Chapter 5 Auditing Borrowing Activities

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

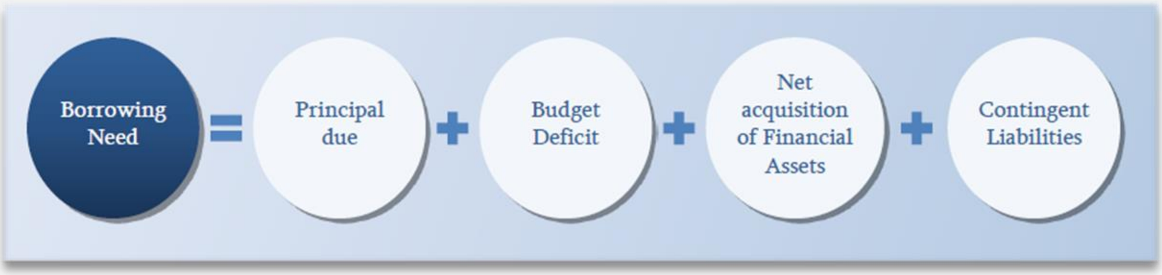
5.1 Public Borrowing Cycle

Borrowing allows governments to bridge the discrepancies between budget revenues and expenditures. Such discrepancies can be the consequence of internal or external factors. In either case, a strategic, well-considered and transparent borrowing plan is necessary for sustainable public finance.

The public borrowing cycle comprises several specific activities that can be examined by SAIs, such as the estimation of borrowing requirements, the preparation of an annual borrowing plan that is consistent with the country's DeM strategy and the identification of best borrowing instruments, such as concessional loans and/or benchmark securities.

Determining how much to borrow is part of the planning cycle of borrowing activities. There are four main factors that public debt managers need to know to obtain a reliable estimate of borrowing needs in the coming period, say one year: (a) debt coming due within a year; (b) an estimate of next year's budget deficit; (c) an estimate of the contingencies, such as defaults of guaranteed loans that would be triggered next year; and (d) an estimate of net financial assets, including accumulation of cash balances, that would be acquired within a year, as shown in *Figure 6*.

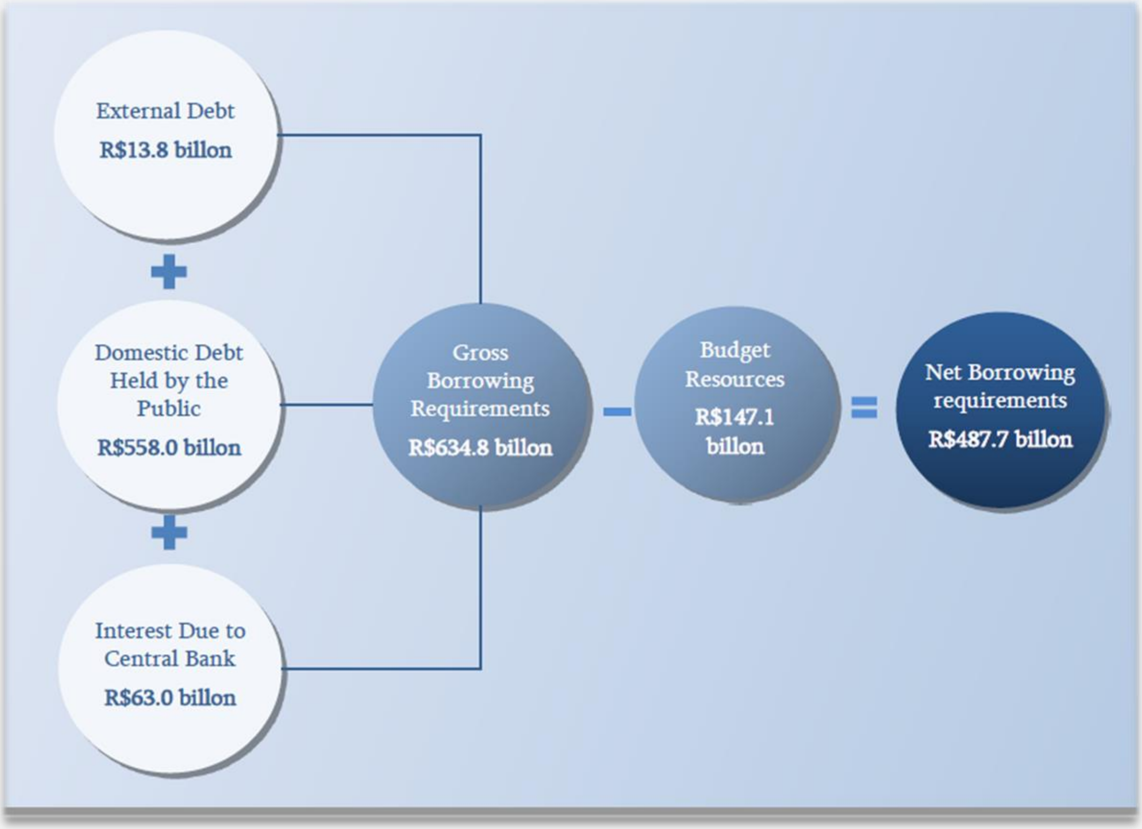
Figure 6. The General Formula for Determining Public Debt Need



