or the biggest factor. Do you agree?

Senator CONROY—Significant. I think you nodded. I am just asking you to say what you nodded.

CHAIR—Do you accept that or do you not?

Mr Allen—It is one of the factors that contributed to the movement.

Senator CONROY—Is there a more significant factor?

CHAIR—Mr Allen or other officers at the table, it is a proper question. Now what is the answer?

Senator Ian Campbell—We are talking about managing this over the period from 1988 through to 2001, and Senator Conroy asked: roughly when the interest rates narrowed was

this a factor? I think the sensible thing to do for an economics committee and the Treasurer—if you want to have a discussion—is say, 'Let's say in 1997-98 or 1998-99 what were the factors,' because with hindsight you can actually say what the factors were.

CHAIR—Senator Campbell, it seems to me to be a simple question. Senator Conroy has identified one particular factor and his question is: in the judgment of the officers at the table, was that the most significant of all the possible factors?

Senator Ian Campbell—I am saying when. What year is he talking about? What period of years—five years?

Senator CONROY—I did specify that. I said 'the latter period', which I defined as after 1996-97. That is actually when the differential closed. Mr Allen indicated by nodding his agreement with my proposition, and all I am asking him to do—because Hansard cannot record a nod—is say yes.

CHAIR—Sorry, Dr Parkinson, do you want to have a go?

Senator CONROY—I have simply asked Mr Allen to confirm the fact that he nodded, which Hansard cannot record.

Dr Parkinson—I think the question has been answered.

Senator CONROY—It has not. His lips appear to be sewn together by Dr Parkinson.

CHAIR—As I heard Mr Allen's answer, he agreed with you, Senator Conroy, that the factor that you identified was one of a range of factors, of which there were several others. You then asked him whether that factor was the most important factor—

Senator CONROY—'Significant' I said.

CHAIR—or significant factor, and I think that is where we are.

Senator CONROY—Mr Allen—

Mr Allen—I answered the previous question in saying that there was a range of factors impacting on the movement over the period that you are referring to. The factors included interest rate differentials, risk premia and movements in the currency.

Senator CONROY—That is three factors that we have agreed on. One of them has gone to zero. There are two factors left. Which is the more significant?

CHAIR—Just a moment. Do you accept, Mr Allen, that those are the only three factors?

Senator CONROY—Can I ask the questions?

Senator MURRAY—Point of order, Mr Chairman.

CHAIR—Yes.

Senator MURRAY—I am sitting here listening to all of this in amazement because of the degree of interjection from the Liberal senators and the Labor senator, and the rapidity of it is making it impossible to get a measured moment when the panel of officers and the minister can respond. It is almost reaching a level of embarrassment. I would appreciate, as someone trying to follow what is going on, being allowed to hear the questioner ask the question and let the panel answer without a great deal of intercession—unnecessary intercession.

CHAIR—I think we all agree with that, Senator Murray. I think there is a question before you, Mr Allen—Senator Conroy's question.

Mr Allen—Again, I would make the point that there are a range of factors. I mentioned the three factors: interest rate differential, risk premia and currency. Depending upon which particular period you are referring to, the impact of any one of those factors can change. Looking at that particular period, in the absence of actually not undertaking that analysis, drawing the conclusion that in any particular period the movements in the economic value of the portfolio were attributable to just one of those three factors would be dangerous. One would need to understand the definitive starting point and the definitive end point in order to actually undertake that analysis.

Senator CONROY—It is going to be a long morning. I will quote from page 57 of the Auditor-General's report, which might help you. It states:

If interest rate differentials between Australia and the United States remain small, the key determinant in the effective cost of a debt portfolio ... will be the exchange rate.

Do you agree with the Auditor-General?

Mr Allen—I have no reason to dispute what the Auditor-General is saying.

Senator CONROY—So when I asked you: is the most significant factor, with the interest rate differential down to zero, the exchange rate movements—

Dr Parkinson—Sorry, perhaps—

Senator CONROY—It is the same question, just using my words. I am just pointing out that I asked the same question as a statement. You are prepared to agree with the Auditor-General, but you do not want to answer my question.

CHAIR—Sorry, there has been no—

Dr Henry—Perhaps I can clarify.

CHAIR—Dr Henry wants to come in.

Dr Henry—I think the reason we have been having difficulty here is that there is a question about the performance of the portfolio. Just imagine that the portfolio did not change; you have just got a particular stock of swaps sitting there. You could ask this question: over time, as interest rate differentials moved and in particular as they closed, what implications did that have for the performance of that existing portfolio? That is one question. It is a tricky question to answer because in fact a lot of other things do change. What the Auditor-General's report goes to, as I understand it, is really the question of the appropriateness of the continuing strategy. I appreciate—

Senator CONROY—You are anticipating a whole series of questions that I am probably going to ask you. I am happy for you to come in at that point. But I am really just asking you a fairly straightforward question. I appreciate you want to impute where I want to go but, if you let me go there, then you can come on down.

CHAIR—Dr Henry, do you want to continue your answer?

Dr Henry—I will be very brief, I must say. I do not necessarily want to have to repeat myself, and if I am anticipating—

Senator CONROY—Tragically, I anticipate that.

Dr Henry—There is a risk of that. I did want to make the point that clearly in the analysis of the appropriateness of the strategy, issues concerning likely interest rate differentials and exchange rate volatility are important. It certainly is the case—it has to be the case—that

different circumstances can lead to different judgments being made about those things. I think that is what you are trying to say.

Senator CONROY—I understand from the Auditor-General's report that in 1996 Treasury actually conducted a review because of the narrowing interest rate differential. You actually had a look at it in 1996.

Dr Henry—Indeed, we have had several looks.

Senator CONROY—Lots of looks.

Dr Henry—Indeed, and a number of external consultants. As you note, there was the Auditor-General's report. That was followed by a JCPAA hearing. As you also know, at no stage in any of those reviews or those processes, including parliamentary processes, were we advised that despite changing circumstances—circumstances were changing—we should exit the strategy; that is, the strategy was no longer appropriate.

Senator CONROY—I am not having an argument about that at all. I am probably not going to even ask you any exciting questions about that. So thanks for your contribution. Mr Allen, you said that you could not argue, I think, with the proposition that the Auditor-General has made. When did you actually start with AOFM?

Mr Allen—March 2000.

Senator CONROY—So most of this predated you. You inherited the Auditor-General's report.

Mr Allen—That is right.

Senator CONROY—But you coordinated the AOFM's response to the report, because I think you made the submission and appeared before the joint parliamentary committee on accounts.

Mr Allen—That was my first involvement.

Senator CONROY—Yes. But you were originally involved in responding to the Auditor-General's—

Mr Allen—I was involved in that response process.

Senator CONROY—But you were not there in the period on which the Auditor-General reported on?

Mr Allen—No, that report had been tabled.

Senator CONROY—Prior to you starting.

Mr Allen—Yes, in late 1999.

Senator CONROY—Okay. Thanks. Since there were no longer any savings in interest costs by swapping into US dollars, can you tell me whether the Treasury review in 1997 recommended the policy of swapping US dollars was to continue? I was not necessarily directing that to you; it was more to Dr Henry or to Dr Parkinson.

Dr Henry—Sorry, my apology. I missed the time period.

Senator CONROY—1997. Treasury conducted a review in 1997 also.

Dr Henry—Right.

Senator CONROY—I was asking, given the interest—and there were not any savings from the interest costs by swapping into US dollars—can you tell me whether the Treasury review in 1997 recommended that the policy of swapping into US dollars should continue?

Dr Henry—Certainly, the internal review of the benchmark in 1997 concluded that the assumptions underpinning the earlier analysis—and that is the 1996 analysis—still remained valid and that the benchmark should be retained.

Senator CONROY—Can I just clarify here, because the language means different things to different people. When I use the word 'benchmark' I am probably talking about the 15 per cent type benchmark.

Dr Henry—Yes.

Senator CONROY—When I talk about the policy, I am talking about the actual overall strategy of going into it, not whether you maintain 15 per cent. Just so I make sense: it is just that a number of questions have been asked and people keep lapsing into a conversation about the policy and people keep then having a conversation about the benchmark. So I am just trying to differentiate between the policy and the benchmark—the benchmarks within the policy, if I can say. Does that make sense?

Dr Henry—We may have a difficulty going forward then, because my understanding of the policy—

Senator CONROY—Please.

Dr Henry—We should settle this now, obviously. My understanding of the policy was that the debt management office initially and then the AOFM meet a particular benchmark. I cannot draw a distinction between policy and benchmark.

Senator MURRAY—If I might just get some clarification on the same point, the benchmark was always a percentage, not a quantum, wasn't it?

Dr Henry—That is correct.

Senator MURRAY—And the risk increase was in fact because the percentage relationship would produce such a quantum lift; that is right, isn't it?

Dr Henry—As Senator Campbell has indicated, it is certainly the case that, as the denominator increases, if you like, as the stock of debt increases, the debt management office and the AOFM managing to a benchmark expressed as a certain percentage of that stock would be obliged to increase our swaps exposure, our foreign currency exposure.

Senator MURRAY—Through you, Mr Chair, and as an aside to Senator Conroy, the issue then is whether the review should ever have looked at a limiting of quantum as well as a limiting of percentage.

Senator CONROY—I think that is a fair question. You might want to answer it.

Dr Henry—I think over the relevant period that Senator Conroy is referring to debt was actually falling.

Senator CONROY—Can I go back—

CHAIR—I was proposing to have a break, but I do not want to interrupt the flow of your questioning.

Senator CONROY—I am happy to come back. The flow will not be interrupted by having a break.

Proceedings suspended from 10.49 a.m. to 11.03 a.m.

CHAIR—I call the committee to order. Can I just indicate that the expectation is that we will get to APRA at about half past 12.

Senator CONROY—Dr Henry, I was just wanting to clarify so that when I asked a question, if you like, you understood the context of the way I was asking it. I took the policy division to be in US dollars and then there is a benchmark to manage the policy. Does that give you an indication of how I am thinking so you have the context when I ask my questions?

Dr Henry—Yes, I understand.

