

**LEGAL ARRANGEMENTS FOR A
DEBT OFFICE**

by

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Why a Debt Office?

A Debt Office can be described as an agency with at least some autonomy from the political sphere, which is responsible for the management of the State debt. When the Swedish National Debt Office ("SNDO") was established in year 1789 it was quite a unique structure and remained so for almost exactly 200 years. In 1988, however, New Zealand followed the Swedish route and set up the New Zealand Debt Management Office, and in 1990 Ireland established the National Treasury Management Agency. Since then Austria, Belgium, Finland, Portugal and United Kingdom have done the same. Why has the debt office model suddenly become so popular?

In the short run everyone can borrow cheap. The easiest way is to borrow in a currency with low coupon rate and with a short interest fixing period, as on average yield curves tend to have positive slopes. And if the fund raiser is still not satisfied he can probably make the borrowing even cheaper with the help of derivatives like swaps and options. In a pressing political situation any head of funding can be tempted to choose such a borrowing strategy in order to soften internal budget constraints. But everyone with some experience in financing knows that this kind of borrowing is very risky, i.e. can be very costly for the tax payers - at least in the long run.

Over the last ten years the possibilities for borrowers have increased substantially. More markets have opened up and there has been a constant flow of new

instruments, especially in the field of derivatives. The other side of the coin is that the risks, and the temptation to reap the immediate cost benefits, have equally increased. Within SNDO we are now, as compared to some years back, almost daily speaking about interest rate risks, refinancing and other liquidity risks, credit risks, currency risks, legal risks, administrative and other operational risks and, as we are a sovereign, reputational risks. In such an environment it is essential for the Government to have a clearly defined objective and an effective organisation for its debt management. If the loan portfolio contains high risks it will be highly vulnerable to external shocks. Sound management of sovereign liabilities, especially when the State debt is substantial, is therefore an important element in safeguarding a country's economic stability. In order to do that one needs both knowledge and experience in risk-management techniques and sophisticated support systems.

The management of the State debt should also be clearly separate from the implementation of the monetary policy, which is the responsibility of the Central Bank. Otherwise debt management decisions could be perceived to be influenced by inside information on interest rate decisions.

To quote the final remark by Marcel Cassard and David Folkerts-Landau, two former IMF economists, in their instructive article "Sovereign Debt: Managing the Risks" (Finance & Development / December 1997):

"The most pressing issue confronting governments is the need to reform the institutional arrangements governing debt policy, so that the technical expertise and experience required to manage the risks of external debt competently and transparently can be applied. Professionalism and accountability can best be achieved when debt management is assigned to an agency that is separate and autonomous from the political process. Within this framework, the ministry of finance formulates and makes public the strategy for debt management while the debt office implements the strategy and manages the daily risk exposure of the sovereign portfolio. This type of arrangement signals to the financial markets and

the general public a country's commitment to a transparent and accountable debt-management policy.”

Hence the drive in setting up specialised agencies, debt offices, for the daily management of the State debt.

All borrowings through the same entity

All the State borrowings, domestic as well as external, ought to be made through the same governmental agency, preferably a debt office. It will then be easier to co-ordinate the borrowings and risk management. Moreover, the knowledge acquired of different borrowing techniques used abroad which will be achieved through the external borrowings can be applied in the State's own domestic market. With the abolition of the exchange control systems and the steady increase of liquid swap-markets, the different markets have also come nearer each other. A foreign investor can as easily buy a bond issued in the domestic market as a bond issued abroad, and in the swap-market he can change the currency of his investment to the currency he feels comfortable with. Also the State can use the swap-market to increase its exposure in a foreign currency in a more cost-effective way than through direct currency borrowing. As the State has competitive advantages in its own domestic market it can, when the demand is there, through a currency swap between its own currency and the foreign currency receive cheaper funding in the foreign currency than through a direct borrowing in the foreign currency.

The conception of the State

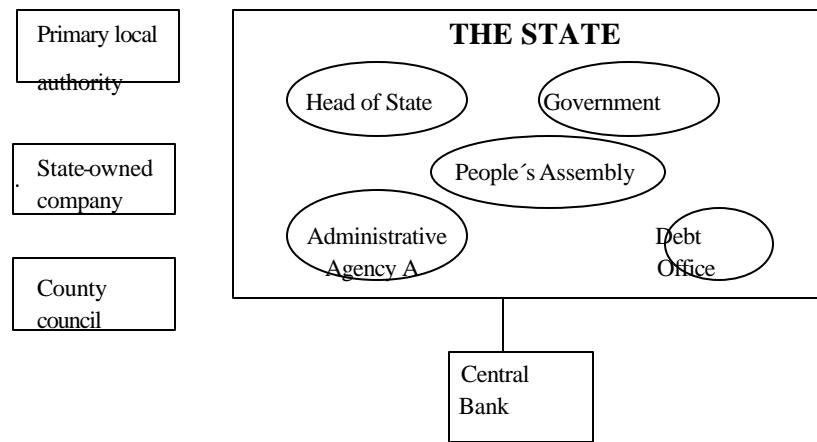
The legal arrangements for sovereign borrowing is basically a delegation of power starting from the body within the State who has the financial power, and ending up in the body who will actually manage the State debt, e.g. a debt office.

