Chapter 1 Introduction to Public Debt Management and the Related Audit Approach

This handbook will help SAIs to understand the public debt-related concepts, the main participants in public debt management (PDM) and their roles, the importance of PDM and auditing, and how SAIs should approach the audit of public debt.

1.1 What Is Public Debt Management?

PDM is commonly defined as 'the process of establishing and executing a strategy for managing the government's debt in order to raise the required amount of funding at the lowest possible cost over the medium to long run, consistent with a prudent degree of risk. It should also meet any other PDM goals the government may have set, such as developing and maintaining an efficient market for government securities'.[2]

According to this definition, the goals or objectives of government debt management (DeM) should be to:

- Meet the borrowing requirements of the government;
- Borrow at the lowest possible cost over the medium to long run;
- Keep a prudent degree of risk in the debt portfolio; and
- Meet any other goals the government may have set, such as developing and maintaining an efficient market for government debt securities.

The main tool to achieve these goals is to prepare and execute a DeM strategy.

Looking at the cost–risk objectives, trade-offs must be made. For emerging market countries, it is commonly cheaper to borrow in low-coupon foreign currencies than in domestic currency. On the other hand, borrowing in foreign currencies normally increases risk in the portfolio (increased foreign currency exposure). While borrowing in the short end of the yield curve is cheaper in most cases than longer-term borrowing, the risk will increase, because the short-term interest is more volatile and the loans need to be refinanced more often (increased interest rate exposure and refinancing risk). Against this background, the essential ingredient in strategy development is to analyse different borrowing scenarios and the trade-offs that must be made. The risk tolerance of the government will finally decide these trade-offs and be reflected in the strategy document.

Thus, the main role of the debt manager is to achieve the desired composition of the government debt portfolio, which captures the government's preferences regarding the cost/ risk trade-offs. The DeM tools are the medium-term debt management strategy (MTDS) based on cost–risk trade-offs of the debt service flow in the actual and forecasted debt portfolio under different scenarios, annual borrowing plans based on the determined strategy, and borrowing and other DeM operations to meet the strategy goals. As elaborated in Chapter 4, the DeM strategy operationalises the DeM objectives and has a strong focus on managing the risk exposure embedded in the debt portfolio—specifically, potential variations in the cost of debt servicing and its direct impact on the budget.

[2] World Bank and IMF Guidelines for Public Debt Management of 2001, revised in 2014. Inputs and suggestions for revising the Guidelines were provided by a working group of public debt managers that comprised representatives from Argentina, Bangladesh, Belgium, Brazil, the Comoros, Denmark, the Gambia, Germany, India, Italy, Jamaica, Korea, the People's Republic of China, Russia, Sierra Leone, Spain, Sudan, Sweden, Turkey, the United States, Uruguay and Vietnam.

The scope of the government DeM strategy is commonly limited to the debt portfolio of the budgetary central government. Extending the scope of the strategy to include debt portfolios of some local governments and administrations can create coordination difficulties when these local administrations are empowered to borrow in the markets to meet their own financing needs. To include such borrowing in the scope of the DeM strategy would require that each local borrowing operation be approved by the central government (i.e., the ministry of finance, MoF) to ensure that all borrowings are in accordance with the strategy. This might not be practicable, nor the most efficient way of controlling borrowing by the sub-nationals.

It has to be clarified that depending on the respective legal framework of each country, the coverage of public debt will be different. The audit should be consistent with the domestic laws of the country and its specific mandate.

The World Bank/IMF Guidelines state the following on the scope of DeM: ‘Debt management should encompass the main financial obligations over which the central government exercises control. These obligations typically include both marketable and non-marketable debt, such as concessional financing obtained from bilateral and multilateral official sources and retail debt in some cases. Whether the broader public sector debt is included or excluded from the central government’s mandate over debt management will vary from country to country, depending on the nature of the political and institutional frameworks.

For the purpose of government DeM, ‘debt’ is simply and commonly defined as financial liabilities created by borrowing, credits accepted under suppliers’ credit agreements,[3] issuance of debt securities for any other purpose than borrowing funds (for example, to regularise built- up arrears), and assumption of the payment obligations under a government loan guarantee (i.e., in case of default, the government takes over the loan from the borrower).

In the macroeconomic statistical system, however, the definition of ‘debt’ is much broader, as the purpose is to include all liabilities that carry obligations to make future payments with the potential to create circumstances that render not only government and public corporations, but also the entire economy, vulnerable to solvency and liquidity problems.[4] Also, the scope is broader, covering the whole public sector: the central government, the local governments, the central bank and the public corporations.

Against this background, the debt is here defined as all financial claims that require payment of interest and/or principal by the debtor to the creditor at a date, or dates, in the future. Based on this broader definition, the Guide on Public Debt Statistics lists the following instruments as debt instruments: special drawing rights; currency and deposits; debt securities; loans; insurance, pension and provisions for calls under standardised guarantee schemes; and other accounts payable.

Comparing this with the narrower definition of debt commonly used in DeM, the only instruments included in both definitions are debt securities, loans and suppliers’ credits.

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[3] A supplier’s credit agreement is a credit arrangement that includes payment of interest between a purchaser and a supplier of any goods or services that gives the purchaser the right to fully pay for these goods and services at some future date from which these goods or services are delivered or supplied. The financial terms of these agreements are similar to those found in a loan contract.

[4] Public Sector Debt Statistics: Guide for Compilers and Users (2013), page VII. This Guide was jointly prepared by the following organisations: The Bank for International Settlements (BIS), the Commonwealth Secretariat, the European Central Bank (ECB), the Organisation for Economic Co-operation and Development (OECD), the Statistical Office of the European Communities (Eurostat), the International Monetary Fund (IMF), the Paris Club Secretariat, the United Nations Conference on Trade and Development (UNCTAD) and the World Bank Group (WBG).

For statistical purposes, however, countries are obliged to report those data to the International Monetary Fund (IMF) and, when borrowing from the World Bank, to it as well.[5]

Finally, government DeM should not be part of determining fiscal policy. The objectives of fiscal and DeM policies are quite different, and separate tools are used to achieve them. While a dedicated debt management office (DMO) is usually responsible for DeM operations, the budget department and the macroeconomic unit normally take the lead in fiscal policy strategy and implementation, including the debt sustainability analyses (DSAs).

Fiscal policy is commonly defined as the use of government expenditure, revenue collection (taxation) and loan proceeds to influence the economy of a country. Common fiscal policy objectives are to achieve a stabilised economic output, improve resource allocation and realise a 'fair' distribution of wealth. The fiscal policy strategy to achieve these objectives includes a least-distorting budgetary policy that is balanced over the business cycle, and sound public finances in the form of clear budget deficits and debt limits. The most important fiscal policy tools are the preparation of a medium-term fiscal framework supported by a sound debt sustainability analysis, and the annual budget bills.[6] Other fiscal policy tools include tax laws and government transfers to promote a fair distribution of wealth, and debt limits to mitigate loose, high-risk or even irresponsible fiscal policy.