Senator CONROY—It might not be quite the strict definition that you have on it. I think some of the public debate has been confused because of swapping in and out of those different interpretations. I was asking this: as there were no longer any savings in the interest rate costs because the differential had closed, did Treasury recommend to continue the policy?

Dr Henry—As I think I have indicated, we have conducted regular reviews. We have had external consultants' reports. At no stage prior to June 2001 did the Treasury come to the view that both the policy and the benchmark were inappropriate. Just on the benchmark, though, I need to clarify something. Obviously towards the end of the previous year—that is, 2000—we did come to the view that it would be appropriate for broader macro-economic reasons for the benchmark to be breached on the upside.

Senator CONROY—You had to stop destabilising the dollar?

Dr Henry—There were broader macro-economic concerns at the time. Those have been addressed quite comprehensively by the Treasurer, certainly in remarks that he made in a recent press conference.

Senator CONROY—But I think the RBA indicated in its press release that it was concerned about the activities that were destabilising the macro-economic conditions.

Dr Henry—That is my understanding.

Senator Ian Campbell—I think it needs to be reiterated, Mr Chair, that the pressure was created on the benchmark because we were paying down the debt. The pressure was created, particularly at that point, because we were repatriating debt. So the 15 per cent seriously comes into play. If you start with $96 billion of debt and you reduce it to $30-odd billion, that creates pressure on the US to a nominated exposure.

Senator CONROY—I am happy for you to, if you like, put up a sign behind you that says that. It is on the record.

CHAIR—Senator Conroy, get back to your question, please.

Senator Ian Campbell—The political focus is on how we manage Labor's debt and how we reduce it in an economically sensible way, in a sound way.

Senator CONROY—Given that the interest differential by 1997 was zero, why did you believe that the policy of swapping into US dollars should continue?

Dr Henry—The analysis indicated prior to that time and after that time that there was a systematic bias in the relationship between interest rates and expected exchange rate movements. The analysis that was conducted—you asked about post 1997—post that point continued to find that there was reason to believe that a systematic bias would continue.

Senator CONROY—Did you believe that the interest differential would widen out again? Was that the belief when you say the bias would continue? The bias was there because interest rates were significantly apart. They had come together. Does that indicate that you believed they would widen out again? We are talking historically, so we do not have to worry about speculating about interest rates. This is a historical analysis that you did.

Dr Henry—The analysis would have gone to more than sensitivity analysis around future changes in interest rates. Obviously, as I previously indicated, it goes to sensitivity analysis around volatility in exchange rate movements. Those, as I think you were indicating earlier, are principal considerations in this sort of analysis.

Senator CONROY—Dr Parkinson and Mr Allen said that there were a couple of other components. One was the dollar and one was the risk premium. I think that was the point Dr Parkinson was making. So those two factors were still going to bring us into the positive in the Treasury's view.

Dr Henry—The strategy was predicated on a view that, whilst there would be unavoidable volatility in the short term, over the long term it was prudent for the portfolio to have some degree of this exposure—that is, there was an expectation that having a limited degree of exposure to US currency and US swaps would have produced economic returns over time.

Senator CONROY—Did you believe that the exchange rate and the risk premia were going to continue to generate positive returns, or did you believe that the interest rate differential would widen out again? There are three components. One of them has closed down to be neutral. I am just trying to understand which of the three components was going to change this position.

Dr Parkinson—Senator, I think there is a more fundamental problem here in terms of our understanding of how these reviews are done. You are right; there were a series of factors which were identified. But it is not then a case of saying, 'Well, this factor has closed down, so let's see under what assumptions going forward it still makes sense to keep the policy.' Essentially, what you are looking at is all factors. You are running a whole series of shocks through them and building up essentially a concept of when this policy would still be sensible to maintain, with all the various combinations and permutations of developments hitting each of the components. During all this time, even though interest differentials were narrowing sometimes and exchange rates were moving, the reviews were actually going back and taking into account all of that and asking: hitting this with all of these sorts of shocks, does it still make sense to keep this policy? The conclusion each time was yes.

Senator CONROY—That is what I am trying to get to and understand. Obviously you were not going to run a long-term policy that was going to generate losses.

Dr Parkinson—No.

Senator CONROY—So presumably you believed you were going to generate returns?

Dr Parkinson—Absolutely. Also, we would not go in and say that because the differential has closed up today that therefore predicates everything. Equally, we were not going to go in and say that we think the differential is going to open tomorrow to X. What was happening was a whole series of simulations based on various developments in each of the factors, aggregating all those together and then asking the question: under all of these assumptions and with all of these shocks, is the policy robust? As the secretary mentioned earlier, all through these reviews the conclusion was that the policy remained robust.

Senator CONROY—The Auditor-General's report noted that the policy devised by UBS in 1996 was based on the assumption of an interest rate differential of 88 basis points. From September 1997 until the policy was ended—to use the Treasurer's euphemism—in December 2000, the interest rate average was just 30 basis points, and that is over a long period. How were you able to reconcile the fact that your recommendation talked about wanting an 88 basis point differential but over a lengthy period, not just the one day, as you have indicated, it averaged only 30 basis points?

Dr Parkinson—I understand the question because it goes back to the point that the original UBS modelling was done on 88, but the subsequent reviews showed that the results remained robust, even when the differential had closed to 20 or 30 basis points.

Senator CONROY—So even after you had incurred a $2 billion loss, the projection was robust?

Senator Ian Campbell—We did not incur a $2 billion loss. You have had that explained by wiser people than us. There was no $2 billion loss, there is no $2 billion loss and what you have just said is misleading. It should be struck from the record.

Senator CONROY—According to your own graph, which gives a dollar figure in the column that says '97-98', there is a negative $2 billion. This is this graph, Senator Campbell, just so you are aware of what I am referring to. This is a Treasury document.

Senator Ian Campbell—The Labor Party balance sheet shows at 1996-97 that the great financial management actually put Australia into hock to $96 billion. That is the actual realised loss of your party's economic management.

CHAIR—Order! Senator Conroy, I think you have a question for Dr Parkinson. Is that right?

Senator CONROY—Yes. I was just asking that—

Dr Parkinson—Before we go on, can we just go back for a moment? Recall earlier we were talking about the difference between the interest rate differential per se and the bias and the like. I think the 88 UBS point may have actually related to the bias. We will need to check.

Senator CONROY—I am just quoting from the Auditor-General's report.

Dr Parkinson—I do not want to be forced to conclude on the run whether or not the Auditor-General characterised the policy appropriately. My understanding is that in fact it is the bias that is 88 basis points.

Dr Henry—Perhaps I should go back to a comment I made earlier. The analysis conducted in the reviews would not have used as an indicator of success or otherwise of the strategy the sorts of numbers implicit in that chart in front of you, rather the question that would be asked is: by the time all of these swaps have matured, what would be the range of possible outcomes with respect to actual returns? So a finding in a chart—such as the one you have in front of you—that dips in one year, even quite sharply, would not necessarily imply anything about judgments on the success or otherwise of the strategy, which requires judgments being made about exchange rate movements and interest rate movements over the 10 years following. That sort of result would not imply that the strategy was unsuccessful.

Senator CONROY—I appreciate that accrual accounting is obviously not your favourite measure for measuring success or failure. Thank you for that.

Dr Parkinson—I do not think accrual accounting is germane to the issue.

Senator CONROY—Dr Henry made it an issue before. He talked about strengths and weaknesses.

Dr Parkinson—You are just attributing to the secretary the view that accrual accounting is the issue here. The issue here is that when you are doing these reviews you are trying to work out under what scenarios the policy continues to make sense in a forward looking fashion. The conclusion was it was robust. It is not predicated on accrual accounting, per se. It is predicated on—

Senator CONROY—'Robust' I am taking to mean that you were going to make gains?

Dr Parkinson—The robustness was that it was going to deliver longer term cost savings.

Senator CONROY—As opposed to longer term losses?

Dr Parkinson—As I think you said before, we would not have ended the policy if we had an expectation of making a loss.

Senator CONROY—So which factors in the measurements do you believe created the robustness at that point in time?

Dr Parkinson—We would have to go back and look at the particular reports, the internal reviews.

Senator CONROY—I was hoping you were bringing them with you to help.

Dr Parkinson—We have been over that, Senator.

Senator CONROY—I appreciate you drew a difference between the risk premium and the interest rate differential. It is a fine point.

Dr Parkinson—It is not really a fine point, because a zero interest differential does not mean that the policy no longer yields you benefits. You actually have this historic stock of swaps that have been entered into in the past. The fact that the interest differential is zero today or, similarly, that the risk premium is zero today can influence your decision on whether or not to enter future swaps. The fact that it has closed up does not invalidate the policy.

Senator CONROY—I appreciate that. The point I was making is that you are splitting a bit of a hair there in terms of the 88 basis points. They are saying you need to have 88 basis points there on the risk premium, which includes the interest rate differential. That is part of it—and a large part of it—but you were going to clarify what the Auditor-General was referring to. I actually have the relevant page.

Dr Parkinson—Can you give us the page?

Senator CONROY—It says, 'The May portfolio benchmark'—

Dr Parkinson—This is paragraph 3.34?

Senator CONROY—Yes.

Dr Parkinson—Here the Auditor-General refers to the 88 as the risk premium.

Senator CONROY—I appreciate they are not an identical concept, but they are not far apart either. The question I was asking was: at the time, 88 basis points was the recommendation from UBS. The average over a long period after 97 was 30 basis points. Your argument is that the assessments then you believed to be still valid and that it was robust—in other words, would deliver cost savings.

Dr Parkinson—Yes. That is correct. We concluded it continued to be robust.

Senator CONROY—Would you get back to us, Dr Parkinson? You said you could not give me an exact reason why you believed it was robust now, that you would have to go back. Would you be able to supply us with a—

Dr Parkinson—At which time?

Senator CONROY—We are talking about your view in September 1997. You said you did not have it with you.

Dr Parkinson—September 1997? We did not do a review in September 1997. I think we did a review in November of 1997—Carmichael Consulting, Coopers and Lybrand—and BT in September 1997.

