UNITAR TRAINING PROGRAMMES IN THE LEGAL ASPECTS OF DEBT AND FINANCIAL MANAGEMENT

INSTITUTIONAL FRAMEWORK FOR PUBLIC SECTOR BORROWING

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INSTITUTIONAL FRAMEWORK FOR PUBLIC SECTOR BORROWING

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PREFACE

UNITAR's work in the field of public finance and debt and financial management has looked closely at both legal and institutional aspects of the borrowing process in general and debt management in particular. This chapter was commissioned by UNITAR and is a result of its direct involvement in institutional aspects of the public sector borrowing at the regional as well as national level as part of its training and research activities.

Our Institute is not only involved in training and research activities, but also aspires to disseminate the current thinking, initiatives and best practices in the field of public sector borrowing to its main constituency, that is, government officials from developing countries and economies in transition. This *document se*ries initiative of UNITAR falls in line with that objective.

Let me also take this opportunity and remind the reader that this initiative forms part of UNITAR's broader and on-going training programme in *the Legal Aspects of Debt and Financial Management for Sub-Saharan African countries*. As part of this training programme, UNITAR brings together African public officials from a range of agencies including the Ministry of Finance, Ministry of Justice, Ministry of Foreign Affairs, the Attorney-General's Chambers, the Central Bank as well as parastatals involved in borrowing or negotiating international agreements. The primary aim of such workshops – conducted in-country and on a regional basis – is to bring together officials with different backgrounds to appreciate the multidisciplinary nature of financial management issues and the centrality and importance of the legal aspects in the borrowing process. Participants at these workshops are not only lawyers but also negotiators, decision makers, financial experts, economists and accountants coming from government offices.

This chapter has been contributed by Mr. Nihal Kappagoda who is a well known macroeconomist and debt management specialist. UNITAR is grateful to Mr. Kappagoda for his contribution to our initiatives and for his input in the publication of this document.

I hope that this document is useful as well as challenging to the readers.

Marcel A. Boisard
Assistant Secretary-General of the United Nations
Executive Director of UNITAR

INSTITUTIONAL FRAMEWORK FOR PUBLIC SECTOR BORROWING[1]

PUBLIC DEBT AND ITS MANAGEMENT

Introduction

Efficient public sector borrowing in a country requires an effective and transparent legal and regulatory framework and organizational structure. The Guidelines for Public Debt Management[2], a publication of the International Monetary Fund and World Bank, confirms that an effective governance structure for public debt management requires a clear legislative framework and well-defined organizational arrangements with the mandates of different agencies articulated to ensure that there is no overlap. Debt management operations should be supported by an accurate management information system which would enable analytical work to be undertaken as loan portfolios become more complex and governments wish to undertake debt and risk analyses. Sound debt management requires the conduct of annual audits to ensure comprehensive reporting on public debt. Staff working in debt offices should be required to work in a modern business environment with clear conflict-of-interest guidelines.

Definition of Public Sector Debt

In the aftermath of the Asian financial crisis, it became clear that the extent of government obligations go beyond its direct borrowings and guarantees issued to include unguaranteed borrowings of the public sector and a range of implicit guarantees. Consequently, there is a need for a more comprehensive coverage of public sector debt, at least for the purpose of collecting full and complete data on these obligations.

There are alternative definitions of public sector debt. In the World Debt Tables the World Bank[3] defines external public debt as the sum of public and publicly guaranteed debt[4]. These two categories are defined as follows:

a) **Public debt** is the sum of all domestic and external obligations of public debtors which include the central government and its agencies; states, provinces or similar political subdivisions including their agencies; and

[1] This paper was written by Mr. Nihal Kappagoda, a Debt Management Consultant residing in Ottawa, Canada. The author wishes to acknowledge with thanks the comments made by Ms. Malvina Pollock of the World Bank and Mr. Jose Maurel of the Commonwealth Secretariat.

[2] Published in March 21, 2001.

[3] Global Development Finance 2002, The World Bank.

[4] This definition also applies to domestic public debt.

autonomous public bodies such as state enterprises and subsidiaries in which they have joint ownership with the private sector and a major shareholding. The obligations of public bodies outside the central government include borrowings that are both guaranteed and not guaranteed by the government.

b) **Publicly guaranteed debt** is the sum of all domestic and external obligations of the private sector that is guaranteed for repayment by a public entity.

In another definition, the International Monetary Fund[5] divides the public sector into the Financial and Non-Financial Public Sector. The financial public sector covers monetary and non-monetary institutions and the non-financial public sector covers the central government, states/provinces and local government authorities and non-financial state enterprises. Public monetary institutions include the Central or Reserve Bank and state owned depository financial institutions including commercial banks. Public non-monetary financial institutions are non-depository institutions such as state owned development finance lending agencies.

The breakdown of the public sector in this manner sometimes leads to the collection of loan data of only the non-financial public sector with data on the financial public sector being collected only if the loan is guaranteed by the government. The reason given for this is that the latter liabilities are included in the statistics of the monetary sector and do not require to be collected with public sector debt. Therefore it falls short of the total debt of the public sector as defined by the World Bank due to the exclusion of the debt of the Central Bank and unguaranteed borrowings of depository and non-depository state financial institutions.

Whatever definition is adopted, it is recommended that data be collected adopting the broadest possible definition. This will facilitate the reporting of public debt to different creditor agencies as it will enable reports to be prepared for a subset depending on the needs of the institution requiring the report.

The International Monetary Fund[6] and World Bank classify the debt of a country as external and domestic debt on the basis of residence of the lender. Accordingly, both foreign and domestic currency debt held by non-residents is classified as external debt and those held by residents is classified as domestic debt. This would not have any implications for total public sector debt though the breakdown into foreign and domestic debt would have to take this into account if this definition is used.

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[5] Government Finance Statistics Manual, International Monetary Fund, 2002.
[6] Balance of Payments Manual (Fifth Edition), International Monetary Fund, 1993.

