Issuance and marketing of debt

Q 1-05. What are the elements of the legal framework for the issuance and marketing of sovereign debt?

The constitution and the state debt law alone do not constitute the entire legal framework about sovereign debt. For the issuance and marketing of sovereign debt, those laws must be supported by a series of related laws involving budgets, the central bank, taxation, public finance, and accounting, laws on public credits, sub-sovereign entities, and guarantee programs.

This body of laws contains provisions that affect the management of sovereign debt. These laws, however, are not self-administering; they require interpretation and implementation, and usually require the promulgation of rules and regulations. In effect, the elaboration makes the governing law operative. The rules and regulations are by necessity more detailed, more technical and more instructive. Since regulations are derived from the law to which they relate, they must be a reasonable and defensible extension of the governing authority. Legal requirements must take precedence over operational guidelines.

Laws of state governance

Q 1-05.01. What is the role of the organic budget law in the debt decision process?

Organic budget laws, i.e. laws specifying the schedule and procedures by which the budget should be prepared, approved, executed, accounted for, and final accounts submitted for approval, establish the authority, the standards, and the practices to be employed in budgeting for the nation's needs. The outcome of the budget process and the structure of that process will affect the details of the debt process.

Q 1-05.02. How do annual *budget laws affect the debt process?*

The annual budget law summarizes the details of the forecasts and plans for receipts and expenditures. Because correct estimates for receipts and expenditures are critical for efficient state borrowing, the budget process and the units that are integral to it must be examined in any institutional review of the debt framework. These laws, particularly the annual budget, are often used to set limits on the amount of debt that can be issued.

It should be noted that the particular body that oversees the national income and expenditures is generally located within the executive branch and more often than not, in the ministry of finance. This body, often called the budget office or the office

of management and budget, may be under the ministry of finance. It would have no role in the issuance of government securities, but its data reports and gathered facts are used in deficit-financing decisions.

As noted, the budget law in some countries provides not only the basis for borrowing, but establishes what limits should be observed. Under the laws of some countries, the decision to borrow, including the terms and conditions thereof, is made by the legislature.

Q 1-05.03. What is the role of the central bank?

The central bank is generally designated as the fiscal agent of the state. That role may be given to the bank by law that creates the bank. It is also possible that the agency relationship will be established in the state debt law.

The fiscal agency role and the bank's responsibilities in the administration of state debt do not imply that either the bank or the ministry of finance is subordinate to the other as entities in themselves. From a legal view, however, the relationship of the principal (i.e., the ministry of finance) to the agent (viz., the central bank) is an important one. The statutory recognition that, in a fiscal context, the central bank serves the ministry of finance and the state is an important one to maintain.

This agent role must be limited in certain critical ways. Despite the fact that central banks are independent and stand-alone institutions, it is not uncommon for some of them to be involved in both monetary and fiscal functions. In some countries, the central bank competes with the sovereign by doing its own financing, often issuing Treasury bills that investors are likely to consider as safer investments. In other cases, the central bank has taken lead responsibility for sovereign debt issuance. Either of these developments can lead to contradictory monetary and fiscal policies, as both are dependent on debt operations. This situation should be avoided. Nor should the agent role be interpreted to encourage monetizing debt by direct central bank purchases of sovereign debt at auction. This is recognized in developed countries as bad practice.[1]

In addition, although there are some limiting drawbacks, the central bank's linkage to the commercial banking sector assists the debt management organization by providing issuer access to most of the key market-makers[2].

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[1] The Maastricht Treaty requires that member states prohibit borrowing directly or indirectly from the central bank. The central bank may only purchase government securities in the secondary market to implement monetary policy.

[2] The advent of book-entry or dematerialized government securities has enhanced the importance of the relationship between the Government and the central bank. Since security trading requires both speed and certainty in the transfer of funds against securities, it is to the advantage of the state that its general fund is usually lodged in the central bank and that the principal securities accounts are

Q 1-05.04. How do taxation laws affect the debt process?

The tax treatment of government securities, particularly regarding interest and original issue discount, affects the actual rate of return and the relative desirability of government securities vis-à-vis alternative investments. For example, exempting interest on state securities from taxation increases their relative return by a factor of the marginal tax rate. The calculation of after-tax return is more problematic when there are possible differences in the taxation of securities in countries that have multiple taxing regimes.

Taxation also can affect debt issuance when the impacts fall on secondary market development. There could be significant tax consequences depending on how the securities are held, for how long, and under what terms and conditions and these may affect behavior or calculated net return on transactions. Other secondary market effects may follow from how taxes are imposed on transactions involving derivatives of state debt or in the tax treatment of repurchase agreements where state debt is used as collateral.

Q 1-05.05. How do laws on public accounting impact the debt process?

The accounting basis used by the state for its accounts, viz. on a cash or accrual basis, and how contingent claims are be recognized will affect the apparent fiscal soundness of the state and the safety of the state's debt. Such accounting decisions may also lead to a better matching of state assets and liabilities.

The choice of the right accounting basis and the explicit recognition of contingent claims, however, still entail some problems. For example, a state that adopts accrual accounting may count the future liabilities borne in the pension rights for public sector workers and this may inflate the apparent liabilities of the state with a much larger prospective fiscal deficit as a consequence.[3] The marketability of the state's debt suffers for this.

In a similar manner, accounting limits on how future assets, such as the ability to collect tax and imprison people who refuse, may be counted will also distort the marketability of sovereign debt by altering the report of the state's fiscal condition.

Q 1-05.06. How does the status of sub-sovereign entities affect the debt process?

The state is often comprised of various entities. Sub-sovereign entities include regions, cities, provinces, districts, municipalities, some special government entities

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likely to be held there also. This means that trades can be consummated more quickly and reflected on the books held at the top tier of the book-entry hierarchy.

[3] How large this impact may be will also depend upon the discount rate chosen in the estimates.

(such as public transport companies or social housing authorities) and the fully guaranteed subsidiaries of all these.

Many sub-sovereign entities are financially dependent on the national budget. The credit strength of sub-sovereign entities, derived from governmental factors such as the ability to tax, the degree of association with and support from the central government, and the inability in most jurisdictions of entities to go "bankrupt," may affect the debt marketability of the state if sub-sovereign entities are by law or by market perception to exert a claim on the central government's resources.

Some sub-sovereign entities lack expertise to manage their balance sheets. The impact of their debt on the national debt needs to be understood, and taken into appropriate account. Unfortunately, it takes considerable research to sort out their debt situation.

Q 1-05.07. How do laws regarding guarantee programs affect the debt process?

Guarantee programs create a contingent liability for the state. Because such a liability may force financing on the sovereign state, the likelihood of this event will be incorporated into market evaluations of the quality of state debt. The more clearly and completely these contingent claims are accounted for and presented to the market, the less debt purchasers will substitute their own assessments of the risk the state is undertaking. As it is rational for buyers to be risk averse, their own estimates, in the absence of data, are likely to discount the quality of debt more heavily than they would with well-documented estimates.