Thus, as a fiscal policy tool, finding the optimal level of debt is not part of developing the DeM strategy. Instead, a DSA or a fiscal sustainability analysis is undertaken to keep a check on the debt level relative to its fiscal risks and the forecasted growth of the economy.

1.1.1 Types of debt

Debt can be classified as either domestic or external. Classification methodology may vary according to, amongst other factors, the risks deemed relevant by debt managers. In countries that have historically experienced balance of payments crises, the criterion to best capture the risk associated with debt is the one related to the denominated currency, i.e., debt denominated in the domestic currency would be classified as domestic, and debt denominated in other currencies would be external.[7] This is also the common classification used by the debt manager to assess the foreign currency risk in the debt portfolio.

Another possibility is to consider residence criteria in debt classification, i.e., the debt held by residents is classified as domestic debt and that held by non-residents is external. This classification is more interesting for countries with free capital flows, assuming that non- resident investors behave differently from resident investors. As a result, securities denominated in local currencies but held by non-residents would be considered external debt while foreign-currency–denominated securities held by residents would be considered domestic debt. This classification is used in the macroeconomic statistical system as described above.[8]

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[5] For good guidance on this broad definition of debt, see ISSAI 5421: Guidance on Definition and Disclosure of Public Debt.

[6] The budget commonly indicates what the revenues (taxes, grants, loan proceeds, etc.) will be used for, whether they go towards education and investment in infrastructure (items that normally promote growth) or towards other expenses.

[7] Silva, A. C.; Oliveira de Carvalho, L.; and Ladeira de Medeiros, O. 2010. *Brazil - Public debt: The Brazilian experience*. Washington, DC: World Bank. http://documents.worldbank.org/curated/en/967171469672182286/Brazil-Public-debt-the-Brazilian-experience

[8] For additional information, see International Monetary Fund, Government Finance Statistics Manual 2014.

In case of public debt, one party always is the government or an institution acting on behalf of the government, and the other party can be an individual, legal entity, bank or government.

By type of creditor, debt can be classified as debt from official creditors and debt from private creditors. Official creditors are governments or government-controlled or -owned financial institutions and international entities as opposed to private creditors. Official creditors include bilateral and multilateral organisations that provide loans. Bilateral creditors are single governments or government agencies that provide loans to other governments, such as when the French government extends a loan to the government of Bangladesh. Multilateral creditors are international organisations (e.g., the World Bank) with countries as Member States that provide loans to country members. In addition to official creditors, there are private creditors. These include private banks that lend money to governments and private buyers that purchase government securities.

1.1.2 Borrowing instruments

Borrowing instruments represent legal agreements concluded between one or several creditors that provide the funds, and the debtor, which receives and uses or 'on-lends' the funds. For every borrowing instrument, there is a specific type of agreement. Agreements specify the terms for the release and reimbursement of the funds and often stipulate specific conditions for their use.

Two main categories of the borrowing instruments are loans and debt securities. Sovereign loans are public credit operations based on a contract that ensures fulfilment of clauses agreed upon by the parties. The parties involved in these operations are the lender of money and the borrower. The parties to a loan contract may be individuals, legal entities, banks or governments.

Based on the nature of the parties involved, there are different types of loans: bilateral, multilateral and private (see the table below). Bilateral loans are those through which a government lends money to another country, for instance, to finance public services or infrastructure to aid in its growth and development. In this case, the borrower is the country receiving the funds for a specific purpose and committing itself to repay to the lender the principal plus interest in the term agreed upon.

When a multilateral body (e.g., World Bank Group, Development Bank of Latin America, Inter-American Development Bank, Asian Development Bank, African Development Bank) grants a loan to the government of one of its member countries, it is a multilateral loan, and if the lender is a private company or private financial institution, it will be a private loan.

Different Types of Loans

Item	Type of Loan	Creditor
1	Bilateral	Another government
2	Multilateral	Multilateral bodies
3	Private	Private company or private financial institution

Public debt also can be raised by using debt securities of various maturities. Bonds and notes are debt securities with an original maturity of over one year. They are usually traded (or tradable) in organised and other financial markets. These instruments provide the holder with regular income (the 'coupon') and return of the principal value on redemption. They can be issued in a variety of forms, of which the most common are conventional, which entitle the holder to a fixed nominal coupon; and index linked, where the coupon payments are linked to an official index, for example, inflation index or the gross domestic product (GDP) index.

In addition, governments also issue short-term debt instruments (often called money market instruments) with maturities of less than one year. Money market instruments are debt securities that give the owner the unconditional right to receive a stated, fixed sum of money on a specified date. These instruments usually are traded, at a discount, in organised markets; the discount is dependent upon the interest rate and the time remaining to maturity. Included are such instruments as treasury bills, commercial and financial paper, bankers' acceptances, negotiable certificates of deposit (with original maturities of one year or less) and short-term notes issued under note issuance facilities. Other governments issue green bonds and have retail markets.

As loan agreements are legally binding contracts, it is of vital importance to thoroughly know the rights and obligations involved, in order to understand the nature of those obligations.

Borrowers' rights and obligations. The borrower—as a party of the contract and compelled by the legal act to pay the agreed interest and repay the money borrowed—has the right to have a copy of the contract, to have the amount corresponding to the loan as agreed upon in the contract and to receive the settlement documents, such as the payment request from creditors, and justifications of payment, as specified.

The agreement is delivered when it is signed by the government official having the mandate for the purpose.

In order to receive the loan, the borrower is required to comply with the requirements of the lender or financing institution involved, as well as to honour its obligations as a borrower. Apart from its debt service obligations, the borrower commonly is obliged to:

- Report on its financial situation;
- Use the funds for the intended purpose;
- Comply with the agreed fees and payments;
- Pay any expenses incurred in delivering the loan;
- Comply with any special agreement made with the lender, if applicable; and
- Report any change in its economic, political or social circumstances to the lender, before or during the loan term, which may affect the compliance with any of the terms and conditions of the loan agreement.

Lenders' rights and obligations. In turn, lenders also have rights and obligations in this co-liable relationship regarding prudent sovereign borrowing. Lenders have the right to receive back the principal lent plus the agreed interest within the agreed timeframe. They can also search the credit history of the borrowing country, amongst other issues.

1.2 Main Participants in Public Debt Management

The chart in *Figure 1* presents the main participants in PDM and their nexus. These are further described in the text that follows.