The Importance of Public Debt Management

Public debt management has become a priority for many developing and transition economy countries, which is a change from the early 1980s. When the debt crisis emerged in 1982, governments that undertook debt management focused their attention on controlling and recording medium- and long-term external public debt. Less attention was paid to controlling and monitoring private non guaranteed debt including short-term debt. Different institutions within governments dealt with domestic and external loans. External and domestic debt obligations were consolidated only when debt service payments of the government had to be estimated for the preparation of the budget and the payments accounted for audit purposes. The management of domestic debt was handled separately and not considered to be a priority at that time.

This approach changed in the 1990s - particularly during the latter half of the decade - as a result of factors that altered the international financial environment. The volume and terms of private sector debt had been subject to regulation under a regime of exchange controls. The borrowings were registered and recorded after the loans were contracted following approval. This changed with the liberalization of capital accounts in many developing countries when the control and approval of private sector debt was dispensed with. In some countries a system of registration was used for monitoring purposes. In many cases, even this was dispensed with in the belief that the external borrowings of private sector firms were their responsibility.

The Asian Crisis of 1997 showed that this approach was untenable. Governments should have known the full extent of the obligations of the public and private sectors - in particular those of large borrowers - for effective public debt management. They took responsibility for some private sector borrowings as defaults would have had an impact on the country's credit rating and consequently on the volume and terms of future external borrowings. Accordingly governments need to estimate total external private non guaranteed debt. A combination of sample surveys, voluntary reporting by borrowers and reporting by commercial banks through which loan transactions are handled is necessary to obtain these estimates. Further, governments should wherever possible eliminate policies that encourage excessive risk taking by the private sector.

The level of contingent liabilities also became a concern for governments after the crisis. These are liabilities that could arise due to predefined events or circumstances such as defaults on guarantees. Further, obligations of the public sector as a whole became those of the government and included borrowings guaranteed by it, both explicitly or implicitly. Borrowings by the private sector that were the result of government policies which encouraged them added a further dimension to the level of contingent liabilities. Payments that could arise due to unfunded pension liabilities, health care and other

benefits of the public sector, insurance and reinsurance programs of the government, indemnities, comfort letters and other forms of assurances that are not legally binding could be a potential burden in times of crisis. These liabilities need to be identified, recorded and quantified and the magnitudes monitored for sound macroeconomic management.

With the removal of capital controls, the public and private sectors have the choice of raising financial resources from either the domestic or international capital markets provided that the domestic markets were adequately developed and had a range of borrowing instruments. These changes eliminated the distinction between domestic and external sovereign liabilities to a large extent and made the management of the total domestic and external debt of the public sector a priority.

Objectives for Public Debt Management

In many emerging market countries the objectives for public debt management are not clearly defined[7]. The same is true of the governance structure and legal basis for public sector borrowings making it difficult for those responsible for debt management to function. The Organization for Economic Cooperation and Development identified four overall objectives for public debt management among its members in a survey[8] of debt management structures conducted in 2000. These are to:

- ensure the financing needs of the government;
- minimize borrowing costs;
- keep risks at an acceptable level; and
- support the development of domestic markets.

While these objectives are appropriate for any country accessing international capital markets that has a well-developed domestic capital market, many developing countries will initially give priority to obtaining the financing needs of the public sector at a low cost. In the initial stages of development countries have little choice in the sources and currencies of funding as the borrowing is mostly from official sources. As access to international capital markets increases, the objectives should also take account of the government's risk preferences and tolerances. The push to strengthen and deepen domestic capital markets and develop secondary markets will take place with the liberalization of the capital account of the balance of payments and when borrowers wish to exercise a choice between the domestic and international capital markets. The main objective of public debt management should be to ensure that the financing needs of the

[7] Developing Government Bond Markets, A Handbook, International Monetary Fund and World Bank, 2001.
[8] Public Debt Management: A New Priority, Nihal Kappagoda in Bulletin on Asia-Pacific Perspectives 2001/02, ESCAP, United Nations, 2001.

public sector are met at the lowest possible cost while bearing an acceptable level of risk in the medium to long-term. This should be included in the mandate of the office given responsibility for public debt management.

DEBT MANAGEMENT FUNCTIONS

The debt management functions that should be performed by a Public Debt Management Office (PDMO) have been identified and listed in the next three paragraphs to enable a full consideration of the range of activities that are required at all stages of the loan cycle. To assist this process and focus attention on the activities that are required they have been grouped into three categories – Resource Mobilization, Management Information System and Settlements, and Debt and Risk Analyses. Every attempt was made to list all the important debt management functions.

Resource Mobilization

Depending on the stage of development of a country, there may be a need to have separate resource mobilization activities for project/program finance and capital market borrowings. Further sub-activities will be required for foreign and domestic borrowings depending on the state of development of the domestic bond market. Activities requiring both foreign and domestic borrowings should be dealt with in a holistic manner instead of handling the two components separately as they are when foreign and domestic borrowings and their management are the responsibility of different agencies. The main functions in this category should be to:

- Implement the borrowing plan based on the strategy approved by the government;
- Mobilize resources for public sector projects and programs from foreign governments and international capital markets and the domestic capital market based on the borrowing strategy;

    Foreign Sources

    - Negotiate loans from international financial institutions and foreign governments
    - Negotiate loans from foreign and domestic commercial banks
    - Access international capital markets

    Domestic Sources

    - Access domestic capital market by conducting auctions and other measures
    - Develop domestic market
    - Develop secondary market

- Organize and execute hedging transactions;
- Identify and execute derivative transactions;
- Process applications for government guarantees, issue guarantees and conclude agreements with borrowers;
- Process applications for on-lending borrowed funds and conclude agreements with the borrowers; and
- Function as clearing house for requests for information from donors, international financial institutions, commercial banks and other creditors.

