The state debt law

Q 1-02. What key policy objectives should a state debt law satisfy?

The state debt laws should:

- Provide that the responsibility for public debt management be placed in a single agency or office, preferably the ministry of finance, or its equivalent.

- Grant to the designated Ministry, agency, or office plenary authority to conduct conventional or recurring Government borrowing without prior legislative clearance, including any borrowing authorized in the annual budget law.

- Require the accounting of all outstanding public debt for which the state has incurred the liability for payment, including contingent liabilities, i.e., any debt issuances or guarantees made by all other state entities the payment of which could become a state responsibility.

- Establish a system of records for the nation's public debt, including guarantees, that shall be continuously updated and be open for public inspection.

- Authorize the entity responsible for public debt management to promulgate such regulations and rules as may be required to implement the foregoing authorizations.

Q 1-02.01. What are the core contents of a state debt law?

The law should definitively set out the nature of sovereign instruments or securities as the absolute and unconditional obligation of the state.

In creating an organization empowered as necessary, the law should establish the basis for public debt management.

Although the law should address critical technical questions related to issuance, it should refrain from being so specific that needed market flexibility is hampered. For example, the law should be non-currency specific since even domestic debt may be a matter of currency choice.

Finally, the law must be seen in its full context; it should be in conformity with other financial laws and its definitions should match international standards.

Defining state debt

Q 1-02.02. What constitutes the universe of sovereign debt?

Sovereign debt is comprised of securities for which the state is the issuer or obligor; loans where the state is the borrower; and guarantees of state liability for obligations that are primarily those of other parties. The debt law of the state should address these matters. The state debt law's key elements should cover securities, loans, and guarantees as they relate to state credit.

Q 1-02.03. Is sovereign debt different from the debt issued by other bodies of the national government?

Yes. The sovereign debt that is *issued* by the State, customarily in the form of bonds, notes, or bills, is distinguished by the fact that terms and conditions of the borrowing represented by the securities are contractual obligations of the national government. The securities could be either domestic or external debt, and may be available to investors everywhere. Unlike the debt of other government bodies, the primary obligation to pay interest and to repay principal is considered risk-free, as the government has ultimately the power to guarantee its commitment through taxation and printing money.

The debt of other government bodies is generally the responsibility of the entities that issued the debt, unless such debt has been guaranteed by the State under appropriate legislation. The primary obligors, however, are the bodies in whose name the securities were issued.

International financial history has shown that, from to time, countries have been unable to meet the promises of payment they have made in the obligations they have issued. (The same has been true of sub-sovereign issuers as well.) Where such situations have arisen, various measures have been used to modify the terms of the original borrowing, e.g., compulsory rescheduling of repayments, interest rate reductions, and, in some cases, even repudiation.

The doctrine of sovereign immunity makes it difficult, if not impossible, to compel bankrupt governments to meet their contractual obligations. No government elects to repudiate its debt except under extreme circumstances. The deterrents are a loss of national credibility and status, the endangering of its sovereign debt rating, and future difficulties in borrowing.

There is an ongoing assessment made by credit agencies and by the international financial community about the stability and credit-worthiness of virtually all countries. The riskier the sovereign debt becomes, the higher is the cost of borrowing.

Defining the nature of the obligation

Q 1-02.04. What is the pledge and promise the sovereign makes in issuing debt?

The debt law should declare the absolute and unconditional obligation of the sovereign government to pay all interest and principal due on its debt. To this end, the law should make it possible for the state to utilize fully its taxing and revenue authority to satisfy these debt claims.[1] It may also be advisable for the debt law to create a permanent and indefinite appropriation for this purpose. Such an appropriation would serve to isolate the debt from the risks of the annual budget process.

Although it would be unusual, there also may be debt laws that identify additional collateral that could be pledged to support the payment of sovereign debt. In addition, the commitment could be further strengthened by a negative-pledge clause.[2]

Q 1-02.05. Should the state make any commitment as to the source from which interest and principal will be paid?

As a corollary to pledging the nation's full faith and credit to the payment of the interest and principal on its securities, the governing law may specify that its sovereign debt enjoys a first claim on the Government's general account, and provide that there shall be no claims senior thereto. In order to avoid confusion, the law should provide that all public debt obligations have the same parity, including those issued before the enactment of the debt law.

It may be consistent with these provisions for the law also to authorize payment for costs incurred in debt issuance and refinancing including debt distribution and service costs.

Risk mitigation

[1] In the United States, the "full faith and credit" (NB. This is not to be confused with the sense it is used in the Constitution in referring to the relationship among states) of the state is pledged to meet the terms and conditions of government securities. It is possible, however, that where the political culture of a country has not distinguished and elevated sovereign debt from other financing, and where the focus has been on marketing and trading, the special nature of sovereign debt may not be apparent.

[2] In an unsecured debt contract, such a clause prevents borrowers from offering collateral to subsequent lenders. This protects the first lender from a situation in which the creditor is impaired as the borrower gives secondary creditors priority access to assets that might be used to satisfy the debt.

Q 1-02.06. How should the issue of a debt limitation be addressed?

It is prudent to specify the limits on sovereign debt issuance and their implementation. There are several benchmarks used by various countries that may be employed to establish a limit. Often, the debt issuance is tied to the annual budget; the budgetary deficit limits the annual increase in debt outstanding. Other states have stated annual limits on total debt increases, limits on net annual aggregates, limits tied to GDP growth or level, or absolute aggregate limits, such as the United States' debt ceiling. Nominal limits will entail a decision to use par values or discount values when applicable. The state will also have to determine whether the limit will apply at all points in time or only at the end of specified accounting periods.

