

STORKEY & Co

MANAGEMENT CONSULTANTS

GLOBAL TRENDS IN SOVEREIGN DEBT MANAGEMENT

**PRESENTATION AT THE
PUBLIC SECTOR FINANCE AND TREASURY
MANAGEMENT CONFERENCE**

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It is a honour to have this opportunity to begin the 2nd Public Sector Finance and Treasury Management Conference which follows on from the success of the conference held in April last year.

Over the past 3 years, I have been encouraging the FTA to consider conferences to cover this important area of government financial management, as sovereign debt management is not that well understood particularly throughout the Asia-Pacific region. There is certainly not the same level of knowledge and understanding as in Europe and North America where sovereign debt managers have been regularly meeting over the past 15 years. In fact, the Government Borrowers Forum met in Stockholm just last week.

My objective is to enlighten you to global trends and some recent and rather innovative developments in public debt management.

PRESENTATION OUTLINE

I will provide an introduction to sovereign debt management, calling on the IMF/World Bank Guidelines for Public Debt Management released in April 2001. I will then cover global trends and developments calling on some country case studies to illustrate some of the more recent and innovative developments.

I would like to wrap up with some key observations from my research and consulting assignments and leave you with some ideas and maybe challenges for you to consider both from a public and private sector perspective.

SOVEREIGN DEBT MANAGEMENT

International financial markets assign the status of sovereign debt to the public debt issued by governments. This status reflects the highest quality debt issuers in the market, and most with the strongest credit rating.

As a result of this status, sovereign borrowers are expected to have a risk management culture that reflects the special set of responsibilities associated with representing the government in international financial markets.

These responsibilities are considerable, particularly if the government's reputation in the financial marketplace is to be maintained at the highest level.

DEFINITION

I have extracted a definition for sovereign or public debt management from the IMF/World Bank Guidelines, which I will cover shortly.

“The process of establishing and executing a strategy for managing the government's debt in order to raise the required amount of funding, pursue its cost and risk objectives, and to meet any other public debt management goals the government may have set.”

IMF/World Bank Guidelines for Public Debt Management (March 2001)

Clearly cost and risk are key components. However, other goals often include developing and maintaining an efficient domestic market for government securities.

IMPORTANCE

A government's debt portfolio is usually the largest financial portfolio in the country (or state/region). It often contains complex and risky financial structures, and can generate substantial balance sheet risk for the government. Large and poorly structured debt portfolios also make governments more vulnerable to economic and financial shocks and have often been a major factor in economic crises.

Therefore, sound risk management and sound public debt structures are required by governments to reduce the exposure to market, funding, liquidity, credit, settlements and operational risk.

Any government should be risk adverse in its financial management therefore protecting against adverse events that may impact negatively on the government's finances.

You will see that I have included not only central and state government, but also local government. This is an area of public finance that has fallen behind central/state governments in most countries, the notable exception would be New Zealand.

IMF/WORLD BANK GUIDELINES FOR PUBLIC DEBT MANAGEMENT

A key catalyst to recent trends and new developments has been the publication by the IMF and World Bank of Guidelines for Public Debt Management, which have been designed to assist policymakers in considering reforms to strengthen the quality of their public debt management and reduce their country's vulnerability to international financial shocks.

The Guidelines cover both domestic and external public debt and encompass a broad range of financial claims on the government. They seek to identify areas in which there is broad agreement on what generally constitutes sound practices in public debt management.

BASIS FOR THE GUIDELINES

It is important to note that the Guidelines are not IMF or World Bank directives. They were designed through an extensive consultative process involving many countries including Australia and New Zealand.

I have used the Guidelines as a benchmark for advising developing countries in building capacity and reforming their public debt management.

The Guidelines cover six components and set out what are sound practices to address each component. Clearly, each country has its own specific characteristics and, therefore, the Guidelines have been designed to allow flexibility in their application to any particular country.

ACCOMPANYING DOCUMENT

Following the release of the Guidelines in 2001, the Executive Boards of the IMF and the World Bank requested the two institutions to prepare an accompanying document containing sample case studies to illustrate how a range of countries from around the world and at different stages of economic and financial development are developing their debt management capacity in a manner consistent with the Guidelines.