Debt and Risk Analyses

The capacity to undertake debt and risk analysis can only be built up over a period as it requires expertise in risk management techniques and market mechanisms. Consultancy inputs and training will be required to build up this capacity. As with the other functions, the performance of the analytical functions will require close coordination and consultation with staff performing the other two groups of activities. It should be recognized that debt and risk analyses are being performed to back up loan operations. Although the work is analytical in nature and involves some research, it underpins a highly operational activity requiring a detailed knowledge of lenders and capital markets. The main activities of this group should be to:

- Undertake frequent portfolio analyses to assess future debt service prospects and problems and propose action that should be taken to overcome them;
- Prepare debt sustainability analyses to assess the long-term sustainability of projected borrowing levels;
- Assess external vulnerability using debt and reserve adequacy indicators[9];
- Formulate policies for the issue of government guarantees and on-lending borrowed funds;
- Assess and manage market, rollover, liquidity, credit, settlement and operational risks in the loan portfolio;
- Adopt specific targets, benchmarks or guidelines for various debt variables such as the currency mix, share of floating debt, share of foreign debt, maturity profiles and share of short-term debt in total debt outstanding;
- Formulate a borrowing policy and an annual borrowing plan for the government/public sector. It could involve the adoption of ceilings for total debt outstanding broken down into foreign and domestic debt and targets for various stock and flow debt indicators;

[9] The importance of this type of analysis was highlighted during the Asian financial crisis. The central cause of the instability was not weaknesses in the government's fiscal position. Vulnerability stemmed from short-term foreign currency liabilities of banks, finance companies and individual firms that were not hedged. The governments in the affected countries were unaware of the full extent of these liabilities.

- Prepare a borrowing strategy for implementing the annual borrowing plan involving choices between domestic and foreign borrowings, foreign markets to be accessed, currency of borrowing, and interest rate and maturity structures;
- Formulate guidelines for unguaranteed borrowings of state enterprises and the private sector; and
- Prepare or provide inputs on public debt to periodic economic and financial reports and data for presentation to Parliament.

Management Information System and Settlements

The major activity in the Management Information System and Settlements category is to maintain the loan database for public sector borrowings using software that is adequate for both recording and undertaking the analytical functions of the PDMO. This will require that the staff responsible for the management information system keeps abreast of developments in information technology and ensure that all the staff of the PDMO is provided access to the database which is updated in a timely manner. The maintenance of an accurate database underpins the analytical work that is performed by the PDMO. It also enables debt service payments to be made on time. The main functions in this category should be to:

- Manage the debt information system and maintain an accurate and up-to-date loan database. Where multiple databases exist, well defined links should be established between them to produce a single database for analytical purposes;
- Link the debt management software to other software used for Treasury management and accounting systems of the government;
- Prepare debt service forecasts for external borrowings of the public sector as an input to the balance of payments forecasts and for total government borrowings (domestic and foreign) as an input to the expenditure estimates of the fiscal budget;
- Process debt service payments and effect payments on time;
- Monitor the implementation of loan agreements including the utilization of loans and the obligations of the government;
- Monitor the performance of loan guarantees issued by the government and report non-performance to the government;
- Monitor the performance of on-lending agreements and report defaults to the government;
- Monitor all contingent liabilities and ensure that adequate loan loss provisions are made in the budget to meet likely defaults;
- Prepare forecasts of government cash requirements to provide guidance on the volume and timing of domestic debt issues of the government;

- Prepare periodic statistical and other reports on the status of public debt that are required by the government and lenders; and
- Maintain a web site for the PDMO and provide critical information on public debt for the information of the public. The long-term goal should be to place the Annual Report on Public Debt on this site.

INSTITUTIONAL FRAMEWORK

A clear legal framework is necessary for making appropriate institutional arrangements for public sector borrowings. This should cover legislation for borrowings by the government (for its own use or on-lending), state enterprises and Central Bank and for regulating and/or monitoring the external borrowings of the private sector. The legislation has to be supported by regulations and procedures which set out the explicit roles of the different agencies involved in loan operations at all stages of the loan cycle for each category of borrower. Legislation covering the issue of government guarantees (typically by the Ministry of Finance (MOF)) on behalf of the government, and criteria and procedures for their approval and monitoring are also required.

There are as stated, several agencies of the government which have responsibility for a part of or the whole loan cycle relating to domestic and external borrowings and debt management functions. The MOF and Central Bank, possibly the Ministry of Planning (where the planning function has not been integrated with the MOF, e.g. in transition economy countries), and Treasury would be the main agencies involved in loan operations. In some instances, an autonomous PDMO may be set up with special responsibility for public debt either by legislation or administrative order. There are, in addition, the agencies implementing projects and programs for which the funds have been borrowed. Well defined organizational arrangements and transparent coordination mechanisms between all the different agencies are required for effective public debt management.

The institutional framework adopted by a country should facilitate the process of borrowing and the effective utilization of borrowed funds. Only the agencies and committees that make a substantive contribution to the loan cycle should be involved in loan operations. Agencies should not participate in the loan cycle for historical or bureaucratic reasons as it will only slow down or impede borrowings. The borrowing process should not be initiated if there is no requirement for funds. Once initiated, the institutional arrangements should ensure that the various stages of the loan cycle are handled expeditiously.

The Need for a New Structure

The changes in the international economic environment and the new requirements for debt management are leading countries to review the institutional arrangements for public sector borrowings and their management. Emerging markets that are liberalizing their capital accounts need to undertake these reviews as a matter of priority cognizant of the fact that public debt management covers all the activities of a loan cycle as before. It requires a higher level of sophistication due to the greater complexity of the loan portfolios covering both domestic and foreign loans and the more advanced techniques in use for debt management including those of multinational investment institutions.

These changes have made it necessary for governments to assess and manage risks in their loan portfolios through the adoption of guidelines, targets or benchmarks. The growing volume of international capital flows arising from globalization has increased the vulnerability of economies that have liberalized their capital accounts. Consequently, periodic vulnerability and debt analyses using selected indicators should be undertaken to obtain early warnings of impending financial crises. In some countries, short-term debt has become a large component of total external debt outstanding, introducing the possibility of a rollover risk if the payments position deteriorates. Monitoring the ratio of short-term debt to foreign exchange reserves has become more important than the import-cover ratio. The latter is more relevant for countries that have only liberalized their current account transactions. The external debt service, government debt service to government revenue and total public debt outstanding to gross domestic product ratios are among the indicators that should be monitored.