Q 1-02.07. What debt limit concerns arise when a state borrows on the international market?

When a state issues debt both externally and internally, it may be advisable to use separate limits for each type of debt.

A range of issues must be addressed if sovereign debt includes both external and internal debt.[3] These elements, however, are more germane to risk management considerations and need not be an integral part of the state debt law except for the option to specify that a different authorization process, e.g., a super parliamentary approval requirement, may be used to authorize external debt.

Q 1-02.08. What technical concerns may be cited in the state debt law with external borrowing?

When a state includes external borrowing among the actions authorized in its state debt law, it will need to address the method of calculating the total of the external debt that is denominated in a foreign currency. The means of converting foreign currencies into domestic values must be specified by the state debt law and may involve decisions about currency choices, exchange rates, and currency risks.

Organization responsible for debt issuance management

Q 1-02.09. Where should one place responsibility for debt issuance?

The state debt law should provide to the ministry of finance the authority for debt issuance and management, including the prerogative to establish a suitable, subsidiary organization for managing and administering the responsibility. If the organization that is charged with debt issuance and management is established

[3] Cf. the Debt Management sections.

outside of the ministry of finance, it should report to the ministry of finance or equivalent body.

The law should grant the ministry of finance and the organization it creates the authority to issue debt and should specify clear lines of authority within the Government for that purpose. Government should have an explicit and well-defined authority to borrow, with such authority to be contained in either the constitution or legislation. The actions of this debt management facility should be taken as fully authorized and final in that they constitute valid, legal binding obligations of the Government. Further, the organization to which borrowing authority is delegated should enjoy this responsibility exclusively as the only borrowing agent of the Government. No other ministries or governmental organizations shall have this authority. No other financial obligations should have status comparable to sovereign debt issued by this facility.

Q 1-02.10. What oversight might the legislature exercise over state borrowing?

The debt organization's actions, of course, may be subject to certain approvals. It is reasonable for the legislative body through the budget process to have a role in guiding the use of public credit.

A concern for flexibility and practicality will argue against explicit legislative approval for every issuance. This would become an encumbrance on the machinery of the state and could subject the government's fiscal flows to political considerations. It is reasonable, however, to require periodic reports from the debt office detailing its operations or for this organization to be subject to audit.

Q 1-02.11. What classes of securities are customarily issued as sovereign debt?

The enabling legislation should not be overly prescriptive in the nature of the securities to be offered.

The debt office and the ministry of finance should be allowed to employ a diversity of securities to enrich the tool set available for debt management and to meet changing market conditions. The authority to issue debt in a wide variety of forms should not be proscribed *a priori* regarding physical or book-entry securities, tenors and maturities, discount (zero coupon) or coupon securities, and nominal or indexed and linked securities.

National debt ledger

Q 1-02.12. As the balance sheet on the national debt is always in flux, how should records be maintained to assure maximum transparency?

The state debt law should establish responsibility for the maintenance and publication of an auditable national debt ledger. One data source should be authorized as the official record of public debt outstanding. The organization tasked with maintenance of the debt ledger should be responsible for carrying out all recordkeeping and reporting requirements consistent with public transparency of debt operations. Further, the entity should be empowered with authority to promulgate such regulations, as needed, to perform its duties.

Fiscal agent

Q 1-02.13. What is the role of the Central Bank in debt management?

Although historic practices are likely to be country-specific, in general, it is preferable to have the central bank designated as the fiscal agent for the state, as principal. That relationship should be elaborated in a fiscal agency agreement, usually between the central bank and the ministry of finance, acting on behalf of the state. Such an agreement will specify support services for debt issuance, such as managing auctions or selecting primary dealers, and market activities that the bank will undertake. As agent, the central bank acts on the instructions of the principal; it should have no independent authority over sovereign debt management. It is likely, however, that it will have a consultative role. An agent acts on the instruction of principal; its status as fiscal agent does not permit the central bank to abrogate the ministry of finance's primary authority for sovereign debt management.

Dispute resolution

Q 1-02.14. What optional terms may be used for handling disputes?

The state debt law need not anticipate default on the debt to be issued. It may be necessary, however, in some circumstances to allow the debt issue to offer a collective action clause as a means of comforting creditors. These terms have been used as a means of overcoming the situation in which a minority creditor extracts additional value by blocking the resolution of a troubled issue and frustrating the wishes of the majority of creditors until his demands are met. While collective action clauses may provide assurance to creditors, it is also possible that their appearance in a prospectus or an offering circular, would inevitably suggest the possibility that the obligation being issued has more risks than is readily apparent. In that case, it could marginally affect the borrowing costs.

There is a further issue of applicable law; sovereign debt offices could differ about their willingness to accede to the law of some other jurisdiction in adjudicating ownership rights and interests of their national securities. Legislatures could react

adversely to having the terms and conditions of their state obligations decided by a "foreign" tribunal.

Q 1-02.15. How might one approach implementation of these terms?

The key aspects given above form the core of a comprehensive debt law. This implementation may be most easily achieved by drafting a law afresh. Our effort has been to provide a comprehensive state debt law model, and it has made sense to do so. The legislative process the world over is complex and time-consuming. Paradoxically, it is easier to draft a "complete" law rather than to graft the key changes onto existing law(s). It may be more difficult to achieve the same completeness by amending a body of existing laws. *Consideration of these principles is a prerequisite to the preparation of any draft legislation. The method of putting such principles into force may be determined by institutional capacity and political realities and may result in a framework that is designed in a manner unique to a country.*