The accompanying document was released in November last year. Many of the case studies illustrate the rapid evolution and increasing sophistication in public debt management globally.

PRUDENT PRACTICES

The Guidelines and Accompany document set out six key areas that constitute prudent practices. These cover clear objectives particularly around debt and monetary management, risk v cost considerations, and sound institutional structures.

They also cover prudent debt levels or debt sustainability, which is still a major issue in most developing countries but less so now in the developed countries as fiscal surpluses or balance has been achieved.

Finally, they cover the risk of contingent liabilities. These can pose a major threat as the World Bank has assessed that the level of contingent liabilities in many countries may exceed the recorded level of public debt.

Those countries that have adopted prudent practices in these six areas have achieved some key outcomes.

KEY OUTCOMES

Many countries have clear and orthodox objectives for monetary policy, normally based on annual inflation targets. On the other hand, government objectives for debt management have not always been well specified, particularly in terms of cost and risk.

The development of clear objectives and risk models has been a key outcome.

Greater transparency and accountability has been another. Many debt offices now produce a detailed annual report setting out their debt management framework and policies along with the debt office objectives and their performance in meeting those objectives.

This can have an adverse reaction if the results show significant losses whether realised or unrealised (as was the case last year with the Commonwealth's foreign currency liabilities). It is probably fair to say that similar losses have been incurred in the past. It is just that they were never reported and "buried" within large budget revaluations.

The development of benchmarks and measures for assessing the performance of the debt managers has been the most significant development over the past 10 years.

INSTITUTIONAL STRUCTURES

In an attempt to increase the efficiency of debt management, a number of governments have delegated the operational dimensions of debt management to separate debt management offices (DMOs).

Other countries have questioned whether it was advisable to operationally isolate public debt management from public policy. These countries have opted to establish a debt management office within the Ministry of Finance or Treasury portfolio with equally clear objectives and accountability as for the separate DMOs.

The notable exception is Denmark where the debt office is located in the Central Bank. The responsibility was moved from the Ministry of Finance in 1991 as it was suggested that attracting and maintaining staff with the relevant skills would be easier if the debt office was placed in the Central Bank. The Danes have concluded that this move has helped centralise the retention of knowledge of most aspects of financial markets within a single authority and enabled stronger coordination between the management of foreign exchange reserves and central-government foreign debt.

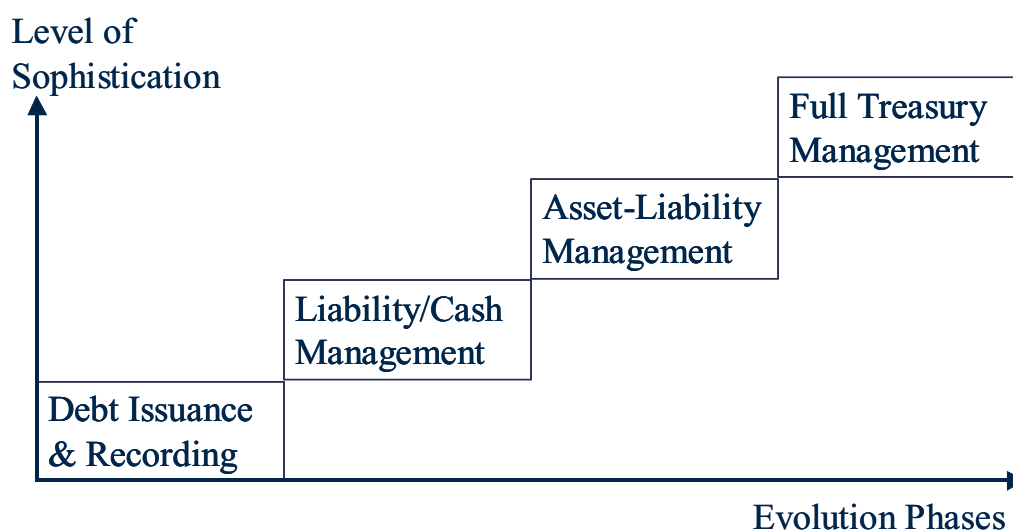
Most debt management offices have been established in the late 1980s and throughout the 1990s. The exceptions are the Swedish National Debt Office (SNDO) established in 1789 and the Dutch State Treasury Agency (DSTA) established in 1841.