From the point of view of civil law the State is a legal person with assets and liabilities of its own. In the case of a State based on the rule of law it can also be brought to court, at least to the national courts.

As regards their organisation, modern States tend to be highly fragmented. The supreme bodies consist of the Head of State, the People's Assembly, the Government and the Judiciary. In addition to these there are various layers of authority, both central and local. The sum of all these parts is a single legal person, i. e. the State. State-owned companies, however, are not part of the State. They are independent legal entities and normally subject to the same corporate laws as privately owned companies. The State's interests in these companies do, however, represent State assets. Nor do the different kinds of subnational governments, like primary local authorities and county councils, form part of the State. Another thing is that the State might have a contingent implicit liability to financially support these entities. But that is beyond any legal obligation.

The status of the Central Bank varies from one country to another. As a rule, since it traditionally has been the "bank of the State", the Central Bank is separate from the State at least in terms of property rights. In some countries the Central Bank is organised as a limited liability company, while in others it has its own assets and liabilities but in some other respects functions as a governmental agency. The foreign exchange reserves are always managed by the Central Bank. However, this does not necessarily mean that the Central Bank owns these reserves. In some countries it does, while in others the foreign exchange reserves are regarded as the property of the State and are only managed by the Central Bank on the instructions of the State.

To illustrate, the State may thus be described as follows.



The State is invested with supreme power within its territory. It has legislative power and the power to collect taxes, as well as being responsible for external security and internal order. If the State collapses, the result is anarchy.

The Constitution

The starting point for any study on legal arrangements for a debt office is to find out the State body which has the financial power. The obvious source here is the Constitution.

Historically the Head of State (the King, the Emperor, the Tsar etc.), his Ministers (the "noble men") and the "ordinary" people have struggled for the power over

the State. The final outcome of that tug of war is normally shown in the Constitution of the country, which regulates the division of powers between the Head of State, the Government and the People's Assembly. In modern democratic States most of the power is vested in the People's Assembly, such as the lawmaking power and the financial power.

The most important element of the financial power is the right to tax the income and the property within the jurisdiction of the country. As the State's assets predominantly consist of the discounted value of future taxes, interest payments on the State loans will at the end of the day be covered by the tax payers. One could thus say that the management of the State debt is the management of future tax payments. Consequently, the body which has the right to levy taxes should also decide on State borrowing and other assumptions of financial obligations, like financial guarantees.

In the Swedish Constitution it is stated in Chapter 9, Section 10, that the Government may not, without authorisation by the *Riksdag* (= the Swedish People's Assembly), borrow funds or otherwise assume financial obligations on behalf of the State.

In order for the State to enter into loan transactions, the People's Assembly must thus delegate the right to manage the debt to the Government or to another body within the State. In some countries, like Sweden, the People's Assembly cannot delegate its powers directly to an agency reporting to the Government. In the case of a debt office, which normally is reporting directly to the Government (the Ministry of Finance), the Assembly must then delegate the borrowing power to the Government and give its consent to the Government's on-delegation to the Debt Office.

In theory the People's Assembly could itself take care of the debt management. But in practice that would be a very inefficient system as the Assembly is a collective body which only meets during its sessions.

The next step is therefore to study the delegation from the People's Assembly. But first some general comments on regulations.

General about regulations

In today's dynamic world "flexibility" is a key word. It is impossible to foresee all the problems, and opportunities, which might occur in the near (or distant) future. This is particularly true in cross-border finance. The regulations should therefore not be too detailed. A better approach is to clearly state the aim of the borrowing activities, give some general operational guidelines, regulate the borrowing entity in a more general form and employ people with professional skill and sound judgment. However, even if the above is the ideal situation one also has to look at the economic development of any country. In a less mature environment it might be wise to start with a more detailed regulation and gradually lessen the restrictions as the competence of the Debt Office grows.

There are two addressees of the regulations, namely the Debt Office and its counterparties in the credit and derivative markets. Both the Debt Office and its counterparties must know what the Debt Office legally can and cannot do. If the counterparties are hesitant whether the Debt Office has the mandate to legally bind the State or not, they will be very reluctant to enter into any transactions with the Debt Office at all and, if they eventually do, they will ask for a risk premium to

cover their legal risk. On this point the delegation must be very clear. Prudent counterparties will ask for their own copy of the regulations and make their own interpretation of the delegation.