Of the above four factors, debt managers will know with certainty only the amount of debt that comes due within a year if their debt records are complete and kept up to date. The other three factors—budget deficit, contingencies and acquisition of net financial assets—are commonly provided by other agencies. Various countries all over the world use different modified versions of this general approach to set the borrowing volume for the upcoming year. For instance, the OECD standardised method for calculating gross borrowing needs states that it is a sum of the budget deficit (net borrowing requirement) and debt coming due within a year (total redemptions).

Shown in *Figure 7* is how the National Treasury of Brazil determines its net borrowing requirements.

Figure 7. Determining the Net Borrowing Requirements, National Treasury of Brazil (in Brazilian real, R$)



In normal years, the government's borrowing need is largely determined by the size of the budget deficit and by the amount of rollover debt; other factors have a smaller effect on borrowing needs.

Budget deficit is the amount by which a government's spending, both for recurrent expenditures and investments, exceeds its income over a particular period of time. The office charged to provide this data to the DMO should be the agency responsible for the preparation and management of the state budget.

Contingent liabilities are potential liabilities that depend on a future event occurring or not occurring. (See ISSAI 5430 on contingencies.)[24]

DeM officials must rely on other ministries and programme managers to determine the likelihood of contingencies that will be realised in the current period. Most governments have several programmes that produce large explicit contingent liabilities, such as government-issued loan guarantees. Certain contingencies can immensely complicate the job of PDM. For example, the triggering of contingencies associated with legal obligations (e.g., explicit contingent liabilities) can exert a large impact on public borrowing. In addition to explicit contingent liabilities, governments are also burdened by implicit liabilities. Implicit contingent liabilities are not linked to any legal obligations. Instead, the triggering of these 'implicit guarantees' is based on political and or moral grounds. Examples of triggering events of implicit guarantees include the default of regional or local governments, state-owned enterprises or strategically important private firms or banks, and natural catastrophes.

[24] This ISSAI is undergoing evaluation relative to Project 2.9 of the Strategic Development Plan for the INTOSAI Framework for Professional Pronouncements.

Once the total amount to borrow is determined within the context of the DeM strategy, an annual borrowing plan should be developed, outlining how the DeM strategy will be implemented over the coming budgetary period. The annual borrowing plan is an explicit document or a special legal authorisation for the DMO to borrow funds in order to cover annual financial needs. Some countries[25] publish the borrowing plan as a separate document. However, in some instances a rough annual borrowing plan is included in the state budget. For example, in Slovenia the key national document in the field of borrowing is the Financing Program of the Republic of Slovenia Central Government Budget, adopted by the government, which defines strategic and operational targets of borrowing for a given fiscal year.

When the sovereign is issuing debt securities in the domestic market through auctions, the borrowing plan should also include the auction calendar. Moreover, efficient and effective cash management supports the development of a more committed and transparent borrowing plan, and contributes overall to reducing the cost of debt. The cash flow forecasts are normally a treasury function, although in some developing countries the DMOs could assume that responsibility also. Because of the close linkage between central government cash flow forecasts and DeM, however, it is essential that regular and reliable information sharing occur between these two functions. It is important to stress that execution of the annual borrowing plan requires consistent and close observation of market conditions. In moments of intense adversity, issuance plans may be adjusted in such a way as to minimise the volatility of the government bond market, thus ensuring an adequate balance between costs and risks.

It is common to link borrowing programs to the fiscal and economic projections contained in the annual budget established by Congress or Parliament. The DeM unit should take part in the budgeting process by informing the decision-makers as to the amount that can reasonably be borrowed in domestic and foreign currency and how much the domestic market can absorb without any detrimental crowding out of the private sector. It is also common to incorporate the views of the central bank on any crowding-out effects. Once the borrowing plan is approved and incorporated into the budget, public debt managers schedule the needed borrowings both in the foreign and domestic markets, broken down in amounts, maturities, currencies, interest rate structure and potential creditors and markets.