Public sector external debt is a smaller component of total external debt outstanding in many developing countries and should become even smaller over time as the private sector develops. Debt managers should keep the volume of private non guaranteed external debt under review though this debt can at best only be monitored in a liberalized economy. Sound debt management practices that include risk management are necessary to avoid a build up of unmanageable debt profiles. In its absence, the macroeconomic consequences and the output losses and costs of a sovereign default could be severe.

Many emerging markets are beginning to coordinate their external and domestic borrowings and have established or are considering establishing PDMOs with varying levels of legal authority. While lessons can be learnt on the organizational structure from developed countries that have established PDMOs the financing requirements in emerging markets are different. One important difference is the continuing need for project financing by the government and state enterprises from bilateral and multilateral institutions at varying degrees of concessionality. There is yet a need for borrowing to meet the foreign exchange needs of the public sector, be it the Central Bank or other agencies of the government. Domestic capital markets are being strengthened and new

instruments introduced to mobilize domestic capital but many countries are some distance away from exercising a real choice between the domestic and international capital markets for mobilizing resources for the public sector.

The Emerging Organizational Structure

The functional organization for public debt management that is emerging is similar to that of an investment institution. While the agencies responsible for debt management may not be structured as in these institutions, three operational offices can be set up to correspond to the three categories of debt management functions identified in the preceding section. These are referred to in this paper as the Front, Middle and Back Offices. **The Front Office** will be responsible for Resource Mobilization and make the major decisions on foreign and domestic borrowings based on the approved borrowing plan. It will also take responsibility for on-lending and guarantee operations and hedging and derivative transactions of the government. **The Middle Office** will be responsible for Debt and Risk Analyses. It should undertake portfolio analyses, develop a risk management strategy and develop borrowing scenarios and compare the emerging debt indicators with agreed benchmarks. This would enable sustainable levels of public sector borrowings to be estimated and a borrowing policy and plan for public sector borrowing to be prepared. The Front Office should formulate a strategy for implementing the borrowing plan by mobilizing resources from domestic and foreign sources with the assistance of the Middle Office. **The Back Office** will be responsible for the Management Information System and Settlements. It will make debt service payments based on creditor invoices that are crosschecked with its own database and also be responsible for monitoring loan utilization and the preparation of accounting and other reports required by creditors and the government. Straddling all three offices will be a legal group whose principal function will be to support the activities of the Front and Back offices. The three offices will be interdependent and exercise checks and balances over each other in the interests of transparency and accountability.

The organizational structure for public debt management should include a Public Debt Policy Committee. It should be a high level Committee chaired by the Minister of Finance and comprise the Governor of the Central Bank, Permanent Secretary of the MOF and heads of other relevant government agencies and organizations representing private sector groups such as banks and manufacturing firms. The membership should be broad-based to function in a transparent and effective manner. It should provide technical direction to the PDMO, oversee and approve the broad parameters of loan operations of the public sector and approve guidelines for the private sector. The government should endorse important policy decisions made by the Committee such as the annual borrowing plan of the public sector. Consideration should be given to making it report directly to Parliament.

Some debt management activities are presently performed by other agencies of the government. It is not proposed that these be transferred to the PDMO immediately in the new organizational arrangements for public debt management. It may be more efficient for them to remain where they are initially and establish firm institutional links to one or more divisions/units of the PDMO in the execution of debt management activities or the use of its output. In the long-term however, they should be brought under the umbrella of the PDMO. The allocation of functions to each of the three offices will depend on the needs of each country. The performance of each of the functions in one office will require coordination with one or both of the other offices.

Many of the Front and Back Office functions are currently performed in the agencies dealing with foreign and domestic borrowings for the government but the same is not true of the functions the Middle Office. A strong analytical capability for public debt management should be built up in the Middle Office to support the borrowing activities of the public sector. This is a long-term process requiring a combination of appropriate staffing, relevant technical assistance and on-the-job training.

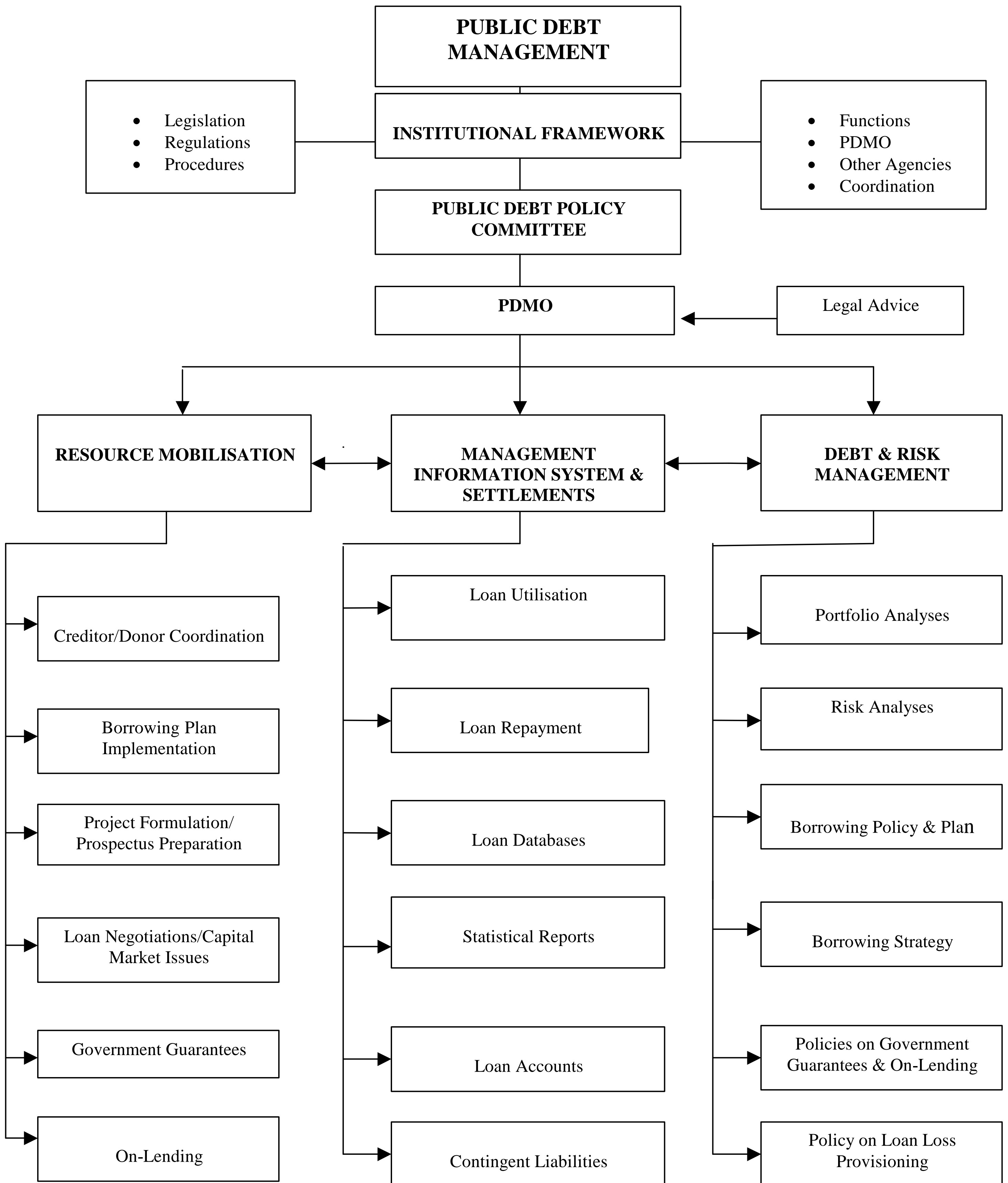
An organizational structure for public debt management should provide for the conduct of an audit to ensure that all explicit liabilities of the public sector are taken into account. This will facilitate the timely payment of public debt service and ensure that all public debt has been contracted following the laws, regulations and administrative procedures relating to public sector borrowing. It will also enable the reporting of public debt in a comprehensive manner to Parliament, international agencies and the public by encouraging the public sector to improve its disclosure of borrowings.