The State/the people/present and future citizens. At the top of the hierarchy lies the State of the nation. Debt is an inter-generational contract. Policymakers must ensure that equity is preserved between today's and tomorrow's generations. Borrowings by the government should not only directly benefit its present citizens, but also especially future citizens who will be responsible for debt servicing. The inter-generational character of public debt imposes significant fiduciary responsibilities on management to act with care and loyalty.

Legislative branch (Parliament or Congress) in central government. The power to borrow and the fiscal powers to tax and spend should ideally be held in the same branch of government. It is the legislature, the direct representative of the people, that holds both powers in most countries. Legislatures are responsible for creating a sound legal framework that provides clear lines of authority and ensures transparency. As explained later in this handbook, the laws should grant the executive sufficient flexibility to manage debt effectively, establish clear performance benchmarks and require timely audited reports that legislators can use to prepare budgets and evaluate the debt management operations.

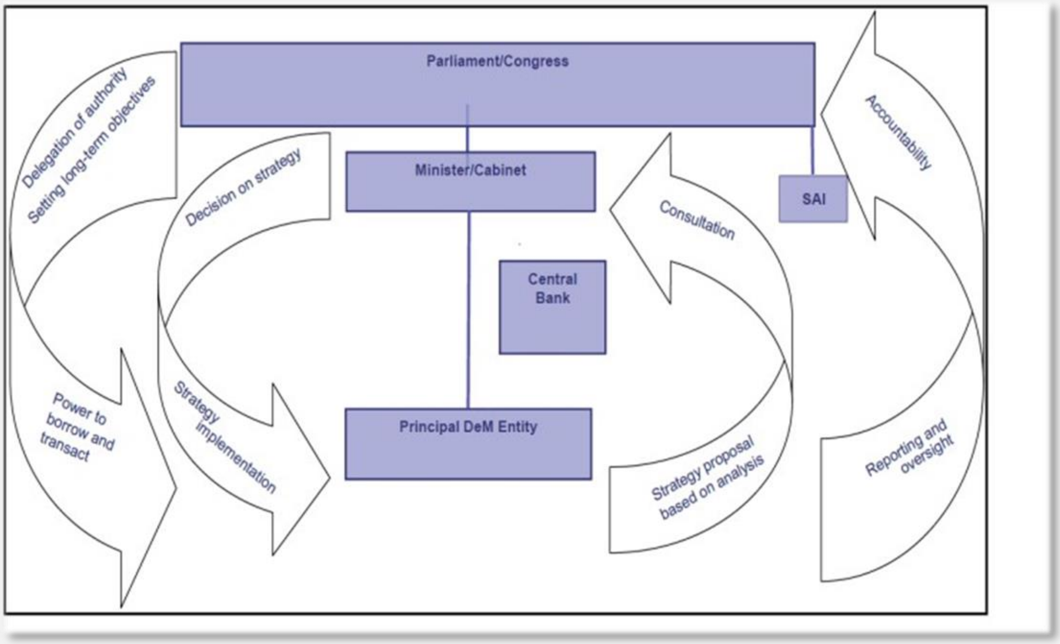


Figure 1. Participants in Public Debt Management

Some external agencies look for help in monitoring PDM at a domestic level. This can be a first stage to understand and enhance the SAI's role.

Executive branch. Executive branch may include MoF; DMO; treasurer and controller; budget, planning, and economic ministries or departments; resource mobilisation units; and programme execution units.

In order to provide greater flexibility and effectiveness in PDM, legislatures frequently delegate or assign the power to borrow to a key ministry or agency in the executive branch, such as the MoF. Generally, organisational arrangements for PDM would require the officials in debt management units within the MoF who perform important front-, middle- and back-office functions. Also, central banks would be included if they act as fiscal agents of the MoF, making payments and receiving funds in local and foreign currencies. In many countries, it may also have to include the following officials and units:

- the treasurer, who is responsible for cash management;
- the controller, who is responsible for public debt accounting;
- the officials in budget, planning, and economic ministries, who are responsible for integrating debt information into budget and macroeconomic plans;
- the resource mobilisation units that take the lead in seeking specific funds for their investment projects; and
- the multiple programme execution units that are responsible for using borrowed funds.

Lender institutions (domestic and external; bilateral and multilateral). DeM activities are determined by the funding sources. Most advanced countries with access to developed financial markets rely on government securities issuance as their principal funding source. Specific institutions, such as primary dealers, make commitments to participate actively in government auctions in exchange for privileged access to government debt instruments. Active secondary markets in government securities provide useful information to debt managers and SAIs that can be used to manage risks inherent in public debt.

In contrast, low-income countries without access to financial markets depend mostly on long-term concessional loans obtained from several bilateral and multilateral institutions, which impose specific conditions. There is no active secondary market in concessional loans, and the inter-agency coordination activities can be challenging. Finally, there is also a group of mostly middle-income countries that have the capacity to issue securities and obtain loans. The challenges of managing and auditing debt performance in each group would be different.

1.3 The Role of the Debt Management Office

A DMO is the dedicated government entity whose primary responsibility is to execute the DeM strategy through borrowing, derivatives and other debt-related transactions. In addition, it is responsible for undertaking analysis and providing advice to decision-makers on potential DeM strategies and the cost–risk trade-offs associated with alternative approaches.

Other functions found within a DMO are cash balance management, guarantee management, and on-lending. Essential support functions, such as cash flow forecasts, legal advice, human resource management, IT and internal audit, are sometimes integrated parts of the DMO, while in other cases—particularly when the DMO is located within the ministry of finance—these support functions are located outside the DMO, serving other units as well as the DMO. *Figure 2* depicts the functions of the DMO.