The delegation from the People's Assembly

The delegation can be very wide like in the United Kingdom and Ireland. In the United Kingdom the following is stated in the National Loans Act 1968 under Section 12, headed "Power of Treasury to borrow":

- "(1) Any money which the Treasury consider it expedient to raise for the purpose of promoting sound monetary conditions in the United Kingdom and any money required -
- (a) for providing the sums required to meet any excess of payments out of the National Loans Fund over receipts into the National Loans Fund, and
 - (b) for providing any necessary working balance in the National Loans Fund,
- may be raised in such manner and on such terms and conditions as the Treasury think fit, and money so raised shall be paid into the National Loans Fund.
- (2) For the purpose of raising money under this section the Treasury may create and issue such securities, at such rates of interest and subject to such conditions as to repayment, redemption and other matters (including provision for a sinking fund) as they think fit.
- (3) For the avoidance of doubt it is hereby declared that the power to raise money under this section extends to raising money either within or outside the United Kingdom and either in sterling or in any other currency or medium of exchange, whether national or international."

A more restricted approach is for the People's Assembly to determine on a yearly basis the maximum amount which can be borrowed in the domestic currency and/or in foreign currencies. In the Finnish Constitution, for example, it is stated in

Section 64: "State borrowings must be founded on the consent of the People's Assembly, from which may be concluded the maximum amount of the new borrowings as well as the maximum amount of the State debt." The problem with this restriction is that it is difficult one year in advance to forecast the total borrowing requirement. Due to the economic development during the year both the revenue side and the expenditure side of the budget might be adversely affected. Also - in the case the State is raising funds for the Central Bank - the Central Bank might get a sudden need to replenish the foreign currency reserves, which will again increase the borrowing requirement above the limits set by the People's Assembly.

The Swedish model

The delegation of the borrowing power from the Riksdag to the Government is stated in the Act (1988:1387) on State Borrowing and Debt Management. The Act is attached as Annex 1.

Section 1 of the Act reads as follows:

"Following specific authorisation by the Riksdag for each individual fiscal year, the Government or, following resolution by the Government, the Swedish National Debt Office (the "Debt Office"), may borrow funds on behalf of the State in order to:

1. finance current deficits in the National Budget together with other expenditures incurred pursuant to Acts of the Riksdag;
2. provide such loans and fulfil such guarantees as resolved by the Riksdag;
3. amortise, redeem and re-purchase State debt; and
4. fulfil the Central Bank's requirements of currency reserves.

The Central Bank shall make full compensation for the State's costs in respect of borrowing in order to fulfil the Central Bank's requirements of currency reserves. The Government may, however,

in consultation with the Central Bank, resolve otherwise where specific cause exists.”

As can be seen, the borrowing authorisation is not limited in amount but to purposes. Still the Riksdag has control over the State debt since it is the Riksdag which, within its financial power, approves the budget, including expenditures and tax rates, and consents to any State lending and the issuing of guarantees. The only exception is the borrowing for the purpose of increasing the foreign currency reserves of the Swedish Central Bank. But also here the Riksdag has, at least indirectly, full control as the Central Bank is an agency reporting directly to the Riksdag. The members of the Central Bank’s governing council are as well appointed by the Riksdag.

The yearly authorisation is a mere formality. As part of its work with the Budget Bill the Riksdag just refers to the Act and gives the Government the authority for the coming fiscal year to borrow in accordance with the Act. The consent to the Government’s on-delegation of the borrowing authority to the Swedish National Debt Office has already been given in the Act itself.

Section 3 of the Act makes it clear that the debt shall be managed by the Government or, following resolution by the Government, the Debt Office. The debt management includes the right to enter into derivative transactions.

As mentioned above it is important to be aware of that the addressee of the delegation is also the counterparties of the State. In Section 4 it is therefore explicitly stated that the State shall be liable for any and all loans entered into by the Debt Office. Without this statement a prudent lender to the Kingdom of Sweden would check if the Riksdag has given its yearly authorisation, if the Government has on-delegated the authorisation to the Debt Office and whether the borrowing is made for an approved purpose. With this Section 4 it is clear that regardless whether the Debt Office had received the necessary authorisation to

make a certain borrowing on behalf of the State or not, the loan will still be a legally valid and binding obligation of the State. If the Debt Office should have overstepped what it is authorised to do, it will certainly be an internal problem within the State but it will not affect any lenders.

Delegation should never be the same as abdication. Therefore the Riksdag in its Act on State Borrowing and Debt Management also has determined the aim of the debt management and given rules on guidelines and reporting requirements.