Forecasting and managing the government's cash requirements is a short-term aspect of public debt management that should be a function of a PDMO. However, the issuance of government securities should be closely coordinated with the open market operations of the Central Bank. This will ensure that the liquidity situation in the market will be taken into account when debt securities are issued. When the issuance of government securities has been delegated to the Central Bank, this function and that of conducting open market operations should be clarified and clearly demarcated. Where they are separated, an explicit coordination mechanism is required.

Depending on the needs of each country and the availability of staff skills, an autonomous PDMO with clearly defined links to the MOF and Central Bank may be established by legislation. Often responsibility for government borrowings and public debt management are assigned to the MOF. In some instances Central Banks have responsibility for some debt management functions of an operational nature delegated to them by the Ministry. In such cases, the functions are specified and the nature of the outputs and their timing set out in an agency agreement.

The organizational structure suggested for a PDMO is illustrated in Chart 1 which sets out the institutional framework that is necessary for public debt management. It corresponds to the three groups of debt management functions that were identified in the preceding section. It is the ultimate structure that should emerge in a PDMO when all the functions are brought under one office instead of being scattered among different agencies of the government.

CHART 1



Coordination with Fiscal and Monetary Policies

Effective coordination of debt management with fiscal and monetary policies while maintaining separate responsibility for each is an important aspect of debt management. In its absence or with poor coordination, it will be difficult to implement the macroeconomic policies of the government. Borrowing policies should ensure the long-term sustainability of the fiscal deficit. Cash flows arising from a given debt structure should be consistent with the long-term fiscal projections of the government. However, debt management policy should not be subordinated to monetary policy. Otherwise decisions on debt management may not be made to achieve sound portfolio management. The monetary authorities may, for example, prefer the issue debt that is index-linked to inflation with a view to preserving price stabilization but the debt managers may take the view that the domestic debt market is not developed adequately to mobilize the required resources using the type of debt instrument chosen. Similarly the monetary authorities may prefer to borrow in foreign currency to bolster foreign currency reserves while those responsible for debt management policy may not agree due to the higher risks associated with foreign currency debt.

The examples given above illustrate that debt management and fiscal and monetary policies should be mutually supportive in the interests of macroeconomic stabilization. In view of this, the institutional arrangements should clarify the objectives of the government in the three policy areas and the separate accountability of the agencies responsible for them. It is not uncommon for officials responsible for policy in the three areas to meet often to discuss a range of issues. Similar consultations take place at operational levels such as on the liquidity needs of the government to ensure that the different agencies are not operating in the same market simultaneously when significant issues are made.

Legislative and Regulatory Framework

Legislation on sovereign borrowing sets out the authority to borrow and delegates power from the body within the state which has the financial authority to the body that does the borrowing on behalf of the state. In democratic states, this power is vested in the Parliament which has responsibility for enacting laws and exercising financial authority. The latter includes the power to levy taxes, decide on the use of state funds and the right to borrow and assume financial obligations on behalf of the state. Since Parliament is a collective body which meets from time to time, borrowing and its management has to be delegated to another agency.

In most countries, the borrowing authority is vested in the MOF though it may sometimes be delegated to the Central Bank. The trend is away from Central Banks because of their independence and need to focus on monetary policy[10]. Since debt management policy may affect both fiscal and monetary policy it is essential that there be close coordination between the Ministry and Central Bank. Sweden is an example where the National Debt Office which has responsibility for government borrowing is independent of the MOF. By the Act on State Borrowing, the Riksdag (Parliament) has delegated the function of borrowing to the government which has further delegated it to the National Debt Office. The legislation authorizes it to borrow for financing the budget deficit, providing loans and guarantees specifically authorized by it, effecting amortization and redemption of state loans, and the Central Bank's foreign currency requirements. Through this legislation, the Riksdag controls the increase in the state debt as it approves the budget, state lending and the level of guarantees. The only exception is the borrowing requirement of the Central Bank for increasing its foreign currency reserves. Even here, there is indirect control as the Central Bank reports to the Riksdag.

