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The Institutional and Legal Base for Effective Debt Management

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1. Introduction

Let me start by saying that I'm truly honoured to have been invited here today to address this important conference.

The topic of my presentation is "The Institutional and Legal Base for Effective Debt Management". The outline is as follows.

First, what do we mean by "effective sovereign debt management"?

Secondly, what are the important factors to be considered in developing a sound institutional structure for an effective debt management?

Thirdly and finally, which institution should be responsible for executing the debt management?

2. "Effective Sovereign Debt Management"

In the Guidelines for Public Debt Management, prepared by the staffs of the IMF and the World Bank, dated March 21, 2001 (the "Guidelines"), "sovereign debt management" is defined in the following way.

“Sovereign debt management is the process of establishing and executing a strategy for managing the government’s debt in order to raise the required amount of funding, achieve its risk and cost objectives, and to meet any other sovereign debt management goals the government may have set, such as developing and maintaining an efficient market for government securities.”

Let us start to analyse this definition from an institution building perspective.

The first goal according to this definition is to raise the required amount of funding. Well, the first reaction is that this is the main purpose of all borrowings. But things get more complicated when we are dealing with the State, and that has to do with the fragmentation and the complicated structure of the modern State, and the size of the debt. A central government’s debt portfolio is usually the largest financial portfolio in the country.

Provided the State has a comprehensive budget system, the main purposes of State borrowings are to finance

- budget deficits,
- State on-lending and State guarantee payouts,
- amortizations, redemptions and re-purchasing of State debt, and
- replenishment of the Central Bank’s currency reserves.

In order to raise the required amount of funding in an effective way it is thus essential to monitor the in and out payments of the State, to forecast the budget outcome and any future on-lending, to monitor the credit risks in the outstanding State guarantees, and to have full control of the outstanding debt. Let me here just mention that an essential step in getting better control over the State’s in and out payments is to create a comprehensive budget

system that includes all financial flows, and to set up the treasury single account.

The second goal is to achieve the optimal balance between the costs and the risks in the State debt. If, for instance, the costs are measured by the average running-yield-to-maturity, the costs can be reduced if the duration (calculated by multiplying the time to each cash flow by the size of the cash flow) of the debt portfolio will be shortened. However, if the duration is shortened the interest rate risk will increase. The presumption is here that on average, yield curves have an upward slope, plus the fact that a more short-term portfolio is refinanced more frequently and is therefore more affected by interest rate volatility.

Another and a more comprehensive way to look at the risks in the debt portfolio is to use an asset and liability management ("ALM") approach. The debt is then seen in the broader perspective of the State finances and the analysis is focused on the correspondence between the attributes of the State assets (primary future tax revenues) and of the debt (future expenditure assumptions). With this approach the risk is shifted from the pure interest rate and currency exchange risk to the budget effects of the State debt. By putting the management of the central government debt in this broader perspective of the central government finances, it is clear that the risks do not stem primarily from the risk of rising interest costs and exchange losses. Instead they arise from the sharp increase in the cost of central government debt during periods when there are strains on central government finances, for example due to a deep economic downturn. In other words, the risk is defined in terms of the contribution that the debt portfolio makes to fluctuations in the budget balance.

For the purposes of analyses and evaluations, the costs can here be measured by their relation to gross domestic product (GDP), the “debt cost ratio”. The presumption is that the budget balance normally co-varies with GDP via both tax bases and government expenditures.

To fully apply this ALM approach it is thus insufficient to analyse how future interest rates and exchange rates may evolve. It is also necessary to find out how, aside from interest payments on the debt and exchange losses, State income and expenditures co-vary – cyclically and structurally – with these financial variables.

Another interesting implication of the ALM approach is that it becomes clear that financial obligations in addition to the State debt, e.g. State guarantees, must also be factored into the analysis. Guarantees may be regarded as contingent State debt, since if a guarantee must be honoured, money must be raised by means of increased State borrowing, which is added to the State debt.

The third goal mentioned in the definition above is the development and maintenance of an efficient market for government securities. This is important mainly for three reasons. First, a well-developed domestic market makes it unnecessary for the State to finance its expenditures through the central bank. Secondly, the State will be able to raise funds in its own domestic currency and thus avoid the currency exchange risks. Thirdly, it will provide all other domestic borrowers with readily accessible financing, even in times of global financial instability.

