Public Debt Management Reform

An Overview: Some International Perspectives

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Outline

- The Context
- The 6 Building Blocks of Sound Practice
- Some Conclusions

Debt Management Matters

Causes

- Size and growth of indebtedness (Debt/GDP)
- Poorly structured portfolio - maturity, currency or interest rate composition (excessive focus on short-term or FX debt)**
- Large and unfunded contingent liabilities
- Exposure to economic shocks (lack of liquidity)

Effects

- Fiscal problems – both short- and long-term
- Financial and economic vulnerability
- Damage to creditworthiness
- Damage to private sector development
- Inter-generational inequity *

* "Blessed are the young for they shall inherit the national debt."
Herbert Hoover (US President 1929-33)

** Emerging market debt crises 20-30 years ago (Mexico, E.Asia, Russia, Brazil, Argentina, Turkey) …were characterised by vulnerabilities arising from poor debt structures (short-term, floating rate, or FX debt => exposure to interest, exchange rate & rollover risks) and crystallisation of contingent liabilities

Both Size and Composition Matter

Debt Sustainability

- The ability to continue servicing debt without an unrealistically large correction to income & expenditure
- The emphasis is on a country’s underlying vulnerabilities
- Debt sustainability analysis feeds into fiscal policy decisions, especially the primary balance
- Stress tests and alternative scenarios expose underlying vulnerabilities, and instill realism into projections

Debt Strategy

- Focuses on the composition of the debt portfolio, rather than its overall size
- But vulnerabilities can also arise from the composition of the debt portfolio
- Objective is improved resilience to economic shocks

- Important in practice to share data and analysis

Modern Debt Management is a response to the Crises of the 1990s

Crises

- Lack of strategy – limited understanding of the risks to which the debt portfolio was exposed
- Lack of professionalism – confusion between roles and responsibilities of central bank, debt manager, fiscal policy manager; and lack of financial market expertise

Responses

- Separation of objectives and accountabilities between management of debt and monetary policy - implies monetary policy independence for central banks
- Greater “transparency and predictability”
- Need for greater professionalism
- Institutional structures and the governance framework matter
- Separation of responsibilities and need for professionalism drive formation of semi-autonomous debt offices with a strong accountability and governance framework

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The 6 Building Blocks of Sound Practice

1. Debt Management Objectives and Coordination
Objectives, priorities and Coordination with Monetary and Fiscal Policy

2. Transparency and Accountability
Clarity of roles; open process; publication of information; integrity

3. Institutional Framework
Governance, legal and decision-making framework, organisation and management of operations

4. Debt Management Strategy
Monitoring and evaluating risks

5. Risk Management Framework
Trading off costs and risks; taking account of contingent liabilities

6. Development and Maintenance of an Efficient Market for Government Securities

Guidelines for Public Debt Management
IMF and World Bank, 2001, updated 2014

What is Public Sector Debt?

Debt consists of all liabilities that require payment or payments of interest and/or principal by the debtor to the creditor at a date or dates in the future.

Essentially all liabilities except for shares and other equity, and financial derivatives

It includes:

- Bills
- Bonds – domestic or external
- Bilateral or multilateral external credits
- Loans from banks – internal or external
- [Arrears to suppliers]
- …etc

Important to identify whose debt

Central & General Government; & Public Sector	
Central Government Debt	A
Provincial, city and municipality government debt	B
of which, borrowed from central government	C
General Government Debt	E=A+B-C
SoE or Public Corporation Debt	F
of which, borrowed from central government or provincial, city or municipality government	G
Public Sector Debt	H=E+F-G

1. Debt Management Objectives

"The main objective of public debt management is to ensure that the government's financing needs and its payment obligations are met at the lowest possible cost over the medium to long term, consistent with a prudent degree of risk… It should encompass the main financial obligations over which the government exercises control."

IMF/World Bank, Guidelines for Public Debt Management

- Same principles (often the same wording) followed in almost all countries when setting their debt management objective
- Many countries have a secondary objective of developing the local financial market

2. Transparency and Accountability

Clarity of roles, responsibilities and objectives of financial agencies responsible for debt management

