
Chapter 2 Auditing the Legal Framework for Public Debt Management

This chapter helps SAIs to identify the elements, recognise the importance of the legal framework for PDM and relate the topic with possible audit types, criteria, sources of evidence, and sample audit questions and findings.

2.1 Legal Framework for Public Debt Management

The legal framework for PDM comprises both primary legislation (laws enacted with approval of the legislature) and secondary or delegated legislation (executive orders, decrees, ordinances and so forth determined by the executive branch of government).

The decision to include certain provisions in the primary legislation is guided by constitutional principles and the desired role of Parliament or Congress in sovereign DeM. Including them in the primary legislation gives those provisions prominence and prevents ad hoc and frequent changes.

In line with sound practice, the primary legislation should include:

- Clear authorisation by Parliament to the executive branch of government (normally to the Cabinet or Council of Ministers, or directly to the Minister of Finance) to approve borrowings on behalf of the sovereign;
- Specified borrowing purposes;
- Clear DeM objectives or goals;
- Requirement to develop a DeM strategy and annual borrowing plans; and
- Mandatory annual reporting to Parliament of borrowings and other DeM activities, covering the evaluation of outcomes against stated objectives and the determined strategy.

The secondary legislation commonly includes:

- Clear authorisation within the executive branch of government for a dedicated DeM unit (sometimes called the debt management office or for short, DMO) to undertake borrowing- and debt-related transactions within a certain framework; and
- Other issues, such as borrowing procedures and other regulations that do not need to be determined by Parliament, following the principle of subsidiarity.

SAIs can examine whether the legal framework has established the necessary governance, audit, reporting and accountability processes. Essentially, the following elements should be present in the legal framework for PDM and should be explicitly, clearly and consistently defined:

- Delegation of sovereign powers by Parliament to the executive;
- Remit (responsibility, sphere of activity) of the DMO;
- Borrowing purposes;¹²
- DeM goals and objectives;

¹² It is common to find in the primary legislation that the government can issue guarantees only when it is deemed to be in the public interest. In this regard, public interest could be defined as 'promotion of economic development, including development of disadvantaged regions, promotion of small and medium-sized enterprises (SMEs), and correction of market failure where creditworthy borrowers may not have access to credit markets, and strengthening of the national security'.

- Requirement for a DeM strategy and annual borrowing plans; and
- Debt reporting obligations.

From the perspective of a performance audit, SAIs can also examine to what extent these elements have been observed in the context of sound PDM.

2.1.1 Delegation by Parliament or Congress to the executive

In most countries, the ultimate power to borrow on behalf of the central government rests with Parliament or Congress. This power stems from legislature's constitutional power to approve central government tax and spending measures. The first level of delegation of the borrowing power therefore would be from Parliament or Congress to the executive branch (for example, to the president, to the cabinet or council of ministers, or directly to the minister of finance).

To keep some control of the borrowings and debt level, Parliament normally restricts the delegated borrowing power to specified purposes or sets a limit on the annual net borrowing or the outstanding debt. Another common control is the retention by Parliament or Congress of the power to ratify loan agreements that are classified as treaties (i.e., international agreements concluded between two sovereigns or between a sovereign and another subject of international law, such as the World Bank). This requirement is normally included in the constitution. Other foreign loans, such as bond issues in the international capital markets and loans directly from foreign banks, do not normally require the approval of the Parliament or Congress.

In their examination of the delegation clauses in the legal framework, SAIs should determine whether the terms of delegation are explicit and clear, both for internal control and for due diligence purposes.

Commonly, the Cabinet or the minister of finance delegates at least some of its borrowing powers received from Parliament to the DMO, e.g., to approve the bids received in auction of government debt securities. The SAIs should examine the existence of those delegated powers and determine if they are adequate to allow the DMO to manage public debt properly.

The next box below illustrates some of the main laws related to borrowing and debt powers in the Philippines.



Philippines' Constitutional and Legal Provisions Related to Public Debt Management

The power to issue debt is one that has been traditionally shared by the President with the legislature, the Monetary Board (MB) of the Bangko Sentral ng Pilipinas and other agencies of government. The power vested in the President to borrow has been extended to the Secretary of Finance by various Republic Acts (RAs) issued by Congress.

Article VI, Section 24, of the 1987 Constitution of the Philippines assigns to Congress the exclusive power to enact 'bills authorizing increase of the public debt'.

Article VII, Section 20, authorizes the President to 'contract or guarantee foreign loans on behalf of the Republic of the Philippines (ROP) with the prior concurrence of the MB, and subject to such limitations as may be provided by law'.

Article XII, Section 21 states: 'Foreign loans may only be incurred in accordance with law and the regulation of the monetary authority. Information on foreign loans obtained or guaranteed by the Government shall be made available to the public'.

