Governance and Institutional Issues in Managing National Assets and Liabilities on a Consolidated Basis

Sovereign Investors' Forum

Washington, September 2007

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The Issue

- Debt strategy expresses government's trade-off between cost and risk
- In advising on strategy, debt managers analyse:
  - Cash flows of the principal assets and liabilities on the entire government balance sheet – ALM approach
  - Allows risk of government's liabilities to be measured against risk of its assets – explore scope for hedging
- Three Questions:
  - What assets and liabilities should be covered?
  - How are foreign currency reserves and wealth funds integrated into the analysis?
  - Who does the integration?

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Which Assets and Liabilities?

- Debt management addresses structure of the debt portfolio within the wider balance sheet
- In principle analysis should include all the government's primary assets and liabilities
  - Domestic and external, financial and physical
  - NB also contingent liabilities and surrogate finance
- In practice debt managers focus on financial (not physical) assets - assets that generate cash flows
- NB: includes the government's power to tax
  - Generates a string of revenue (future tax receipts)
  - Typically dominates other assets

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Two Stage Process

- **Stage 1**: Matching explicitly the risk characteristics of various financial assets and liabilities
  - ALM at the sub-portfolio level
- **Stage 2**: Relating the cost and risk of debt relative to eg GDP (or revenue or primary surplus)*
  - "Fiscal Insurance"

* A proxy for a projection of the revenues from the government's primary assets together with the expenditures relating to its other liabilities

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Stylised Balance Sheet

- "Government" balance sheet (integrating central bank)

Assets	Liabilities
PV of Tax Revenues	PV of Expenditure
Loans	Guarantees due, arrears
Cash and other financial assets	Other contractual liabilities (e.g. pensions)
Foreign currency Reserves	Marketable debt
"Equity" in SOEs	Other debt, credits, etc

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Sub Portfolio Matching

- External credits may be on-lent to public corporations on exactly the same terms as to interest rate and maturity

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Sub Portfolio Matching

- Foreign currency reserves may be financed by matching debt, including swapped local currency debt

Assets	Liabilities
PV of Tax Revenues	PV of Expenditure
Loans	Guarantees due, arrears
Cash and other financial assets	Other contractual liabilities (e.g. pensions)
Foreign currency Reserves	Domestic currency debt
"Equity" in SOEs	Foreign currency (& swapped domestic) debt

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Fiscal Insurance

- Framework boils down to matching the fiscal position - the present value (PV) of future taxes less the PV of future expenditures - and the PV of debt
  - Debt is the equivalent of deferred taxes
  - Ideal debt structure generates servicing cost positively linked government revenues – ie fiscal insurance

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Identifying the Cost Risk Trade-Off

- Debt managers project the debt servicing flows of different strategies and evaluate their costs and risks under alternative scenarios (deterministic or stochastic) for future macro variables
  - Cost of debt = annual debt servicing cost (or its net present value) usually compared to GDP, revenues, or the primary surplus.
  - Risk = variation in these costs under different scenarios.
- Modelling should explore impact of severe economic shocks
  - It is the extremes, not the means of the distributions that potentially cause problems