According to the Guidelines the following, apart from a sound macroeconomic environment, is needed for an effective government securities market:

- good securities market regulation;
- good market infrastructure;
- demand for government securities; and
- supply of government securities.

3. Some important factors to be considered

Before we start to discuss which institution is most suitable to execute the management of the debt, let us look at some factors related to the debt management that need to be considered in that decision.

1. Which State debt should be managed by the debt institution? In my opinion the same institution should manage all the State debt, domestic and foreign as well as the over-night funding. There is important though to have full control of the borrowing need. But once a system has been established for that purpose, I cannot see any advantages to have the management split up into different institutions. On the contrary, the concentration of all debt to one institution will make it easier to coordinate the borrowings and the risk management. Moreover, the knowledge acquired of different borrowing techniques used abroad, which would be achieved through the external borrowings, can be applied in the State's own domestic market. After abolition of exchange controls, a foreign investor can as easily buy a bond issued in the domestic market as a bond issued abroad and, e.g. by using derivatives, change the currency exposure of the investment according to his or her preferences. In the same way, the State can use the swap-market to adjust not just its interest rate exposure, but also to adjust its exposure in foreign currencies in a cost-effective way. If, as is often the case, the State has a competitive advantage in its own domestic bond market, it can use

a currency swap structure to receive cheaper funding in the foreign currency through the swap spread, compared with a direct borrowing in the foreign currency.

2. It is important for the active debt institution to get close to the financial markets, keeping a dialogue with the market participants. One reason for this dialogue is to simply know the markets appetite for different maturities etc. Knowing that, would allow the debt institution to adjust the issuances to better meet the demand and thereby receive cheaper funding. Another reason for pursuing this is to assist in improving the functioning of the capital market, including better securities regulations and infrastructure, and thus lowering long-run borrowing costs, which is an indisputably beneficiary strategy.
3. Financial guarantees, both credit guarantees and standing or open-ended guarantees, are issued by the State to financially promote projects that are deemed to be in the public interest. They serve as economic incentives for the capital market to finance the projects. The other side of the coin is that the credit risk on the borrower (the “Beneficiary”) is transferred from the lender to the State. Thus, if not the credit risks are properly assessed and monitored, the financial guarantees can easily cause a “hidden” budget deficit. The challenge is here to create a system under which the State will be able to issue financial guarantees without losing the grip on the budget. Because of these risks, it is important that a professional institution should be responsible for the pricing of the credit risks, the drafting and the actual issuing of the financial guarantees, and the monitoring of the issued guarantees. In my opinion, the debt institution is well suitable for that task, mainly for the following reasons.
 - The debt institution will get a holistic grip on the entire debt burden, not just the explicit debt, but also the financial guarantees (the

contingent debt); the financial guarantees affect both the borrowing requirement and the duration of the loan portfolio.

- Similar analytical competence is needed both for an active debt management and for an active management of financial guarantees; the basic methods for calculating market and credit risks are similar.
 - Knowledge of the financial markets is needed both in debt management and for an effective management of financial guarantees; as the risk taker, the State should have some control over what the Beneficiaries are doing in the markets and consequently must have the competence to evaluate their activities from a market risk perspective.
 - The debt institution will have the competence to control the pricing of the loans raised by the Beneficiary; the price difference between the loans raised by the State and the State guaranteed loans should not be unreasonably high. (The guarantee should support the Beneficiary, not the banks!)
 - The debt institution should co-ordinate its own borrowings and the borrowings of the Beneficiaries, particularly in the foreign markets.
4. On-lending is a substitute for guarantees, involves the same credit risk for the State and should be priced and managed, *mutatis mutandis*, in the same way as guarantees. The only difference is that the State instead of the Beneficiary borrows the necessary amount in the market. It is thus important to include on-lending activities in the same framework as the State guarantees.
5. In order to achieve an effective sovereign financial guarantee and on-lending management, the following is important.
- Financial support through guarantees or on-lending should only be given to a beneficiary that is likely to generate sufficient income to recoup its costs.