RA No. 245 (12 June 1948), Section 1, authorizes the Secretary of Finance, with the approval of the President, after consultation with the MB, to borrow from time to time on the credit of the ROP such sum as may be necessary, and to issue therefor evidences of indebtedness of the Philippine Government.

RA No. 4860 (8 August 1966) authorizes the President of the Philippines to, among others, obtain such foreign loans and credits, or to incur such foreign indebtedness, as may be necessary to finance approved economic development purposes or projects, and to guarantee, in behalf of the ROP, foreign loans obtained or bonds issued by corporations owned or controlled by the Government of the Philippines for economic development purposes including those incurred for purposes of re-lending to the private sector.

Source: various

2.1.2 Borrowing purposes

Legal limits to borrowing purposes are a safeguard against borrowing for speculative investments and borrowing to finance expenditures that have not been included in the annual budget or approved by legislature. If the executive branch of the government could borrow to finance expenditures not approved by legislature, the legislative budget process would be ineffective, since the legislature would be forced in the future to take fiscal actions to pay interest and service a public debt obligation that was contracted without its direct or indirect approval. Another negative effect of such a framework would be that Parliament or Congress would lack the opportunity to scrutinise those expenditures and weigh them against other priorities, which is one of its core functions in a democracy.

SAIs should examine whether the legal framework clearly and explicitly defines the borrowing purposes. Examples of common borrowing purposes specified in legislation are to finance budget deficits; fill short-term cash gaps; refinance maturing debt; finance investment projects approved by the legislature; honour government payment obligations under outstanding guarantees; add to foreign currency reserves; support monetary policy objectives (for example, to drain excess liquidity from the domestic market); and eliminate effects caused by natural environmental disasters.

The bulk of borrowing is normally to cover the budget deficit. It is important to clarify that this deficit should have been approved by the legislature. Other borrowing requirements are to build

up and sustain a liquidity buffer to be determined by the minister, to finance any on-lending, and in general for any other purposes determined by Parliament.

2.1.3 Debt management goals and objectives

The legal definition of public debt goals and objectives helps to formulate a PDM strategy. SAIs should examine whether the country's legal framework contains public debt goals and objectives that are logically consistent and mutually supporting. SAIs should also assess whether the goals are clear, stable and robust enough to serve as an anchor for the DeM strategies.

This is a key provision. It is important to carefully consider the drafting of the DeM goals, because these serve as both the anchor for the DeM strategy development and the benchmark for the evaluation process. To serve these purposes, the goals must be clear and long-term, and have certain robustness. In addition, they must be achievable, directly related to DeM activities and specific. An example of a goal that does not meet these criteria is a general statement that DeM activities shall promote economic growth. This is impossible to evaluate. Another example is a statement that DeM activities will ensure that the debt is kept at a sustainable level. But the government's debt level is driven much more by loose fiscal policy and contingent liabilities than the structure of the debt.

SAIs may use DeM goals and objectives as criteria in their performance audits of PDM. In particular, SAIs can assess whether goals are translated into a DeM strategy that defines how the goals will be achieved. Discussion of how goals were achieved pursuing specific strategies should be important elements of public debt reports.

2.1.4 Debt management strategy

A DeM strategy should cover all central government existing debt and projected borrowing, including from the central bank, with a minimum of three years' scope (thus it needs to be updated annually). In particular, a DeM strategy identifies how cost and risk characteristics vary with the changes of composition of the debt portfolio. The content of the strategy and risk indicators will vary from country to country, depending on the stage of economic development, the sources of funding, the breadth and depth of the domestic debt market, and the transactions used to manage central government debt.

The DeM strategy document preferably includes 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
- Recommended strategy and its rationale.

SAIs should examine whether the requirement for a debt management strategy has increasingly been adopted in DeM legislation. This would include a requirement to publish a DeM strategy. A DeM strategy is usually approved by the executive (either by the minister of finance or the council of ministers) as a formal document. It provides the strategic path in the medium term to meet the high-level DeM objectives, including ensuring its consistency with macroeconomic policies.

2.1.5 Debt reporting

A debt statistical bulletin (or its equivalent) covering domestic and external central government debt, loan guarantees and debt-related operations is essential for ensuring transparency of the debt portfolio and of outstanding loan guarantees, and it is vital for the investors in the central government debt securities.

This bulletin could be in the form of either regular MoF or central bank publications or as statistical tables produced by a bureau of statistics. The bulletin should be published at least annually (preferably quarterly or semi-annually) and provide information on central government debt stocks (by creditor, residency classification, instrument, currency, interest rate basis, original and residual maturity); debt flows (principal and interest payments); debt ratios and indicators; and basic risk measures of the debt portfolio.

SAIs should examine whether clear and explicit legal reporting requirements exist to hold public debt managers accountable to senior debt officials, ministers and boards (if any) charged with governance, and to the legislature. SAIs should also verify whether there are other legal reporting requirements such as financial statements, budgetary reports and public debt reports, and whether the reports are subject to external audits.

