Policy review chapter IX article 11 – Financing national debt

Management Summary

In this policy review the full text of Article 11 – 'Financing national debt' – of budget chapter IX is reviewed for the policy period 2016-2019. The effectiveness and efficiency of the policy conducted in the period 2016-2019 has been investigated and the 15 questions from the Periodic Evaluation Regulations (*Regeling Periodiek Evaluatieonderzoek*) have been answered.

The previous policy review from 2015[1] concluded that the policy framework over the period 2012-2015 was effective and efficient and contained five recommendations for the policy framework 2016-2019:

- Define clear risk and cost criteria against which the total debt portfolio can be assessed (including maturity extensions), on the basis of which the results vis-à-vis those criteria can be clearly reported and that can be used as a basis to steer policy.
- Reduce the scale at which interest rate swaps are used in view of the adverse side effects.
- Analyse the extent to which extending the maturity of the portfolio is desirable considering the historically low interest rate and flat yield curve.
- Carry out additional research into whether and to what extent greater flexibility on the capital market is desirable and possible, without compromising on predictability.
- Carry out an interim evaluation of the new policy framework regarding debt financing, in particular with respect to the ability to respond to changing circumstances.

The general objective of Article 11 reads: 'Debt financing at the lowest possible interest cost under acceptable risk to the budget'. Efficiency is thereby part of the policy article. The central research question of the policy review was: "To what extent has the policy pursued contributed to debt financing at the lowest possible cost at acceptable risk to the budget?". Part of the research for this policy review was carried out by SEO Amsterdam Economics (*SEO Economisch Onderzoek*)[2], which was supplemented by analyses of the DSTA (Dutch State Treasury Agency).

The DSTA finances the Dutch national debt by issuing debt securities on the capital market (Dutch State Loans - DSLs) and on the money market (treasury bills - DTCs). On the money market the DSTA also uses Commercial Paper and deposits. The DSTA can place surplus funds on a deposit account at the central bank (DNB), subject to conditions. For trading, distribution and promotion of Dutch debt securities, DSTA annually appoints a number of financial institutions as Primary Dealers (PDs). PDs receive a fee for their services, depending on their performance. Every year in December, the DSTA announces in its 'Outlook' the estimated funding need of the Dutch state for the following year, including its funding plan and issuance calendar.

There are several risks involved in financing the national debt, such as interest rate risk, currency risk, (re)financing risk, liquidity risk, credit risk, settlement risk and operational risk. These risks are managed and mitigated in various ways, for example by setting credit rating requirements for counterparties, applying limits to the amounts placed with counterparties, only lending out funds for very short periods, requiring collateral to be posted or using currency swaps. The funding policy aims to manage the (re)financing risk and the liquidity risk; the interest rate risk is managed by the interest

[1] *Parliamentary Papers II*, 2014/15, 31935, no. 20.
[2] Assessment of DSTA's 2016-2019 Risk Framework and Funding Policy – Input for the DSTA's 2016-2019 evaluation, 15 March 2019, SEO

rate risk framework. The funding policy and the interest rate risk framework are the two most important pillars of the risk policy for the national debt.

The funding policy consists of all the rules and preconditions applied by the DSTA to the use of financial instruments for funding the national debt. Three qualitative core values, based on international guidelines of the IMF and the Wold Bank,[3] are central in this regard: transparency, consistency and liquidity. The underlying idea is that by being predictable and reliable, any uncertainty premiums the DSTA may have to pay when issuing loans will be kept to a minimum. And when debt securities are liquid (tradable), this reduces the risk for investors of not being able to sell the securities, or only under unfavourable conditions, should they wish to do so. This also contributes to lower funding costs.

The interest rate risk framework consists of two quantitative indicators: the average maturity – or more precisely the average time to refixing – of the portfolio and the 12-month refixing amount (*RA*). The average maturity is an indicator for long term risk and related interest costs. In principle a trade-off exists between interest costs and risk: the longer the period during which the interest on a loan remains fixed, the smaller the risk that the budget is affected by interest rate fluctuations, but the higher the interest costs are on that loan. The RA tells us something about the interest rate risk in the short term: it represents the percentage of the total debt for which the interest rate must be refixed in the upcoming 12 months (and for which there is a risk that a higher interest rate will apply).

Following the recommendations of the 2015 policy review and based on various scenario analyses at the end of 2015, the DSTA decided - given the circumstances at the time such as the historically low interest rates - to gradually extend the average maturity of the portfolio to 6.4 years at the end of 2019 (within a margin of +/- 0.25 years) and that the RA could amount to a maximum of 18% of the national debt. The choice for these indicators was based on the implicit hypothesis that by steering on the basis of these two variables, an efficient portfolio would be achieved, that being a portfolio with the lowest possible costs at a risk to the budget which is equal to or lower than the risk in the previous policy period.