Senator CONROY—The Treasury reviewed the policy in August 1998 in response to the fall in the exchange rate. By this stage, as we know from the chart, there was an economic loss of $2 billion. I use the words ‘economic loss’ there just so Senator Campbell does not start jumping up and down. Did Treasury continue to support the policy with an interest differential way down on its original forecast and the dollar then having fallen substantially?

Dr Parkinson—I think, as we have said a number of times, we did not propose changing the policy until June 2001. I think it is fair enough for you to therefore conclude that, at every review we did all through this period, irrespective of what was happening at the time, we concluded that it was worth while continuing the policy. As I said before, given the way in which those reviews were undertaken, that meant we were concluding the policy was robust to both the existing situation and a whole range of potential scenarios going forward.

Senator CONROY—I appreciate that. So we have the three elements, Mr Allen. The interest differential is still substantially below the original 88 basis points. It has gone virtually to zero. It has widened out a little bit from zero, if you look at the chart, so I am not saying it is exactly zero. The exchange rate has collapsed. Will that risk premium still pull it through into the positive? Would you think, with two of the three arms of the strategy haemorrhaging badly, that there was still enough punch in the other leg to lift us into the positives?

Mr Allen—What is the time period that you are referring to there?

Senator CONROY—August 1998. There are the three components which we talked about. One is close to negligible. The currency movements have plunged. There is only the one leg left that can be the robust part. Do you think there was any prospect that that could drag us into the positives?

Mr Allen—The analysis that I would assume is the benchmark assumption looks at the historical relationships. From those historical relationships an assessment is made of the optimal mix, and that was part of the original work that was undertaken by UBS in 1996. Subsequent reviews, as I understand it—I obviously was not directly involved in the process—were undertaken, both internal and external, which tested the then current assumptions of the benchmark using historical market movements. Obviously, it is dangerous to assert what exactly the assumptions were in terms of the—

Senator CONROY—This is historical, though. I am not asking you to look forward; I am asking you to give me an assessment of what the historical position was.

Mr Allen—The analysis underpinning the benchmark in terms of coming up with those relationships is over a much longer term horizon. As Dr Parkinson mentioned in his opening comments, some short-term volatility was, and has always been, accepted as part of the policy framework. Whilst you could, particularly with the benefit of hindsight, make some particular

assertions about very specific periods within a historical database regarding these financial market relationships, clearly, drawing that conclusion was inconsistent with the approach that was being taken, certainly, as I understand it, by UBS. That analysis looked at a much longer period of time. Obviously, there was testing done in terms of ensuring that the benchmark parameters that were defined were very robust. But they were based on much longer term horizons of movements in Australian and US dollar interest rates as well as the cross-rates. So it is certainly acknowledged that at times the interest rate differential would have been very narrow, perhaps. But that does not necessarily question the overall methodology which underpins that benchmark.

Senator CONROY—You would have to take a view on where interest rates were going, though, to be able to make a projection as to whether it was robust, surely?

Mr Allen—I think that is a very fundamental point that needs to be considered. As we have already mentioned, certainly in our opening comments and subsequently, taking views on particular interest rate outcomes or currency outcomes would be inconsistent with the approach. The methodology was based on historical relationships, on an assessment about the risks associated, on an ex ante basis, with looking at what would be the outcome in the context of those historical relationships, rather than forming any particular judgment about interest rates either here in Australia or in the US or about whether the Australian dollar was going to appreciate or depreciate in a particular fashion which was not derived from looking at historical relationships.

Dr Henry—Could I clarify this? I know I am running the risk of anticipating, but are you putting the proposition in your questioning that once we observed that the yield gap had closed we should have formed a judgment that that was going to remain the case forever and a day and we should have fed that into our—

Senator CONROY—No, I am just asking what was the basis of coming up with the idea that it was robust? You must have formed a view that the differential would broaden out again?

Dr Henry—Not necessarily. Certainly, the analysis that was conducted would have asked this sort of question: supposing that both Australian and US interest rates move within particular bands and supposing that the bilateral exchange rate moves within a particular band—think of these as tolerance bands, if you like—does the strategy remain robust? That is, provided that interest rates and exchange rates move within those bands, would you expect in the long term that the strategy would provide positive returns? On every occasion that that question was asked the answer was yes, with the exception, obviously, of the study that was undertaken in the first half of 2001, which was an internal study.

Senator Ian Campbell—But it should be interposed—while Senator Conroy is getting to his next question—that the exact time we are talking about was when the significant reduction in the overall debt was coming into play. We inherited from Labor a figure of $96.28 billion and, in the time we are talking about, in the fiscal years 1997-98 to 1998-99, the debt went from $82.9 billion down to $70 billion and then down to $53 billion. As Dr Parkinson said in his introduction, February 1999—to put it into context historically—was the date of the last swap that increased our exposure to the US. That was at about that same time.

Senator CONROY—I think there have been some Federal Airports Corporation swaps for which AOFM have taken over the liability after that date.

Dr Parkinson—If they were taken over by us, they have not added to the—

Senator CONROY—No, I just wanted to make that point. To be absolutely technically accurate, AOFM actually has got some extra swaps after that date that were taken over on behalf of the Federal Airports Corporation, I think.

Mr Allen—As I understand it, those transfers were underlying physical debt as well as a swap position.

Senator CONROY—But there were some swap positions in there?

Mr Allen—If I could qualify that: in isolation, saying that they were just swaps would give the impression that the stock of foreign currency exposure was increased. My understanding is that the stock of foreign currency was not increased through those transactions.

Senator CONROY—I am just making the point. It is actually in your own annual report.

Mr Allen—Yes.

Senator CONROY—That is where I noticed it.

Dr Parkinson—Senator, I am conscious that you have a limited amount of time and you want to get through your questions, but I think we really do have a fundamental problem here in terms of the discussion about interest rate differentials. I apologise if we have not been as clear from our side as we should have been. If you think about the relationship between Australian and US interest rates, the Australian interest rate is equal to the exchange rate plus US interest rates, in a very crude sense. There is a risk premium through this period, and that is not directly observable.

Senator CONROY—It is a guess?

Dr Parkinson—All you can see is the interest differential, and movements in the interest differential can reflect either an expectation of changes in the exchange rate or changes in the risk premium.

Senator CONROY—It is still a guess, though, isn't it—the risk premium?

Dr Parkinson—So the fact that the risk premium in the original analysis was 88 basis points and the interest differential closed up does not tell you, in and of itself, anything in particular. That is why I am just making the point that you have to go back, take all of this, shock the whole thing and see how robust it is.

Senator CONROY—The risk premium is fundamentally not based on anything other than your best guess?

Dr Parkinson—It was based on—

Senator CONROY—To be fair, historical data is the way—

Dr Parkinson—It was based on historical data.

Senator CONROY—you come up with your interest rate differential. Your risk premium is just your best guess?

Dr Parkinson—When we put together forecasts for the economy going out the next 12 months—

Senator CONROY—It is your best guess?

Dr Parkinson——it is our best guess, based on all of the tools that we have available to us.

Senator Ian Campbell—What is not a guess, Mr Chairman, is the historical fact that if you did not have Mr Keating and Mr Edwards—John Edwards of HSBC, former economic adviser—

Senator CONROY—Get up and give a speech on him in parliament.

Senator Ian Campbell——running up the debt to $96 billion, you would not have to spend all of this time trying to manage Labor’s debt. I think it is fantastic for Senator Conroy to put the political focus on Labor’s debt. It is something that we try to do continually, and I congratulate Senator Conroy on belling the cat.

CHAIR—Dr Parkinson, this form of words, ‘your best guess’, has been reiterated a number of times. Another way of putting that, I suppose, would be to say ‘your best professional judgment as an economic forecaster’.

Dr Parkinson—That would be a far more appropriate way to describe it.

CHAIR—And a fairer way, I would have thought.

Dr Parkinson—It would be a fairer way. Let me go back for a moment, too, because maybe this highlights the issue: you can actually estimate the risk premium in history. The question is: going forward, what do you do? In terms of testing for robustness, one of the techniques was to look at what was implied by consensus numbers. So essentially the entire market expectation of future movements puts those in as part of the whole approach to shocking and testing the system. So it is the best judgment of the people who are involved in doing this analysis at the time. It used some external sources of input, that is, the market expectations through the consensus data. The conclusion that it was robust was the best professional judgment of the people we have available to us, both internally and externally.

On that, I draw your attention—and I know this is a bit unfair because you have not had a chance to read the UBS reports—to the 30 June 1998 report, which specifically states in the executive summary that the purpose of the review was to update the initial debt benchmark in light of changes in financial markets and experience with employing a benchmark strategy. The report states:

The original report ... was written ... before the turbulence in Asian financial markets... We find that our earlier conservative assumptions remain consistent with recent financial market moves and with current market expectations.

That is picking up your point that, even with the closure of the differential and the movements in the exchange rate that occurred at the time of the Asian financial crisis, UBS was still concluding that the policy remained robust, which was entirely consistent with the results of our own internal reviews.

CHAIR—Senator Conroy, are you going to move on to another topic?

Senator CONROY—I am about to do just that.

CHAIR—Senator Watson has a couple of questions relating to the last topic if he could quickly interpose them, please.

Senator WATSON—I refer to the Warburg Dillon Read analysis titled *Efficient debt management—a review of Australia’s debt benchmark*. I have two questions. This analysis states:

The benchmark’s composition is derived from the perspective of a medium-term steady-state analysis. This implicitly assumes that the size of the debt is reasonably stable and hence that a steady state can be

defined. In view of the heavy cash surpluses that are likely to arise over the next five years, this assumption would be invalidated.

Given therefore the coalition's heavy debt repayment program, why was not the management of the debt program changed to recognise the new reality of the lower debt as a result of the heavy debt repayment? Warburg correctly analysed what was going to happen as a result of the heavy surpluses expected over the next five years. They expected the program to come down, but they said that their analysis was based basically on a high-debt program. Why was not the philosophy changed given that report, because you were warned about the limitations in the Warburg report? It appears that not much was changed.