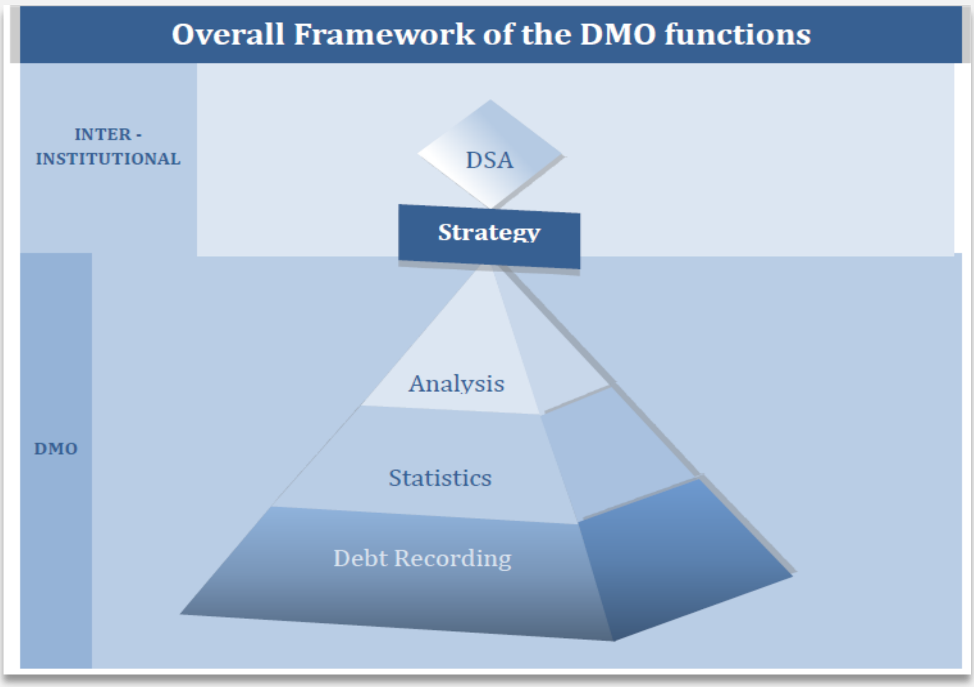


Figure 2. DMO Functions

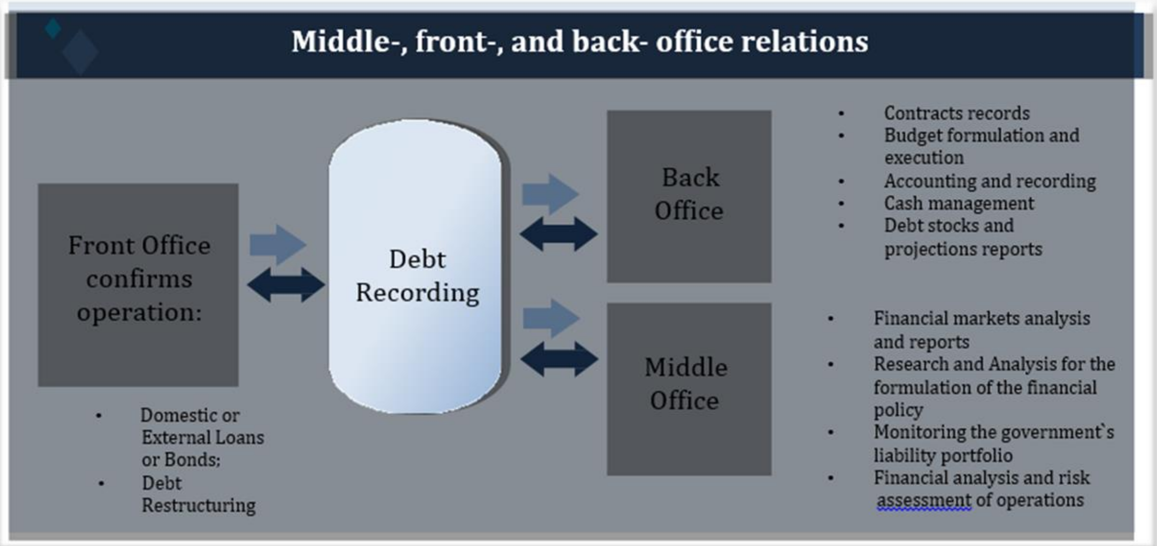
Source: The DMFAS Programme from UNCTAD

The sovereign DeM functions of a fully-fledged DMO can be as set out below:

- Take part in all borrowing and credit arrangements and other DeM activities, both foreign and domestic.
- Prepare and propose an MTDS with annual updates on a rolling basis, both to be approved by the Cabinet.
- Prepare annual borrowing plans based on the strategy, including auction calendars, taking into account government borrowing requirements and cash flow forecasts.
- Stay in regular contact with the investor base for government securities and other market participants to, *inter alia*, inform on the financing needs and borrowing plans of central government.
- Maintain relations with credit rating agencies.
- Take responsibility for the official debt recording system and assure that the debt data are always accurate, timely and complete.
- Send withdrawal requests to the creditors and keep track of all disbursements.
- Check that the disbursements are undertaken in accordance with the original disbursement plan, and, if not, raise this issue with the designated project management unit. (See also below re: disbursement schedule.)
- Assure that all interest payments, payments under derivative contracts and repayments are made on the due dates.
- Regularly prepare a debt statistical bulletin (or its equivalent) that provides information on central government's debt portfolio (by creditor, residency classification, instrument, currency, interest rate basis and residual maturity), debt flows (principal and interest payments), debt ratios and indicators, and basic risk measures of the debt portfolio.
- Prepare an annual report to Parliament providing details of government DeM activities, evaluation of outcomes against stated DeM objectives, the chosen DeM strategy and the rationale behind it, and compliance of the DeM activities with this strategy.
- As part of the annual budget preparation, prepare debt service forecasts based on both present and forecasted debt, and include some sensitivity analysis on how this forecast will change due to currency and interest rate movements.
- During budget preparation, comment on the size of the planned budget deficit (if any) and whether it can be financed by borrowing in the domestic market and/or in external markets without excessive cost, and how much the domestic debt market can absorb without any detrimental crowding out of the private sector.
- Keep the central bank regularly informed about planned and undertaken borrowings and DeM activities.
- Store all original loan contracts and debt administration records in a safe place.
- Contribute to the minimisation of operational risks in DeM activities.

The functions of the DMO can be further classified, in general terms, according to front (negotiation), middle (analysis) and back (recording and reporting). *Figure 3* depicts the relationships amongst these three offices comprising the DMO.

Figure 3. DMO Units and Functions



The DMO keeps all loan transaction data in its debt recording system, including the original disbursement schedule for each project loan. Each time a loan is disbursed, the disbursement is entered into the system. By regularly checking the disbursement schedule against the actual disbursements, the DMO can easily check whether the loans have been disbursed as planned and, if not, raise this issue with the project management unit. An added benefit of this communication is that the DMO will get a better grip on any delays in completing the project and, consequently, on the time for disbursements, which will help the DMO to prepare reasonably reliable forecasts on the total debt service as part of the yearly budget preparation. Project management, however, is not a DeM activity and should not be part of the DMO's mandate.

The DMO, particularly in developing countries, is commonly established as a government unit or department within the MoF. Other countries, e.g., Germany, Hungary, Nigeria, Portugal and Sweden, have set up the DMO as a separate government agency.

A third option is to set up the DMO in the central bank. Amongst countries that have opted for this solution are Denmark and India. The advantage of this arrangement is that knowledge of most aspects of financial markets is retained centrally within a single authority. The disadvantage is that the central bank's involvement in domestic DeM may generate a market perception that DeM benefits from inside information on the future path of interest rates. This was the main reason why the United Kingdom shifted domestic DeM from the Bank of England to the United Kingdom DMO in 1998, and why India has decided to transfer the federal DeM function from the Reserve Bank of India to a separate Indian DMO. To have the DMO within the central bank might also make it more difficult to separate DeM and monetary policy objectives and accountabilities.