In its research, SEO observed that during the period 2016-2019 the DSTA implemented its funding policy in accordance with aforementioned international guidelines for debt management, by focussing on transparency, consistency and liquidity. According to SEO, the Netherlands scores high on consistency and transparency compared to a number of other European countries[4]. SEO also concludes that the liquidity of the Dutch debt securities is well-maintained by the DSTA. The DSTA introduced a little more flexibility in its funding policy during this period, among others by applying a range instead of an exact target volume when announcing the borrowing amounts. According to SEO, this flexibility has not led to higher funding costs. Due to a declining funding need in this policy period (in particular as a result of budget surpluses) the DSTA lowered the target size of its 10-year bond issued annually, from €15 billion to €12 billion. SEO found, on the basis of quantitative research, that this led to a rise of 0.4 basis points (bp) in the so-called *bid-ask* spread; this slightly higher difference between the bid and ask can be a sign of reduced liquidity. However, the Primary Dealers observed hardly any effects, if at all, on the liquidity in the capital market and also consider the liquidity of DTCs to be sufficient.

With regard to the development of the interest rate risk framework, SEO observed that the method used by the DSTA to analyse various scenarios at the end of 2015 for the purpose of defining the indicators, was relatively simple and could be improved upon. At the same time, the calculations performed by SEO using a more refined method led to outcomes which were very close to the

[3] "Revised guidelines for public debt management", https://www.imf.org/en/Publications/Manuals-Guides/Issues/2016/12/31/Revised-Guidelines-for-Public-Debt-Management-42600

[4] Belgium, Germany, France, Italy, Portugal and Spain.

outcomes of the calculations by the DSTA. SEO also concludes that the risk appetite of the DSTA for the period 2016-2019 is in fact still equal to or lower than its risk appetite in 2002, when it was last made explicit. Since then, the starting point has always been that the risk for a new policy period should not be higher than the risk in the preceding period.

During the period 2016-2019, the DSTA has met its targets for the risk indicators RA and average maturity.

Overall, SEO concludes – based on the information available at the end of 2015 – that the risk indicators chosen by the DSTA for the period 2016-2019 did in fact lead to a portfolio with low funding costs and a risk no higher than the risk at the end of 2015. To put it another way, at that time it would have only been possible to achieve lower funding costs by accepting higher risks. Considering the risk appetite for the period 2016-2019, the objective of Article 11: funding the national debt at the lowest possible cost under acceptable risk to the budget, has thereby been met.

The DSTA uses interest rate swaps on the capital market to convert a fixed interest rate to a variable interest rate (*receiver swap)* or vice versa (*payer swap*). During the period 2016-2019 the DSTA reduced its dependency on interest rate swaps, in particular by no longer 'swapping back' the maturity of long term loans to the 7-year rate, by not entering into new swap agreements on the capital market and by terminating receiver swaps early. As a result, the swap portfolio has substantially reduced in size. The early termination of receiver swaps greatly contributed to meeting the objectives for average maturity and *RA*.

It follows from this policy review that the DSTA met the aim of Article 11 in the period 2016-2019 and that the policy was effective and efficient. The five recommendations from the policy review 2015 have been carried out.

This policy review contains the following recommendations for the new policy framework for the period starting in 2020:

- Explicitly decide on and outline the (maximum) risk appetite of the government with regard to debt management and choose a risk indicator that measures that risk appetite.
    - In doing so, use a stochastic model to analyse ex ante various portfolios under certain interest rate and funding need scenarios, in order to assess the (weighted) impact of shocks.
    - Use scenarios that are consistent with the scenarios used by public bodies and market participants to predict economic and budgetary developments.
    - Conduct scenario analyses for the development of the risk indicators, also in the longer term.
    - Consider whether the way in which the RA as a risk indicator is calculated could be made clearer and more robust.
- Consider the dependency between the interest rate risk framework and the funding policy.
- Keep transparency and consistency at the current high levels, by continuing to inform both the market and the public in the present manner. At the same time, leave room for flexibility in the funding policy. Set priorities as to which government bonds should or should not be issued in the event of a declining funding need.
- Consider monitoring the liquidity of Dutch debt securities on a more continuous basis by referring to various different indicators.
- Remain conscious of becoming too dependent on interest rate swaps. At the same time, continue to regard swaps as a valid instrument for steering interest rate risks, if adjustments through debt issuance only is not considered desirable, for example for liquidity and/or

consistency reasons. When applying swaps, try to implement the swap strategy in the most efficient way possible, for example by:

- formulating an explicit benchmark against which the performance of the swap transactions can be measured;
- assessing whether it is preferable, from a cost/risk perspective, to enter into new swap agreements or terminate existing ones and – in the event that new swaps are entered into – whether a central counterparty (CCP) or a bilateral agreement with a counterparty is to be preferred.

The policy framework 2016-2019 stated that the policy would be evaluated in the interim if changing market circumstances would provide reason for doing so. Alternatively, it could be considered to determine immediately at the start of the new policy framework, that such an interim evaluation is to take place.