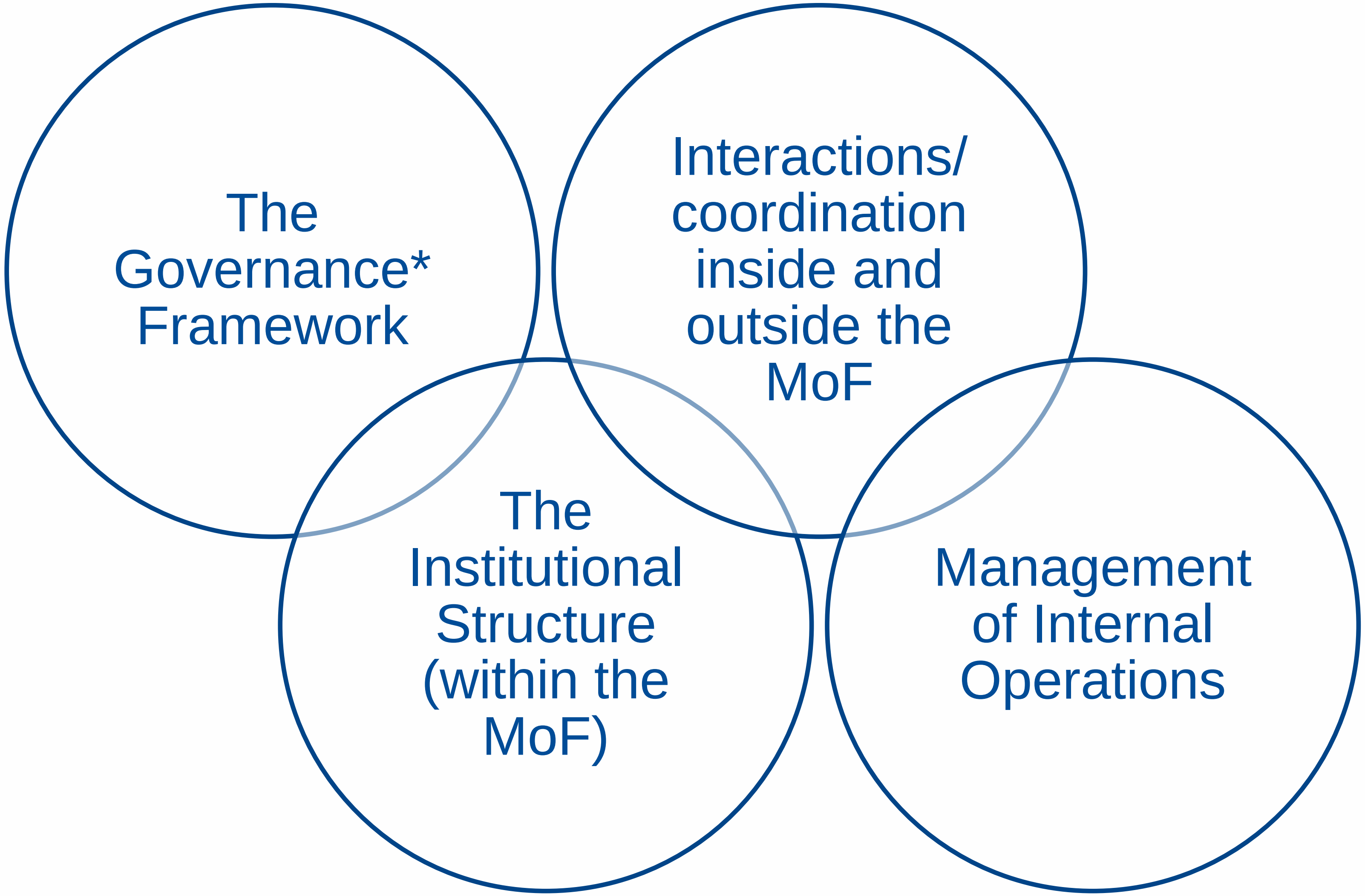
Open process for formulating and reporting of debt management policies

Public availability of information on debt management policies

Accountability and assurances of integrity by agencies responsible for debt management

Improves credibility, reduces uncertainty, reduces costs

3. Institutional Framework



*Governance is *"The legal, administrative & accountability structures – formal and informal – within which policies are made, executed and monitored."*