Most governments can borrow money from both domestic and international markets. Local capital markets are important to obtain stable funding sources in domestic currency and help governments to match their debt liabilities with government revenues. The recommended best practice in this market is to concentrate government borrowings in a reduced set of liquid benchmark debt securities that help in the development of domestic markets, enhance their ability to financial intermediation and provide the creation of a broader range of risk-management assets, such as a futures market, thereby facilitating better risk management for all.

When issuing debt instruments in the domestic market, sovereigns typically use competitive auctions to decide the price or the yield of the Treasury bills and/or bonds that are being issued, as well as the total amount of each issuance. To obtain the lowest interest possible on these debt instruments (i.e., the highest price), the sovereign should publish an auction schedule well in advance, including the type of debt instruments to be issued and the scheduled dates for each issuance, a good practice consistent with the transparency principle.

[25] Brazil, Mexico, and Bosnia and Herzegovina

The terms and conditions of debt instruments issued by the sovereign in the domestic market are short and simple, since they include only the financial conditions relevant to buyers (investors): interest rate to be paid, dates on which interest is payable, date on which the sovereign is bound to redeem the debt instrument and the process applicable to these payments. The DMO should keep a record of all the holders of debt instruments and follow up all the sales of these securities at the secondary market.

It is important when developing domestic debt markets not only to keep track of the institutional investors but also to capture the savings of the individuals through simple information and attractive financial conditions.

Although auctions are the most common price-setting and sales technique used by governments, there are other options, such as subscription and syndication or book-building best efforts.

In many developing countries, the government borrows primarily from external multilateral and bilateral lenders. Low-income countries qualify for official development assistance, which are multilateral funds lent at concessional rates and with longer terms to maturity. In contrast, some medium-income and most high-income countries sell marketable debt securities at market-based interest rates. The table below illustrates the main activities that can be examined in both types of borrowings.

Main Borrowing Activities Are Different for Debt Securities and Loans

I – Debt Securities	II – Loan Borrowings
• Define the debt structure: maturity structure of bonds, call provisions • Prepare the official statement • In case of an international bond issue, ask for a credit rating of the bonds • Choose methods of sale: competitive bids or negotiated sales • Conduct sales of securities • Perform after-sale closing procedures • Report on issuance of debt securities.	• Plan country's capital projects • Identify projects and programme • Determine scope of projects and programme • Prepare project or programme appraisal • Negotiate loan • Obtain approval of the loan contract terms • Sign loan documents • Manage loan disbursements • Closing of loan • Report on loan contracting activities

Source: various

From a legal perspective, it is more complicated when the sovereign borrows funds from foreign creditors or investors, either by means of loan contracts or by issuing debt instruments in foreign markets. In this case, the sovereign is treated as any other borrower, and lenders demand to have guarantees that the sovereign will repay the funds borrowed as per the loan contract. Since most of these loans are not guaranteed (unsecured debt), the only protection that the lenders may get is the construction of guarantees in the loan contract. Typically, a foreign loan contract contains its financial conditions, use of the financing resources, pre-conditions, representations and warranties, covenants, events of default and governing law and clauses on jurisdiction.

The financial terms stipulate the amount and currency of the loan; the disbursement process; interest rate and instalments to be paid by the borrower; the loan repayment process (to be repaid in instalments during the life of the loan or in a lump sum on the loan due date); repayment conditions; accounts to be used, etc. The destination of the funds must be stated in the loan agreement, declaring that the loan funds shall be used for a specific purpose as provided for in the loan contract.

Some creditors may impose non-disclosure agreements. It would be useful for the audit to assess whether such agreement is consistent with domestic laws and if not, to opine whether a new law or regulation is needed that sets the parameters for whether such contractual agreements are permissible under the law.

Loans by foreign creditors are usually governed by the applicable foreign law; loans by bilateral creditors, by the law of the lending institution; and issuances of fixed-income securities, by the law of the country where the bonds were issued.

Determining borrowing needs is a complex function that requires a significant amount of information and coordination amongst government agencies. Governments with the capacity to estimate correctly will avoid over-borrowing, which is costly and could lead to a deterioration of the government's fiscal position. Governments can also avoid under-borrowing, which may force governments to alter their budgets, create a liquidity crisis or trigger a debt default. Auditing borrowing needs, therefore, can result in useful findings and recommendations to improve inter-agency coordination efforts, minimise borrowing, strengthen budget execution, estimate loss contingencies and increase returns on financial investments.

