Chapter 4 Auditing Debt Management Strategy Development

This chapter helps SAIs to understand the importance of a country's development of a DeM strategy as an important part of public fiscal policy and to relate it to the possible audit types, criteria, sources of evidence and sample audit questions and findings.

4.1 Debt Management Strategy

A DeM strategy is a plan that the government intends to implement over the medium term to achieve a desired composition of the government debt portfolio, which captures the government's preferences with regard to the cost–risk trade-off. It operationalises the country authorities' DeM objectives—e.g., ensuring that the government's financing needs and payment obligations are met at the lowest possible cost consistent with a prudent degree of risk.[20]

Although the strategy is commonly specified for the medium term[21] (3 to 5 years), it should be subject to periodic review to assess whether its assumptions still hold in light of changed circumstances. Such a review would ideally be undertaken annually, preferably as part of the budget process. If the existing strategy is viewed as appropriate, the rationale for its continuation should be stated explicitly.

The scope of MTDS depends on the information available and on the existing institutional arrangements in a country. At a minimum, the scope should include the total (domestic and external) direct central government debt. The exact definition of the scope will depend on the degree to which the debt manager can influence the risk exposure of specific portfolios. The coverage of the MTDS could be gradually expanded as information becomes available and as institutional arrangements allow for a broader and more comprehensive strategy to be implemented.[22]

The content of the strategy will vary from country to country, depending on the stage of development or DeM reform, the sources of funding and the transactions used to manage central government debt. Preferably, the strategy document should include the following:

- Description of the market risks being managed (currency, interest rate and refinancing or rollover risks) and historical context for the debt portfolio;
- Description of the future environment for DeM, including fiscal and debt projections, assumptions about interest and exchange rates, and constraints on portfolio choice, including those relating to market development and the implementation of monetary policy;
- Description of the analysis undertaken to support the recommended DeM strategy, clarifying the assumptions used and limitations of the analysis; and
- The recommended strategy and its rationale.

[20] World Bank and IMF (2009): Developing a Medium-Term Debt Management Strategy (MTDS)—Guidance Note for Country Authorities, p. 3.

[21] If the time horizon is too short, e.g., the budget cycle, there is a risk that short-term expediency will dominate, turning the focus on short-term costs and away from risks that could materialise later.

[22] World Bank and IMF (2009): Developing a Medium-Term Debt Management Strategy (MTDS)—Guidance Note for Country Authorities, p. 9.

To guide the borrowing decisions and other DeM operations, the strategy commonly includes parameters or strategic benchmarks. When those benchmarks have been determined, all borrowings should be within those limits, such as:

- Ratio of foreign currency debt to domestic debt;
- Currency composition of the foreign currency debt;
- Minimum average maturity of the debt;
- Maximum share of debt that can fall due during one and two budget years;
- Maximum ratio of short-term (up to one year) to long-term debt;
- Maximum ratio of floating rate to fixed rate debt; and
- Minimum average time to interest rate re-fixing.

For countries that have limited access to market-based debt instruments and rely mainly on external official concessional finance, these risk-based parameters may not be equally relevant. In such cases, the most relevant parameters for containing the risks to the debt portfolio will probably be currency composition, interest rate composition and amount of debt that must be refinanced over a particular time. As an interim step, it would be sufficient to express the strategy as guidelines to indicate the direction in which certain key indicators are expected to evolve (for example, a statement that 'the amount of local currency debt maturing within 12 months shall be reduced').

In some countries, the DMO has developed or has access to relevant tools for undertaking a quantitative assessment of the cost and risk of alternative strategies. Typically, such tools compare the cost of debt to the risk (as defined by the change in the cost) over a specific time horizon under different scenarios. Such tools allow the DMO to simulate the impact of various financing options, tracking the evolution of the key cost and risk indicators for each strategy tested.

In the absence of any specific quantitative tools for analysing alternative strategies, the DMO should consider what characteristics of debt or debt composition would mitigate key sources of volatility for the budget and consider the potential costs of achieving that debt composition. For example, if the country is exposed to external shocks and the real exchange rate is volatile or at risk of a downward trend, the DMO may want to avoid aggravating that by reducing external financing. This would allow the DMO to specify the preferred direction of specific risk indicators, such as increasing the share of domestic currency debt, or lengthening debt maturity.

DeM strategies cannot be developed in isolation. The outlook on key macro variables (real, monetary, external and fiscal) defines the environment in which the debt managers operate, and is essential for DeM strategy development. Against this background, it is common that the DMO closely coordinates with the macroeconomic unit in preparing the strategy.