In terms of organisation, normally the DMO has three departments, namely front, middle, and back office, with their respective functions:

The front office is responsible for funding transactions, relations with investors, underwriters and banks, through loans and security issues including external loans and debt securities negotiations and domestic government debt auctions, and in this process seeks the most efficient funding cost versus risk factors. The front office implements the strategy and manages the portfolio against a benchmark. In some countries, the cash management is the DMO's responsibility, and the front office has an active role in this, with the middle office providing the necessary feedback.

The middle office is responsible for analysis and advice on the debt management strategy, which will enable the senior management to choose the suitable strategy. It also monitors the front office performance, designing limits on deviations from benchmarks, as well as implementing risk controls. The middle office also provides information and participates in the implementation of the sustainability analysis on regular basis, and within this context, undertakes consistency analysis of the debt variables with the real economy variables. The middle office fixes the prices that must be paid for guarantees as well as the margins to be charged for on-lending operations. In some countries, the cash management is the DMO's responsibility, and the middle office takes care of this in coordination with the front office.

The back office is responsible for debt registration, and handles transactions confirmations, settlements and payments, and also maintains records of all debt contracts, disbursements, payments, debt restructuring, on-lending, issued guarantees, settlement of transactions, etc. The back office has to implement security for payments instructions and settlements. The back office is also responsible for budgetary projections of disbursement and debt service in addition to being responsible for the implementation and maintenance of the Debt Management System and its integration with the integrated financial management information system (IFMIS).

Realising that DeM should be treated as a separate public policy, there is today increased consensus that consolidating DeM functions into one DMO is one of the most important steps that can be taken to improve the overall quality of DeM, and pave the way for a more strategic management. This set-up will likely increase efficiency, transparency and accountability, as well as result in better cost and risk trade-offs in the debt portfolio and a more professional approach to the markets.

It is common, though, to still find a fragmented managerial structure, particularly in developing countries. In some countries, one entity is responsible for external concessionary borrowing, a second entity for external borrowing on commercial terms, a third entity for domestic borrowing from institutional investors, a fourth entity for borrowing from the domestic retail sector, and so forth. This organisational model can work reasonably well when the main DeM objective is to raise the needed funds with little priority assigned to managing the risks in the overall debt portfolio. However, when the focus on government DeM is more on cost and risk trade-offs in the debt portfolio, promotion of domestic debt market development, strategy development, accountability, and coordination with fiscal and monetary policies, this fragmented managerial structure becomes increasingly difficult and inefficient.

1.4 The Role of Supreme Audit Institutions

Supreme audit institutions or the SAIs have a central role to play in exercising independent external oversight on PDM in a country and in publicly reporting on the results of their audit. SAIs carry out financial, performance and compliance audits on the subject matter of PDM. The audits carried out and the reporting procedures depend on the legal mandate and reporting procedures established in the country. In the subsequent chapters of this handbook we will be exploring how SAIs can exercise their mandate and audit different topics related to PDM.

1.5 Importance of Sound Public Debt Management

PDM is important because public debt is often the largest financial liability of the government and a major contributor to the country's external debt. Given the nature and size of public debt in most countries, it is clearly important to lower its costs. High debt leads generally to high debt service liability. Generally, high debt service liabilities become a cause of poverty, inequality and unemployment in highly indebted countries, because debt settlements in the face of slow economic growth do not leave enough money to finance the needed expenditures on health, education and general welfare. In this context, the issues related to DeM become particularly important.

Every government faces policy choices concerning DeM objectives, in particular, its preferred risk tolerance, the parts of the government balance sheet that debt managers should be responsible for, the management of contingent liabilities and the establishment of sound governance of PDM. On many of these issues, there is increasing convergence on what are considered prudent PDM practices that can also reduce vulnerability to contagion and financial shocks. These practices include

- The recognition of the benefits of clear objectives for DeM;
- Weighing risks against cost considerations;
- The separation of debt and monetary management objectives and accountabilities (where appropriate, combined with consultation and information sharing between the debt manager and the central bank);
- The need to carefully manage refinancing and market risks and the interest costs of debt burdens; and
- The necessity of developing a sound institutional structure and policies for reducing operational risks, including clear delegation of responsibilities and associated accountabilities amongst government agencies involved in DeM.

Poorly structured debt portfolios, in terms of maturity, currency or interest rate composition and large contingent liabilities, have been important factors in inducing or propagating economic crises in many countries throughout history. For example, irrespective of the exchange rate regime, or whether domestic or foreign currency debt is involved, crises have often arisen because of an excessive focus by governments on possible cost savings associated with short-term or floating-rate debt. Issuance of large volumes of such debt instruments has left government budgets seriously exposed to changing growth and financial market conditions, including changes in the country's creditworthiness, when this debt has to be refinanced.

Excessive reliance on foreign currency debt poses particular risks, as it can lead to exchange rate and/or monetary pressures if investors become reluctant to refinance the government's debt. By reducing the risk that the government's own debt portfolio will become a source of instability for the private sector, prudent government DeM with sound policies for managing contingent liabilities can make countries less susceptible to contagion and financial risk. Further, a debt portfolio that is robust against shocks places the government in a better position to effectively manage financial crises. [9]

[9] The World Bank-IMF Revised Guidelines for Public Debt Management (2014).

1.6 Best Practices in Public Debt Management

The following documents are known for presenting sound practice in government DeM:

- The UNCTAD Principles on Promoting Responsible Sovereign Lending and Borrowing (2012)
- The joint World Bank/IMF Guidelines for Public Debt Management (2001, revised in 2014)
- The World Bank Debt Management Performance Assessment (DeMPA) tool (2007, revised in 2015)

The UN principles is a set of generic statements not only covering the borrowing responsibilities but also the lenders. The DeMPA tool is a methodology for assessing debt management performance through a comprehensive set of indicators spanning the full range of government debt management functions. The guidelines were elaborated by the World Bank and the IMF to establish a framework of best practices for DeM.

1.6.1 Principles on Promoting Responsible Sovereign Lending and Borrowing (UNCTAD Principles)

Compared with the joint World Bank/IMF Guidelines and the DeMPA tool, the UNCTAD Principles also include principles of responsible sovereign lending. These principles are set out below:

Responsibilities of lenders

1) Lenders should recognize that government officials involved in sovereign lending and borrowing transactions are responsible to the State and its citizens for protecting public interest.

2) Lenders have a responsibility to provide information to their sovereign customers to assist borrowers in making informed credit decisions.

3) Lenders have a responsibility to determine, to the best of their ability, whether the financing has been appropriately authorized and whether the resulting credit agreements are valid and enforceable under relevant jurisdictions.

4) A lender is responsible to make a realistic assessment of the sovereign borrower's capacity to service a loan, based on the best available information and following objective and agreed technical rules on due diligence and national accounts.