The annual borrowing plan, together with the DeM strategy and other relevant documents, should be a simple and clear set of documents and tools that promote better coordination and communication with other State institutions and levels of government in a country, and also make it easier for creditors or investors and the public to become more familiar with the goals and policies of the government's DeM.

Borrowing activities are subject to significant operational risks that can prevent the government from achieving the lowest borrowing costs over time, even with due regard to the risk. For example, many developing countries that obtain concessional loans to finance projects also have to pay large and recurring commitment fees on unused loan balances. Inefficient borrowing activities in some cases can be a significant drag on economic development when they cause significant and recurring delays and cancellation of strategic capital projects.

5.2 Auditing Borrowing Operations in Public Debt Management

After obtaining sufficient evidence to determine if the DMO has complete and reliable information on debt coming due, such as a complete, updated debt amortisation schedule for all loans and debt securities, the SAI will also have to assess the government's capacity to produce the budget figures on revenues and expenses and communicate them promptly to debt managers.

In order to be able to forecast the borrowing requirements caused by a triggering of contingent liabilities, SAIs can include in their audit plan a set of procedures for determining how government officials assess the probability of these triggering events and the financial effects they would incur. Some countries have included these contingencies in the budget planning process. In addition to explicit contingencies, the SAIs should make inquiries about implicit contingent liabilities, which are not linked to any legal obligations.

Auditing borrowing activities involves assessing whether the government has a documented borrowing plan aligned with public debt goals, objectives and strategy, and whether sovereign DeM has adopted best practices and procedures.

5.2.1 Compliance audit of borrowing activities

Planning audit procedures for an audit of borrowing needs involves designing procedures to respond to the identified risks of non-compliance with laws and regulations governing public debt.

The following audit objectives can be considered in a compliance audit:

- To determine if the borrowing plan was developed in accordance with statutory requirements (for example, including the borrowing plan as an annex of the budget law);
- To determine if project loans contracted followed the prescribed project development and financing process; and
- To determine if issuances of government securities were within the set authority or limit.

5.2.2 Performance audit of borrowing activities

The SAI should be interested in whether borrowing activities align with the principles of economy, efficiency and effectiveness, and if they contribute to prudent practices of borrowing. The SAI's role would be to evaluate the performance of the government's borrowing activities, including the planning and execution parts of the public borrowing cycle.

The following audit objectives can be included in the plan:

- To ascertain whether actual borrowing by government was based on sound estimation process of the borrowing needs;
- To determine whether there were reliable estimates of contingencies; and
- To determine whether the principle of economy (minimisation of cost and risk) was considered when borrowing.

5.3 Representative Audit Questions on Borrowing Operations for Public Debt Management

Audit objective: To ascertain whether actual borrowing by government was based on a sound estimation process of the borrowing needs.

1) How does the government determine an annual borrowing requirement?

2) Does the DMO participate in the government's budgeting process?

3) Does the government comply with the strategic benchmarks, if any?

4) Who is responsible for coordinating debt and cash management? Is there a formal agreement with the roles and responsibilities of each party?

5) Does the government have a documented borrowing plan? If so:

   a. Does it include indicative dates of each borrowing and the methods and sources of each borrowing?

   b. Is the plan aligned to the government's debt strategy, if it has developed a strategy?

   c. Is the borrowing plan coordinated with the monetary authority (central bank)?

   d. Is the borrowing plan implemented on a regular and predictable basis? Do DeM officials produce a report on the implementation of borrowing plans? Are there public notices that explain changes in the borrowing plan?

6) Does the DMO have complete, up-to-date records for the debt that will become due in the coming period?

7) Are implicit contingencies included in the estimate? If not, why not, and what could be the risks?

8) When does the government announce the domestic borrowing plan, and what information is provided? How frequently is this information updated during the fiscal year?

9) Who is responsible for forecasting government cash flows?

10) How often are forecasts prepared?

11) How accurate have the forecasts been? If forecasts over the years have been materially inaccurate, what were the reasons, and what actions were taken to improve the system of forecasting?

Audit objective: To determine whether the principle of economy was considered when borrowing

1) What is the process for negotiating and contracting new loans? Which entity is responsible for managing this process?

2) Does the DMO select the best funding source by balancing cost and risk?

3) How are the terms and conditions set for each loan, and what scope is there to negotiate these terms and conditions?