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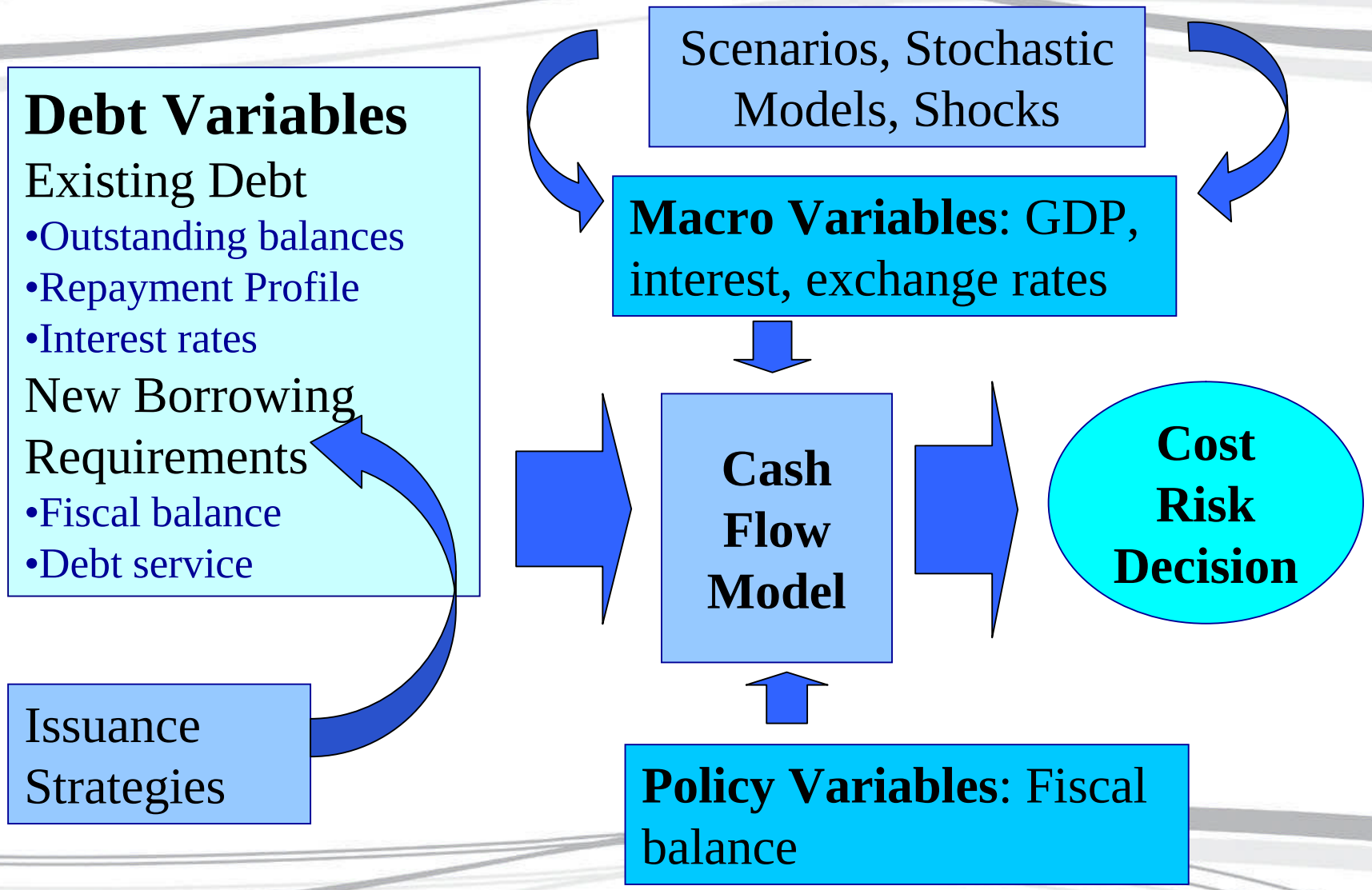
The Cash Flow Simulation Model