Senator Ian Campbell—It might have been the risk of Crean becoming Treasurer again and running the debt back up.

Senator WATSON—My second question—

CHAIR—Before you ask your second question, let us have an answer to your first question.

Mr Allen—If I take the point that you are making, that is, that the UBS Warburg advice in 1998 suggested that we revisit the strategy and look at the impact of projected budget surpluses, I think they make the comment that the portfolio could effectively be split in two parts.

Senator WATSON—That is right. That was going to be my second question.

Mr Allen—Perhaps if I take the liberty of then answering in the context of that question: the policy under which the portfolio has been managed is a policy whereby the proportions that are allocated, for example, to our foreign currency share, are determined by looking at the net of AOFM's debt portfolio. In effect, that has actually picked up the point that UBS were making. UBS, in their concluding paragraph, make the comment about the need to set up a defeasance/immunisation portfolio which, from that perspective, would require the portfolio to be split into the two component parts. The approach that has been adopted by the Commonwealth has not been to split the portfolio into its two component parts; it has been to manage the exposures from a net portfolio perspective.

The foreign currency exposure is always calculated as a percentage of the AOFM's net liability position. As the budget proceeds have been applied to the repayment of AOFM's debt, that impacted on AOFM's balance sheet, so the requirement to reduce foreign currency exposures had been met by the rundown of maturities. As we have seen in another analysis the stock of US dollar outstandings has reduced over time. That enabled the 10 to 15 per cent target benchmark range to be maintained over that period from 1998 forward.

Senator WATSON—Earlier, Dr Parkinson chastised me when I suggested a different approach to debt management maturity for that debt in the near future. Dr Parkinson, if I recall correctly, suggested that such an approach would be speculative and would therefore not be used by the Commonwealth. However, the Warburg report suggests that the UBS benchmark continue to apply to that portion of the debt —

Senator CONROY—They recommended—

CHAIR—Senator Conroy, let him finish his question.

Senator WATSON——that is not targeted for repayment. However, Warburg does state that the remainder should be handled cost effectively through a tactical combination of defeasance/immunisation, anticipatory hedging and debt repurchase. You chastised me when I

suggested debt repurchase as one of the ways of treating the early maturity separately because you said it was going to be speculative.

Dr Parkinson—Senator, if you have interpreted my comments as chastisement, then I apologise profusely because that was not my intention.

Senator WATSON—You indicated I was down the wrong track.

Dr Parkinson—I was trying to make clear some of the issues here. We would obviously have to go back and see exactly what *Hansard* had recorded. The point I was making at the time, if I recall correctly, was that if we were to attempt to, in a sense, pocket the apparent economic gain, that would be akin to speculating. What Warburg is advising—and I stand to be corrected by Mr Allen if I have got this wrong—is advising de facto essentially the same as what we have done—

Senator CONROY—No, the costs are different, Dr Parkinson.

CHAIR—Let him finish and then you can have your question.

Dr Parkinson—in that Warburgs were proposing that that part of the debt that is not targeted for repayment continue to have the foreign currency exposure. What we have done is say that that part of the debt that has not been repaid has that exposure. But it is slightly more complicated than that, because there have been limitations on our capacity to go into the market and repurchase debt. So we have actually built up term deposits at the Reserve Bank and the foreign currency exposure is therefore calculated on whatever AOFM has outstanding less the term deposits it has at the Reserve Bank.

Senator WATSON—But surely that is what Potter Warburg refer—

Senator CONROY—That is what they were saying.

Senator WATSON—They refer to it as immunisation anticipatory hedging.

Dr Parkinson—Yes.

Mr Allen—If I could just add a point there. I think if you read into it, there are a couple of issues in terms of the technical details of what UBS is recommending. Regarding the comment on trying to anticipate hedging requirements, moving forward, suggesting that that is in advance of the receipt of actual cash flows, there were some aspects of UBS's advice at the time that would be inconsistent with the philosophy that the Commonwealth has been managing its portfolio under, notwithstanding the point that I think you are making, which is that as the net debt has been reduced—

Senator WATSON—But what I was saying is that the circumstances have changed.

Senator CONROY—Yes.

Senator WATSON—That is the very point, and Warburgs say that when the circumstances change as a result of surpluses through anticipatory repayments, you come down this line of splitting it into two parts.

Mr Allen—And as the portfolio has declined, the level—

Senator CONROY—But there were extra costs that you have incurred by not following the UBS Warburg recommendation, because you left all of the $80-odd billion in the market and they said, 'Take half of it out—that is going to be retired—and don't have it subject to the benchmark.' That means you have left the whole $80 billion out there and you have incurred an extra loss because you did not follow the recommendation.

Mr Allen—I think that suggestion is not—

Senator CONROY—Suggestion? You have hired them to give you advice.

CHAIR—Senator Conroy, it is an important question. Let him answer it, please.

Mr Allen—The policy that we have been managing the portfolio under requires us to meet particular benchmark targets. There have been a couple of factors that have been influencing the way in which the benchmark is being managed. There has been an application of budget proceeds to the repayment of net debt, and in this context I am talking about AOFM's balance sheet of net debt. That is the first principle. So the net debt has been declining consistent with the application of surplus budget proceeds.

The second impact is that there has been the assessment of the benchmark parameters. So the risk that we are managing our portfolio to is defined by our net liability position. So gross liabilities less financial asset holdings equals net liabilities. The net liability position is used to then determine the ratios. Foreign currency is a percentage of that net liability position. So certainly in terms of the foreign currency issue, that is one aspect.

In terms of the other issues which I think you have just introduced into this discussion, and that is the difference on AOFM's balance sheet between gross and net liabilities, which is an interest rate exposure effectively, we have not left $80 billion, to use your number, of liabilities in the marketplace. What we have been using in order to reduce our interest rate exposure—so instead of directly repurchasing that debt to effectively buy an asset to offset that liability risk—we have been using the interest rate swap market, as Dr Parkinson outlined in his opening comment. The suggestion that we have allowed the debt portfolio in net terms to reduce without a corresponding reduction in the portfolio interest rate risk is a misrepresentation.

CHAIR—Dr Parkinson wanted to add to that answer.

Dr Parkinson—Let us be completely clear here. We have got $65 billion outstanding and we have got $15 billion sitting in term deposits at the Reserve Bank waiting for an opportunity to purchase back debt. We are applying the 15 per cent benchmark to the $50 billion, not to the $65 billion. To go back to Senator Watson's question, that is effectively the same as anticipating that you are going to defease $15 billion at some stage. So you are putting that off to the side—you are not opposing the benchmark on that; you are opposing the benchmark on the bit that you are not going to pay off in the course of this year or that you do not have the cash to pay off at the moment.

Senator CONROY—I appreciate the point that you are making and I am not arguing that you disagreed with the recommendation from the consultants for what you may have thought at the time were good reasons. I am not arguing that. But Mr Allen characterised that this is a suggestion. You do not hire people to give you suggestions; you hire them to give you recommendations. There was a recommendation from UBS Warburg to split the portfolio. You disagreed, on analysis, with that and decided not to split a portfolio. It was not a suggestion; it was a recommendation. Can Mr Allen answer? He is paid more than Dr Henry, me and Dr Parkinson combined, so I would actually just like to hear Mr Allen's answer.

CHAIR—But what is the question, though?

Senator CONROY—The question is whether it was a recommendation or a suggestion. Mr Allen might want to characterise it as a suggestion from the consultant, but in actual fact it was a recommendation. Treasury and AOFM disagreed, and I am not querying the fact that you disagreed; I just want to get on the public record that there was a recommendation which

was disagreed with—in terms of how to manage; not to get out, Dr Henry, just an alternative suggestion by your consultant on how to manage it. Treasury disagreed with it for the reasons that Mr Allen and Dr Parkinson have outlined. Mr Allen, is that correct?

Mr Allen—The recommendation that was outlined by UBS to establish the defeasance/immunisation anticipatory hedging as a separate portfolio, certainly within the AOFM's balance sheet—obviously, I was not involved at the time—I could not represent to you that we do have a defeasance portfolio, because obviously in an accounting sense, a defeasance portfolio is something quite different from the way in which we manage the AOFM's balance sheet, which is managed on a net portfolio basis. So if that is the conclusion that you are drawing from that, I do not disagree with that.

CHAIR—Dr Henry may wish to answer.

Dr Henry—I am struggling to understand why this discussion is not more than semantic, and I do not mean to be offensive.

Senator CONROY—Could it get any more semantic?

Dr Henry—I do not mean to be offensive at all.

CHAIR—They are your questions, Senator Conroy.

Dr Henry—The suggestion was made earlier: one, we did not follow a UBS recommendation and, two, because we did not follow that recommendation, we exposed the balance sheet to greater costs, and that in fact greater cost was incurred. I am struggling to accept that.

Senator CONROY—You are struggling to accept your own graph, Dr Henry, frankly. You are trying to pretend that Australian taxpayers have not lost $5 billion on your own graph.

CHAIR—Senator Conroy—

Senator CONROY—You can object to it or not accept it all you want.

CHAIR—Order! Senator Conroy, questions not speeches. Dr Henry, were you finished?

Dr Henry—No.

CHAIR—Please proceed with your answer.

Dr Henry—Thank you, Mr Chairman. On the first point, whether one takes part of the portfolio and puts it in a defeasance book and does not apply the 10 to 15 per cent benchmark to it or whether one takes part of the portfolio and puts it on deposit at the Reserve Bank and does not apply the 10 to 15 per cent benchmark to it scarcely seems to matter—at least to me—in terms of the US dollar swaps exposure. I do not see the economic or financial significance of the distinction, and I would have to see the economic or financial significance of the distinction in order to conclude that one was more costly than the other.

Senator CONROY—I guess the Auditor-General fundamentally disagrees with you. It is the Auditor-General who noted this recommendation was made; it is the Auditor-General who has drawn attention to the size of your losses; and it is the Auditor-General who seems to believe that a saving could have been made if you had followed the UBS recommendations. That is what the Auditor-General came up with. It is not what Stephen Conroy came up with; this was said by the Auditor-General, Dr Henry.