GLOBAL TRENDS

I will now turn to global trends and key developments in sovereign debt management.

EVOLUTION PHASES

To demonstrate the evolution of sovereign debt management, I have found through my experiences that I can use four categories to characterise the different levels of development and sophistication.



I will go through each category to identify the key characteristics, debt management policies and practices, and to provide country case studies.

DEBT ISSUANCE AND RECORDING

The first category I have referred to as “Debt Issuance & Recording.”

The major characteristic of this category is the focus on debt issuance to fund maturing debt and often significant fiscal deficits. Therefore, most debt managers focus on identifying borrowing opportunities both in external and domestic debt markets. For many developing countries, the domestic debt market is not well developed and the government is forced to access international markets, primarily from multilateral or bilateral sources.

A secondary but important function is to record, service and account for debt transactions, which is essentially a “debt ledger” operation.

There is often a “silo” approach to managing debt with different agencies of government responsible for domestic debt, external debt, FX reserves, domestic investments, cash management, and capital flows.

There are also significant problems with identifying and managing contingent liabilities. Indonesia is a good example here, which I will cover shortly.

Most developing countries fit into this category, although it should be noted that Australia and New Zealand were in this category up until the reforms in the mid-1980s. Why is it difficult to reform public debt management practices?

To a large extent it will be dependent on the macroeconomic and fiscal environment. Australia and New Zealand did not start to focus on debt management reform until the fiscal deficit reduced and the debt managers were then able to give more attention to debt structures and management of risks in the debt portfolio.

Developing countries are starting to consider reforms but have fundamental problems such as institutional rigidities and disincentives for change, low levels of remuneration leading to difficulties recruiting and retaining staff with the right skills, and strong political involvement in day-to-day debt management operations. Doesn't this sound familiar! It reminds me of the early 1980s in New Zealand and I suspect Australia.

For the small number of countries in default, there has been an initiative out of the IMF to introduce a Sovereign Debt Restructuring Mechanism, but this is not gaining much support from the financial community.

CASE STUDY: INDONESIA

I have chosen Indonesia as the case study in this category. The Government of Indonesia issued around US\$50 billion of bonds to the banks for recapitalisation following the Asian economic crisis and is now building debt management capacity within government and developing the domestic debt market to refinance these bonds, which primarily mature between 2004 and 2009.

This is a huge challenge for the Government of Indonesia given the credit rating of the country and the impact previous government regimes have had on the country's reputation in the financial markets.

The Australian Government is providing technical assistance through an AusAID funded project to build capacity in Pusat Manajemen Obligasi Negara (PMON), utilising debt management expertise from Australia and New Zealand.

There is still a highly fragmented approach to debt management with PMON now responsible for domestic bonds, Bank Indonesia responsible for treasury bills, and two different areas of the Directorate of Budget responsible for external debt and cash management. The Government of Indonesia is planning to set up a Treasury to integrate these functions.

LIABILITY/CASH MANAGEMENT

The second category I have referred to as "Liability/Cash Management."

The major characteristic of this category is the increased focus on managing debt within a risk management framework and the integration of debt management with all of government's cashflows.

This has led to many countries deciding to reduce or eliminate foreign currency exposures. European governments have been able to achieve this more quickly as a result of Euro denominated debt becoming classified as domestic debt.

In developing risk models, countries in this category have assessed the major risk as being the extent to which volatility of financial variables affects the budget through changes in debt servicing costs. These debt offices have preferred to measure risk on a cashflow basis rather than full mark-to-market basis using Value-at-Risk.

Portugal is developing a model based on an integrated Budget-at-Risk indicator for the debt portfolio. Canada, Denmark and Italy are developing Cost-at-Risk measures based on the effect of interest rate fluctuations on the annual costs of the debt.

As I mentioned, a major characteristic is the integrated approach to government debt and cash management.

