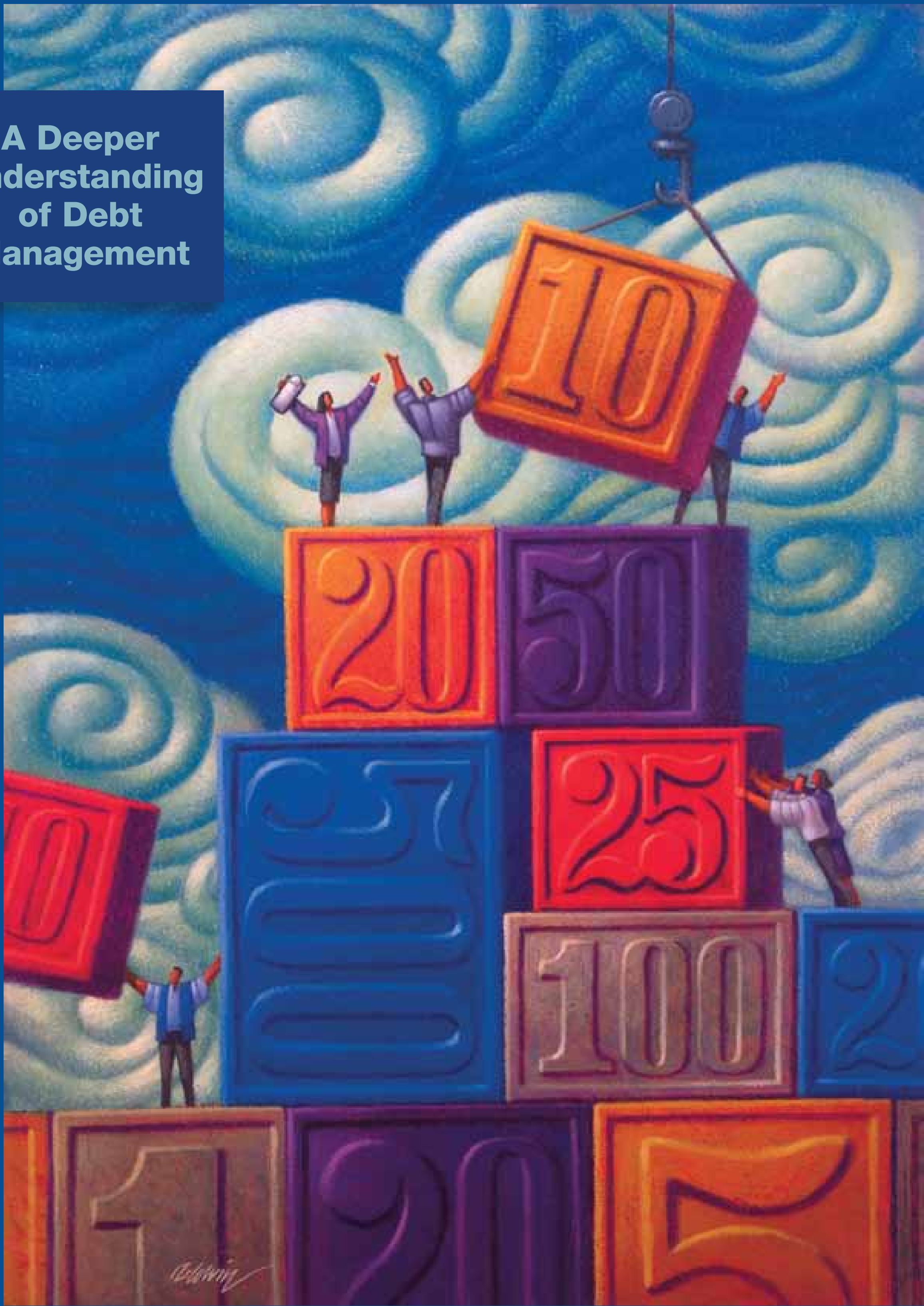
A Deeper Understanding of Debt Management



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In the narrowest sense, the concept of debt management as used by public finance professionals covers the financial and regulatory obligations imposed on debt issuers by agreements and laws. But this definition does not incorporate the full scope of tasks and duties associated with managing a public debt portfolio. A broader understanding of debt management, one that accounts for the interplay between organizational, economic, and political forces, would help issuers by increasing the likelihood that they will identify the risks associated with managing their debt portfolio — and in doing so, they are more likely to develop strategies to eliminate or mitigate that risk, and to be better able to plan and manage their obligations.