Good Governance applies at different levels

The Legal Framework and the role of Parliament/National Assembly

High-level policy formation

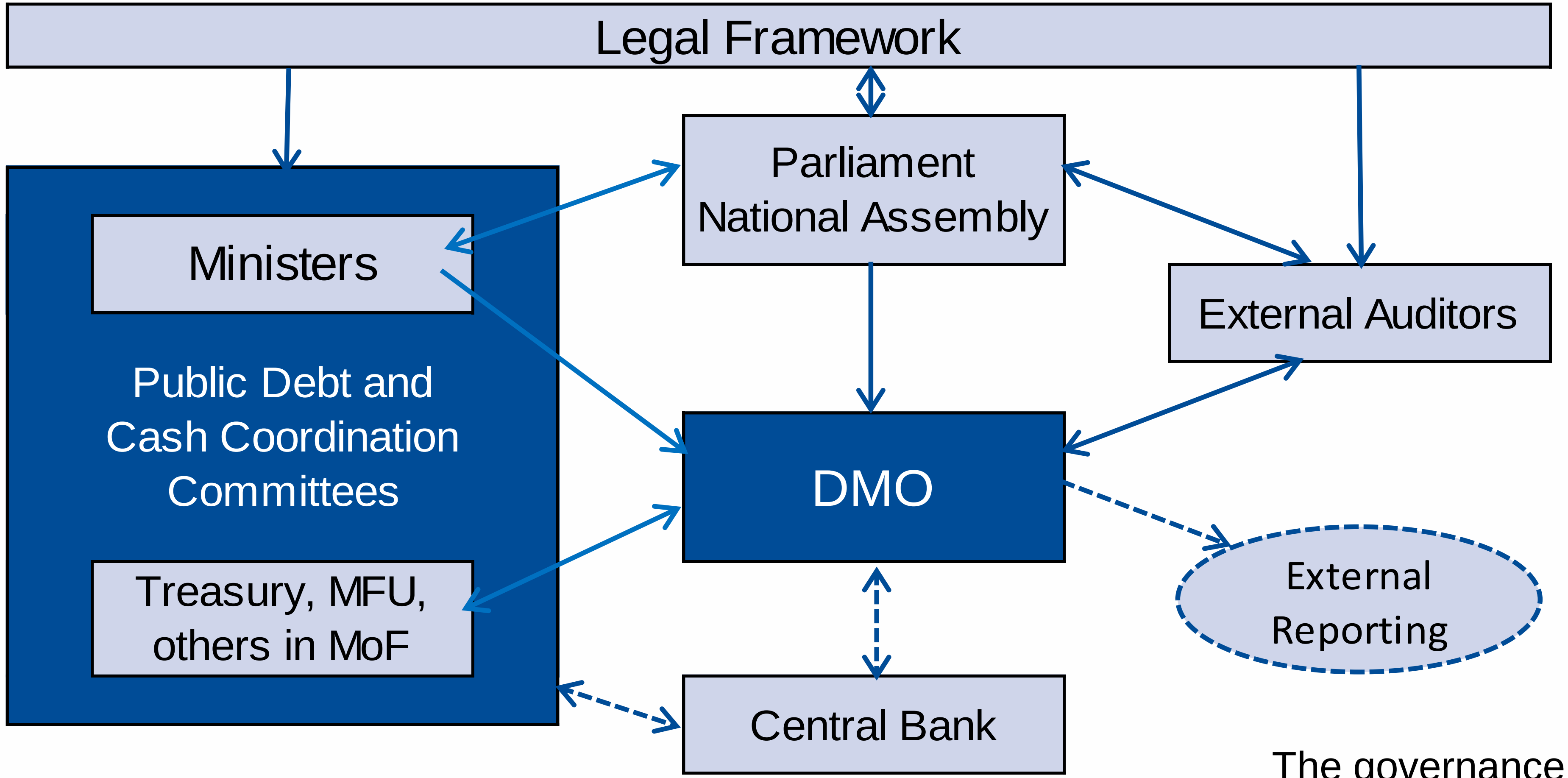
- Setting the debt (and cash) management strategy
- Delegation to the DMO for execution of the strategy – and the DMO's accountability

"External" governance of the debt managers

- Information flows – reporting to Ministers, officials and the Parliament
- Performance assessment and external audit

"Internal" management and governance structures, decision making, internal audit

A Typical International Governance Structure



The governance structure within the DMO is not shown

Role of Public Debt Steering Committee

Main role is approval of Debt Management Strategy [and ABP]

May be advisory or decision-making

Mandating those responsible for strategy execution; setting targets and objectives; and subsequent monitoring of performance

Chaired by the Finance Minister (or vice-minister or senior official): representatives from Treasury, Macro-Fiscal and Central Bank: DMO is Secretariat

Note that the Committee:

Ensures DMS is consistent with the thrust of macro-economic and fiscal policy more generally – and does not conflict with monetary policy

Facilitates separation of policy formation from execution – with benefits to clarity and credibility

Helps to buttress operational independence of debt managers, reducing risk of interference in debt management decisions once the strategy has been set

Why have DMOs been established?

Clarity and transparency

- Internally, with focus on the debt management task
- Support separation between policy formation (the MTDS) and its execution
- Externally, in the perception of markets in relation to objectives and intent; emphasises separation between debt management & monetary policy
- Often linked with accountability and governance reforms

Improving capacity, efficiency and effectiveness

- Expertise, professionalism
- Improving focus; avoiding inconsistent decisions
- Greater pay flexibility to help recruitment, retention**