2.2 Auditing Legal Framework for Public Debt Management

Examination of the legal framework is a required audit procedure for understanding the environment in which public debt operations are executed. Therefore, when performing a financial, compliance or performance audit of public debt, SAIs need to have a good understanding of the legal framework for PDM.

In general, carrying out performance or compliance audits allows SAIs a better overview of the legal framework, including the governance, reporting and accountability processes. When auditing the legal framework for PDM, however, SAIs can perform a performance audit, looking at whether decisions by the legislature or the executive are efficiently and effectively prepared and implemented. On the other hand, compliance audits look at whether debt-related activities, financial transactions and information comply with the authorities which govern the audited entity. Examples of compliance audits for PDM are presented in the succeeding chapters, which deal with DeM and other related activities.

2.2.1 Performance audit of legal framework

A performance audit of the legal framework for PDM can examine whether the elements discussed are present in the legal framework for public debt and are explicitly, clearly and consistently defined. Examples of audit objectives for a performance audit could include the following:

- To determine whether a clear and explicit legal framework is in place;
- To determine whether the legal framework for DeM provides clear and explicit delegation of powers for DeM; and
- To determine whether debt reporting obligations are explicitly stated in existing legislation for PDM.

The first three audit objectives would fall under a systems-oriented audit approach to performance auditing where the SAI focuses on the examination of the proper functioning of DeM systems. The last two objectives could be a results-based approach, which assesses whether the DeM objectives have been achieved as intended.

Performance audit promotes transparency by affording the legislature, taxpayers and other sources of finance; those targeted by government policies; and the media an insight into the management and outcomes of different government activities.

The following could be examples of audit objectives relating to performance audit of the legal framework for PDM:

- To evaluate the adequacy of the legal framework for public debt for an effective debt management; and
- To determine to what extent the legal framework provides mechanisms to determine the maximum limit for the external debt the government can borrow.

2.3 Representative Audit Questions on the Legal Framework for Public Debt Management

The following are examples of audit questions that could be used to support the audit objectives for performance audits of the legal framework for PDM:¹³

Audit objective: To evaluate the adequacy of the legal framework for PDM for an effective DeM

- 1) Do laws exist that clearly define the purposes for which borrowing can be undertaken, for example, to finance the budget deficit as approved by the Parliament?
- 2) Do laws exist that clearly define DeM goals and objectives to be achieved?
- 3) Which sections or clauses in the legislation cover the following?
 - a. specified borrowing purposes;
 - b. clear debt management goals;
 - c. requirement to develop a medium-term debt management strategy (MTDS); and
 - d. annual mandatory reporting to Parliament and Congress covering DeM activities and, where applicable, loan guarantees issued.
- 4) Do laws exist that provide for mandatory reporting at least annually by the executive to Parliament on the public debt outcomes against stated goals and the determined DeM strategy?
- 5) Are there overlaps or inconsistencies between different sets of legislation relating to public debt?
- 6) Does the legal framework provide for an effective sanction regime for non-compliance?

Audit objective: To determine whether the legal framework for DeM provides clear and explicit delegation of powers for DeM

- 1) Is there a clear legal authorisation by Parliament to the executive (the cabinet or council of ministers, the president or directly to the minister of finance) to approve borrowings and guarantees on behalf of the central government? If so, which legislation provides authorisation, and what are the relevant sections or clauses?
- 2) Who signs the loan documents and other necessary documents related to a particular

¹³ DeMPA 2015.pdf (relating to questions 3 to 6 only); see <http://documents1.worldbank.org/curated/en/305821468190742099/pdf/96671-WP-DEMPA-2015-Box391446B-PUBLIC.pdf>.

borrowing? Which legislation provides this authorisation, and what are the relevant sections or clauses?

- 3) Is there a clear legal authorisation from the executive branch of government to a DMO to undertake borrowing and debt-related transactions and to issue loan guarantees on behalf of the central government? If so, which legislation provides authorisation, and what are the relevant sections or clauses?
- 4) Has the DMO carried out its reporting duties on a timely basis such that there have not been significant negative financial consequences due to passiveness?

The SAI shall analyse the collected information and ensure that the audit findings are put in perspective and respond to the audit objective(s) and audit questions.¹⁴

2.4 Audit Criteria for Auditing Legal Framework

In conducting an audit of legal framework for PDM, an SAI may use the indicators identified by the DeMPA tool as sources of criteria to examine the robustness of the framework. The DeMPA tool's DeM Performance Indicator 1 (DPI-1) is used to assess the existence, coverage and content of the legal framework on authorisation to borrow and undertake other DeM activities and to issue loan guarantees.

An SAI may also use UNCTAD principles as sources of audit criteria. The following UNCTAD principles may be considered.