WHY DEBT MANAGEMENT IS IMPORTANT

Government debt portfolios are complex, involving different commitments, securities, and risks. Failing to adopt and maintain adequate debt management practices leaves issuers exposed. Points of weakness include:

- **Subjecting the Agency to Increased Structural Risk.** Issuers should avoid even minor levels of risk in their debt portfolios. Unfortunately, some do not. In an effort to lower costs, some issuers may rely too heavily on short-term debt and expose themselves to interest rate risk as a result. Others may take on forms of debt that include terms (e.g., acceleration provisions) that may affect their ability to meet other outstanding obligations.
- **Incomplete Understanding of Debt Burden.** Debt limits are either set by statute or policy. Neither reflects the issuer's capacity to generate the required revenues to repay the debt, and they do not necessarily take the perspective of the taxpayer into account in considering the impact of overlapping debt.
- **Planning Processes Do Not Tie Together.** Public agencies often do not undertake the effort to develop and administer plans that can be used to guide financing decisions or achieve policies and goals. That means they do not use the outcomes of their strategic plan, capital plan, or long-term financial plan to guide debt financing decisions.
- **Inadequate Data to Manage Long-Term Financial Risks.** Issuers focus their attention on the debt schedule and repayment, but they may not collect or have the technological capacity to manage other data points (e.g., refundings, swap and arbitrage calculations, or term bonds) on their financial position.
- **Inadequate Data to Understand the Benefits of Debt Financing.** Post-issuance data collection, particularly with regard to the use of proceeds, is seldom a consideration for issuers. As a result, neither the issuer nor the taxpayer understands the full cost or benefit of issuing debt. Issuers are also susceptible to the misuse of bond funds and the long-term legal and financial impacts of resolving such problems.

> Government finance officers would benefit from a broader interpretation of debt management.

THE OBJECTIVES OF A FULL-SCOPE DEBT MANAGEMENT SYSTEM

It is generally assumed that a debt management system will provide the resources necessary to allow a public agency to finance its borrowing needs efficiently and to ensure that its financial and legal obligations are met. But if the debt management system is only tracking debt payments and disclosures, it may not be doing enough. In contrast, a full-scope debt management system can:

- Ensure that its debt portfolio is managed according to its cost and risk goals.
- Maintain liquidity and minimum levels of cash reserves to attend to program and debt service obligations.
- Manage financing strategies to use available financing authority efficiently.
- Meet compliance and reporting obligations.
- Establish best practices that achieve the agency's policy and program objectives.
- Build a common interface that establishes a single book of record for financial and program information and provides easy access to this information to taxpayers and investors.
- Eliminate redundant data management systems or needless rework by integrating accounting, disbursement, budgeting, and financial reporting in one system.

- Reduce reliance on external data providers or consultants by allowing the agency to own its own data.

If adopted, a full-scope debt management system offers a strategy for prudently managing the agency's debt in order to meet its financing needs, its cost and risk objectives, and provide disclosure, compliance reporting, and performance and financial management reporting. It must, by necessity, cover all the agency's liabilities, including direct or privately placed debt, conduit debt, and debt guaranteed or backed by the agency.

Refundings and short-term cash financing may not significantly increase the size of the agency's debt portfolio over time, but capital financing will.

Writing for the World Bank, Abha Prasad and Malvina Pollock assess the status of debt management practices and performances among developing countries. Their report, *Measuring Performance in Debt Management: Key Findings from the Debt Management Performance Assessment (DeMPA)*, employs 15 indicators to determine the performance of individual country debt management practices.[1] They define debt management as "a multifaceted process that encompasses the governance and managerial framework, institutional and staff capacity, coordination with macroeconomic policies (fiscal and monetary), the policies and procedures for borrowing from external, domestic sources and the issuance of loan guarantees, cash management, the management of operational risk and the availability of systems for debt data storage, compilation, analysis and reporting." While some of the indicators used in their study are not applicable to non-sovereign governments, they do provide an expanded view of debt management that better reflects the obligations debt issuers.

Using the work of Prasad and Pollock, it is possible to identify the elements of a full-scope debt management system. It should include the agency's:

- **Legal Framework.** This sets forth the legal authority for the agency to borrow funds and the types of instruments it may use, including municipal securities, loans, guarantees, and positions it may take in securing obligations of other borrowers.
- **Managerial Structure.** This guarantees the separation of power between those who set policies and strategies regarding the use of debt and those who implement them. The planning processes undertaken by the agency provide a clear understanding of the link between the two sides of this equation.
- **Debt Management Strategy.** A debt management strategy that is based on the agency's longer-term financial plan and policies related to the use of debt helps to minimize the cost and fiscal impact of debt on the agency. A debt management strategy is based on (a) the composition of the debt portfolio; (b) benchmarking; and (c) assessment of new financing instruments.
- **Evaluation of Debt Management Operations.** The agency must be able to gather data on its debt management operations and its performance against short- and long-term objectives contained in the debt-management strategy.
- **Audit.** Regular internal and annual external audits help establish accountability and identify opportunities to improve practices with regard to (a) reliability and integrity of financial and operational information; (b) effectiveness and efficiency of debt management operations; (c) safeguarding of public funds; (d) compliance with laws, regulations, and contracts; and (e) the agency's adherence to its debt management strategy.
- **Off-Balance Sheet Borrowing.** Some direct loans, leases, and guarantees free agencies from the legal and regulatory obligations imposed on municipal securities and are a recognized source of capital financing. But these transactions may impose conditions or risk that the agency has not fully considered or considered in relation to its publicly traded debt securities. A debt management system must be able to incorporate the financial, regulatory, and administrative responsibilities of these structures into the agency's financial and operational systems.
- **Conduit Issues and Derivatives.** Relationships with conduit borrowers and counterparties present both financial and reputational risk to issuers if they fail to meet the terms of agreements. As a result, agencies should continue to closely watch them both to make adjustments

to potential risks and to make the requisite disclosures.