Sound practice is to make the DeM strategy public once it has been approved. Transparency is essential in helping the markets to have a clear understanding of what the DeM's activities' aims are, which will make the borrowing more cost effective by reducing the risk premiums. In addition, dissemination of the strategy will in addition help the debt manager strengthen the relationship with creditors, investors and other key stakeholders (e.g., credit rating agencies) and facilitate an open dialogue on key factors influencing the choice and implementation of the strategy. This could help secure support for the chosen strategy and reduce investor uncertainty.

By adopting the DeM strategy, the authorities can make informed choices on how the government's financing requirements should be met, while taking into account potential risks. Such a systemic approach ensures effective DeM and helps to reduce operational risk. If the government has chosen a strategy that turns out to be too risky or too costly, this will affect the budget outcome much more than any mispriced and/or badly timed DeM transaction.

In addition, and provided this is in line with the DeM objectives, the strategy can support efforts to develop the domestic debt market by facilitating a transparent and predictable strategy for domestic borrowing.

4.2 Auditing Debt Management Strategy in Public Debt Management

SAIs must understand the importance of evaluating the DeM strategy. Compliance and performance approaches are the most common types of audit to examine DeM strategy. If a country's legislation has some standards for developing a strategic plan to take on new debt, a compliance audit and performance audit could be carried out together.

SAIs can assess to what extent a country's debt and other strategic fiscal or monetary goals are supported by the DeM strategy. Therefore, SAIs can examine how the following aspects are defined by the DeM strategy:

- Exposure levels to foreign currency risk;
- Target debt maturity structure;
- The sensitivity of the government's budget to interest rate changes;
- The share of public debt that is indexed to inflation; and
- A plan for supporting development of the domestic debt market.

In assessing a DeM strategy, SAIs can evaluate to what extent DeM has followed a sequence of logical steps, such as those shown below, in formulating and implementing debt strategies:

- Identify the objectives for PDM and scope of the strategy;
- Identify and analyse the cost and risk of the existing debt;
- Identify and analyse potential funding sources, including their cost and risk characteristics;
- Identify baseline projections and risks in key policy areas—fiscal, monetary, external (exchange rate movement and anticipated balance of payments development) and market (projections for relevant yield curves);
- Review key longer-term structural factors;
- Assess and rank alternative strategies on the basis of the cost–risk trade-off;
- Review implications of candidate DeM strategies for fiscal and monetary policy authorities, and for market conditions; and
- Submit and secure agreement on the strategy.

SAIs should determine the frequency of debt strategy reviews to assess whether the assumptions that support the strategy still hold in light of changed circumstances. Such a review would ideally be undertaken annually, preferably as part of the budget process, and if the existing strategy is viewed as appropriate, the rationale for its continuation should be stated explicitly.

4.2.1 Compliance audit of the debt management strategy

A compliance audit must identify all legal arrangements and how they affect indebtedness. SAIs should examine whether the DeM strategy complies with the country's legislation for taking debt, the DeM strategy complies with the longer-term DeM objectives and the DeM strategy is in compliance with the international standards.

Planning audit procedures for a compliance audit of the DeM strategy involves designing procedures to respond to the identified risks of non-compliance with laws and regulations for public debt.[23]

Common objectives for a compliance audit could be the following:

- To ascertain whether the DeM strategy complies with the requirements of the sovereign's legal framework on public debt;

- To determine whether the DeM strategy is consistent with the longer-term DeM objectives; and

- To ascertain whether the designed DeM strategy is in accordance with international best practices.

4.2.2 Performance audit of the debt management strategy

Conducting a performance audit to evaluate the results of a country's DeM strategy is not a simple task. SAIs must ensure that economy, efficiency and effectiveness of DeM involve other public policies and are within the SAI's mandate.

Sound practices in DeM are aimed at helping to manage the government's balance sheet risks and to reduce the economy's vulnerability to economic and financial shocks. Government debt managers, fiscal policy advisers and central bankers need a shared understanding of the objectives of DeM policy and of traditional macroeconomic policy instruments.

SAIs can determine whether the DMO had executed the DeM strategy as planned, how changes to assumptions and risks had been responded to in the DeM strategy, and how the DMO had performed in terms of the DeM strategy development, implementation and reporting on outcomes.