UNCTAD Principle 3 on Due Authorization requires that lenders make sure the public counterparty has the proper authorisation to enter into a credit agreement and the agreement is valid and enforceable under its jurisdiction. Lenders should be acquainted with the law and ensure that they are dealing with duly authorised entities. Should the lender determine that these conditions do not exist, it should not conclude the agreement.

UNCTAD Principle 10 on Transparency provides, 'The process for obtaining and assuming sovereign debt obligations and liabilities should be transparent. It is the responsibility of the governments 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'.

UNCTAD Principle 13 on Adequate Management and Monitoring provides, *inter alia*:

- 'Debtors should design and implement a debt sustainability and management strategy and to ensure that their debt management is adequate'.
- 'A DMO should be involved in both the pre- and post-disbursement aspects of any credit for which the State or one of its instrumentalities will be liable. DMO should have sound processes in place to develop an effective medium-term debt strategy (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 budgetary position, to monitor performance and to report clearly and transparently the outcome of the strategy)'.

¹⁴ Para. 112, ISSAI 3000 – Standard for Performance Auditing

2.5 Sources of Evidence in Auditing Legal Framework

An SAI may use the following sources to collect evidence or understand the legal framework:

1) All primary legislation, which should be available on the websites of the government, MoF, DMO or central bank. Ideally these documents should be requested formally to the audited authorities.

a. Country constitution

Sets out the fundamental principles or established precedents according to which a state is governed. In the Philippines' Constitution, for example, *the President is given the authority to contract or guarantee foreign loans on behalf of the Republic of the Philippines xxx.*

b. Budget law

Regulates the arrangements governing the adoption, records, management, preparation, development and execution of the budget of the Republic.¹⁵ In the Philippines, for example, the budget law called *General Appropriations Act*, which is enacted on a fiscal-year basis, includes provision for debt servicing.

c. Public finance law and/or related regulations

Refers to legislation and regulations relating to the financial activities of government or public sector organisations. These govern the funding and administration of specific governmental activities including the sale and purchase of various types of bonds.

d. Public credit/debt law and/or related regulation

In some countries, refers to legislation and regulations relating to public credit and DeM operations and institutional organisation, including functions and missions of the DMO.

2) All secondary legislation which should be available on the websites of the government, MoF, DMO or central bank.

a. Regulation of the domestic capital market, if any

Rules and regulations related to the functioning of the domestic debt market, including the definition of institutional actors—for example, sovereigns, registry entities, market makers, and institutional and individual investors—and their rights and obligations.

3) Other related documents, such as Debt Management Strategy

¹⁵ www1.worldbank.org/.../BudgetLaws/Montenegro%20Budget%20Law%20Official%20

2.6 Illustrations of Audit Findings on Legal Framework

This section contains some of the audit findings related to the audit of a legal framework. These audits were conducted by SAIs participating in IDI's Auditing of Lending and Borrowing Frameworks (ALBF) programme during 2015 and 2016. The main findings from the ALBF programme can be traced to two levels of maturity of the PDM system, namely, situations where there is no legal framework or there is vague legislation related to PDM. In addition, we also provided some examples of audit findings that could provide more guidance for SAIs in performing audits of the legal framework for PDM.

1) Unclear legislation on allocated authority

In cases where legislation was not clear in the allocated authority, it was found that the front office, middle office and back office activities were uncoordinated and spread across a number of entities in inefficiencies in the DeM function. This impacted the availability of information to departments and specifically to the SAIs.

2) Inadequate legal framework for PDM

Without an adequate legal framework, the PDM strategy or borrowing plans were not developed, resulting in high borrowing cost and less optimal covenants for the countries. This goes hand in hand with lack of operational manuals and policies (institutional arrangements) on how on lending and borrowing activities are carried out, resulting in high debt levels and high exposure to certain currencies in relation to economic conditions.

3) Deficient borrowing plans

SAIs found that where legislation requires a borrowing strategy and borrowing plans to be developed, these documents did not contain key parameters, such as borrowing limits and currency mix. Monitoring of the strategy and plans was also found to be non-existent, resulting in different outcomes than envisaged. SAIs have noted also that this related to the lack of skills and staff trained in the public debt offices to fulfil the requirements of the strategies, and to the lack of review.

4) Inconsistent definition of public debt

The participants in the ALBF programme have also highlighted the definition of public debt as a contentious issue. The public debt definition is not consistent as some countries exclude the debt of state-owned enterprises where guarantees have been offered and nowadays the standard position is that the guarantees should be included as part of the indirect public debt.

In reviewing the results of the audits, it was observed that good legislation regarding public debt forms the building blocks for a good DMO, as it supports all the other principles related to good PDM. SAIs that conducted the audits on other initial topics found that their root causes relate mainly to the legislative framework and as a result had to narrow the scope of work or change the objectives of the audit.