- **Cash Flow Forecasting.** To ensure that the agency is always in a position to meet it financial commitments and to maintain its programs and services, it must be able to forecast cash flows. The ability to analyze its cash position will also allow the agency to manage its financial resources in a way that provides for the lowest cost of financing.
- **Debt Administration, Separation of Duties, and Staff Development.** Administering a debt portfolio involves processing and recording debt transactions as well as developing and maintaining the systems and procedures required to carry this out in an effective and secure way. There should be strong controls and well-documented procedures for settling transactions, maintaining financial records, and accessing debt management system.
- **Business Continuity and Data Security.** The agency should undertake a comprehensive assessment of these operational risks and develop mitigations and protocols to ensure business continuity and data security.
- **Debt Records.** The agency should maintain and make available all public documents associated with debt transactions, including the offering documents, indentures, lease agreements, security arrangements, financial analyses, and ratings reports.
- **Debt Reporting.** The agency should provide full disclosure of the balance of the outstanding obligation and the uses of proceeds. Accountability builds trust among those the agency serves.

> Although good debt management practices may not, in and of themselves, lead to lower financing costs, they can contribute. But if an issuer's debt management practices are poorly designed, they may generate negative assessments from creditors, analysts, and regulators.

TAKING STEPS TO IMPROVE DEBT MANAGEMENT PRACTICES AMONG PUBLIC AGENCIES

In essence, a full-scope debt management program involves:

- Establishing clear debt management objectives and supporting them with the appropriate governance structure.
- Building a prudent cost and risk management strategy.
- Coordinating this strategy with other policies, including the agency's strategic vision, capital improvement plan, and long-term financial plan.
- Issuing debt that is appropriate, given the strategic objectives of the agency.
- Monitoring and administering cash flows and balances.
- Undertaking financial and administrative risk assessment and implementing risk-reducing mitigation.
- Creating a document library and providing timely and complete reporting.
- Implementing best practices that ensure that debt managers are accountable for carrying out their duties in a transparent and responsible manner.

Public agencies may perform all of these functions, to one degree or another. What most lack, however, is an integrated approach that can result in lower costs, less risk, and improved compliance.

What do public agencies need to do to get there?

First, issuers need to acknowledge that the common understanding of debt management fails to include several essential functions, and it does not encourage the necessary elements of integration, coordination, and administration. This leaves issuers at risk of mismanaging their debt programs or failing to achieve their program goals.

Second, issuers need to avail themselves of technologies that offer an integrated approach to data management, recordkeeping, reporting, and the sale and administration of debt obligations. This means moving from spreadsheets and paper files to an electronic platform. Using a single technological solution will provide transparency and enable the issuer to adopt a set of best practices that ensures standardization and data reliability. It also provides for business continuity and data security that paper files do not offer.

The aim of debt management is to ensure that the agency's borrowing needs are met efficiently and that its debt, and the short- and long-term obligations arising from budget and off-budget debt, are managed in a manner consistent with the government's cost and risk preferences.

Third, issuers need to adopt new practices and train staff to manage additional duties and operate in an integrated, strategic environment. Issuers should also increase their efforts to provide taxpayers information on their debt programs and provide reliable data on the cost and benefits of debt financings. In the long run, issuers will benefit from an educated taxpayer base that understands the objectives and strategic advantages of debt financing. A robust debt management program supported by technologies that provide access, standardization, and analysis is essential to providing this education.

Note

1. Abha Prasad and Malvina Pollock, Measuring Performance in Debt Management: Key Findings from the Debt Management Performance Assessment (DePMA), World Bank.

GFOA Best Practices Help with Debt Management

GFOA offers a number of best practices to help you with different aspect of debt management. Following are some of best practices you might find most useful; all are available at gfoa.org.

- *Debt Management Policies*
- *Maintaining an Investor Relations Program*
- *Understanding Your Continuing Disclosure Responsibilities*
- *Using Technology for Disclosure*
- *Primary Market Disclosure*
- *Refunding Municipal Bonds*
- *Investment of Bond Proceeds*
- *Post-Issuance Policies and Procedures*
- *Debt Service Payment Procedures*
- *Cash Flow Analysis*
- *Use of Cash Flow Forecasts in Treasury Operations*
- *Establishing a Policy for Repurchase Agreements*

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This article is adapted from a California Debt and Advisory Commission paper, CDIAC No. 18-06, "Towards A New Understanding of Debt Management: Adopting Practices and Technologies That Meet The Expanding Obligations of Debt Issuers."