Dr Henry—Senator, I do not read the Auditor-General's report that way at all.

Senator CONROY—You do not read that there are any losses involved to taxpayers; the Auditor-General does.

Senator Ian Campbell—The record shows there is no loss. You are unfortunately struggling to make the case—

Senator CONROY—I thought the loss was because of Labor. You cannot have it both ways.

Senator Ian Campbell—Your problem, Senator Conroy, is that by trying insufficiently to make the case that there has been a loss, you have actually drawn attention to the fact that Labor ran up a $96 billion debt and we are trying to manage it down. You are very embarrassed politically because you have drawn once again attention to Labor's economic vandalism and lack of credentials in this area. Now you have to try to pull yourself out of that hole, and good luck.

Dr Henry—In the public commentary on this issue over the last few weeks, a lot of people have claimed to speak for the Auditor-General in respect of what the Auditor-General may or may not have said. Most of the commentary that I have read has been highly inaccurate. In fact, there is very little of it, frankly, in respect of what the Auditor-General may or may not have said, that has been accurate. Some of it has amounted to blatant untruths, including attributing comments to the Auditor-General or to the ANAO by some journalists and enclosing those comments in inverted commas. I know those comments to have no basis to them whatsoever.

I would caution people in the way in which they are choosing to play rather free and loose with comments of the Auditor-General. I do not believe it is helpful, and not just because the comments are being made in order to reflect poorly on the operations of the Treasury. Even if that were not the case, I would caution people to be much more careful in the remarks that they have been attributing to the Auditor-General.

Senator CONROY—I refer to the Auditor-General's report in 1999. The Auditor-General states on page 59 of his report that there is ministerial endorsement of the annual swaps strategy. Can Treasury and AOFM confirm that they have sought ministerial approval for the annual swaps strategy from the responsible minister, the Treasurer, and in which years—since 1996?

Dr Parkinson—I am happy to take that question. Each year, as part of the budget funding decision, we have gone to the Treasurer. The Treasurer has been advised that there will be a budget funding program of X billion dollars, and he has been advised in the process of that that we will use cross-currency swaps to ensure that our foreign currency exposure is maintained. He has not been given any more information than that. Occasionally we may have said, 'We will undertake X billion dollars of swaps to maintain our exposure.' He has not been given any other information than that. When it says 'ministerial endorsement', these minutes go up and they say, 'Treasurer, please note (1), please endorse (2), please note (3).' That is all that he has been asked to do. In terms of the swaps program, I think the language here is not sufficiently precise as to what the Treasurer has been asked to do.

Senator CONROY—The language where? In the AOFM's report?

Dr Parkinson—The language you were quoting, saying that he has been asked to authorise—was that your wording?

Senator CONROY—There are some parts of this government that are hopefully still working under the Westminster system of ministerial responsibility, Dr Parkinson. So if I sign my name to something, I am taking responsibility for it.

Dr Parkinson—Senator Conroy, these matters were delegated to the Secretary of the Treasury and members of the Treasury executive by Treasurer Keating in 1988. That has been a practice that has been followed by every Treasurer that I am aware of since. The Treasurer gets advised that we will be managing to the benchmark. If that benchmark requires us—as it does and as it has done—to continue to maintain a foreign currency exposure, that is what we will do. That is the sum total of what he has been told. He has not been asked for anything else. As I said in my opening statement, there is nothing that he has been asked to approve that is not—

Senator CONROY—On the public record. We will get to that. Did Treasury or AOFM draw attention to the deteriorating economic return under the swaps strategy when obtaining this sort of thing—one of those notes stating, 'Oh, by the way, we appear to have had not quite as robust a result as we were hoping for,' or anything like that?

Dr Parkinson—That would go to the nature of advice provided to the Treasurer. I think I would have to take advice from the minister as to whether he wished me to answer that. But I will tell you—because I have already said it in my opening statement—that when issues have been drawn to the Treasurer's attention he has been advised that the focus is on the long term.

Senator CONROY—He has been advised that the focus is on the long term, so I presume that is to reassure him that those short-term losses were not anything for him to be particularly concerned about.

CHAIR—That is not a fair question because it puts to the witness a proposition which he expressly disaffirmed from answering, or declined to answer.

Senator CONROY—Declined to answer, not disaffirmed.

Senator JACINTA COLLINS—Chair, I take a point of order. I think there is an issue that needs to be distinguished here. A 'yes' or 'no' answer to a question as to whether the minister was advised on this matter is quite different and separate from seeking the detail of communications or advice to the minister. We have dealt with this issue several times throughout estimates. I think that distinction should be made quite clearly and the officer should answer the question as to whether these matters were brought to the minister's attention.

Senator Ian Campbell—Where you start saying, 'What was the advice given to the Treasurer,' that is exactly where the line needs to be drawn quite distinctly; otherwise you get the very important issue of the frank and full advice coming from public servants.

Senator JACINTA COLLINS—'Was the Treasurer advised'—that was the question.

Senator Ian Campbell—I will finish, if I may. All of the Treasury officers have made it quite clear at this hearing and, I believe, at the previous hearing, and the Treasurer has made it quite clear to the House of Representatives, that on every occasion he was advised to maintained the policy until that advice changed, when the pressure crystallised in relation to the benchmark, because we had reduced the domestic debt so significantly. So here we are managing the paying back of the debt, and the advice was clear on every occasion that the Treasurer was advised. He agrees. Treasury have reinforced that here today. Until that advice changed, which was in late 2000—that is when the advice changed.

CHAIR—I will rule on Senator Collins's point of order. As I understand it, it is the custom and practice of the committee not to explore advice given to ministers. The further and different point is: I will not allow—nor should any chairman allow—questions to a witness that attribute to a witness an answer which the witness did not give and are therefore based on a false premise. That is simply unfair to the witness and, indeed, unfair to the process. Dr Henry, I think you were going to say something.

Dr Henry—Thank you, Mr Chairman. I was going to repeat something that we have already said, but it is highly relevant to this point. There has been substantial material on the public record over a number of years now recording unrealised foreign exchange gains and losses with respect to the swaps portfolio. After all, that is why we are here. There are AOFM annual reports, and before that Treasury annual reports, which are obviously tabled in the parliament. In addition, annual reports on the debt management strategy have been published since 1996 and which go to the performance of the portfolio. That material is on the public record. Everybody is entitled to be aware of it and everybody is able to make themselves aware of it. That is the first point.

The second point is that there has been no reporting to the Treasurer on these issues which provides further information than what is available in those reports. There has been no other advice to the Treasurer on the performance of the portfolio which goes beyond what is contained in those documents—that is, what is on the public record. The third point, as we have said on a number of occasions this morning, is that at no time—up until June 2001 in fact—did the Treasury ever advise any Treasurer or recommend to any Treasurer that foreign currency exposure should be terminated; that is, that we should exit the strategy or, in Senator Conroy's words—

Senator CONROY—Have I alleged that someone said that it should be exited?

CHAIR—Dr Henry, were you finished?

Dr Henry—Yes, I was. Thank you, Mr Chairman.

Senator CONROY—The AOFM reports are tabled in parliament by the Treasurer. Is that right?

Dr Henry—That is correct.

Senator CONROY—AOFM is his ministerial responsibility?

Dr Henry—That is correct.

Senator CONROY—Were the Commonwealth debt management reports prior to 1999-2000 tabled by the Treasurer as part of the Treasury reports?

Dr Parkinson—No. They are just published documents.

Senator CONROY—They are publicly available. In the AOFM report, the famous page 80 contains the schedule of administered—

CHAIR—Sorry, Senator Conroy. Senator Campbell?

Senator Ian Campbell—I just wanted to reiterate that those reports did not exist prior to 1996.

Senator CONROY—Page 80 contains the schedule of administered revenues and expenses. Can you tell me where they are in the Commonwealth debt management reports that predated AOFM being created? Was there a similar table? Was it contained in the Treasury report?

Dr Parkinson—I was about to say that—and my colleague has just confirmed this—it is not in the Commonwealth debt management report in terms of separating out the foreign exchange gains and losses related to the cross-currency swaps, but I think it is in the Treasury annual report.

Senator CONROY—Yes. I was going to say that if it is not here, I am assuming it is in the Treasury annual report.

Dr Parkinson—Yes.

Senator CONROY—If the Treasurer had read his own annual report, he would have been aware of those figures contained in those schedules. In other words, he would have been aware of the net foreign exchange losses if he had read the Treasury report. It is his report; he tabled it; it is contained in there.

Dr Parkinson—You are asking me to conclude what somebody would take away if they had read a particular document. I cannot tell you whether the Treasurer would have taken that information away if he had read the report. I presume he has read the report.

Senator CONROY—So you assume he has read the report?

Dr Parkinson—He has tabled the report. The report—

Senator CONROY—I think that is a very fair description, Dr Parkinson. You assume he has read the report and those reports contained—

Dr Parkinson—Mr Chairman, can I seek some protection here for a moment?

CHAIR—Yes, Dr Parkinson.

Dr Parkinson—Senator Conroy, are you attributing to me the comment that I am assuming that the Treasurer has not read the report, because if you are—

Senator CONROY—No, please Dr Parkinson—

Dr Parkinson—that is not what I said.

Senator CONROY—I was not trying to.

CHAIR—I want to make sure the *Hansard* record picked that up, because Senator Conroy did speak over you. What exactly is your position, Dr Parkinson, just to make sure that it is clearly on the record?

Dr Parkinson—My position is that the information is available in the Treasury annual report. The Treasury annual reports and the AOFM annual reports are tabled in parliament and have been for some time.

CHAIR—And the position that you say that you do not wish to have attributed to you?

Dr Parkinson—I do not know whether I misinterpreted Senator Conroy comment, but I thought Senator Conroy was making some comment about whether I had a view as to whether or not the Treasurer read the reports. The Treasurer has tabled the reports; they are his reports.

Senator CONROY—So the Treasurer ticks off on the Treasury report. The table 'schedule of administered revenues and expenses' which contains net foreign exchange loss details was supplied as part of the Treasury report to the Treasurer, who then approved the report and tabled it in parliament. Is that correct sequentially?

