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Appendices
1

Date

Concerning: Policy review on risk management of the national debt and key aspects of the policy for 2016-2019.

Dear Speaker,

Hereby, I present you with the policy review on Risk management of the national debt. This policy review was announced in budget chapter IX (Finance and National Debt) and addresses article 11 (financing of the national debt). The policy review concerns the framework for risk management in the financing of the national debt over the period 2012-2015.

As requested by the House in the debate on the 2014 Autumn Memorandum, I will also set out my plans for the new policy framework coming into effect on 1 January 2016. The new policy is based on the results of the review and covers a 4-year period. For these reasons this letter is necessarily limited to the key aspects of the new framework and the details will be worked out in the months to come. I will provide the House with more information on this before the end of the fiscal year.

In the policy review grateful use was made of the contributions of two external experts: J.F.P. Hers of the CPB Netherlands Bureau for Economic Policy Analysis and J. Veerman of De Nederlandsche Bank. Their jointly formulated opinion has been attached to the report as an annex.

The current policy framework

The core of the current interest rate risk framework dates back to 2008 and is based on following a benchmark. In the benchmark the national debt is financed by issuing a notional 7-year loan each day. The maturity is based on weighing up costs and risks against each other. Short-term loans are usually cheaper, but entail a greater interest rate risk. They have to be refinanced more often, as a result of which changes in the interest rate are reflected in the interest costs sooner. In reality, the benchmark portfolio based exclusively on the issue of 7-year loans cannot be achieved cost-effectively. The Dutch State issues loans on market terms in maturities ranging from 3 months to over 30 years. Interest rate swaps

are used to approach the benchmark as closely as possible by converting the interest rates into 7-year interest rates when the loan is issued.

Since the most recent review of the risk framework in 2012 it has been possible to deviate from the benchmark. This means that it is no longer necessary to swap each long-term loan back to the 7-year interest rate. The reason for this change of policy was the historically low level of interest rates combined with budgetary forecasts featuring more than average uncertainties. Making use of this option to deviate from the benchmark will result in the maturity of the portfolio being extended. This extension creates more certainty and, accordingly, reduces the budgetary risks. On the other hand, a higher rate of interest was paid for issuing a long-term loan because the 30-year interest rate is higher than the 7-year rate, for example.

In the period from 2012 to 2014 the national debt increased from € 330 billion to € 379 billion, whereas at the beginning of 2008 the figure was € 212 billion. Deviating from the benchmark has led to the average maturity of the national debt increasing from approximately 3.5 to 4.5 years between the beginning of 2012 and the end of 2014. Despite this, the fall in the interest rate has resulted in the cost of financing the national debt decreasing from € 9.6 billion in 2012 to € 8.4 billion in 2014.

Conclusions of the policy review

The policy review shows that in recent years the current risk framework has largely met the primary objective of financing the national debt at the lowest possible interest rate under an acceptable budgetary risk. The structure of the policy is in line with the international guidelines for debt managers as formulated by the IMF and the World Bank. The efficiency of the policy is demonstrated by the fact that in the period from 2012 to 2014 the combination of loan issuance and swaps resulted in virtually the same interest costs as those resulting from financing according to the benchmark. Deviating from the benchmark resulted in this being accompanied by lower interest risks in the long term. This policy has contributed to budgetary certainty because interest charges are fixed for a relatively long period of time.

It is noted in the review that the policy has been largely effective, but that a number of adverse side effects have occurred in recent years. First, the deviations from the benchmark have led to the actual debt portfolio (including swaps) departing substantially from the current benchmark. This reduces the policy's transparency and accountability. Secondly, the swap strategy used to replicate the benchmark in practice is under pressure. The scope of the swap portfolio is interfering with the consistency of the financing policy, for example. The fall in the interest rate has led to large sums of cash collateral inflows. This unpredictable inflow is a form of debt financing that displaces the regular money market instruments. The interest rate movements result in sharp peaks in the amount of cash collateral to be collected or repaid each day, which hampers the State's day-to-day cash management. The question also arises whether the current swap strategy will remain tenable in the longer term. The swap landscape is changing rapidly, not least owing to new legislation. Liquidity in the market is lower and taking out interest rate derivatives is becoming more expensive. There is also a possibility that the State will be unable to avoid furnishing collateral in the future.

Currently the State is still entering into contracts in which only the counterparty is subject to this obligation.

Response to the policy review

Although the risk framework has been largely effective, I believe that there are a number of reasons to consider making different choices in the years to come. First, developments in both costs and risks make it necessary to reassess the situation. The costs of increasing debt maturity are currently historically low. This applies both to the relative and absolute costs. The relative costs are determined by the extent to which the interest rate level increases if loans are fixed for a longer period, e.g. the difference in interest between a 5-year and a 20-year loan. The absolute costs are determined by the level of the entire yield curve. As a result of the current low costs it is now possible to fix these low interest rates for a longer period of time. At the same time today's exceptionally low interest rates are leading to an increase in the interest rate risk. The potential impact of an interest rate shock and its effect on the budget will now be greater than that accompanying the higher interest levels in the past. This effect is amplified by the increase in the national debt.

For the reasons given above I intend to further increase the maturity of the debt in the period up to the end of 2019, continuing the policy pursued since 2012. My aim is to reach a portfolio maturity within a range of 5.5 to 6.5 years in 2019 as compared to a maturity of 4.5 years at the end of 2014. I consider it desirable to extend the maturity to at least 5.5 years in order to avoid an excessive increase in the budgetary risks. An extension along these lines is in keeping with the choices made by many other countries. If the situation on the financial markets changes significantly and the interest rates rise sharply I will reconsider the risk framework on an interim basis.

In view of the composition of the current portfolio it will only be possible to make changes to the maturity of the debt gradually. For that reason since the beginning of 2015 I have been making use of additional options for extending the maturity within the current framework. Under certain conditions, swaps contracts are no longer concluded for the issue of 10-year loans, for instance. Up until the end of 2014 this departure from the benchmark was applied only to loans with a maturity of more than 10 years. The Dutch State Treasury Agency has also started to unwind long-term interest rate swaps. The effect of this on the maturity is similar to that of not concluding swaps for new long-term loans. The unwinding of long-term interest swaps will be used in the new policy framework as an instrument for further extending the portfolio maturity.

Finally, I would like to further reduce our dependence on interest rate swaps in order to address the problems outlined above. This means that interest rate swaps will no longer automatically be entered into for new loans. This will reduce the size of the swap portfolio. This does not alter the fact that swaps will remain a regularly used instrument for managing interest rate risks in the new policy framework. This is also in line with the current practice of debt managers in other countries.

To conclude

I will provide the House with more information about the content of the risk framework for 2016 - 2019 later in the fiscal year. At that time I will address aspects including how we will seek to achieve the desired extension, the relationship with the financing policy and the extent to which this will depend on the interest rate climate. Attention will also be paid to how short-term budgetary risks can be controlled and how I propose to be accountable to the House on the new risk framework. I intend to put in place clear standards in the form of an adapted benchmark or target to assess the interest rate risks. Accountability is an important criterion for this so that the results can be transparently reported to the House. A key principle underlying the next phase of the work will be consistency in the pattern of debt issuance. This promotes liquidity in the market for the Dutch sovereign debt market and thus contributes to reducing the State's financing costs.

Yours sincerely,

The Minister of Finance

J.R.V.A. Dijsselbloem