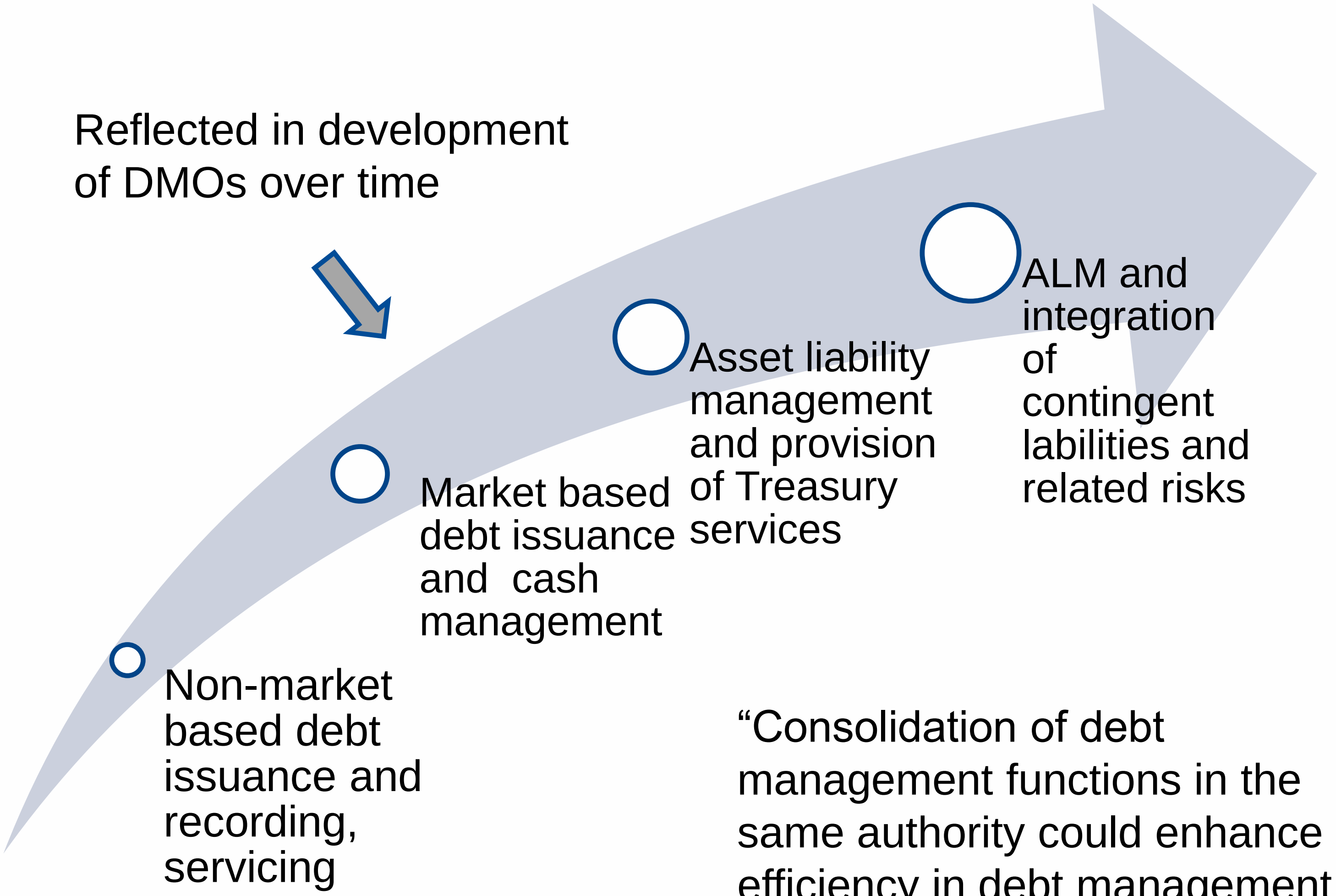
** Some pay flexibility (or other benefits) often essential to staff retention in countries with unified government-wide pay structures – staff otherwise easily bid away by private sector

See also: Kalderon & Blommestein, OECD 2002

The Importance of Full Integration

Integration of Functions reflects

- Importance of developing a debt management strategy for the whole government balance sheet
  - Including cash and other assets
  - Assessing exposure to a range of risks
  - Drawing on an integrated database
- Focusing accountability for delivering that strategy
- Those responsible for execution have control over the full range of instruments
- Dispersed decisions risk
  - Inconsistent decisions on different parts of the balance sheet
  - Inconsistent approach to or appetite for risk
  - Inadvertent/unapproved agreement to debt
  - Unnecessary additional resource costs
- Progressive integration apparent in e.g. Thailand, Indonesia, Philippines. Several Latin American and East European countries



Source: Storkey 2006

“Consolidation of debt management functions in the same authority could enhance efficiency in debt management operations” (World Bank IMF Guidelines).