Dr Henry—The Treasury annual report or the AOFM annual report?

Senator CONROY—No, this is pre AOFM. Dr Parkinson said that this table is contained in the Treasury report.

Dr Henry—I understand.

CHAIR—Just to clarify, Senator Conroy, which year's report are you referring to?

Senator CONROY—AOFM came into existence in 1999-2000, so I am talking about Treasury reports before that year.

CHAIR—Pre 1999?

Senator CONROY—Yes. But, either way, all of these reports were supplied in the form of either an AOFM report or a Treasury report to the Treasurer's office as part of the report and he then signed off on it—whatever the formal process of ministerial endorsement is when the Treasurer signs off on a report. So all this information was given to the Treasurer's office as part of the report—the Treasury reporting process or the AOFM reporting process—and he then tabled it in parliament.

Dr Parkinson—It is in the report. If it is in the report and it was tabled by the Treasurer, I think there is nothing more I can add.

Senator CONROY—I am not trying to put words into your mouth.

CHAIR—I think Dr Parkinson wants to say something more, Senator Conroy. Just bear with him, please.

Dr Parkinson—Can I clarify one thing, though. The infamous page 80 in the AOFM annual report is only the net foreign exchange gains and losses associated with the portfolio. In the Treasury annual report, it will be that and it will be any other foreign exchange gains and losses associated with other aspects—

Senator CONROY—Was Treasury doing any other foreign exchange speculating to measure out against this?

Dr Henry—I think the point he is making is that—and this is a point that has not been made here; certainly if it has, it has not been made often enough—focusing on the performance of the foreign currency denominated part of the portfolio to the exclusion of everything else is a highly dangerous exercise. It is not an exercise that I would enter into if I wanted to judge the overall success of the Commonwealth's debt management policy. I understand why there is a focus on that, but I would not endorse it.

Senator CONROY—I would not expect you to, Dr Henry. I want to explore the powers of the AOFM to enter into swap agreements and swap transactions. Does the AOFM have the power to enter into swap agreements and swap transactions? I am drawing a distinction here between the agreement which determines the terms and conditions under which swap transactions are undertaken and each swap transaction made pursuant to the swap agreement. Under what act of parliament is that power granted to you, if you have it?

Mr Allen—I will refer to my colleagues to get the exact name of the piece of legislation.

Senator CONROY—Do you believe you have the power?

Dr Parkinson—Yes.

Mr Allen—It is the Loans Securities Amendment Act 1988 which was introduced by then Treasurer Keating. It outlines the powers which enable us to enter into a range of financial transactions.

Senator CONROY—Does it specify the type? I am happy for you to consult, because—

Senator Ian Campbell—I might quote the then Treasurer, if I may, Mr Chairman. The explanatory memorandum which Treasurer Keating tabled stated:

The new section 5d expands existing arrangements for the Treasurer to delegate his powers regarding overseas borrowings, swaps and other financial agreements or arrangements to officials.

He then said:

In seeking Executive Council authority for the Government to undertake overseas loans and swap agreements, under the terms and conditions of borrowings or swaps, which the Treasurer is authorised to determine, it has been customary for the Governor-General to give approval.

I now quote the current Treasurer, Peter Costello:

But the amendments, as he said in paragraph (7), will bring the Commonwealth's ability to issue short-term debt overseas in line with the issue of Treasury notes in Australia.

The Treasurer tabled that document in its entirety on 11 March this week.

Senator CONROY—Dr Parkinson mentioned counterparties earlier. I will not revisit that explanation, which I thought was very helpful. You have a credit policy. How do you reduce credit risk?

Mr Allen—How do we reduce credit risk?

Senator CONROY—Could you explain how the credit policy works and how it reduces the credit risk?

Mr Allen—I will answer the first part of the question and then go to the second. The AOFM has a credit policy in place which provides guidance on the level of exposures that it can take to counterparties that it uses within its portfolio management activities. That credit policy is similar, you might find, to a range of other public or private sector institutions in that it tries to ensure that we maintain exposures to highly rated counterparties. In the Commonwealth's case, we take a very conservative view to the range of counterparties that we are prepared to transact with. We are also, in terms of that policy, trying to ensure that we get the appropriate diversification across our credit counterparties, as well as having a mechanism in place which enables us to require the AOFM under our corporate governance framework to take action where credit exposures rise above a particular level as prescribed within the policy. That general framework is the way in which we manage our counterparty risk.

Senator CONROY—I note from the last four annual reports of AOFM and Treasury that the percentage exposure to lower rated AA-minus credit has more than doubled from 20 per cent of total exposure to 45 per cent. This has come at the expense of exposure to the higher rated AAA creditors. Why has there been a deterioration in credit quality?

Mr Allen—Without wanting to be seen to be passing any comment on the range of available credit counterparties, obviously within the banking sector—and they are predominantly our counterparties—if you track the performance of the international banking sector generally, you would note that there has been a credit deterioration. The number of AAA banks that we had as available counterparties three or four years ago are significantly less today, just reflecting the general trend in the credit quality of the bank sector. That shift would be apparent in the reports of any market participant, just reflecting the shift in credit ratings of the major bank counterparties.

Senator CONROY—Surely you prefer all AAA?

Mr Allen—That goes without saying. Obviously, we do try, within the constraints of our credit policy, bearing in mind that we are at the very conservative end of credit exposures. We are targeting towards that very high end of the investment grade. So we are not talking about a significant deterioration, notwithstanding that statistic that you cite. We do try to target and maintain as many of our transactions as possible with the counterparties that have the highest credit rating.

Senator CONROY—With what types of organisations does the AOFM transact its swaps business?

Mr Allen—Without necessarily including the total list, we have a range of between 10 and 20 counterparties who are active in the Australian interest rate markets, effectively. Those names would be the Commonwealth Bank of Australia, Westpac, the ANZ Bank, the National Bank, the list of major global investment banks which are represented here in Australia. Anybody who fits within that group who fits within our required credit rating is obviously a potential counterparty. Without wanting to be quoted publicly on this issue and not making any suggestions about those counterparties who are not rated at that particular level, there are obviously a lot of market participants that we do not deal with because of our concerns with respect to credit rating.

Senator CONROY—Has AOFM ever breached its credit limits with the organisations with whom it enters into swap transactions?

Mr Allen—There have at times been actions required under our credit policy in order to ensure that we do not have a breach of the credit policy. There have also been instances where, for example, specific ministerial approval is obtained for a particular counterparty who may be undergoing some credit downgrade and where we come to a view about the taking of any action—for example, to either close out that particular transaction or to require alternative credit mitigation strategies to be adopted. In the absence of one of those mitigation strategies being a sensible strategy from the Commonwealth, we would seek specific approval to have that counterparty remain as an ongoing counterparty but, obviously, outside the normal constraints of our credit policy.

Senator CONROY—So, yes, there have been breaches for the reasons that you have outlined?

Mr Allen—Yes, but I would be very specific about the use of the term ‘breach’. I think it is all treated within the operational constraints of our credit policy. In the sense that it is a breach, I think, would be misrepresenting the nature of our credit policy.

Senator CONROY—Is your exposure to swap counterparties measured in terms of the gross exposure, what they owe you, or in net terms, what they owe you minus what you owe them? Do you have a netting-off agreement? Is that how it works?

Mr Allen—In cases where that legal agreement is in place, we do use a net. By and large, with most of our counterparties, given the nature of our portfolio management activities, we tend to have one-way exposures with those counterparties.

Senator CONROY—It is mainly gross.

Mr Allen—No, it is a net exposure basis.

Senator CONROY—Mainly net.

Mr Allen—Yes.

Senator CONROY—Do you measure your credit exposure at current market prices?

Mr Allen—Yes.

Senator CONROY—In your annual report you state on page 40 that in 2000-01 mark to market adjustments were undertaken in respect of a number of existing swaps. Does this mean that you choose which swaps you value at current market prices and which ones you do not? I am mindful of an answer that you gave in previous evidence before the committee. I am just trying to understand what is meant by a previous answer that you have given, which probably does not come to your mind immediately, in respect of the mark to market question.

CHAIR—In fairness to the witness, if you are going to play him off a break on an answer that he gave in some previous evidence, you had better tell him what the previous answer was.

Senator CONROY—I am actually not trying to play him off a break. I just cannot remember the exact quote that he gave. That is why I have asked this specific question.

Senator Ian Campbell—But the Treasury officer should remember?

Senator CONROY—No, I am not suggesting that Mr Allen should remember it.

Mr Allen—I thank you for your point. Maybe in the interests of addressing the question on a timely basis, if I could say that the use of a mark to market adjustment is part of our credit mitigation strategy.

Senator CONROY—Credit?

Mr Allen—Mitigation.

Senator CONROY—Yes.

Mr Allen—So what we are doing in these sorts of circumstances is we are monitoring our credit exposure of that counterparty. Just quickly stepping through the process, the amount of money of that particular counterparty due to market movements means that it has increased over time. It has got to a level at which, under our credit policy, we say that is a maximum level that that particular counterparty can owe us. So we have a choice of undertaking two options.One is that we do not do any further transactions with the counterparty because our credit exposure is at a maximum or we then engage in some form of credit mitigation to reduce that counterparty exposure so we can then engage in new transactions. The credit mitigation strategy we are talking about is that the counterparty will pay us the amount of money that they owe us and so our credit exposure goes back to zero. This type of mitigation strategy is relatively common and it has been used extensively by the Commonwealth since these sorts of strategies were first implemented under our credit policy, which was approved back in 1996. So I think in any—

Senator CONROY—But at all points mark to market is being used?

Mr Allen—Yes.

Senator CONROY—The report goes on to state that these adjustments substantially reduced the Commonwealth's credit—and I think you have explained some of this—exposure to several swap counterparties. That was the process you just explained, wasn't it?

Mr Allen—Yes. That is one of the mitigation strategies we use.

Senator CONROY—That was what you described.

Mr Allen—Yes.

Senator CONROY—So when you took the action that you have described—mark to market adjustments in respect of a number of existing swaps—were you in breach of your

credit limits with any of your counterparties at that time? Were you just anticipating or had you gone through the barrier to bring you back?

