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Concerning Submission Aanbieding beleidsdoorlichting hoofdstuk IX, artikel 11 and main features of risk management policy for the national debt as from 2020

Dear president,

With this letter, the policy review of article 11 *Financing public debt* from chapter IXA *National Debt* over the period 2016-2019 is submitted to your House.

The policy review was carried out in 2019 by the Ministry of Finance. The plan of action was sent to your House on 14 September 2018.[1] Separate supporting research was carried out by SEO Amsterdam Economics (SEO), the results of which are included in the appendix.[2] The review was assessed by independent expert *dr. ir.* Paul Wessels, head of risk management at the Dutch Central Bank (DNB). His assessment is included as an appendix in the policy review. The policy review also forms part of the Insights to Quality programme ('Operatie Inzicht in Kwaliteit'), on which I recently informed your House.[3]

The policy review relates to the full text of budget article 11. The general aim of this article reads: 'Debt financing at the lowest possible cost at acceptable risk to the budget.' In this review the effectiveness and efficiency of the policy pursued during the 2016-2019 framework is reviewed. The central research question of the policy review was therefore: "To what extent has the policy pursued contributed to debt financing at the lowest possible cost at acceptable risk to the budget?".

Conclusions SEO & assessment by independent expert
SEO observes that the policy pursued in the period 2016-2019 contributed to the aim of debt financing at the lowest possible cost at acceptable risk to the budget. This follows from the fact that the Dutch debt policy scores high on internationally recognised indicators for prudent debt management, namely consistency, transparency and liquidity. Through such prudent debt management, the uncertainty premium required by investors when purchasing Dutch debt securities is kept as low as possible. SEO also concludes that the ex-ante target values for the indicators for long and short term interest rate risk (namely the average maturity of the debt portfolio – more precisely the average time to refixing - and the 12-month refixing amount ('RRB'), respectively) were achieved. The policy

[1] Parliamentary Papers II, 2018/19, 31935, no. 50
[2] SEO, Assessment of DSTA's 2016-2019 Risk Framework and Funding Policy – Input for the DSTA's 2016-2019 evaluation, 15 March 2019.
[3] Parliamentary Papers II, 2018/19, 31865 no. 156

review supports these conclusions. The policy review also notes that the recommendations from the previous policy review of article 11 performed in 2015,[4] have been implemented.

Independent expert Paul Wessels observes that a thorough evaluation took place. His opinion contains an endorsement of the conclusions and recommendations arising from the SEO report as well as several of his own recommendations.

Reaction
The government concurs with the findings of the policy review, namely that the policy in the period 2016-2019 meets the objectives of article 11 and that the policy was effective and efficient. The policy review – including SEO's research and the assessment by the independent expert – has led to several recommendations for the financing of the public debt. The government adopts these recommendations. The follow-up of these recommendations and the main features of the policy framework for the subsequent period are described below.

Several recommendations have already been implemented while developing the new policy framework for the period from 2020 onwards. A number of other recommendations, such as improving the information about the liquidity of Dutch government bonds and reconsidering the way in which the RRB is calculated, require more time for further analysis and will be taken up in the coming period.

New policy framework
The policy framework for the years ahead will focus on further extending the average maturity of the debt and swap portfolio, from the current 6.4 years towards 8 years. Interest rate swaps will play a limited role. While taking into account the principles of the funding policy, market demand and the development of the funding need, issuing loans with a longer maturity will be prioritised in the coming years. Through this policy choice I follow up on the recommendations to consider the dependencies between the funding policy and the interest rate risk framework, while leaving sufficient room for a consistent and at the same time flexible issuance policy.

By further extending the average maturity of the debt portfolio the current low interest rates are locked in for a longer period, thereby creating greater budgetary certainty for the medium term. This is also a response to the current low (historically speaking) term premium: the difference between the cost of issuing long term debt and short term debt is relatively small. This means that it is possible to lock in interest rates for a longer period at relatively little extra cost. At the same time, extending the average maturity follows logically from the policy pursued in previous frameworks (since 2012 the average maturity of 3.5 years has been gradually extended). Furthermore, it is consistent with the policy applied by numerous debt managers from other countries, and with the advice given by many market participants to the Dutch State Treasury Agency (which is charged with the financing and management of the national debt).