In many countries foreign and domestic loans are handled separately. The legal framework for government borrowing is set out in a Foreign Loans Act for foreign borrowing and a Domestic Loans Act for domestic borrowing. These laws should be combined into a single Public Debt Management Law where foreign and domestic borrowings of the government are combined and handled in a holistic manner. Such a law should include the following basic provisions:

- Authority to borrow and undertake loan transactions on behalf of the government;
- Recognition of the sole responsibility of the MOF to borrow and issue guarantees on behalf of the government. This role should not be shared with other agencies though some operational functions could be delegated;
- Regulations to provide for consultations with other agencies such as the Central Bank on the terms and conditions of the loans;
- Recognition of the role of the MOF and/or Central Bank in public debt management;
- Establishment of a PDMO at the highest departmental level in the MOF or as an autonomous body;
- Establishment of a High-Level Public Debt Policy Committee under the chair of the Minister of Finance to set the borrowing policy and strategy. Its terms of reference should be described in the regulations;
- Requirement to set limits on government and government guaranteed borrowings in the annual Appropriations Act;

[10] See the section Coordination with Fiscal and Monetary Policies.

- A separate ceiling for unguaranteed borrowings of state enterprises. Where the capital account has not been liberalized, such a ceiling would be administered by the Exchange Control Department of the Central Bank;
- The role of the Central Bank in loan operations related to government and government guaranteed borrowings. This relates mainly to making debt service payments at the request of the MOF and the issue, servicing and redemption of the domestic debt of the government performed as an agency function;
- Responsibility of the MOF to maintain a database of all government and government guaranteed debt and prepare periodic reports to the Cabinet and Parliament; and
- The right of sub-national bodies such as provinces/states to borrow in the domestic market or abroad if the constitution provides for such borrowing within agreed parameters.

The issue of government guarantees on state enterprise and private sector borrowings could be governed by a Loans Guarantee Act. It could also be a part of the Foreign and Domestic Loans Act(s) or a unified Public Debt Management law. Such legislation should authorize the Minister of Finance to issue guarantees after obtaining the approval of the Cabinet and/or Parliament. In some countries, the Minister is only required to report on the guarantees issued on a periodic basis to Parliament. In others, a copy of the guarantee agreement has to be tabled in the Parliament within a specified period after the signature. The Minister of Finance also has to ensure that ceilings, annual or cumulative, which have been adopted by the government and/or Parliament, are complied with.

There are borrowings by state enterprises which do not require government guarantees. These could be governed by a State Enterprises Act which may require the approval of the borrowing by the Minister of Finance following that of the board of the state enterprise and supervising Ministry. Even in cases where there is no overall Act governing state enterprises and their borrowings, the individual Acts establishing them may set out similar provisions. If these do not exist, action should be taken to introduce procedures for monitoring these borrowings in the same manner as unguaranteed borrowings of the private sector. Experience has shown that in the absence of such procedures, borrowings by state enterprises that are not monitored have led countries to debt service difficulties.

The legal requirements governing private sector borrowings should be set out in the Central Bank and Exchange Control Acts and regulations framed under them. In situations where foreign exchange transactions are subject to control, private and state enterprise borrowers are required to obtain the approval of the Central Bank before contracting loans and for making service payments. Where such requirements do not exist as is increasingly the case due to liberalized foreign exchange regimes, it is

necessary to introduce a system for registering these borrowings with the Central Bank for the purpose of monitoring their build up.

The legal framework described in the preceding paragraphs should be established in all developing and transition economy countries. It illustrates the predominance of the MOF and Central Bank or an autonomous PDMO in public sector loan operations and consequently in public debt management. In the absence of such a legal framework, countries have issued Presidential and/or Cabinet Decrees to meet various debt management functions in an ad hoc manner as needs arose. These fall considerably short of the comprehensive legal framework that is recommended.

Regulations

It is necessary to formulate regulations and procedures which set out the explicit roles of the MOF, Central Bank, Office of the government/Cabinet Office, Ministry of Planning and other agencies involved in loan operations at all stages of the loan cycle. These are required to implement the legislation approved by the Parliament for public sector borrowings. They should set out in a transparent manner the responsibilities for:

a) the formulation of proposals for submission to lenders, negotiation of agreements and obtaining the approval of the Cabinet of Ministers for the signature of agreements;
b) the satisfaction of conditions preceding effectiveness of loans and the fulfillment of other obligations of the borrower during implementation;
c) monitoring utilization and the effective use of loan funds; and
d) ensuring timely debt service payments.

Clarity in regulations will assist discussions and negotiations with creditors who need assurances that the staff in the agencies has the legal authority to represent the government and that the government stands by the decisions and transactions of its sovereign debt managers. It should also facilitate the flow of loan data to the MOF to enable it to build up a loan database

In the interests of expediting public sector loan operations procedures should be drawn up for:

a) applying for government guarantees and on-lending;
b) concluding agreements for the issue of government guarantees and on-lending the proceeds of government borrowing;
c) collecting debt service payments from individual borrowers; and
d) monitoring the performance of guarantee and on-lending agreements.

Capacity has to be built up in the MOF in close coordination with the Ministry of Planning to assess the viability of projects and financial status of agencies implementing

them, without which it is likely that the government would have to assume responsibility for a substantial portion of the contingent liabilities.

Issue of Guarantees

In the case of a payment guarantee, the guarantor takes on an obligation to pay some or the entire principal amount of the debt and accrued interest if the borrower defaults. The guarantor assumes the risks of the obligation to honour the guarantee if it is called and the underlying debt and related rights of recourse against the debtor when the guarantee is issued. The guarantor also has a receivable from the debtor, i.e. the guarantee premium or fee, with possibly some collateral pledged by the debtor.

An important requirement of an effective guarantee policy is the thorough assessment of projects and programs for which guarantees are requested followed by the rejection of all those that are judged to be non-viable. The agency responsible for the issue of guarantees should undertake this prior to the issue of the guarantee and at regular intervals thereafter. The main purpose of such assessments is to evaluate the prospects of the beneficiary generating adequate income to repay the loan. There are instances when capital markets are unwilling to finance projects at a reasonable price without a government guarantee. Such situations are often encountered in large-scale projects which require long-term financing. The government should consider the alternative of borrowing the funds and on-lending the proceeds. Costs and risks of issuing a guarantee should be compared with that of on-lending before a decision is made.