5) Lenders financing a project in the debtor country have a responsibility to perform their own ex-ante investigation into the likely effects of the project, including its financial, operational, civil, social, cultural, and environmental implications. When applicable, they are also responsible for post-disbursement monitoring of the effects. This responsibility should be proportional to the technical expertise of the lender and the amount of funds to be lent.

6) All lenders have a duty to comply with United Nations sanctions imposed against a government regime. In circumstances where a sovereign is manifestly unable to service its debts, all lenders have a duty to behave in good faith and with cooperative spirit to reach a consensual rearrangement of those obligations. Creditors should seek a speedy and orderly resolution to the problem.

Responsibilities of sovereign borrowers

1) Governments are agents of the State and, as such, when they contract debt obligations, they have a responsibility to protect the interests of their citizens. Where applicable, borrowers should also consider the responsibility of lenders' agents toward their organizations.

2) A sovereign debt contract is a binding obligation and should be honored. Exceptional cases nonetheless can arise. A state of economic necessity can prevent the borrower's full and/or timely repayment. Also, a competent judicial authority may rule that circumstances giving rise to a legal defense have occurred. When changes to the original contractual conditions of the loan are unavoidable due to the borrower's economic state, principles 7 and 15 should be followed.

3) The process for obtaining financing and assuming sovereign debt obligations and liabilities should be transparent. Governments have a responsibility to put in place and implement a comprehensive legal framework that clearly defines procedures, responsibilities and accountabilities. They should particularly put in place arrangements to ensure the proper approval and oversight of official borrowings and other forms of financing, including guarantees made by State-related entities.

4) Relevant terms and conditions of a financing agreement should be disclosed by the sovereign borrower, be universally available, and be freely accessible in a timely manner through online means to all stakeholders, including citizens. Sovereign debtors have a responsibility to disclose complete and accurate information on their economic and financial situation that conforms to standardized reporting requirements and is relevant to their debt situation. Governments should respond openly to requests for related information from relevant parties. Legal restrictions to disclosing information should be based on evident public interest and be used reasonably.

5) In the context of project financing, sovereign borrowers have a responsibility to conduct a thorough ex-ante investigation into the financial, operational, civil, social, cultural and environmental implications of the project and its funding. Borrowers should make public the results of the project evaluation studies.

6) Debtors should design and implement a debt sustainability and management strategy and ensure that their DeM is adequate. Debtor countries have a responsibility to put in place effective monitoring systems, including at the sub-national level, that also capture contingent liabilities.

7) Governments have a responsibility to weigh costs and benefits when seeking sovereign loans. They should seek a sovereign loan if it would permit additional public or private investment, with a prospective social return at least equal to the likely interest rate.

8) If a restructuring of sovereign debt obligations becomes unavoidable, it should be undertaken promptly, efficiently and fairly.

1.6.2 Guidelines for public debt management (IMF/World Bank)

The following are the guidelines for PDM recommended by the World Bank and the IMF.

1) The main objective of PDM is to ensure that the government's financing needs and its payment obligations are met at the lowest possible cost over the medium to long run, consistent with a prudent degree of risk.

2) DeM should encompass the main financial obligations over which the central government exercises control.

3) DeM should be anchored on sound macroeconomic and financial sector policies to ensure that the level and rate of growth in public debt are sustainable.

4) Debt managers, fiscal and monetary authorities, and financial sector regulators should share an understanding of the objectives of DeM, fiscal, monetary, and financial sector policies given the interconnections and interdependencies between their respective policy instruments.

5) In principle, there should be a separation of DeM policy and monetary policy objectives and accountabilities.

6) Debt managers and fiscal and monetary authorities should share information on the government's current and future cash flow needs.

7) Although the responsibility for ensuring prudent debt levels and conducting DSA lies with fiscal authorities, debt managers should monitor any emerging debt sustainability problems based on portfolio risk analyses and market reactions observed when conducting DeM operations, and should inform the government on a timely basis.

8) There should be public disclosure of the allocation of responsibilities amongst the MoF, the central bank, or a separate DeM agency, for DeM policy advice and for undertaking primary debt issues, secondary market arrangements, depository facilities, and clearing and settlement arrangements for trade in government securities.

9) The objectives for DeM should be clearly defined and publicly disclosed, and the measures of cost and risk that are adopted should be explained.

10) Materially important aspects of DeM operations should be publicly disclosed.

11) Easy public access to the documentation describing the legal basis for DeM policy and operations should be ensured.

12) The legislature and the public should be informed, through an annual report, about the context in which DeM operates and the outcomes of the DeM strategy.

13) The debt manager or government should regularly publish information on the outstanding stock and composition of its debt liabilities, financial assets and contingent liabilities, where they exist, including their currency denomination, maturity, and interest rate structure.

14) If DeM operations include derivatives, the rationale for their use should be disclosed, and aggregate statistics on the derivatives portfolio should be published periodically, conforming to recognised accounting practices. The government is likely to benefit from a function within the DMO that deals regularly with the main debt stakeholders and produces investor-friendly reports with debt statistics and other relevant information.

15) DeM activities should be audited annually by SAIs. Information technology (IT) systems and risk control procedures should also be subject to external audits. In addition, there should be regular internal audits of DeM activities, and of systems and control procedures.

16) The legal framework should clarify the authority to borrow and to issue new debt, to hold assets for cash management purposes, and to undertake other transactions on the government's behalf where applicable.

17) The organisational framework for DeM should be clearly specified and the mandates and roles well-articulated.

18) Operational risks should be managed according to sound business practices, including well-articulated responsibilities for staff, and clear monitoring and control policies and reporting arrangements.

19) Staff involved in DeM should be subject to a code-of-conduct and conflict-of-interest guidelines regarding the management of their personal financial affairs.

20) DeM activities should be supported by an accurate and comprehensive management information system with proper safeguards.

21) Sound business recovery procedures should be in place to mitigate the risk that DeM activities might be severely disrupted by theft, fire, natural disasters, social unrest, or acts of terrorism.

22) Debt managers should ensure that they have received appropriate legal advice and that the transactions they undertake incorporate sound legal features.

23) Collective action clauses in bond contracts could help to achieve a more orderly and efficient resolution, in case of a sovereign debt restructuring.

24) The risks inherent in the government's debt structure should be carefully monitored and evaluated. These risks should be mitigated to the extent feasible, taking into account the cost of doing so.

25) In order to help guide borrowing decisions and reduce the government's risk, debt managers should consider the financial and other risk characteristics of the government's cash flows.

26) Debt managers should carefully assess and manage the risks associated with foreign currency, and with short-term and floating rate debt.

27) There should be cost-effective cash management policies in place to enable the authorities to meet their financial and budgetary obligations as they fall due.

28) A framework should be developed to enable debt managers to identify and manage the trade-offs between expected cost and risk in the government debt portfolio.

