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Your letter of (reference)

Appendices

Date

Concerning: Further specification of the risk framework national debt 2016-2019

Dear Speaker,

The policy review Risk management of the national debt and the key points of the 2016-2019 policy were submitted to the House on 19 June 2015[1]. By way of this letter I am honouring the commitment to provide you with further information about the new policy framework before the end of the year.

I set out the key points of the 2016-2019 policy framework in my letter of June. The objective remains to minimise interest costs under an acceptable budgetary risk. The most important elements of the new policy framework are an extension of the maturity of the debt portfolio and a reduction of the dependence on interest rate swaps. This builds on the adopted policies in the 2012-2015 framework and is in line with developments in many other countries.

As announced in June, this letter contains a more detailed elaboration of the following aspects: the extension of the average debt maturity and the relationship with the funding policy; the method used to manage the short-term budgetary risks; the procedure for reporting to the House on the new framework and the circumstances that may lead to an interim review. I will address each of these points below.

[1] Letter to parliament "Policy review on risk management of the national debt and key aspects of the policy for 2016-2019" (Parliamentary paper 31935, No. 20).

1. Extension of the maturity of the debt portfolio

In recent years the national debt has increased and interest rates have fallen to historically low levels. For that reason I consider it sensible to extend the average debt maturity. That way relatively low interest rates can be locked in for a longer period, which will reduce the budgetary interest rate risks and contribute to budgetary stability.

The aim of this policy is to achieve an optimum average maturity for the national debt. This means a debt portfolio with the lowest possible costs at an acceptable level of risk. The starting point was to ensure that in the new framework risk does not exceed the level inherent in the current policy framework. I indicated in my letter of 19 June that the aim is to achieve an average remaining maturity of the debt portfolio by 2019 of between 5.5 and 6.5 years. By way of comparison: at the end of 2015 the average maturity of the current debt portfolio will be about 5 years. Additional analyses have been carried out in recent months with a view to making a specific proposal within this range. The financial implications of a number of interest rate scenarios have been assessed for many types of debt portfolios in order to determine the optimum long-term portfolio. Debt portfolios differ in terms of the size of the debt issued annually in different maturities. However, each portfolio is subject to the condition that it is realistic and attainable in view of the key principles of the funding strategy pursued by the Dutch State Treasury Agency (DSTA).

As pointed out above, the starting point was that risk should not exceed the level inherent in the current policy framework. 'Risk' is defined in this context as the additional interest costs in the medium term caused by an upward interest rate shock. For example, one of the interest rate scenarios that was assessed is one in which the interest rates increase by 4 percentage points in the next 4 years, up to levels that were common prior to the financial crisis.

The next step was to assess which debt portfolios have the same or a better future risk profile compared to the portfolio that would result if the current policy were continued. Of the portfolios that met this criterion, the portfolio with the lowest costs was chosen to form the basis of the target portfolio in 2019. This target portfolio has a maturity of 6.4 years in 2019, which in principle can be achieved without concluding any new swaps contracts. This is in line with the goal of reducing the dependence on swaps in the new framework.

In practice, unforeseen deviations in the maturity could occur due to fluctuations in the debt issuance resulting from changes to the budget and market conditions. This means that in practice it might not be possible to steer precisely towards the exact level of maturity. For this reason, an uncertainty margin of 0.25 years will be applied to the target maturity, both upwards and downwards.

The target portfolio for 2019 can be achieved without making any major adjustments to the issuance policy. Over the past few years the DSTA each year issued a new 10-year bond and one or more shorter bonds maturing in 3 or 5 years. In the period since 2010 the Dutch State also issued debt with long maturities (20 to 30 years), which was partly done by reopening old bonds. Debt issuance in the long segment will remain important in the years to come. However,

the Dutch State cannot issue unlimited amounts of long-term debt, as this cannot be absorbed by the market.

In recent years, the average debt maturity increased from about 3.5 years at the end of 2012 to around 5 years at the end of 2015. As explained in the policy evaluation, this increase can be attributed mainly to the issue of 30-year bonds, without engaging in any interest rate swaps contracts. Under such swap contracts the Dutch State would receive a fixed interest rate, such as the 30-year swap rate, and a variable interest rate is paid. These swaps result in a reduction in the average maturity of the debt portfolio. No longer concluding these receiver swaps for all long-term bonds extended the maturity from about 3.5 to 4.5 years between 2012 and 2014. Additionally, a start was made in 2015 with unwinding receiver swaps that were concluded in the past (most of them prior to 2012). These unwinds have also resulted in an extension the average debt maturity. I previously informed parliament about these swap unwinds in the letter accompanying the policy review and at the regular budgetary occasions such as the Budget Memorandum.

Within the current risk framework the intensive use of swaps makes it possible to separate the funding strategy (the choices of maturities in which the debt is issued) from the interest risk policy (the 7-year benchmark). This separation is largely abandoned as a result of the decision to reduce dependence on interest rate swaps. Funding choices will therefore have a major effect on the interest rate risk going forward. Although engaging in interest rate swap contracts will no longer be done automatically, in the 2016-2019 policy framework it will, however, remain a useful and standard instrument for guiding the interest rate risks towards the objectives where necessary.

2. Management of the short-term interest rate risk

The average maturity reflects the interest rate risk exposure over a longer period. A portfolio with an average maturity of 10 years has a lower interest rate risk than one with an average maturity of 5 years because it will take longer before the effects of a rise in interest rates affect the budget. A higher average maturity should also lead to a more gradual rise in interest costs for the budget in the event of an upward interest rate shock. However, choices made in the past could in practice lead to peaks in the repayment profile, leading to undesirable short-term risks.