A Spectrum of Institutional Arrangements Internationally

1. Part of MoF (Italy, South Africa, Indonesia most in E.Europe) or another ministry (Spain)
2. Separate status as a “Treasury Bureau”* within MoF (Finland, USA, Brazil, Philippines)
3. Semi-independent agency within MoF (Australia, Netherlands, UK, Belgium, France)
4. Agency within Central Bank (Denmark, Iceland)
5. Semi-autonomous agency within government (Sweden, Portugal, Ireland, Nigeria)
6. Company owned by Government (Germany, Austria, Hungary)

In all cases	An identifiable separate status – with specific governance framework
	Some degree of operational independence
	A separation from monetary policy but may still use the central bank as fiscal agent or for other services

Debt Managers' Objectives and Functions

- Objectives
  - "to ensure that the government's financing needs and its payment obligations are met at the lowest possible cost over the medium to long run, consistent with a prudent degree of risk" [and develop the domestic bond market]
- Key roles
  - "to establish and then execute a strategy …in order to raise the required amount of funding, and to achieve its cost and risk objectives"

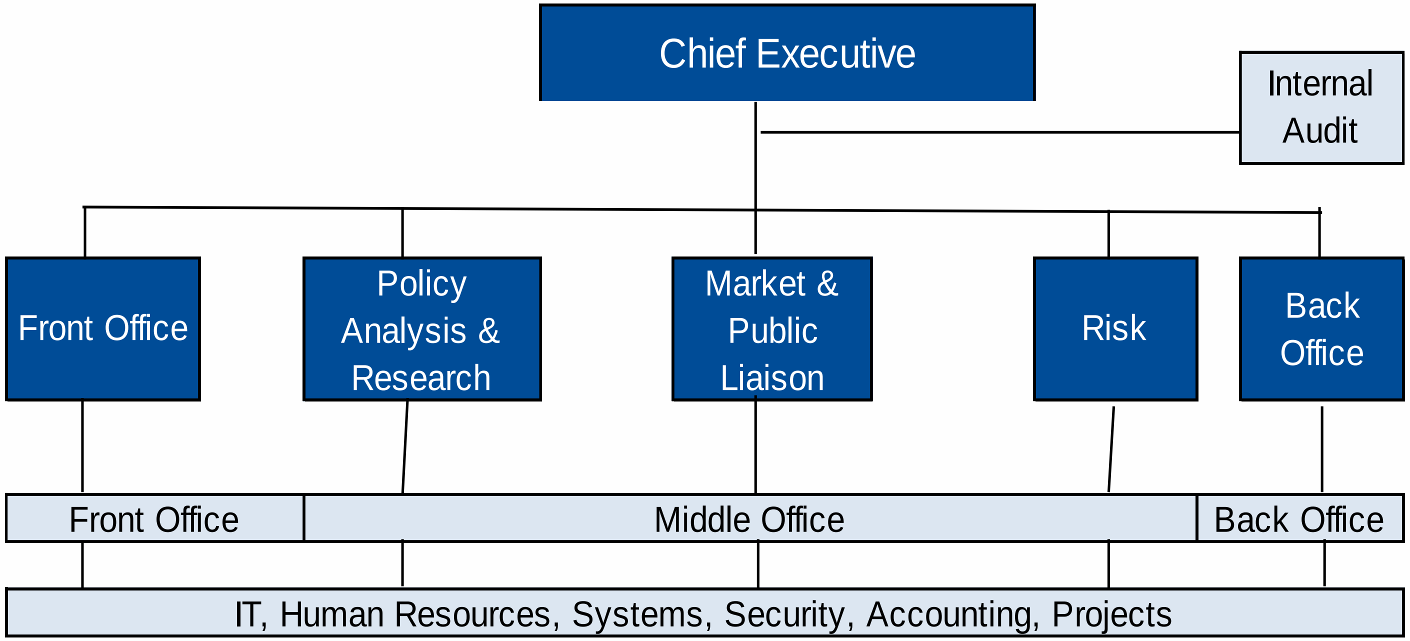
[Both quotes: IMF/World Bank Guidelines]

- Core Functions
  - Debt management strategy design
  - Transactions execution, negotiation with creditors
  - Transactions processing & recording
- Also
  - Financial reporting
  - Risk monitoring and compliance
  - Stakeholder relationship management
- Additional Functions
  - Contingent liability management
  - Cash Management
  - Policy and advisory services
- Note – debt sustainability is not in the list

Internal Specialisation

- Distinguish between key responsibilities
  - Senior management
  - Front office: primary issuance and execution, internal and external, secondary market transactions (debt and cash)
  - Middle office: policy and portfolio strategy development and accountability reporting
  - Middle office: risk management: policies, processes and controls
  - Back-office: transaction recording, reconciliation, confirmation and settlement; debt servicing; debt data
  - Internal audit and compliance – reporting to Head of Office

- Separate front, middle and back-office
  - Allows specialisation
  - Avoids duplication
  - Contributes to risk management



These services may be supplied from elsewhere in MoF or developed in house

4 & 5. Risk Management

Debt managers have two risk management functions:

1. Designing the **high level risk strategy** – largely focused on market risk in the government's balance sheet and debt portfolio

- Risk relates to the fact that borrowing takes place at unknown market rates
  - Market risk – changes in interest rates, exchange rates, commodity prices
  - Rollover or refinancing risk
  - Liquidity risk
- Focus is on annual payments cost of the debt, not the market value
- Risk indicators give information on the vulnerability of debt to changes in market rates: the potential volatility of debt servicing

2. Designing a **framework of systems and controls** to

- implement the high level market risk strategy
- manage other risks, e.g. credit & operational risk.