29) To assess risk, debt managers should regularly conduct stress tests (apply new values of existing variables to the debt portfolio and evaluate new scenarios, in general the new values related with interest rates, exchange rates and/or market prices) of the debt portfolio on the basis of the economic and financial shocks to which the government and the country more generally are potentially exposed.

30) Debt managers who seek to manage the debt portfolio actively to profit from expected movements in interest rates and exchange rates that differ from those implicit in current market prices should be aware of the risks involved and be accountable for their actions.

31) When derivatives are used to manage debt portfolio risk positions, debt managers should be aware of the financial cost and redemption scenarios that could arise as well as the potential consequences of derivatives contracts (e.g., in case of a downgrade of a market counterparty).

32) Credit risk should be assessed and managed consistently by debt and cash managers.

33) Settlement risk should be controlled by having clearly documented settlement procedures and responsibilities and limiting as appropriate the size of payments flowing through any one settlement bank.

34) Debt managers should ensure that the impact of risks associated with contingent liabilities on the government's financial position, including its overall liquidity, is taken into consideration when designing debt management strategies.

35) In order to minimise cost and risk over the medium to long run, debt managers should take adequate measures to develop an efficient government securities market.

36) The government should strive to achieve a broad investor base for its domestic and foreign debt instruments, with due regard to cost and risk, and should treat investors equitably.

37) DeM operations in the primary market should be transparent and predictable. To the extent possible, debt issuance should use market-based mechanisms, including competitive auctions and syndications.

38) Governments and central banks should promote the development of resilient secondary markets that can function effectively under a wide range of market conditions.

39) The systems used to settle and clear financial market transactions involving government securities should reflect sound practices.

1.6.3 DeMPA tool (World Bank)

The Debt Management Performance Assessment (DeMPA) tool is a methodology for assessing DeM performance through a comprehensive set of indicators spanning the full range of government DeM functions. It highlights strengths and weaknesses in government DeM practices through a scoring methodology, which facilitates the monitoring of progress over time in achieving government DeM objectives in a manner consistent with international sound practice.

The performance indicators encompass the complete spectrum of government DeM operations, as well as the overall environment in which these operations are conducted. For each indicator, the DeMPA tool contains detailed background information and rationale for the inclusion of the indicators. Although the DeMPA does not specify recommendations for reforms or capacity and institution-building needs, the performance indicators do stipulate a minimum level (the 'C' score) that should be met under all conditions. Consequently, an assessment showing that the DeMPA minimum requirements are not met indicates an area requiring reform or capacity building or both. The criteria for the highest score (the 'A' score) are considered sound practice.

The DeM performance indicators (DPIs) to be assessed using the DeMPA tool are as follows:

1) Governance and strategy development

- DPI-1 Legal Framework
- DPI-2 Managerial Structure
- DPI-3 Debt Management Strategy
- DPI-4 Debt Reporting and Evaluation
- DPI-5 Audit

2) Coordination with macroeconomic policies

- DPI-6 Coordination with Fiscal Policy
- DPI-7 Coordination with Monetary Policy

3) Borrowing and related financing activities

- DPI-8 Domestic Borrowing
- DPI-9 External Borrowing
- DPI-10 Loan Guarantees, On-lending and Derivatives
- DPI-11 Cash Flow Forecasting and Cash Balance Management

4) Debt recording and operational risk management

- DPI-12 Debt Administration and Data Security
- DPI-13 Segregation of Duties, Staff Capacity, and Business Continuity
- DPI-14 Debt and Debt-Related Records

1.7 Audit of Public Debt Management

1.7.1 Importance of SAI's legal mandate

As earlier explained, in most countries, the legislature has the borrowing power of the central government, sometimes delegated to the executive with periodic monitoring. Given the technical nature of PDM and the fact that many potentially significant debt-related transactions are not public, the members of the legislature and the public must rely on the independent audits performed by the SAI to determine whether the executive's public debt reports show the true condition of public debt and its most relevant details.

The SAI's legal framework is a major contributor to defining audit objectives, scope and reporting obligations. Some SAIs may have the legal authority to conduct compliance audits of budget resources but not financial and performance audits of public debt. A clear and explicit legal mandate helps SAIs to gain access to debt officials and records. Thus, ISSAI 100 made the recommendations set out below.

An SAI will exercise its public-sector audit function within a specific constitutional arrangement and by virtue of its office and mandate, which ensure sufficient independence and power of discretion in performing its duties. The mandate of an SAI may define its general responsibilities in the field of public sector auditing and provide further prescriptions concerning the audits and other engagements to be performed.

"The head of the SAI should seek to obtain a suitable legal mandate that comprises the following criteria:

- A mandate to carry out performance auditing on the economy, efficiency, and effectiveness of government programmes and entities;

- Freedom to select what to audit, when to audit, and how to audit, conclude, and report on findings;

- Freedom to place the audit results in the public domain;

- Access to all information needed to conduct the audit; and

- Freedom to decide whom to recruit.”

Here, ‘Legal Mandates to Carry out Audits’ shows the law in Uganda that grants authority to its Auditor General to conduct performance audits, and the law that grants authority to the Comptroller General of the United States to perform a financial audit of the government’s financial statements.

Legal Mandates to Carry Out Audits

Uganda – *Legal Authority for Performance Audits, National Audit Act of 2008, Section 21: random value for money audits in accordance with Article 163(3)(b) of the Constitution and report as he or she considers necessary…organizations and local government councils...*

United States of America – *Legal Authority for Financial Audit, USC, Title 31:*

‘The Secretary of the Treasury, in coordination with the Director of the Office of Management and Budget, shall annually prepare and submit to the President and the Congress an audited financial statement…’

‘The financial statement of the U.S. shall reflect the overall financial position, including assets and liabilities, and results of operations of the executive branch of the United States Government…’

‘The Comptroller General of the United States shall audit the financial statement …Not later than 31 March 1998 and each year thereafter...’

‘The financial statements shall be prepared annually’ … ‘in accordance with the form and content requirements set forth by the Director of the Office of Management and Budget’

Source: various

SAIs play an accountability role in public debt reporting and management. Regular financial audits of public debt help to make public debt managers accountable for their public debt actions. Also, financial audit reports may enhance the transparency of public debt issues, depending on their ability to communicate clearly key debt information to legislators and informed citizens.

Performance audits contribute to enhancing the effectiveness, efficiency and economy of debt management, and strengthen internal control to prevent fraud in public debt activities.

According to the ISSAI Standards and guidelines for performance auditing (ISSAI 300), SAIs may consider auditing public debt issues where they have the ability to provide new knowledge, insights and perspective. SAIs' audit reports should have the potential to influence policy-makers and thereby make a significant contribution to improving PDM. For example, SAIs could enhance transparency and accountability in public debt by examining current reporting practices; strengthen internal control in public debt programmes to reduce risks of fraud and corruption by providing recommendations to improve existing systems and procedures; and modernise public debt's legal framework by examining best practices identified in ISSAI's public debt audit guidelines. Whether SAIs can select these and other topics for audit depends critically on their legal mandate.