The aim, as stated in Section 5, is that the State debt shall be managed so that the costs of the debt from a long-term perspective are minimised with due regard to the risks associated with debt management. This means that the borrowing costs shall be calculated on a risk-adjusted basis. "Long-term" has been elucidated by the Government in its annual regulatory communication to the Debt Office to mean rolling five-year periods.

Not later than 1st October each year the Debt Office shall submit to the Government a proposal for guidelines for the management of the debt. After receiving the proposal the Government sends it to the Central Bank for its opinion. The Central Bank mainly checks that the proposed guidelines will not adversely affect the implementation of the monetary policy, the object of which is to maintain price stability. Thereafter the Government not later than 15th November decides upon the guidelines for the Debt Office's management of the State debt.

Not later than 15th February each year the Debt Office is obliged to submit to the Government data for the evaluation of its debt management, which are normally given in the annual report to the Government. The evaluation is then presented by the Government to the Riksdag in a report not later than 25th April. After reading the evaluation the Riksdag is able to give its view to the Government on the

management in the last year (or years) and on the future guidelines to the Debt Office.

Both the Debt Office's proposal and the Government's guidelines are made public. Hence a guarantee that both the proposal and the guidelines are based on good analyses and well-founded arguments. Also the Government's evaluation is made public.

The Swedish system can thus be described as transparent and having a strong emphasis on accountability.

Instructions for the Debt Office

The Swedish National Debt Office is a governmental agency reporting directly to the Government. The on-delegation of the borrowing authority, duties and aims, management etc. of the Debt Office are prescribed by the Government in the Ordinance (1996:311) Prescribing Instructions for the Swedish National Debt Office. The Ordinance is attached as Annex 2.

Section 1, subsection 1, reads as follows:

”The Debt Office shall enter into and manage loans on behalf of the State pursuant to the Act (1988:1387) on State Borrowing and Debt Management. The object of this activity shall be to minimise, on a long-term basis, the costs of the State debt with due regard to the risks associated with debt management. The management shall occur within the framework of the requirements imposed by monetary policy and the guidelines determined by the Government.”

Section 3 states that the Debt Office shall consult with the Swedish Central Bank with respect to issues concerning the general focus of the borrowing activities and

that these consultations shall relate primarily to issues of significance relating to monetary policy.

These consultations are usually relatively informal. They are conducted on a mid-management level and normally through telephone calls. Over the years a common understanding has been established on the topics which are of interest to the Central Bank. In addition to telephone calls and *ad hoc* contacts there are four meetings a year between the Central Bank, the Ministry of Finance and the Debt Office where more general questions are discussed. These meetings are also held on a mid - management level.

The Debt Office is managed by a Board of Commissioners which is chaired by the Director General, who is also the chief executive (Sections 6 and 7). They are all appointed by the Government.

In addition to the Director General, the Board consists of seven persons. Four of the Commissioners are Members of the Riksdag. On the current Board are also three Professors of Economics, of which one is a high level officer of the Ministry of Finance.

The Board normally meets six times a year and decides, inter alia, on the proposal to the Government for guidelines for the management of the debt, the principles as to the manner in which the guidelines issued by the Government shall be implemented, the data to the Government for its evaluation of the Debt Office's management of the debt and the limits and guidelines for the management of the risks associated with the Debt Office's activities (Section 9). In addition the Board takes decisions with respect to the Debt Office's interim and annual reports to the Government, the budget data, the audit reports and the internal audit plans.

Organisational guidelines for the Debt Office

We have now come down to the last regulation, namely the Debt Office's own organisational guidelines determined by the Director General. Extracts from the organisational guidelines are attached as Annex 3.

The organisational guidelines regulate the internal organisation of the Debt Office. In principle it is up to the Debt Office to decide its own organisation. Thus the guidelines regulate such matters as the areas of responsibility and the objects of the departments, the responsibility of certain senior officials and the general principles for the decision-making.

The decision-making (Section 5.1) is delegated to the head of the respective department, apart from matters of great importance or of significance as a matter of principle. Those matters shall always be referred for determination to the Director General or, in certain cases, to the Deputy Director General. But to give comfort to the Debt Office's counterparties it is stated that any decision shall be binding on the Debt Office notwithstanding the absence of such referral.

The heads of department, in turn, are entitled to delegate the decision-making power to subordinate officials. Such delegation must be in writing with a copy to the Director General or the Deputy Director General. However, agreements binding on the Debt Office (i.e. Kingdom of Sweden) must always be approved by the Law and Documentation Department and shall also be countersigned by the General Counsel or a legal counsel appointed by the General Counsel.

Over the years the organisation has proved to be very flexible and has enabled speedy decisions in order to take advantage of market opportunities.

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