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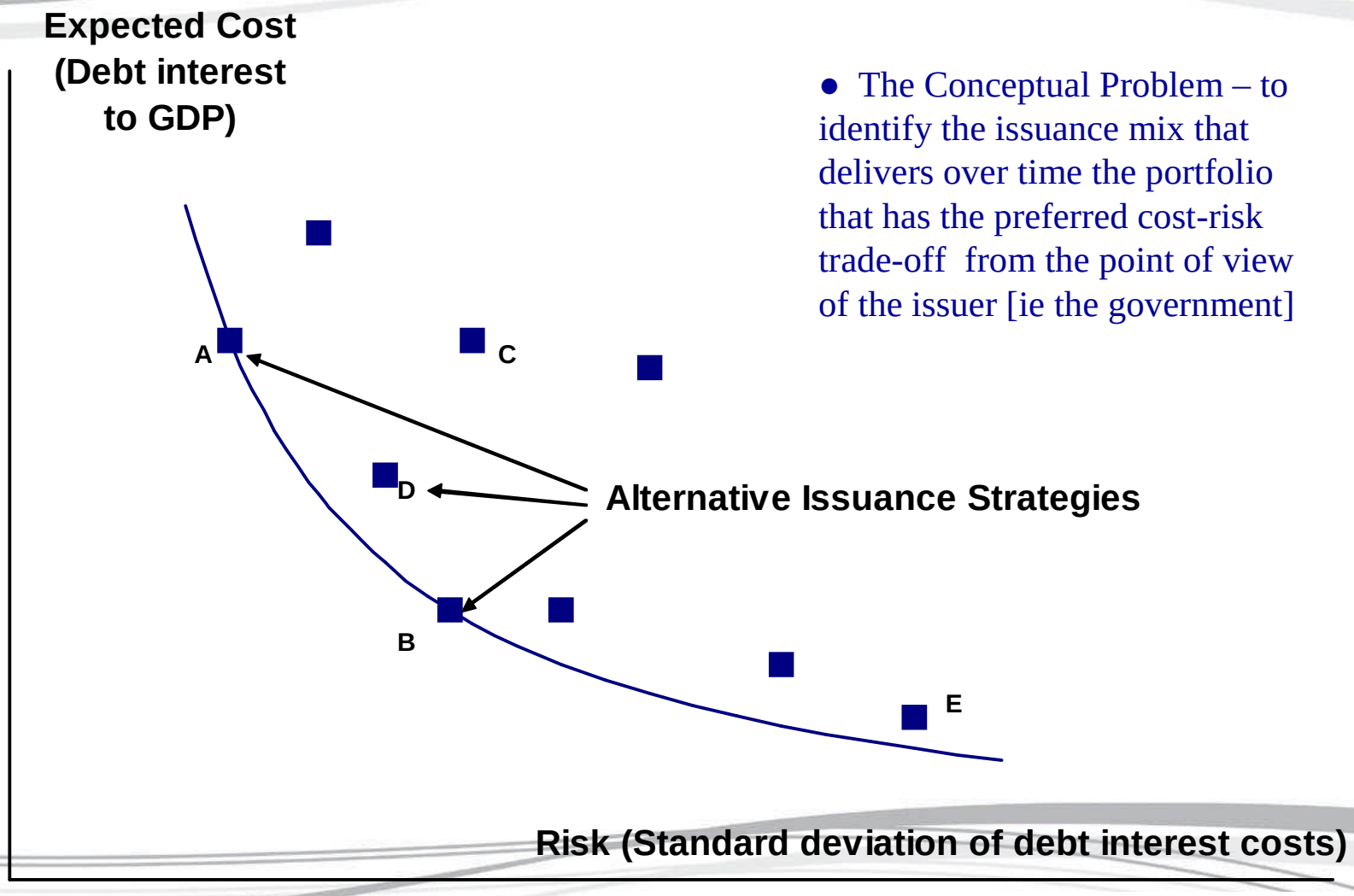
Identifying the Cost Risk Trade-Off



- The Conceptual Problem – to identify the issuance mix that delivers over time the portfolio that has the preferred cost-risk trade-off from the point of view of the issuer [ie the government]

Matching Foreign Currency Assets and Liabilities

- Examples: Canada, New Zealand, UK…..
  - Decision about which currency to finance the reserves may be taken largely on value for money grounds.
- These countries (mostly) have floating exchange rates, stable capital markets, rarely use reserves for intervention purposes and have rather stable assets.
- But currency reserves in many countries have a much wider function
  - Precautionary: linking reserves accumulation directly to vulnerability and current or capital account volatility
  - Mercantilist: central bank purchasing reserves to prevent appreciation of the exchange rate

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Role of Reserves

- Optimal size of reserves driven by analysis of the private sector's position, rather than the public sector's
  - Matching the reserves composition reflects only the risks faced by the public sector
  - Fails to take into account the uncertainty in the size of the reserves, and the type of risks that the government might face in a currency crisis.
- Complicates the debt manager's role
  - Debt managers unlikely to be able to isolate and match government foreign currency liabilities closely to foreign currency assets in the form of the reserves

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Excess Reserves and Wealth Funds

- Reserves in many countries more than necessary to satisfy prudent analysis of required cautionary balances
- Debt manager faces the same task
  - The ALM framework holds, with income flows being matched against debt service flows
    - Where reserves < government debt must still identify structure for net liabilities that provides resilience against economic shocks.
    - Where reserves > government debt, may be case to shrink the size of the national balance sheet - buy back debt
- But "excess reserves" rarely managed by debt managers
  - How should they be integrated into the ALM framework
  - What is the role of the debt office in this?