- The credit risks should through different means be reduced, if possible, and always be assessed and priced.
- Reserves for future payouts and loan losses should be built up.
- Any subsidies should be accounted for.
- During the term of the guarantee/loan, all proper means should be used to reduce any losses.
- The management should contribute to the satisfaction of the political goal of the support, but only within the guidelines stated above.

6. At the end of the day the taxpayers must cover the cost of the State debt; for the simple reason that the State's assets predominantly consist of the discounted value of future taxes. One could say that the management of the State debt is the management of future tax payments. From this follows that the political bodies, the People's Assembly and the government (the Cabinet), ought to have some say in the management of the debt. As the People's Assembly normally is the institution that has the tax power, it is proper for the People's Assembly to set the goals for the debt management. The role of the Cabinet would then be to adopt binding guidelines for the debt institution. These guidelines would be in a form of a strategic benchmark and tell the debt institution how the Cabinet values the trade-off between costs and risks. The guidelines should thus include the share of foreign currency debt, if any, the acceptable interest rate risk and the maturity profile of the debt, aimed at reducing the rollover risk. The expertise in this field is likely to be found within the debt institution, since these are variables that the professionals of this institution will need to follow during the daily debt management activities. A proposal from the debt institution is thus a natural starting point of the process of establishing the guidelines. There is also the question of possible conflicts of interest between a suggested debt policy

and the rules set for the monetary policy, which needs to be addressed within the framework for setting the strategic benchmark. The simplest solution is here that the central bank will have the opportunity to give its comments on the guideline proposal before the Cabinet makes the final decision.

7. One of the goals with a clearly communicated strategic benchmark is to achieve increased transparency. To accomplish this, it is important to make all the documents of the guideline process public, including the proposal of the debt institution, as well as the comments of the central bank. There are at least two good reasons for this. First, the quality of documents that are to be made public and directly sent to the financial markets in general becomes higher. Secondly, and more importantly, if analysts clearly and fully can understand the entire process that has led to a certain strategic benchmark decision, they will be more successful in forecasting the actions of the debt institution, which thereby will be perceived as more transparent and predictable.

4. Which institution should be responsible for executing the debt management?

Finally, which institution should be responsible for debt management? Here there are three natural choices: the central bank, an autonomous debt office reporting to the Ministry of Finance (an "ADO"), or a separate unit/department within the Ministry of Finance, which we simply can call a debt office (a "DO"). Let us start to look at the central bank.

The central bank's prime responsibility is the implementation of the monetary policy and the foreign exchange policy. If, which is quite common,

the central bank is pursuing an inflation target through buying and selling securities in the domestic market in order to adjust the monetary condition, it makes sense to separate the accountability for debt management policy from that for monetary policy.

The main reason for the separation is the following. In implementing the monetary policy the market will listen and react on signals from the central bank. If the bank should be responsible for the implementation of the debt management policy as well, there is a risk that debt management policy could be seen as another instrument of monetary policy aimed at reinforcing the price stability objective. Even if the debt management should be handled in a separate department within the central bank, there is still a risk that the debt management decisions could be perceived to be influenced by inside information on interest rate decisions. In such a case, neither the implementation of the monetary policy nor the implementation of the debt management policy will be optimal.

A clear separation of roles means that the State debt is sold directly by the ADO or DO, and that the central bank neutralises the monetary impact of the State borrowings through its own market operations.

If, on the other hand, there is no developed domestic market and the bulk of the State borrowings are made in foreign currencies, the central bank can very well be used to do the borrowings on behalf of the State. The advantage is here that the central bank as one of its core activities is managing the currency reserves. The competence gained in that field can easily be used in borrowing activities in foreign markets. Also, from an ALM perspective it makes sense to try to match the currency composition of the debt with the currency composition of the currency reserves.

An ADO is a governmental agency with a clear long-term goal for the debt management and with at least some autonomy from the political sphere.

There are some clear advantages with an ADO.

