STORKEY & CO
MANAGEMENT CONSULTANTS

Active Domestic Debt Management

Commonwealth Secretariat
Seminar on Requirements for
Domestic Debt Management
Tools Module

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Outline

- Domestic Debt Management Objectives
- Approaches to Active Debt Management
- Questions and Discussion

Domestic Debt Management Objectives

- Develop and maintain a well functioning market for domestic government securities
- Ensure a smooth maturity profile
- Ensure transparency, predictability and even-handed approach
- Manage funding and interest rate risk
- Diversify the investor base

➔ Funding + Rebalancing

Evolution of Debt Management

- 1970s & early 1980s
- Mid-1980s
- Late 1980s & early 1990s
- Mid-1990s to present

- Heavy borrowing programs
- Development of new debt instruments & sophisticated financial products
- Deregulation (eg “Big Bang”)
- Privatisation / asset sales
- Set up of debt offices
- Portfolio optimization
- SDM developed
- ALM & BaR / CaR / VaR

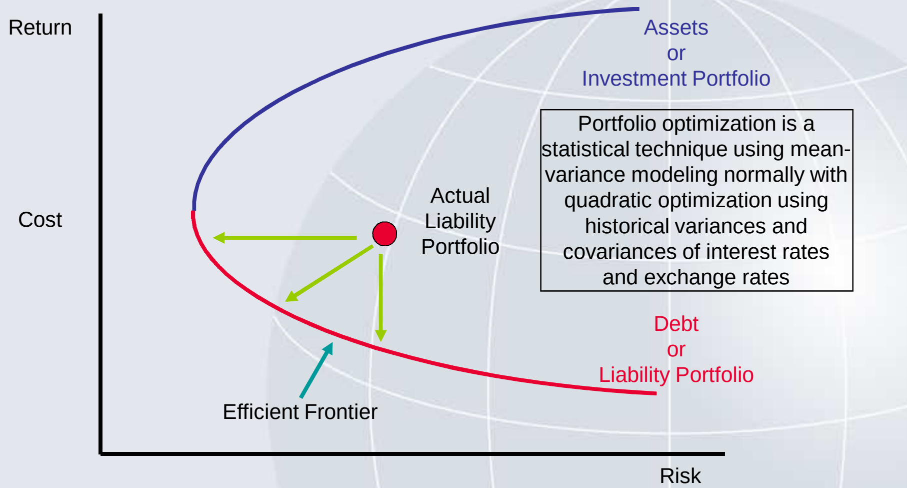
Approaches to Active Debt Management

- ALM approach
  - Integrated management of financial and fixed assets and liabilities
  - Canada, Denmark, New Zealand and United Kingdom
- Partial ALM approach
  - Integrated management of liabilities and some financial assets (e.g., exclude FX reserves)
  - Australia, Brazil, Ireland and Sweden
- Liability management approach
  - Usually use Cost-at-Risk (CaR) or portfolio optimization approach
  - Italy, Mexico, Poland, Portugal

Techniques used by DMOs

- Portfolio optimisation with mean-variance approach
  - efficient frontier and optimal (gross or net) liability portfolio
- Cost-at-Risk (CaR)/Budget-at-Risk (BaR)/ Debt Service-at-Risk (DSaR) using Monte Carlo simulation techniques
  - reduces variability in budget debt service costs
- Value-at-Risk and stop-loss limits
  - manages market risk of (gross or net) liability portfolio

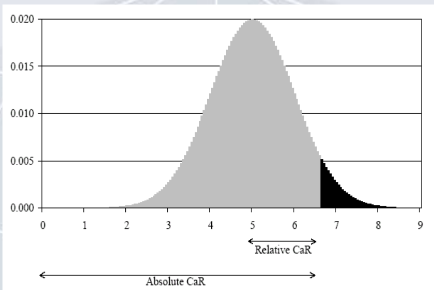
Portfolio Optimisation

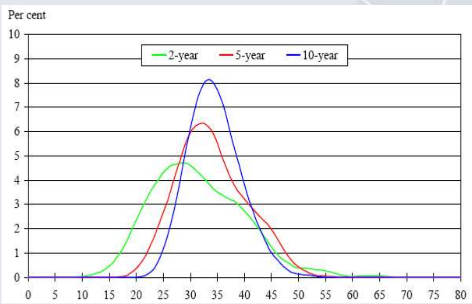


Portfolio optimization is a statistical technique using mean-variance modeling normally with quadratic optimization using historical variances and covariances of interest rates and exchange rates

Cost-at-Risk

Cost-at-Risk (CaR) determines the maximum expected increase in annual costs of the government debt with a given probability over a given time period





CaR differs from VaR by focusing on the changes in financing costs, whereas VaR focuses on changes in the market value of the portfolio

What questions are answered?

- How much debt and how much should we borrow? NO
- When, in what structure and from whom should we borrow? YES
- How should we manage existing debt? YES

- Debt sustainability results from fiscal and monetary policy parameters, not debt management
- Debt management indicates preferred structures, timing and creditor profiles
- Debt management provides framework for minimising or smoothing existing debt costs

Framework for Debt Management

- Identify the cost-risk trade-off, clarify debt policy goals, and improve transparency
- Avoid taking uninformed or speculative views on FX and interest rates
  – Establish benchmarks and use stress testing
- Asset-liability management identifies natural hedges in the government balance sheet
  – Losses on liabilities can be offset by gains in assets

Questions and Discussion