Risk is not Symmetrical

Weaknesses exacerbate economic crises	Poor performance triggers contingent liabilities
	Credit ratings deteriorate when most need to borrow
	Worse if private sector balance sheet mismatch
	Also risk of contagion and feedback effects unrelated to country policies
Sound debt management is about robustness and resilience	More important that the economy can withstand crises than the debt structure is optimised when all is going well
	In addition operational failure can have reputational and political costs over and above the purely financial
Sound debt management policies not a substitute for good economic policies	But reduce feedback effects and provide resilience

The Central Role of the Debt Management Strategy

Debt strategy is about how best to:

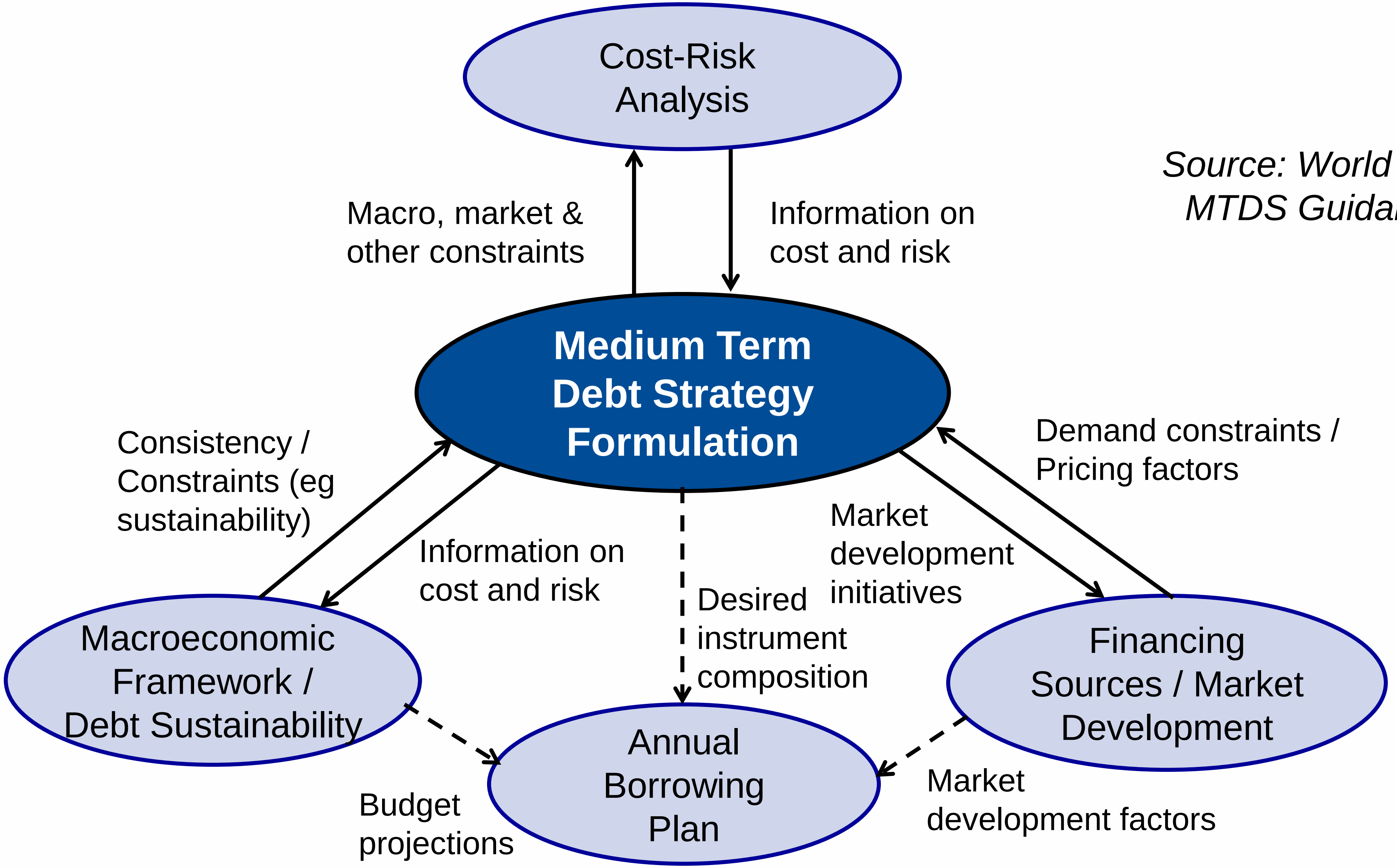
- Develop a borrowing strategy that leads to the preferred debt composition, i.e. the preferred cost/risk trade-off, taking into account constraints