Mr Allen—We were anticipating that unless we took corrective action there would be a policy breach of the credit exposure limit. Under the mechanics of our credit policy we are required to take action well before the technical limit is reached. The technical limit being breached for a long period of time obviously would require ministerial approval, as I have already indicated. The whole philosophy behind the credit policy is to take corrective action in order to keep our exposures within the levels as defined within the credit policy.

CHAIR—Senator Conroy, I am sorry, I have just got an eye on the time.

Senator CONROY—I am just trying to rush to finish my questions.

CHAIR—We cannot sit after 1 p.m. There is no capacity, because we are sitting under an express resolution.

Senator CONROY—Who made the decision to move into interest rate swaps in 1997? Did the Treasurer approve the decision? Was it a recommendation? How did that happen?

Dr Henry—My understanding is that we would have had authority under the 1998—

Senator CONROY—I was not sure about interest rate swaps. I know you said swaps generally. I am just not sure what the legal position was on that.

Dr Henry—But I do want to clarify. We would have had that power. But my recollection is that we did, nevertheless, go to the current Treasurer and seek his agreement to our using interest rate swaps. It was technically unnecessary, but we did.

Senator CONROY—Since first using interest rate swaps in 1997, AOFM has entered into contracts with a notional value of $32 billion. Is that correct?

Mr Allen—My understanding is that it was closer to $31 billion.

Senator CONROY—You explained earlier that these swaps exchanged fixed a floating rate liability; that is correct? And the government receives fixed and pays floating; that is the way it works?

Mr Allen—That is right.

Senator CONROY—So if interest rates fall I think you are saying that AOFM will pay less and if they rise AOFM will pay more?

Mr Allen—I think that is a statement made in isolation about the swap portfolio.

Senator CONROY—I actually agree. I wish the Treasurer had made that point yesterday.

Mr Allen—But obviously as we have explained in some earlier questions, the basis under which we undertake that activity within our balance sheet is that it is within a net portfolio. So obviously it relates to our physical debt and offsets the impact of physical liabilities.

Senator CONROY—So you would enter into these contracts if you thought interest rates were going to fall?

Mr Allen—You would not enter into those contracts for that reason.

Senator CONROY—You would have to have a view on it, though? You just wander around—

Dr Henry—This is a very important issue and I thought it was dealt with rather well in Dr Parkinson's opening statement. We are not taking positions here on—

Senator CONROY—I will withdraw the question, if that makes you any happier. I am conscious of the time and I am not trying to suggest contrary to Dr Parkinson. I just wanted to move on. I am happy to withdraw the question.

Dr Henry—I do not know that I am happy about that, frankly, Chairman.

CHAIR—Senator Conroy, I propose to allow Dr Henry to finish that clarifying statement, because it is an important issue and it is obviously of concern to the officers. Dr Henry?

Dr Henry—Thank you very much. I do not want to waste time, but really there has been a lot of misinformed comment in the press recently about our use of interest rate swaps. As Dr Parkinson made clear this morning, our use of interest rate swaps is directed at reducing the volatility of the portfolio to changes in interest rates. That is what it is about. It is not taking a position on rates. It is about reducing our exposure.

Senator CONROY—As an example, when the first contract was written, short term rates were around five per cent. By December 2000 interest rates had risen to six per cent. According to the AOFM submission to the JCPAA, this would have added approximately $2.2 billion to the cost of servicing government debt—can I just confirm that this is what the submission said—and that a 0.5 per cent rise in interest rates would at that time have resulted in a $2.2 billion increase in government liabilities?

Mr Allen—I am sorry, Senator. I cannot actually see those numbers on that table. I take it that you are reading the correspondence we sent to the JCPAA on 31 May, which looked at the portfolio sensitivities on 26 May 2000?

Senator CONROY—I am just looking at the last page.

Mr Allen—I have that table here in front of me.

Senator CONROY—And there is the negative 113 total figure.

Mr Allen—I think this is quite an important point. There is a net number at the bottom of the total column, which is derived by looking at numbers that are computed for the physicals and for the—

Senator CONROY—Physical swaps total.

Mr Allen—It is perhaps not as clear, but what is represented by the physicals is our physical debt portfolio. That is our liability portfolio. In this particular case we are talking about interest rate swaps. Again, if you go to the bottom of the table, you are looking at a number there in the order of $579 million as being the impact of a plus 0.5 per cent change in interest rates. Again, if you look at that negative 113 number, that is derived by having observed the impact of an increase in interest rates on our physical portfolio. That increase in interest rates—

Senator CONROY—I accept it is a net figure.

Mr Allen—It offsets the volatility of the physical portfolio.

Senator CONROY—I accept the points you are making. I just wanted to confirm that your submission said a 0.5 per cent rise—

Mr Allen—Would lead to a net movement.

Senator CONROY—Yes.

Mr Allen—So the value of the physical portfolio drops from 75 to in the order of 74.

Senator CONROY—Can you just show me in your annual report where this increased cost comes out? I have not been able to find them in here to be able to make any calculation. Is there a page reference?

Mr Allen—The suggestion to increase costs?

Senator CONROY—Yes, with the interest rate movements—netted or grossed or whatever. I have just been trying to go through your report to make a calculation. I just cannot find it.

Mr Allen—The point we are making here is that there is a net movement.

Senator CONROY—I am just trying to establish where it is accounted for or reported in your annual report.

Mr Allen—The reporting convention that our annual report is reported under—

Senator CONROY—Is it note 14 or 15?

CHAIR—Let him finish.

Mr Allen—The physical debt and our swap portfolio is marked at the original book value yield, effectively. So we do not pick up market value movements in our balance sheet in the same way as we do for foreign currency exposures.

Senator CONROY—No mark to market for physical?

Mr Allen—No. That is a number that is not required to be reported under—

Senator CONROY—It is not required to be reported, but it is still a number that exists.

Senator MURRAY—Mr Chair, could Senator Conroy put the rest of his questions on notice?

Senator CONROY—I appreciate the prod, Senator Murray. I do.

CHAIR—Senator Conroy—

Senator CONROY—This is my last question.

CHAIR—Go on.

Senator CONROY—Since your report, outstanding interest rate swaps have increased. So if interest rates were to rise, as many are now predicting, through the year by one per cent or somewhere up to one per cent, the increase in debt servicing costs would possibly be greater than $2.2 billion, given that it was roughly around that for when you reported back then.

Dr Henry—Could I ask a question of clarification? Where does this $2.2 billion come from?

Senator CONROY—A calculation against the total size. It is Mr Allen's 0.5 per cent measured against the actual portfolio.

Dr Henry—My understanding—

Senator CONROY—The problem is that the figures are all disparate. They are all over the place. I am trying to put them together.

Dr Henry—My understanding is that that analysis said that a 0.5 per cent shock would lead to a deterioration in the physicals position by $1.7 billion or thereabouts and an improvement in the swaps position by around about $600 million. That actually rounds out to a net of $1.1 billion, not a net of $2.2 billion.

Senator CONROY—I accept the point you are making.

CHAIR—Dr Henry, have you finished or do you want to clarify this?

Dr Henry—I think the number is 1.1, not 2.2.

Senator CONROY—I am saying that one per cent gets you then up to 2.2.

Dr Henry—You are saying one per cent?

Senator CONROY—A one per cent movement would get you to 2.2.

Dr Henry—Okay. I will listen to the next question.

CHAIR—Are you happy now, Dr Henry?

Senator CONROY—A change of 0.5 will get you 1.1. Therefore, one per cent gets you 2.2.

CHAIR—Senator Conroy, do you have any more questions?

Senator CONROY—The point I am making is that you got into the market when it was at its bottom in terms of interest rates. You moved from fixed to floating and you increased the exposure because you are in floating, not fixed.

Mr Allen—The point might have been raised in two separate discussions that I am aware of. One was the opening comment in terms of Dr Parkinson outlining the use of interest rate swaps as part of our portfolio management strategy. The secretary also made the same point that we use interest rate swaps to achieve a particular duration target or a particular volatility measure of debt service costs or of market value. The purpose of using the interest rate swaps in managing our portfolio is to manage the impact of changes of interest rates to be within certain boundaries and—

Senator CONROY—I appreciate that.

Mr Allen—So the suggestion that we in isolation, due to an upward move in interest rates, necessarily gain or lose is not the point—

Senator CONROY—It might not be to you but, in terms of the increased cost, you have jumped from fixed to floating—

CHAIR—Senator Conroy, I think you did say that was your last question.

Senator CONROY—I am happy to rest, and I apologise for taking extra time.

CHAIR—Dr Henry wants to say something in relation to that. So I will give Dr Henry the call and then we will finish the examination of these officers.

Dr Henry—Thank you, Mr Chair. Now that I understand what that $2.2 billion means, the committee may wish to understand that, were there no interest rate swaps in the portfolio, for a one percentage point move in interest rates you would have had a $3.4 billion move in the value of the portfolio.

Senator CONROY—I am not disagreeing.

Dr Henry—Because there are swaps, instead of being 3.4—

Senator CONROY—The size of your loss is less.

Dr Henry—it is 2.2.

CHAIR—Senator Conroy, let him finish. Dr Henry.

Dr Henry—That is the only point I wanted to make.

Senator CONROY—By jumping from fixed to floating you have increased the risk.

CHAIR—That is the end of your question, Senator Conroy. Senator Murray, do you want to ask—

Senator CONROY—As I said, I apologise to my Democrat colleagues.

Senator MURRAY—Your apology is not accepted. It is gross discourtesy.

CHAIR—That concludes the further examination of the additional estimates of the Treasury and the Australian Office of Financial Management. Once again, I thank the secretary to the Treasury and other Treasury officers for attending and for their courteous responses. I call officers of the Statistics Unit at the Australian Prudential Regulation Authority.

[12.40 p.m.]

Australian Prudential Regulation Authority

CHAIR—I welcome to the table Dr Roberts from the Australian Prudential Regulation Authority. Dr Roberts, in view of the time, do you mind if we commence before Senator Campbell returns to the table?