4) Are there guidelines and limits for non-concessional external borrowing?

5) What is the basis used by DeM officials for selecting funding sources: multilateral, bilateral and commercial sources?

6) Are non-concessional loans taken even though the government might have been eligible for concessional funding? If so, what were the reasons?

7) What debt instruments are sold in domestic markets, and what techniques are used to issue each instrument?

5.4 Audit Criteria for Auditing Borrowing Operations

The DeMPA tool evaluates the borrowing and related financing activities by three DPIs.

DPI-8 and DPI-9 deal with the domestic and external borrowing activities, respectively. In terms of domestic borrowing, it is important to check the following:

- The extent to which market-based mechanisms are used to issue debt;
- The preparation of an annual plan for the aggregate amount of borrowing in the domestic market, divided between the wholesale and retail markets;
- The publication of a borrowing calendar for wholesale securities; and
- The availability and quality of documented procedures for borrowing in the domestic market and interactions with market participants.

To evaluate the external borrowing activities (DPI-9), the following dimensions should be investigated:

- Documented assessment of the most beneficial or cost-effective borrowing terms and conditions (lender or source of funds, currency, interest rate and maturity) and a borrowing plan;
- Availability and quality of documented procedures for external borrowings; and
- Availability and degree of involvement of legal advisers before signing of the loan contract.

In addition, the importance of sound cash management in developing the borrowing plan is highlighted by the DPI-11. Cash flow forecasting and cash balance management are assessed by the following two dimensions:

- Effectiveness of forecasting the aggregate level of cash balances in government bank accounts; and
- Decision on a proper cash balance (liquidity buffer) and effectiveness of managing this cash balance (including the integration with any domestic debt borrowing program, if required).

UNCTAD Principle 14, Avoiding incidences of over-borrowing, states, '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'. Furthermore, 'Engaging in borrowing to solely cover large chronic budget deficits could eventually erode the debtor country's credit standing, impair its ability to obtain loans on favourable terms in the future and effectively impose a tax on subsequent generations of citizens. Borrowing for this purpose, when not justified by a national emergency, could therefore be inconsistent with a sustainable economic policy'.

5.5 Sources of Evidence While Auditing Borrowing Operations for Public Debt Management

The SAI should obtain sufficient evidence to determine if the DeM units have complete and reliable information on debt due. An example would be an updated debt amortisation schedule for all loans and debt securities.

The SAI can also assess the government's capacity to produce and communicate promptly to debt managers the budget figures: revenues and expenses.

Also, they will assess the reliability of the estimate of the amount of contingent liabilities that will be triggered in the current period. In their audit plan, it is necessary to include a set of audit procedures for examining the management of explicit contingent liabilities; that is, legal obligations based on a contract (e.g., a guarantee issued for a specific project) or a particular law (e.g., a deposit insurance scheme). As it is a legal obligation, the government has no choice but to make the payment after the occurrence of the event triggering the contingent liability.

The SAI may use the following sources to collect evidence or understand the borrowing operations:

1) For domestic debt operations
    a. Information memorandum or prospectus for each instrument
    b. Operating procedures for investors or participants in the primary market
    c. Annual borrowing plan
    d. Issuance program for T-bills and T-bonds announced by the principal DeM entity, the DeM entity responsible for the domestic wholesale borrowing or the central bank

2) For external debt operations
    a. Documented procedures for external borrowing
    b. Most recent analysis of the most beneficial and cost-effective terms and conditions
    c. Documentation of the involvement of legal advisors (for example, recommendations on changes to clauses submitted at various stages of the negotiation process)

5.6 Illustrations of Audit Findings on Borrowing Operations

For SAIs which focused on the borrowing needs of countries during the ALBF programme, the main focus of the audit was on the effectiveness of the operations of the DMO as well as whether conditions of loan agreements were adhered to by the lender or borrower and whether the necessary approval was sought for sovereign loans.

The results of the audits were mixed and difficult to generalise. There were some positive observations during the audits as well as some negative relating to the authority on the borrowing needs.

1) Need for authority from Parliament for emergency borrowings

> Where the legal framework is not as comprehensive and institutional arrangements are not as strong, i.e., borrowing strategies and borrowing plans and operational procedure handbooks, the need for emergency borrowings creates a vacuum in terms of the authority in the form of resolution needed from members of Parliament.
>
> On the other hand, where borrowing strategies and borrowing plans are in place together with good institutional arrangements, the SAIs found the foreign borrowing process very effective, and also that the covenants established as part of the negotiations were adhered to and much easier to monitor.