Debt manager should establish a framework to identify cost v risk trade-offs

- Assess different issuance strategies against range of macroeconomic scenarios – deterministic or stochastically generated
- Stress tests to ensure that portfolio and economy can cope with possible economic shocks
- Identify scope for active management – in secondary market or use of derivatives – but manage properly

Take account of contingency liabilities

Debt Management Strategy: Key Linkages



Source: World Bank/IMF MTDS Guidance note

6. Developing the Government Securities Market

- Debt managers should ensure that policies and operations are consistent with development of an efficient* government securities market -

Reducing portfolio risk	Developing efficient local financial markets	Wider benefits to the economy
• Especially market risk (in domestic currency) • Widening access to funds; reducing cost of funds • Improved financing choices	• Liquid market and greater competition reduces risk for private sector borrowers • Benchmark curve makes pricing more efficient and more transparent; allows development of hedges • Risk-free asset facilitates portfolio construction	• Improved resource allocation from channelling of savings • Greater resilience at time of financial crisis

*Efficiency means: Low transactions costs; Competitive market processes; Liquidity (ability to buy and sell close to market price); High substitutability between instruments; Completeness – allows maturity transformation and allocation of capital to productive uses.

LCBM: the Building Blocks

Macro fundamentals

- Constrained fiscal policy, established monetary policy implementation
- Sustainable debt, contained inflationary pressures, Sound financial sector
- Central for investor confidence and demand for government securities

Money market

- Essential for liquidity management
- Anchors prices for government bond yield curve

Primary market

- First source of price formation
- Provides pricing references supporting yield curve development
- Good practices support competition, facilitate portfolio management

Secondary market

- Improves price discovery and transparency
- Stimulates liquidity (e.g. trading venues, market making)

Investor base

- Supports demand and liquidity in primary/secondary markets

Custody and settlement

- Foundation for safe and efficient settlement of transactions
- Reducing risks & costs to which investors would otherwise be exposed

Legal and regulatory framework

- Provides the foundations to enable issuance
- Supports market integrity and investors' confidence

Outline

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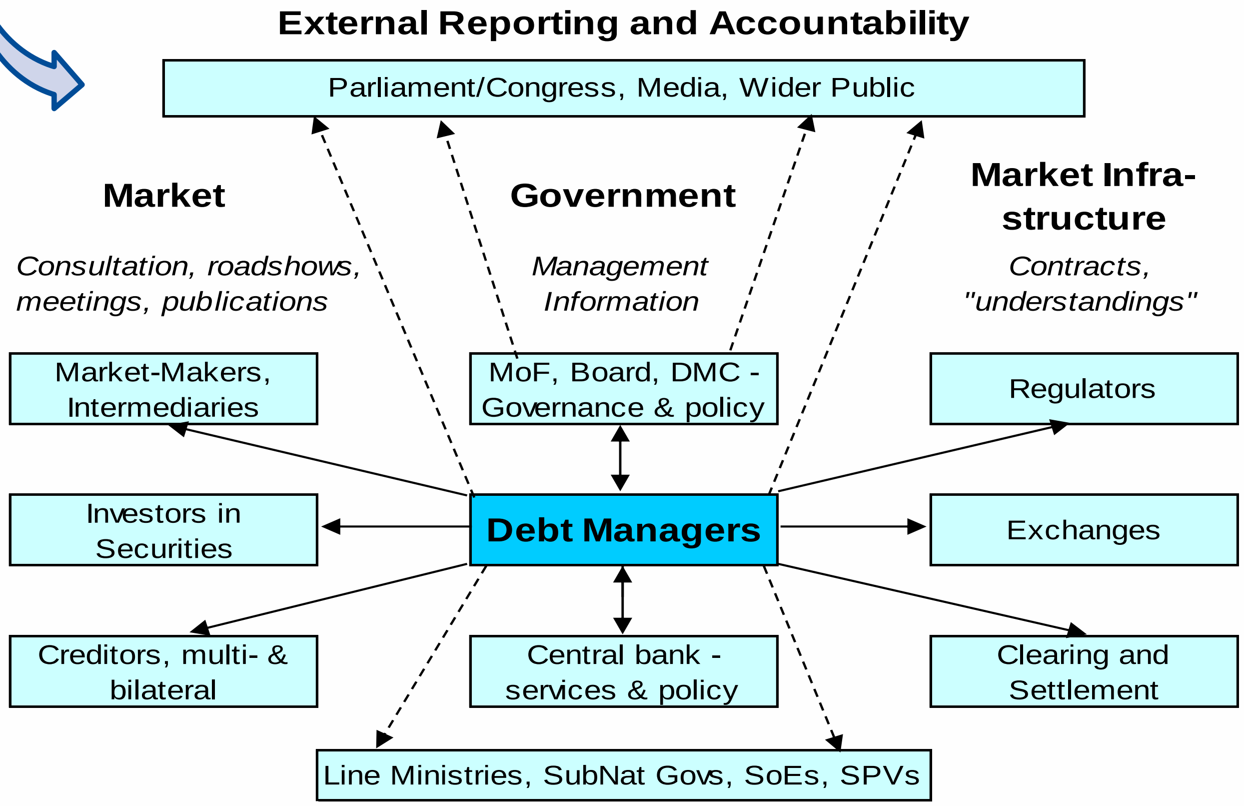
The 6 Building Blocks of Sound Practice