The issue of guarantees for borrowings allows the government to achieve a range of policy objectives such as reviving ailing sectors of the economy and export promotion. Guarantees have many advantages. These are that

- the issue of a guarantee is a more attractive option fiscally than obtaining a direct government loan to finance a project and on-lending the proceeds. The government avoids building up the public debt by providing a guarantee. This factor is more important in the case of larger borrowing requirements;
- guarantees improve the flexibility of the borrowing options as the loan could be tailored to reflect the borrower's needs as regards the maturity and terms of repayment; and
- guarantees offer spin-off benefits, particularly with large-scale projects by bringing the borrowers into direct contact with the lenders. This provides direct and quick access to new financing arrangements and market instruments.

The greater the underlying risk of the investment or loan the larger the comfort that a guarantee provides to the creditor. The main purpose of the guarantee is to transform a

high-risk loan into a low-risk loan. Total elimination of risk is impossible, since sovereign guarantors may also default, although the likelihood of this event is less than default by a borrowing enterprise.

The guarantee transfers all or part of the risk of default from the borrower to the guarantor, and entails a cost to the government. Guarantees do not always require payment but they demand careful management, accounting and administration. Payments arising from borrowers defaulting may disrupt the fiscal balance when the total amount of guarantees is large and adequate provision is not made for these debt service payments in the budget. Guarantees have been the primary cause of debt crises in some countries.

A guarantee represents a potential expense to the government from a fiscal point of view. Resources must be diverted from other government programs if it is called. It is possible to provide a special expenditure item or guarantee provision funded partly from the guarantee fee levied. The government can protect itself from the excessive costs of guarantees by the following action:

a) the borrower should be required to provide collateral as security. The lien can be on its future output if the net worth of the enterprise is small;
b) monitor the use of the loan to ensure that it serves the intended purpose, it is repaid in accordance with the agreement, and the beneficiary is adequately insured; and
c) the loan and guarantee documentation are clear and not subject to interpretation due to ambiguity; and
d) if the borrower has difficulties in raising loans without a guarantee or where the borrower's right to enter into transactions is in doubt, the government should decline the issue of a guarantee.

Governments must actively manage each guarantee as soon as it is issued and undertake risk analyses on a regular basis when the underlying market conditions change as the levels of risks vary from one project to another. A lender should notify the guarantor in the event of a payment default. The borrower should provide all relevant financial information and in case of large guarantees, conduct regular consultations with the guarantor.

The following risks associated with the issue of guarantees must be evaluated:

- credit risk that the debtor will not meet its obligations;
- legal risk that the right of recourse against the debtor cannot be enforced,
- market risk due to changes in interest rates that will result in losses if loans have to be refinanced at higher rates in the future; and
- operational risk due to inadequate internal control systems, human error, management failure or fraud.

A borrowing enterprise could estimate the value of a guarantee as being roughly equal to the difference between the present value of the guaranteed and unguaranteed loans that could be contracted. The absence of a guarantee fee is a public subsidy to the borrower. A decision to provide such a subsidy should be an exception and not the rule, and made individually for each guarantee issued. Moreover, this subsidy may vary in size. Excessive costs of guarantees to the guarantor could be mitigated by issuing partial guarantees which would cover only a part of the underlying loan amount, thereby reducing the risk of default and consequently the guarantee fee.

There are several agreements that have to be negotiated when government guarantees are issued. They are the loan agreement between the lender and the borrower, guarantee agreement between the lender and the government, and agreement between the government and the borrower which set out the conditions under which the guarantee is issued. Normally, government guarantees are given only for borrowings by state enterprises but there are examples where governments have guaranteed borrowings by the private sector. Government guarantees required by joint enterprises between private firms and state entities should be limited to the share of the state entity in the enterprise. The government could provide a guarantee for the whole loan although this is not the usual practice. Problems have arisen in the case of guarantees issued for borrowings by state enterprises that were subsequently privatized. The nature of these guarantees should be clarified when the enterprises are privatized.

The agreement between the government and the borrower should include the following:

a) the amount of the guarantee and form of the security that the borrower provides;
b) the procedures that the borrower follows on receipt of the invoice for debt service payment;
c) reports required from the borrower on a regular basis; and
d) the procedure for the payment of the guarantee fee to the MOF prior to the issue of the guarantee.

Management of Guarantees

The government should adopt some operational guidelines for the issue of guarantees. The MOF should issue guarantees after approval by the Cabinet of Ministers and maintain full records. No other government agency should have the right to issue a guarantee.

The total amount of government guarantees issued each year should be within the overall ceiling set for public sector borrowings in the annual borrowing plan or the Appropriations Act. Once this plan is approved, the Ministry should not request any revisions that are not consistent with the overall fiscal and monetary objectives of the government.

Agencies receiving government guarantees should pay the MOF a guarantee fee up front. This should cover the administrative cost of processing and monitoring the guarantee and the risk of default of the loan in question and should be paid into a Special Fund. In addition, the government should make an annual appropriation in the budget of a given percentage of government guarantees outstanding as loan loss provisions. Each loan should be evaluated individually for the risk of default and an average ratio estimated and applied to the total amount of guarantees outstanding. This appropriation should also be transferred to the Special Fund each year. Accordingly, this Fund will be made up of guarantee fees and loan loss provisions and should be used only to make debt service payments on guaranteed loans that are in default.

Surpluses in the Special Fund should be invested in short-term instruments, at the discretion of the government, and the proceeds used for budget support. Supplementary provision should be sought from general revenue in the event of a shortfall in the availability of funds to make debt service payments on loans in default. The Public Debt Management Law should establish the framework for the issue of guarantees. The procedures to be followed for processing guarantee applications, managing and monitoring their performance and ensuring that debt service payments are made from the government budget in case of default should be included in the regulations that are drawn up for implementing the law. The policy on making loan loss provisions should be approved by the PDMC.

On-Lending

Often public sector borrowers seek the assistance of the government when direct borrowing is difficult or not possible. The issue of guarantees as described is one modality chosen in such cases as it does not increase the level of public sector debt. In other cases, governments borrow the funds and on-lend them to the ultimate borrowers. There are cost advantages to the borrower in such on-lending and it is easier for the government to monitor loan utilization. However, the level of public sector debt outstanding increases.