Dr Roberts—That is fine.

Senator CHERRY—I wanted to ask a couple of questions about the most recent statistics on the general insurance industry, which I think were released on 25 February. Those figures appear to show a fall in the number of claims in the first six months of 2001 in the public liability line. I just wanted to get APRA's view on what that figure actually means in terms of whether there has in fact been a fall in claims or whether there may be other factors which may be affecting the collection of these statistics.

Dr Roberts—There are a number of factors that make interpretation of this data difficult, and considerable caution is required. I should say that the general insurance statistics are very useful in a macro sense. We have been improving them progressively over time. At the more micro level and at product line level there are a number of factors that complicate them and mean that they should be interpreted with a lot of caution. In relation to the liability statistics, for those product lines—that is public liability, product liability and professional indemnity, for example—there are some problems. I will just mention some of those.

HIH was the top insurer in the professional indemnity market. I think it had about 60 per cent of the market. It was the second largest player in the product and public liability market, with about 30 per cent, and it was about the fourth larger player in workers compensation. So this company was heavily involved in these longtail liability product lines, and we have had no data in relation to the HIH business since December 2000. Therefore, the data that we have reported most recently, for June 2001, is missing the HIH component and that compromises the interpretation of that.

In addition, there are some other points I would like to go through. With the liability data, there is also the complication that it is longtail business, which means that there is a large element of claims that have to be provisioned that have not yet been reported. So claims in relation to policies that are currently in force but will manifest or materialise in future years have to be estimated by the companies. When they are eventually turned into hard claims, that could be some years after the date when the relevant premiums were received. So there are long lags involved between policy and premium and claim in relation to longtail lines. That

also means that you need quite a long time series to identify meaningful trends in this line of business.

Also, particularly under the old general insurance regime we had operating until 1 July, there is a lot of unevenness between companies and their provisioning for their claims liabilities. That would be resolved in our new regime where we are mandating a more standardised form of estimating and provisioning for claims liabilities, but at present it varies. Some companies take a more conservative approach in provisioning; some take a more minimum approach, and we have been unhappy with this for a long time. But it does mean that the estimation of future claims can vary from company to company purely on the basis of their attitude to provisioning. You also get reporting differences between companies as well. Some companies use actuaries and are kind of very rigorous in their claims calculations. Others are less scientific. Again, our new regime is trying to get more science and consistency into those claims provisionings. So there are company to company variations there.

We also find it very difficult with the statistics when companies change balance dates, and some companies have changed balance dates in recent years. When reporting is very slow, we do end up sometimes putting out figures where we like to keep publishing the data because the macrodata is very useful, but the microdata can be compromised by having a company left out of a particular half year or, if there is a reporting date change, we can end up getting some double reporting. In relation to the current data which you are referring to, we have become aware of some flaws in that data and we are currently engaged, back in the office, in revising that data or putting up revisions that correct some flaws that have come to our attention due to things like balance date changes.

While the size of the industry is fairly stable, it varies between, for example, 140 and 160 licensed general insurers, but that is a net number. Companies come and go all the time. When new entrants come in and companies go, again that makes the time series data to detect trends harder to interpret. Within companies they will come and go in terms of product lines from time to time as well.

The technology and the statistical processes we have in APRA for processing general insurance data and, indeed, all our other data have been regarded as inadequate since APRA started in July 1998. We are currently finalising a major project to modernise both the technology and the forms with the data we collect from all our industries. In the general insurance case that will mean new forms and new technology will be employed for reporting from the September quarter 2002 onwards. That will also be based on a new regime. In addition to our current problems, there is going to be a discontinuity as we move from our old forms to our new forms later this year.

You will probably also have noticed that we have combined the public liability data with product liability data since 1997. There have been changes made to the reporting over a period of time to try to get the right balance between getting sufficient data from companies for us to fulfil our charter to monitor the solvency strength on the one hand and the compliance burden on companies on the other. That has resulted in changes from time to time. Since 1997 we have not been publishing separate categories for public and product liability.

I do not mean by that litany of difficulties to imply that the data is useless. It is still good data, particularly if people are using the aggregates to look at the industry overall. However, there are a lot of improvements that can be made and we are making. The conclusion of all that in relation to your interest, Senator, is that to draw conclusions from what we have

published in relation to public liability and product liability is very difficult. I would be cautious about drawing any firm conclusions from that data.

Senator CHERRY—The Insurance Council has been citing the rising claims up until December 2000 using that data. Do companies differ in their definition of claims for the purposes of reporting? Are intimations of claims or other natural claims countered by some companies?

Dr Roberts—In the balance sheet, the claims liabilities of a company along with another item sometimes called the technical provisions do, as I mentioned earlier, vary from company to company according to their estimation processes. Particularly in relation to longtail business, companies have to estimate the future claims that are likely to be triggered by a current policy and an event that might occur this year.

For example, in lines of business with injuries to people involved—such as workers compensation, public liability and compulsory third party—quite often the final amount of that claim will not be known until the person's condition has been stabilised, any disagreement or dispute between the company and the victim has been resolved and perhaps a court has made an award. At the time that the company has received the premium, the policy is in force and the provision needs to be made in the accounts. That provision is an estimate in relation to what we call incurred but not reported claims. Companies vary in the science and the degree of actuarial rigour with which they make those calculations, and they vary in the degree of their conservatism.

Senator CHERRY—On that issue, at the end of 1999-2000 the figures show that there were outstanding claims of $3.135 billion, but the figure at the beginning of 2000-01 showed that the allowance of outstanding claims was $2.6 billion. How would you account for that $535 million overnight revision, so to speak, in the value of outstanding claims?

Dr Roberts—There would be a number of factors I think, including the difficulties I mentioned. Sorry, what was the second figure in 2001?

Senator CHERRY—Yes. At the beginning of the financial year 2000-01 there was a figure of $2.6 billion whereas the corresponding figure for the end of 1999-2000 was $3.15 billion for outstanding claims.

Dr Roberts—I mentioned the HIH factor.

Senator CHERRY—Would HIH have been taken out of the entire year figures? You said that you had figures for HIH up to December 2000.

Dr Roberts—Yes, so we have incorporated there. While we would be cautious about trying to identify claims trends, what we do know is that claims volatility has increased in recent years in the liability class. Therefore, there are a lot of short-term fluctuations as well as long-term trends at work in these product lines. Therefore, looking at a short period of time—one period compared with the previous one—is difficult to interpret. To look at a trend, there can be a number of timing reasons. For example, in medical indemnity, which is also a liability class in PT, New South Wales health care legislation resulted in lawyers bringing forward claims to get an advance of tort law reform in New South Wales, and that resulted in a spike of claims that we saw in that particular product line. So there can be all kinds of short-term factors that can result in the numbers going up and down if you look at a short period.

Senator CHERRY—There was a view a couple of years ago that the provision for outstanding claims for public liability was too low. I think one figure from Peter McCarthy

suggested it could be a billion dollars too low. Is APRA now broadly happy with the level of provision for outstanding claims for public liability?

Dr Roberts—We will be after 1 July, which is when our new rules come in, because after 1 July general insurance companies will be required to get actuarial advice given to the board before the board sets the claims for the year. The actuaries, in providing that advice—and the companies, as well—would need to comply with a new liability valuation standard that has been tabled in parliament and will—if not disallowed—take effect from 1 July. So we will be a lot happier after 1 July with the soundness and the consistency of the outstanding claims provisions in our companies.

Senator CHERRY—Do you expect that will increase premiums as a result or increase the expectation of allowances?

Dr Roberts—It will vary from company to company, because some companies have been prudent, have been using actuarial advice in the past and have been conservative in their provisioning. But for companies that have been provisioning less conservatively and using less actuarial advice in developing their estimates, I would expect that their provisioning will need to go up. But it will vary from company to company.

Senator CHERRY—Looking at claims over the last three or four years, is APRA capable of producing a breakdown by industry within the public liability category?

Dr Roberts—Sorry, by company?

Senator CHERRY—By industry. How many would be small business, tourism, product liability, charities, sporting or whatever?

Dr Roberts—We do not collect data on the policyholders that insurance companies have. Because our charter is for solvency basically of an insurance company to maximise its chances of staying in business and able to pay claims, we do not have a consumer protection role other than to try to keep the company solvent. So we do not collect data on the customers and the types of customers they have.

Senator CHERRY—How do you think the general claims trends compare against litigation rates in the court system, which appear to be fairly stable over the last four to five years?

Dr Roberts—In regard to the litigation activity, I would have to say APRA is a spectator on this debate like other parties. At this stage we certainly take an interest in what the drivers of insurance company costs are. So we would take an interest in the debate about litigation activity, but we do not have a view ourselves. We do not have that data and we would have an open mind on the role of litigation. We would have a view that court awards increase over time, particularly for large payouts. That has been well recognised in the industry for a long time. We have a term ‘superimposed inflation’—actuaries and companies need to take account of rises in community standards that exceed inflation, if you like, that have to be built into pricing. But at this stage, whether litigation activity is a driver of increasing costs or not, I would say we are agnostic.

CHAIR—Senator Cherry, I see the hour is almost 1 o’clock. The committee finishes at 1. There is no flexibility to extend that. May I thank Dr Roberts and the minister at the table, Senator Campbell, for their attendance this afternoon. I also thank committee staff, Hansard and parliamentary sound and vision for their cooperation and assistance in these additional estimates hearings.

Senator JACINTA COLLINS—Can I just clarify whether, in the remaining time we have, Senator Cherry wants to put anything else on notice?

CHAIR—Yes. Do you want to put any questions on notice?

Senator Ian Campbell—We are very happy from the government's point of view to give Senator Cherry a meeting with Dr Roberts. Obviously there are benefits in sometimes getting things on the record. If Senator Cherry has any other issues—it is obviously a very important issue; the government is aware of it, but there is no simple answer—if he wants to have a private briefing—

CHAIR—Thank you, Senator Campbell. Thank you, Senator Cherry. I declare this reconvened hearing of the additional estimates closed.

Committee adjourned at 1.00 p.m.