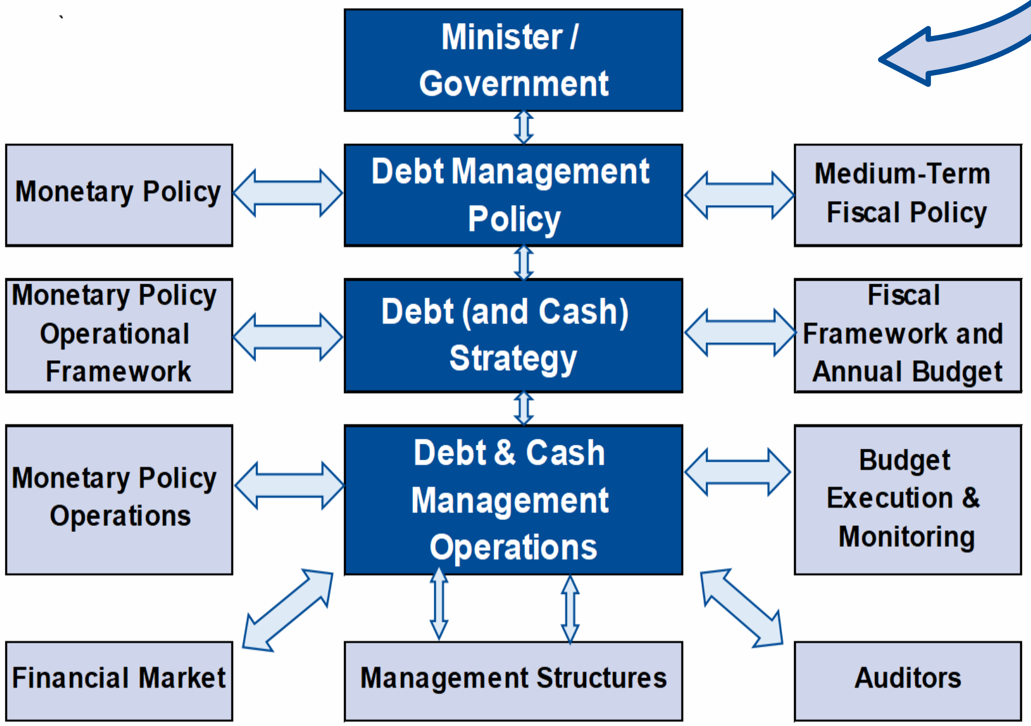
Some Conclusions

Establishing the DMO is only the start

There are many external relationships to be managed…

…and policies to be addressed and coordinated





No Shortage of Challenges

For emerging market countries the recurring themes are strategy development; market development; and governance and capacity building

Building resilience to shocks

- Risks of sudden stop in external markets; volatility in domestic market
- Actively managing the debt portfolio – benchmark building and liability management operations also help support the market
- Efficient cash management and access to safety nets – working closely with debt management
- Flexibility to consider new instruments, new issuance techniques and active management of relationship with primary dealers

As capacity grows it means thinking more strategically about the government balance sheet as a whole; handling changes in market structure and demand

Not all DMOs have been successful – at least at first – much can go wrong

Turf wars: lack of agreement between competing baronies

- PDSC often papering over cracks – no desire for collaboration

Semi-independent DMO stretches governance structures

- Little MoF control, lack of accountability
- Some false starts (Kenya, Nigeria)

Running disagreement with central bank

- Role of TBills & issuance decisions (confusing debt & monetary policy)
- Fiscal “agent” acts as the “principal” eg for auctions (Kenya – until recently)
- Unwilling to loose control (Sri Lanka, India)

Poor balance between front, middle and back office

- Front office has the exciting tasks; middle office the cerebral tasks; and back office the humdrum tasks.
- Lack of understanding of operational risk and its importance

Lack of active or sufficient management; timetables lengthen

- Made worse by staff or skill shortages

Some Conclusions

The management of government debt has developed substantially over the last 25 years

Internationally-accepted norms (IMF/World Bank Guidelines) have improved professionalism and governance

- Encouraged a more strategic approach
- Improved debt structures have brought greater resilience – response to the GFC and Covid
- Covid has put pressure on sustainability ratios – but arguably some of the countries currently in debt distress added to their problems with unwise fiscal and borrowing policies

But many challenges remain….

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