The information that debt managers need to make borrowing and investment decisions can be complex, particularly if there is little coordination between government agencies and unexpected flows to/from the government. Often each of the flows shown in the diagram is managed by different agencies.

Debt offices in this category have become very focused on aggregate cashflows. Quality cash management requires accurate forecasting of the cash flows between the government and the banking system and end-of-day cash balances in government accounts. Many countries have difficulty forecasting cashflows accurately, particularly daily as required by the central bank for monetary policy purposes. Some countries have adopted incentives for government cash management to improve the forecasting and management of expenditure and revenue cashflows, and to utilise surplus funds.

Australia and New Zealand have been at the forefront of reforms in government banking and cash management.

I have chosen Australia and the UK as the case studies in this category.

CASE STUDY: AUSTRALIA

The Commonwealth followed the trend of most OECD countries by establishing the Australian Office of Financial Management (AOFM) in July 1999. The AOFM, which is located within the Treasury Portfolio, has an objective that addresses both cost and risk.

At this point, the focus is on Commonwealth debt portfolio management and the Commonwealth's aggregate cash position. The Department of Finance and Administration administers the day-to-day cash management regime. The Reserve Bank of Australia manages the Commonwealth's foreign currency reserves.

CASE STUDY: UNITED KINGDOM

The UK Debt Management Office (DMO) was established in April 1998 following an earlier announcement by the Chancellor of the Exchequer that responsibility for setting of official interest rates was being transferred from Treasury to the Bank of England and that the Bank of England's role as the Government's agent for debt and cash management was being transferred to Treasury. The objectives were to ensure that debt management decisions could not be influenced by, or thought to be influenced by, inside information on interest rate decisions, and to increase transparency in debt and cash management operations.

The DMO assumed responsibility for debt management on 1 April 1998 and for cash management on 3 April 2000.

As the Government's treasury manager, the DMO aims, with Treasury, to lead, develop and deliver the Government's debt, cash and fund management objectives.

The DMO aims to:

1. Deliver the Government's debt, cash and fund management requirements and local authority lending services efficiently and effectively.
2. Develop and lead with Treasury the strategy on debt, cash and fund management.
3. Develop and drive with Treasury the strategy on the management of the central government financial balance sheet.
4. Advise on and deliver innovative and practical solutions to broader government financial issues.

In 2002, the DMO took over operational responsibility for the parts of the former National Investments and Loans Office that handle lending to local authorities and manage funds for other government departments.

Therefore, the UK DMO is now moving to the third category on my diagram and potentially to the fourth category.

ASSET-LIABILITY MANAGEMENT

The third category I have referred to as “Asset-Liability Management.”

The major characteristic of this category is the full integration of assets and liabilities including contingent liabilities and a balance sheet risk management approach. There are only a select number of countries that have moved in this direction.

The main characteristics are a risk management approach based on full market values using Value-at-Risk methodologies and the widespread use of benchmark portfolios for measuring performance of the debt managers.

New Zealand has been particularly innovative in this approach, which is the next case study.

CASE STUDY: NEW ZEALAND

The Government established the New Zealand Debt Management Office (NZDMO) in July 1988 as a separate Branch in the Treasury. It was integrated into the Asset and Liability Management Branch in 1997, just after net foreign debt was eliminated.

NZDMO has pioneered many of the innovations in sovereign debt management, particularly within an asset-liability management framework. You will hear more about this from Philip Combes and Greg Horman from the NZDMO in the plenary session tomorrow morning.

One unique characteristic of the New Zealand framework has been the zero net foreign currency position through hedging of foreign exchange reserves. The foreign exchange reserves, which are managed by the Reserve Bank of New Zealand (RBNZ) are immunised by foreign currency debt issued by the NZDMO. The RBNZ specifies the currencies and term structure and then enters into a transaction with the NZDMO to create a RBNZ liability and a Crown asset. This approach is unique across OECD countries and to-date has only been replicated by Canada.

While looking at New Zealand, it is worthwhile covering the recent developments with Local Government treasury management as this has been significant and has established international best practice.

The Local Government Act 2002 permits local authorities to borrow in New Zealand dollars, with the debt raised not guaranteed by the Government of New Zealand.