The legal basis for the on-lending operations of the government should be set out in the Public Debt Management Law and procedures for approval and monitoring of performance in the supporting regulations. The principal basis for the decision to on-lend is that the project or program, when completed, would generate adequate revenue to make

debt service payments without a government subsidy. This requirement may be modified in the case of social infrastructure, environmental protection and some physical infrastructure projects assigned national priority.

The government may decide to use multiple channels for on-lending. It may establish a separate entity for on-lending for a category of projects such as investment projects in infrastructure. Another channel for on-lending may be financial institutions such as those established for the promotion of small and medium-scale enterprises. The repayment period normally stipulated for on-lending would depend on the repayment capacity of the project as determined in the feasibility study. In principle, the repayment period should not exceed that in the agreement between the government and the lender. Further, where the government borrows under commercial conditions and makes sub-loans in foreign currency, the applicable rate of interest should be the interest and fees payable to the lender by the government plus a domestic on-lending fee which should be paid annually. A preferential rate of interest may be charged for some categories of projects but these should be limited to projects in the social sector, environmental protection and reconstruction following national disasters. It is an accepted principle that these rates should not be lower than the rate of interest and fees payable by the government to the lender plus the domestic on-lending fee. The MOF will set out the terms and conditions for on-lending in the agreements with the institution used to channel on-lent funds. The terms also reflect the conditions for on-lending that are imposed on the government by donors.

The institutions through which government loans are on-lent should take full responsibility for the management of the individual loans that are extended by them. They should be required to provide periodic reports to the MOF on the implementation of the projects/programs financed. Similarly, each borrower should be required to submit reports on implementation to the on-lending agency. This will provide the basis for the reports to the MOF along with data collected through supervision of the loans by the relevant on-lending agency. Debt service payments are made by individual borrowers to the on-lending agency which transfers these funds to the MOF. When payments are not made on time, the on-lending agencies should take the measures necessary to recover the funds from the borrower based on the agreement signed with the borrower and current laws of the country. Persistent defaulters should be reported to the Public Debt Policy Committee through the MOF.

CONCLUSION

Governments need clear authority to borrow granted to them in the constitution or in legislation. The law should enable this authority to be delegated to an agency of the government subject to prior legislative authorization or within ceilings set in Annual Appropriation Acts. Governments are required to meet their repayment obligations and provide assurances to lenders regarding the borrowing process and their rights. The legislation should also assign the responsibility for public debt management to a single agency while the regulatory framework describes the internal management process for public sector borrowings. The organizational structure set in place should enable borrowings to be undertaken in the most effective manner based on the legal and regulatory framework that is established.

A dynamic aspect of public debt management is the development of a domestic securities market. It will require stability in political institutions, sound fiscal and monetary policies, an effective legal and regulatory framework, a transparent settlement system, and a financial system that can support an evolving domestic securities market. Sound debt management by the PDMO can assist the process.

This paper has endeavored to describe the various elements of the legal and regulatory framework and organizational arrangements that must be established. There is no model institutional framework that could be replicated in all developing and emerging market countries. Whatever framework is adopted it must be dynamic in nature and subject to change periodically as each country develops, its needs evolve and the international environment changes. The frameworks in more developed countries can be studied for lessons and provide guidance but ultimately the needs of each country will dictate what should be done.

PROFILE OF THE AUTHOR

Mr. Nihal Kappagoda is a senior international consultant with 35 years experience at the national and international levels as a macroeconomist and specialist in debt management. He works as a free lance consultant since 1989. Immediately prior to this he was the Director, Technical Assistance Group of the Commonwealth Secretariat where he launched the programme of advisory services in debt management. This included the CS-DRMS debt management software used in 50 countries with seven of them outside the Commonwealth. He worked in the Development Policy Office of the Asian Development Bank coordinating a study on the Bank's Priorities and Plans for the 1980s. From 1973-81 he worked for the International Development Research Centre (IDRC) in Canada, first as Director of the Regional Office in Singapore and later as Vice President Planning in Ottawa. His work in Sri Lanka was at the Central Bank and Ministry Planning. He was responsible for the country's external borrowing program as head of the External Resources Division.

From 1989 he has undertaken debt management consultancies for the Asian Development Bank, Commonwealth Secretariat, Department for International Development (UK), IDRC, UNDP and World Bank during which he delivered several training programs. He has worked in other areas for these agencies and the Canadian International Development Agency and North-South Institute.

Nihal Kappagoda was born in Sri Lanka and holds a Master of Philosophy degree in economics from the University of Oxford where he was Sri Lanka’s first Rhodes Scholar. He has written two books and published numerous journal articles including some in the field of debt management.

UNITAR

UNITAR is an autonomous body within the United Nations which was established in 1965 to enhance the effectiveness of the UN through appropriate training and research. UNITAR's programmes in the legal aspects of debt, financial management and negotiation are among a wide range of training activities in the field of social and economic development and international affairs carried out, generally, at the request of governments, multilateral organizations, and development cooperation agencies. UNITAR also carries out results-oriented research, in particular research on and for training, and develops pedagogical materials including distance learning training packages.

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During 2002, the programme will focus on :

- Training government officials through short-duration regional seminars and workshops on various aspects of debt, financial management and negotiation ;
- Developing On-line Training Courses (in parallel with its traditional regional training) with a view to tapping a wider audience and reducing cost of training per participant ;
- Strengthening existing ties with regional training centres and offering joint courses with partners in the field ;
- Creating awareness among senior government officials of the importance of the legal aspects in the borrowing process and of putting together a multidisciplinary team for loan management and public administration;
- Providing in-depth training and skills development for accountants, economists, financial experts and lawyers coming from government ministries and departments involved in negotiation, financial management and public administration ; and
- Developing and disseminating training packages and 'best practice' materials directly related to the practicalities of legal aspects of debt and financial management, with a view to strengthening existing human resources and institutional capacities at the national level.

A description of UNITAR's latest activities and training programmes in the area of debt and financial management is available on its website at : www.unitar.org/dfm.