As per the advice of SEO, the DSTA developed an interest rate risk model to assess costs as well as risks associated with possible strategies for issuing debt securities. *Interest costs* are estimated based on refinancing existing debt, budget balances and interest rate expectations. Budget balance projections of the Ministry of Finance are based on the economic forecasts of the CPB (Netherlands Bureau for Economic Policy Analysis). These budget balances and the refinancing

[4] Parliamentary Papers II, 2014/15 31935, no. 20

of existing debt are combined with interest rate scenarios anticipated by the market as reflected in so called *forward rates*. Interest rate risks are quantified through technical analysis by determining, on the basis of historical interest rates, potential levels to which interest rates could move in the worst 5% cases. Defining the interest costs and interest rate risks in this way, allowed me to follow up on the recommendation to make the risk appetite more explicit. The outcomes of the analyses are combined with the aforementioned intentions regarding a limited extension of the average maturity and the desire to limit the dependence on interest rate swaps.

All things considered, I have come to the conclusion that an issuance policy which results in an extension of the average maturity of the debt portfolio towards 8 years creates the right balance between costs and risk for the coming period. The extension to 8 years will take place gradually, and the maturity can fluctuate within a range of 6 to 8 years. This permits the DSTA to decide on debt issuances which meet market preferences and contribute to efficient debt financing, without having to use interest rate swaps on a large scale. This is in line with the recommendations in this policy review. The annual funding plan published by the DSTA each December, always contains an indication of the bonds to be issued. Such issuance choices are becoming more important as funding needs decline, as we have seen in recent years. Current projections also predict a relatively low funding need for the years ahead.

Based on current insights, the short term interest rate risk – measured by the 12-month refixing amount (RRB) – is expected to exceed the current ceiling of 18% of the national debt in the coming years. The RRB represents the part of the national debt for which the interest rate must be refixed within the next 12 months. The rise in the RRB follows from the composition of the existing interest rate swap portfolio: part of the interest rate swaps is set to expire in the years ahead, resulting in relatively more short term (variable) interest that has to be paid on the swap portfolio (thereby creating more short term interest rate risk). This development is of a temporary nature and the RRB will decline again in due course, when many interest rate swaps on which variable interest is paid expire.

For the new policy framework an RRB limit is set at 30% of the national debt. In principle this means that interest rate movements (both negative and positive) could have a greater impact on public finances than under the previous policy framework in which the RRB limit was 18%. At this moment however the national debt is lower than four years ago when the previous policy framework was designed, leading to a greater capacity to bear such risk. The RRB can therefore be limited to a value which is higher than in the previous policy framework. I also consider this risk to be acceptable, because market expectations are that interest rates will remain relatively low in the years ahead, which would have a favourable effect on the value of the swap portfolio. Another important nuance with respect to the higher RRB is that the interest charges and revenues on the swap portfolio are not relevant to the budget balance ('niet-saldorelevant') and therefore, in contrast to the interest charges on debt issuance, not affected by the expenditure ceiling set by government ('uitgavenplafond'). Since the rise of the RRB is primarily a consequence of developments in the swap portfolio, the risk of setbacks for the budget balance (in case of an interest rate rise) will not increase. Any setback or windfall on the swap portfolio will however affect the level of the EMU-debt.

The new policy framework will be introduced for the coming six years (2020 to 2025). In 2026 the framework will be evaluated in its entirety by means of a policy review of article 11 as a whole. Due to previously positive experiences with regard to outsourcing research questions to an external party, it is the intention to also (partly) outsource the future policy review to an independent party. Furthermore, the DSTA will carry out an internal evaluation at least once every two years. This will give the opportunity to respond more quickly and flexibly by means of policy decisions to market developments (with respect to interest rates, ECB policy and liquidity for example) and to reflect economic and budgetary developments and prospects more quickly in the policy framework for the financing of the national debt. This allows for the continuous assessment of the need for adjustments of the policy framework on the basis of current circumstances, without having to define an exact response function in advance. This also creates sufficient flexibility, the importance of which is emphasised in this policy review.

The government is of the view that this proposal for the future framework implements (or will implement) the findings of the policy review, while incorporating sufficient flexibility to allow for future market and national debt developments to be taken into account.

Yours sincerely,

The Minister of Finance,

W.B. Hoekstra