Firstly, it decreases the risk that fiscal policy advisers view debt management policy as another vehicle for opportunistically reducing debt servicing costs in order to reduce the budget deficit, short term. This "political risk" is based on the following reasoning. In the short run everyone can borrow cheap. The easiest way is to borrow in a currency with low coupon rate and with a short interest fixing period, as on average yield curves tend to have positive slopes. And if the fund-raiser is still not satisfied, he/she can probably make the borrowing even cheaper with the help of derivatives like swaps and options. In a pressing political situation any head of funding can be tempted to choose such a borrowing strategy in order to soften internal budget constraints. But everyone with some experience in financing knows that this kind of borrowing is very risky, i.e. can be very costly for the taxpayers - at least in the long run.

Secondly, an ADO will focus only on its core issue, i.e. debt (and guarantees and on-lending) management. If, as an alternative, the debt/guarantee management is to be handled within a DO, the risk increases that competent employees will be moved to other departments and that the DO will be "burdened" with tasks not related to its core activities.

However, there are also some important disadvantages with an ADO. One is the agency risk. The more far away from the principal (the Ministry of Finance) the ADO is, the higher is the risk that things will go wrong. The ADO might e.g. be too keen on trading activities and focus more on the status they could gain from its financial counterparts (i.e. investment banks)

than on doing the best possible job for the State. The ADO can, in other words, become a pure borrowing machine.

This risk could of course be mitigated by setting up at the ADO a board of directors with an experienced and reliable chairman and to create both an independent risk control department and an internal auditing department within the ADO, which are reporting directly to the board. However, the most important thing is to find the right chief executive; one who is able to create the appropriate culture within the organisation. And that is an operational risk in itself.

Another risk is that the ADO will be too partial in its debt management, i.e. that it will run its own shop, forgetting it is a part of the State and thus ignore some aspects of the fiscal risk. Equally, the distance might lead to the Ministry of Finance refraining from using the competence and knowledge of the financial markets, which over time will be accumulating in the ADO. The advice of the ADO could be useful to the government, for instance in matters like privatisation of State owned companies and law reforms affecting the bond market, including the clearing and settlement of securities.

Another argument, which is often put forward for the establishment of an ADO, is that wages could be increased and that it thus will be easier to hire professionals from the market. This is, in my view, not a strong argument since the ADO, irrespective of how it is organised, must still report to the Ministry of Finance. If the ministry is to be able to fulfil its role it must, in a broad sense, have the same competence in these matters as the ADO. This is even more important if a guideline based steering of the debt management, as recommended in this paper, is adopted. Of course, it is important that the State and especially the Ministry of Finance have enough resources to be able

to recruit the right people. That is, however, another topic not delimited to State debt management.

Let us now look at the DO. The disadvantages mentioned above with an ADO will most probably disappear if the debt is managed by a DO. But what about the political risk? Well, that risk will be substantially reduced if, as recommended above, the People's Assembly will set a clear goal for the debt management and a guideline based steering is introduced. The latter will increase transparency and predictability, make the DO to focus on its task, and result in a political commitment to a clear strategy for the State debt management.