SAIs can consider the following objectives for a performance audit of the DeM strategy:

- To ascertain whether the DMO had efficiently performed its responsibilities and accountabilities relating to the DeM strategy development;

- To determine how efficiently the DMO had made changes to the DeM strategy in view of changes to assumptions and risks considered in the DeM strategy; and

- To determine whether the DeM strategy had been implemented as planned.

[23] https://www.issai.org/pronouncements/issai-4000-compliance-audit-standard/

4.3 Representative Audit Questions on the Debt Management Strategy

The following are potential audit questions related to the DeM strategy.

Audit objective: To ascertain whether the DMO had efficiently performed its responsibilities and accountabilities relating to the DeM strategy development

1) Did the DMO prepare an MTDS? If so:

   a. Who is responsible for producing the strategy, and what were their respective roles?

   b. How is the strategy produced? Does it follow good practice (e.g., the World Bank and IMF guidance on developing an MTDS)?

   c. What is the content of the strategy? Does it clearly state the desired objectives? Does it use appropriate risk indicators?

   d. Does the strategy follow special debt regulations or legal mandates?

   e. What analysis is undertaken in formulating the strategy?

   f. How is the analysis undertaken? Who is responsible for setting economic and budget parameters, and who is responsible for debt forecasts?

   g. Does the DMO consider a range of alternative strategies from a cost and risk perspective before finalising its strategy?

   h. Does the DMO consider what characteristics of debt or debt composition would mitigate key sources of volatility in the budget, and consider the potential costs of achieving that debt composition?

   i. Are the risks embedded in contingent liabilities taken into account, and how are these risks assessed?

2) Is the central bank consulted in formulating the strategy? Is it consistent with the central bank's monetary policy implementation? Is the debt strategy approved by a senior policy-making authority? Is the strategy made publicly available? If so, when was it published, and in what format?

Audit objective: To determine whether the DeM strategy had been implemented as planned

1) Has the DMO followed the strategies planned in the DeM strategy?

2) Are the strategies responsive to existing conditions?

3) Are expected results achieved?

4) Are there changes to the DeM strategy? What are the bases for the changes, and are they documented?

5) How often is the strategy reviewed and updated?

6) Is a report on the outcomes of the strategy prepared and submitted to the legislature and concerned authorities?

4.4 Audit Criteria for Debt Management Strategy

According to the UNCTAD Principle 13, the DMO should have sound processes in place to develop an effective MTDS, including procedures to review the strategy periodically, to monitor emerging risks, to monitor interest costs, to take into account other liabilities that could impact on the government's budgetary position, to monitor performance and to report clearly and transparently the outcome of the strategy. Furthermore, all debt contracted should be in line with the DeM objectives and strategy of the sovereign.

The DeMPA tool DPI-3 also highlights the importance of the DeM strategy and assesses whether the strategy document meets certain quality requirements, whether the government has a robust decision-making process and whether the documents are publicly available.

4.5 Sources of Evidence in Auditing Debt Management Strategy for Public Debt Management

SAIs should obtain sufficient evidence to determine if the DMOs have a formal DeM strategy in place and a process for its formulation, implementation and reporting.

The following are some supporting documentation which would be useful in the audit and can be obtained from the DMO:

- Most recent DeM strategy;
- Defined process of strategy formulation and approval and related documentation;
- Documents providing the statistics and bases for the DeM strategy;
- Documents supporting any change to the DeM strategy;
- Monitoring reports of DeM strategy implementation; and
- Reports on the outcomes of the DeM strategy.

4.6 Illustrations of Audit Findings on Debt Management Strategy

Within the framework of the program, SAIs that conducted public debt strategy reviews in some countries were able to assess whether the models and estimates used by the manager were accurate in generating the changes proposed by debt agencies.

This section contains some findings related to the DeM strategy.

1) Insufficient DeM strategy

SAIs found that in some cases where borrowing strategies were established, they were insufficient; i.e., there were no parameters or they were not followed at all. The lack of strategy resulted in unfavourable borrowings and shortages in cash on hand, resulting in higher borrowing costs.

2) Absence of requirement for DeM strategy in legislation

A requirement in legislation for the development of a DeM strategy to establish the responsibility and accountability for its development, publication, periodic review and updating, and reporting on the related outcomes could be highlighted in certain cases.

In other cases, there were no requirements for a DeM strategy, and the absence of this requirement has not established responsibility and accountability for its development, publication, periodic review and updating and reporting on the related outcomes.

On the other hand, there were also positive findings where the borrowing strategy resulted in lower borrowing costs and shortening of the maturity profile of debt due to meeting debt obligations before they were due.