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The Role of the Debt Management Office

- Debt managers are best placed to advise on risk profile of the government's balance sheet as a whole.
  - Professional and skilled staff
  - Understanding government's objectives, attitude to risk.
  - Increasingly being given wider responsibilities
    - Treasury, asset management and other services
    - Allows governments to lever off debt managers' capabilities
- Debt managers unlikely to be directly responsible for the whole balance sheet
  - Can still get an overview of the whole balance sheet
  - Scope to influence/control other government agencies
  - Setting policies, prices and risk parameters
- DMO advice on debt structure and balance sheet may be pulled together for ministers by MoF/Treasury, together with long-term fiscal policy choices

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The Role of Central Banks

- Central bankers in text books
  - Manage the country's foreign currency reserves
  - Guard against financial catastrophe - financial instability, exchange rate collapse, banking or systemic risks
- In real world many central banks have become *de facto* asset managers
  - Central bankers may share role with specialised agencies
  - But role of the debt office as (non cash) asset managers has been modest (exception of Irish NTMA)

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The Governance Challenge

- Purpose of the central bank "funds" often unclear, and the legislative framework for objectives, governance or accountability undeveloped
- But strategic decisions - how the balance sheet should develop over time and implied cost risk traded-offs - are political not technical
  - Major implications for intergenerational equality and future taxation
- Reserves management should be integrated in ALM framework
  - Implicit in process must be scope for political authorities to make decisions on cost risk trade-offs
  - Investment objectives for reserves - liquidity, safety and return - considered in the context of strategic objectives for other parts of the government balance sheet including the debt portfolio

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Compromising Independence?

- Central banks cannot be outside all political processes
  - "Independence" is about operational autonomy
  - Enhancing the credibility of monetary policy
- But legislation applying to central banks often very general
  - Central banks have their own agenda; and it is they who interpret and elaborate their objectives
  - Reluctant to cede any power to bodies that might "compromise their position"

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Who Owns the Reserves?

- Should not matter who "owns" the reserves
  - Level and structure of the reserves, along with the level and structure of liabilities, are part of overall economic management
  - Central banks are underwritten by governments - their accounts can conceptually be consolidated with the government's
  - Double problem for governments.
    - Have no say in management but have to underwrite any losses
    - Moral hazard: even if central bank acts responsibly and cautiously, at the margin the risk/reward ratio may be distorted

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New Machinery Needed

- Coordination and accountability mechanisms must ensure
  - Differences are confronted
  - High-level policy objectives are shared
- Machinery needed to guide the relationship – policy and operational – between the debt office and central bank
  - Must give central banks
    - sufficient control over assets needed for management of liquidity, of monetary policy and of financial crises
    - confidence their operational autonomy in agreed areas will be respected
- Formulation and expression of long-term objectives can be institutionalised through a public debt committee (PDC)
  - Ministry of Finance, Debt Office, and Central Bank [maybe others]
  - Need not compromise central bank's monetary policy responsibilities
  - But government has the ultimate responsibility, including meeting the costs of a crisis

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Benefits of Separate Asset Management Agencies

- Bringing the central bank to the table does not of itself resolve the different objectives.
- Hiving off excess assets into separate agency helps to reduce tensions
  - Clear objectives and governance structures
  - Allows for sub-portfolio matching and for asset allocation decisions taken in wider balance sheet context
- Examples of Australia, New Zealand and Ireland
  - In governance terms, funds some distance from government, and expected to follow private sector best practices; but objectives clear
  - Linked to pension liabilities – ie sub portfolio matching
    - grossing up balance sheet also helps sustain domestic debt market

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Conclusion

- Must bring all assets within the scope of the ALM analysis that underpins debt management strategy.
- It is debt managers who:
  - Are responsible for ALM analysis, and advising ministers accordingly
  - Directly manage part of the financial balance sheet
  - Are best placed to ensure other parts of the public sector take decisions consistent with the strategy; and there is a common understanding of the risk-return trade-offs
- Central banks need to be integrated in this process.
  - Not aiming to jeopardise central banks' operational autonomy

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