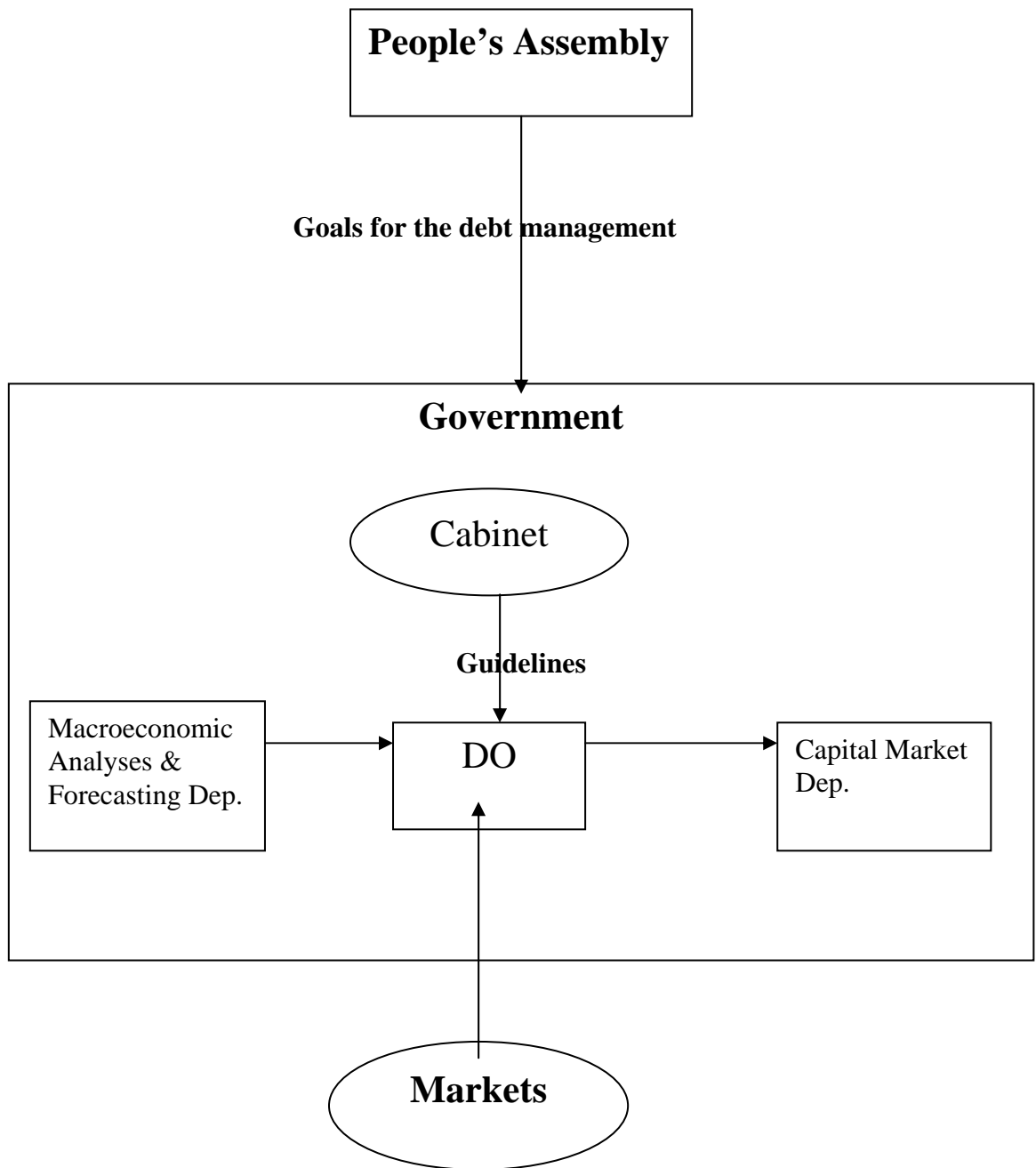
There are also other advantages with a DO. As mentioned above, the State debt ought to be seen in a broader perspective of the State finances and, consequently, the risk to be defined in terms of the contribution that the debt portfolio makes to fluctuations in the budget balance. In order to analyse the debt portfolio with this ALM approach it is thus necessary to study not only how interest rates and exchange rates vary in different scenarios, but also and equally important how State income and expenditure vary in these scenarios. This is clearly a task that is more natural for the Ministry of Finance to perform than an ADO, especially as the Ministry of Finance anyhow has to do those analyses in its budget work.

Another advantage is that the Ministry of Finance through the DO will get direct contact with the capital market, which will be an essential input in its work to develop the market through regulations and infrastructure building.

5. Conclusion

In conclusion, after weighing the pros and cons, my recommendation is that a DO, i.e. a special unit within the Ministry of Finance, will be responsible for executing the debt management, any on-lending and the guarantees. It is important though that the DO has clear goals for its activities, set by the People's Assembly, and that the Cabinet determines guidelines for the debt management. Regarding the organisation, it would be a clear advantage for the DO to have good working relationships with both the Macroeconomic Analyses & Forecasting Department and the Capital Markets Department (or similar departments) of the Ministry of Finance.

By way of illustration, see below.



Finally, to those of you who do not agree with my analysis, here are some comforting words from the Guidelines.

“Experience suggests that there is a range of institutional alternatives for locating the sovereign debt management functions across one or more agencies.....Regardless of which approach is chosen, the *key requirement* is to ensure that the organizational framework surrounding debt management is clearly specified, there is coordination and sharing of information, and that the mandates of the respective players are clear.”