Therefore, an additional measure will be introduced in the new framework to manage these short-term risks. This measure - the 'refixing amount' - is the amount for which the interest rate has to be refixed within the next 12 months. This amount comprises the debt to be refinanced and the net amount of interest rate swaps for which the interest rate is to be refixed within the next 12 months. The interest rate risk is measured as a percentage of the total national debt.

The refixing amount is maximised to a value that is realistic in view of the size and composition of the debt and which is in line with a target maturity of 6.4 years. At the current debt level at least two capital market loans of € 15 billion will have to be refinanced each year. Additionally, the money market consisting of bills shorter than 1 year will also have be refinanced. The target for the money market is a

level of approximately € 25 billion[2]. Taken together this represents roughly 15% of the current national debt. Cash deficits during the course of a year have to be added to this amount. Limited but positive cash deficits of around 3% of the national debt (approximately 1.5% of GDP) were used in calculations for the coming years. The maximum short term interest rate risk, the refixing amount, has therefore been set at 18% of the national debt for the years 2016-2019.

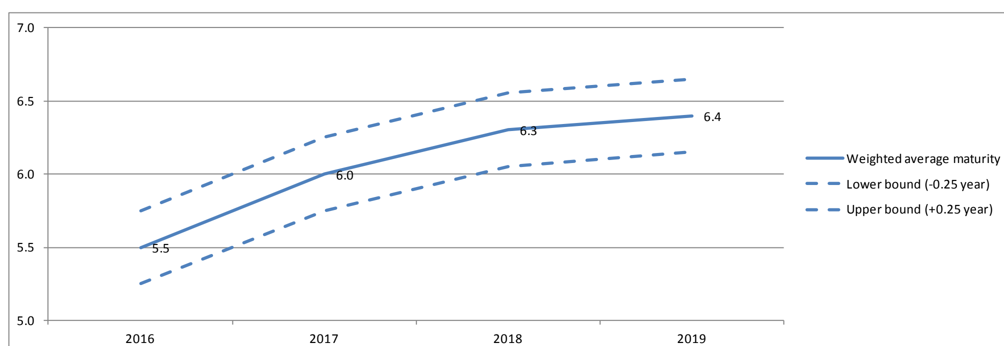
If the maximum value is exceeded due to unforeseen circumstances, this will be a reason for the DSTA to actively lower the refixing amount. Instruments that can be used for this purpose include buying back outstanding debt, a degree of flexibility in the capital market issuance and actively managing the swap portfolio.

3. Annual reporting of results

In the coming years the long and short term risk targets described above will be managed actively. This will be done subject to the precondition of minimising long-term costs. After the end of the year, as in the current framework, parliament will be informed about the results and, if relevant, any deviations from the presented framework.

The report will address the development of both risks and costs. First of all the report will cover the average maturity of the overall portfolio of bonds and swaps. The average maturity achieved will be compared to the target values that follow from a predetermined roadmap for the years 2016-2019 (figure 1). This roadmap reflects the current estimate of the course of the average maturity, taking into account that the refixing amount will remain under the set maximum value.

Figure 1: The average maturity gradually increases in the period 2016-2019



An explanation of the causes of any deviations will be provided, combined with an update of the path that is still to be followed until the end of 2019. Secondly, the development of the refixing amount will be accounted for. If relevant, special attention will be paid to the reasons for exceeding of the maximum refixing amount and which instruments have been used to guide the interest rate risks. Thirdly, the total costs of the debt portfolio, including swaps, will be reported in the usual way in the budgetary tables of the annual report. Finally, the annual interest

[2] An average value of at least € 25 billion is needed in the longer term to maintain sufficient liquidity in the money market.

costs will be reported in relation to the target roadmap. The costs of the actual debt issuance are compared in the annual report with the costs of the target portfolio. The report must show the extent to which deviations can be attributed to interest rate developments, developments in the budget and the choices made regarding the use of the various instruments.

4. *Review of the framework under substantially altered circumstances*

The letter to parliament of June leaves open the possibility to carry out an interim evaluation of the policy framework if financial market conditions change significantly. In practice, it is mainly a substantial rise in the interest rate that will prompt a review. A substantially steeper interest rate curve, implying that long-term interest rates have risen compared to the short-term rates, may also give rise to the policy framework being reviewed. After all, since interest rate developments such as these make extension more expensive, they may have implications for the weighing up of costs and risk and, accordingly, for the target maturity. Given the fact that the national debt has risen sharply since the beginning of the financial crisis, interest rate risks have risen accordingly for the budget. Extending the portfolio might still be desirable in order to mitigate the risks to the budget should interest rates go up in the years to come.

A review will be carried out if the analysed upward interest rate scenarios materialise (or become imminent). During the next few years the DSTA will monitor the desirability of a new balance between costs and risk on the basis of the interest rate developments. Important signals include, for example, the level of the long-term interest rate (a 10-year interest rate of more than 3%) and the steepness of the interest rate curve (a difference between the 10-year and the 30-year interest rate of more than 75 basis points). In practice, there might also be other contingencies that could make it necessary to subject the policy framework to an interim evaluation. I will inform parliament should such an interim evaluation prove necessary.

Yours sincerely,

The Minister of Finance

J.R.V.A. Dijsselbloem