However, the Act requires the local authority to have in place amongst others:

- a revenue and financing policy
- a liability management policy
- an investment policy

Therefore, each local authority has developed a comprehensive treasury management policy, which is fully disclosed during the planning process. For example, details are on their respective website.

This transparent approach and level of disclosure and reporting has received positive comments from a number of sources including one of the rating agencies.

FULL TREASURY MANAGEMENT

The fourth category I have referred to as "Full Treasury Management."

The major characteristic of this category is the inclusion of client servicing through the provision of treasury services to other government agencies and to local authorities. Ireland is one of the few countries to provide these services at central government level, which I will now cover as the next case study.

CASE STUDY: IRELAND

The management of the national debt in Ireland was delegated to the National Treasury Management Agency (NTMA) by legislation enacted in 1990. This delegated authority includes issuance, secondary market activity, and all necessary ancillary activity such as for example, arranging for clearing and settlement.

The debt management activity of the NTMA relates only to the debt of the central government. The debt of other arms of the government, such as local government authorities, regional health boards and state bodies, remains the responsibility of those bodies, subject to approvals and guidelines issued by the Department of Finance. However, NTMA has additional mandates in these areas.

The NTMA has been empowered to offer a central treasury service, in the form of deposit and loan facilities, as well as treasury advice to a range of designated local authorities, health boards and local education committees. It has also been authorised to advise ministers on the management of funds under their control and, where the requisite authority is delegated, to manage such funds on behalf of that minister. The NTMA currently manages the assets of the Social Insurance Fund under such delegated authority.

It has also been mandated to manage the National Pensions Reserve Fund under the direction of the National Pensions Reserve Fund Commissioners who are appointed by the Minister for Finance.

Finally, the NTMA is mandated to manage claims against the State to ensure that these liabilities and associated legal and other expenses are contained at the lowest achievable level.

CASE STUDY: AUSTRALIAN STATE GOVERNMENTS

I would like to finish the case studies by briefly referring to the Australian State Central Financing Authorities (CFAs). It would seem that the NTMA is adopting many of the services provided by the CFAs.

The CFAs were set up in the 1980s to provide full treasury services to the State Government and government agencies. They clearly fit within this last category.

They have clear mandates, strong governance structures, and best practice risk management frameworks. For example, TCV's Prudential Supervision policy is based closely on APRA and BIS requirements and will be required to comply with Basle II requirements when these are introduced.

You will hear more about liquidity risk management from Fiona McNabb and Chris Sutton from TCV later this morning.

KEY OBSERVATIONS

I will finish this presentation by providing a few observations from my own experiences and recent consulting assignments.

Last year, I was involved with a study visit to the debt offices in Australia and New Zealand by representatives from the Thailand Public Debt Management Office. During a post-visit review, we identified six key factors that would be needed to become a “high performing DMO.” These were identified as:

- a clear mandate and delegated authorities to operate freely within this mandate, subject to limits and controls set by Government;
- a strong governance structure with a Board of Directors or Advisory Board to oversee the operations;
- a strong risk management culture with clear risk management policies, limits, and compliance monitoring;
- good treasury systems to support the operation;
- a clear organisational structure based on segregation of front, middle and back office functions;
- responsibilities of managing debt closely integrated with government cash management and financial assets.

All six factors certainly differentiated the debt offices or financing authorities from their counterparts in Thailand, and I suspect for most of the countries across Asia-Pacific.

There are four key observations I will leave you with.

1. Given the sovereign status, one of the highest priorities for all DMOs is the preservation of the reputation of the government in financial markets commensurate with this status. This was certainly imbedded into the culture of the NZDMO.
2. There has been significant progress and innovation in applying standard risk management practices to the management of sovereign debt portfolios. Many of these developments I have covered throughout this presentation.
3. The expertise developed and maintained within the DMO is increasingly being used to assist public sector policymakers in wider areas of financial management. For example, NZDMO and the UK DMO are involved in advising on balance sheet management, particularly with respect to various government unfunded or contingent liabilities.
4. This expertise can be of value to other government agencies, as they do not have the resources or skills to manage their treasury activities. This is of course a core function of the CFAs. Could this service be provided to other countries?