1.7.2 Strategic planning and audit of public debt management

Based on its mandate, resources available, situation in the country and expectations from stakeholders, an SAI may include audit of PDM in its strategic and operational plans. In order to actually conduct such audits in accordance with applicable ISSAIs, it is necessary for an SAI to ensure that it has the following:

- A defined audit methodology (financial, performance and compliance) as applied to the subject matter of PDM;
- Professional staff competent in both the respective audit methodology and the subject matter of public debt audit;
- A mechanism for identifying PDM areas to be included in its strategic portfolio of audits and that it includes these topics in its annual audit plans; and
- A quality assurance mechanism to provide independent assurance on the quality of the audit conducted.

The box here shows an extract from an SAI strategic plan that identifies a significant amount of debt rollover as a potential public debt audit topic.

Example of an SAI Institutional Plan[10]

> ***United States Government Accountability Office (GAO) Strategic Plan 2014–2019***
>
> Since fiscal year 2007, debt held by the public has more than doubled as a share of GDP from about 35 percent to 70 percent at the end of fiscal year 2012. While the deficit has fallen considerably since 2009, cumulative debt held by the public continues to grow. Debt held by the public reached $12.0 trillion, or 72 percent of GDP, at the end of fiscal year 2013—the largest as a share of GDP since 1950.
>
> The United States is not alone in facing high debt levels. Many advanced countries are facing similar challenges and will need to continue to undertake unprecedented fiscal efforts to stabilize debt ratios at unsustainable levels. In GAO's Baseline Extended and Alternative simulations, debt held by the public continues to grow as a share of GDP in the coming decades. High debt—even if stable—retards potential growth, constrains the scope for future discretionary policy, and leaves economies exposed to further market shocks. Although sharp increases in public debt have not led to high interest rates in most countries, including the United States, lower rates are unlikely to persist indefinitely, in part because they reflect relaxed monetary conditions that cannot continue forever. As the economy strengthens, and interest rates rise, the large amount of the debt held by the public that the Department of the Treasury (Treasury) must roll over becomes costly. Treasury has been taking steps to increase the average maturity of its outstanding debt securities, not in response to any one interest rate environment, but consistent with its goal of funding the government at the lowest cost over time.
>
> Helping the Congress and the federal government better understand and manage the challenges will require that GAO take a crosscutting approach in its work that incorporates the full and complex array of economic and social factors. Therefore, GAO plans to conduct long-term fiscal simulations and analyses of federal deficits, federal debt levels, and the state and local sectors.

1.7.3 Applying ISSAIs in audit of public debt management

As mentioned above, SAIs may apply compliance, financial or performance audit ISSAIs to ensure high-quality audits of public debt management.

- A compliance audit could focus on whether particular public debt management subjects comply with authorities identified as criteria. Compliance audit of public debt is performed by assessing whether the DeM process, borrowing and lending activities, public debt financial transactions and information are, in all material respects, in compliance with the authorities that govern the audited entity. These authorities may include rules, laws and regulations of sovereign DeM, debt budgetary resolutions, fiscal and monetary policy, established codes, loan agreements or the general principles governing sound public sector financial DeM and the conduct of public debt officials.

- A financial audit focuses on determining whether the government's financial information with respect to sovereign debt is presented in accordance with the applicable financial reporting and debt regulatory framework. This is accomplished by obtaining sufficient and appropriate audit evidence to enable the SAIs to express an opinion on whether the financial information with respect to sovereign debt is free from material misstatement due to fraud or error.

[10] Full document available at: http://www.gao.gov/assets/670/661281.pdf

- A performance audit focuses on whether borrowers and lenders, sovereign DeM and other related parties are performing in accordance with the principles of economy, efficiency and effectiveness, and whether there is room for improvement. Performance is examined against suitable criteria, such as national laws and regulations governing sovereign debt activities, policies and procedures set by DeM officials, and best recommended practices by organisations carrying out similar activities or having similar programmes, policies and procedures set by DeM officials, loan and contract agreements. The causes of deviations from those criteria and other problems are analysed. The aim is to answer key audit questions and to provide recommendations for improvement.

There are standardised audit steps that SAIs must take when they plan audits of public debt. Therefore, SAIs should follow adopted planning procedures and incorporate to the extent possible INTOSAI standards ISSAI 100 (Fundamental Principles on Public-Sector Auditing) and ISSAI 200 (Financial Audit Principles), ISSAI 400 (Compliance Audit Principles) and ISSAI 300 (Performance Audit Principles), respectively. In addition, ISSAI 5400-5499[11] (Guidelines on audit of public debt) provide specific guidance to plan and conduct audits of public debt.

SAIs may have specific obligations related to the timing and scope of audits of public debt. In that case, SAIs should perform those audits following the rules they are subject to. Alternatively, SAIs may choose to select amongst the topics discussed in this handbook. Given the technical complexity of public debt issues, the availability of sufficient technical knowledge and audit experience within the SAI are important factors in the selection of the first performance audit of public debt. Hence, it is not recommended that a single audit cover all topics. The best audit approach is to prepare and execute methodically a multi-year audit plan that allows the SAIs to build their technical expertise over time and examine all the important PDM areas in a cost-effective and efficient way.

Where relevant or necessary, and in line with the SAI's mandate and the applicable legislation, the auditor may use the work of internal auditors, other auditors or experts. The auditor's procedures should provide a sufficient basis for using the work of others, and in all cases the auditor should obtain evidence of other auditors' or experts' competence and independence and the quality of the work performed. However, the SAI has sole responsibility for any audit opinion or report it might produce on the subject matter; that responsibility is not reduced by its use of work done by other parties.

The objectives of internal audit are different from those of external audit. However, both internal and external audit promote good governance through contributions to transparency and accountability for the use of public resources, as well as economy, efficiency and effectiveness in public administration. This offers opportunities for coordination and cooperation and the possibility of eliminating duplication of effort.

Where an internal audit office/unit (IAO/U) exists and performs audit of public debt-related operations, it is good practice for the internal and external auditors to understand and discuss their respective audit scope, methodology and audit plan, and to agree on the exchange of and access to audit reports. This will facilitate the auditor's work, preclude redundancies and conflicts and ensure improved effectiveness of the audit process. The SAIs' reliance on the work performed by the IAO/U is, however, influenced by the competence, objectivity and nature of work performed by the IAO/U.

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[11] Currently, these ISSAIs are subject to harmonisation and alignment with ISSAI 100 and will be revised as a guidance instead of an ISSAI.