

# **SUBNATIONAL DEBT MANAGEMENT PERFORMANCE ASSESSMENT (DEMPA)**

## **METHODOLOGY**

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## ABBREVIATIONS

Comsec	Commonwealth Secretariat
DeM	debt management
DeMPA	Debt Management Performance Assessment
DMFAS	Debt Management Financial Analysis System Program
DMO	debt management office
DPI	Debt Management Performance Indicator
DRP	disaster recovery plan
DSA	debt sustainability analysis
FABDM	Financial Advisory and Banking Debt Management Department (WB Treasury)
INTOSAI	International Organization of Supreme Audit Institutions
IT	information technology
MEFMI	Macroeconomics and Financial Management Institute of Eastern and Southern Africa
MFM GP	Macroeconomics and Fiscal Management Global Practice
MTDS	Medium-term debt strategy
N/A	not applicable
N/R	not rated or assessed
PEFA	Public Expenditure and Financial Accountability (Program)
PI	Performance indicator
SAI	Supreme audit institution
SN	Subnational
SNG	Subnational government
UNCTAD	United Nations Conference on Trade and Development
WAIFEM	West African Institute for Financial and Economic Management

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# 1 INTRODUCTION

Subnational debt levels in developing countries are becoming increasingly significant as central governments continue to decentralize spending responsibilities, revenue-raising authority, and borrowing rights to subnational governments<sup>1</sup> (SNGs). The trend began in the 1990s and is now prevalent in developing countries with both federal and unitary political systems. The World Bank, in collaboration with other partners, has developed a global knowledge program on subnational fiscal reform and debt management. The program aims to strengthen developing countries' institutional capacity to maintain subnational fiscal sustainability and prudent debt management alongside a stable macroeconomic framework; effective infrastructure finance to support inclusive growth; and capital market development. A key component of this global knowledge program is the application of the Debt Management Performance Assessment (DeMPA) methodology for SNGs.

The DeMPA is a methodology for assessing the full range of government debt management functions through a comprehensive set of indicators. It highlights strengths and weaknesses in debt management practices and facilitates the design of plans to build and augment capacity and institutions tailored to specific needs of a country. The indicator set for the central government (the sovereign DeMPA) has evolved as an internationally recognized standard in the central government debt management (DeM), and was updated in July 2015.

The subnational DeMPA highlights strengths and weaknesses at the level of subnational DeM practices. This performance assessment facilitates the design of plans to build and augment capacity and institutions tailored to the specific needs of a subnational. The subnational DeMPA (SN DeMPA) also facilitates the monitoring of progress over time in achieving the objectives of subnational DeM in a manner consistent with international sound practice.

Both sovereign and subnational DeMPA methodologies are modeled after the Public Expenditure and Financial Accountability (PEFA) framework. If the DeMPA exercise precedes a PEFA assessment, the latter can use the DeMPA results to inform its assessment of the relevant indicators, alternatively the DeMPA provides a detailed assessment of the underlying factors leading to poor PEFA ratings in the area of DeM. The PEFA framework was also significantly revised in 2015; it was first published in 2005.

While many indicators of the sovereign DeMPA can be applied to the SN DeMPA evaluation, the

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<sup>1</sup> Subnational government (SNG) refers to the governments sector below national government, and include states or provinces at second tier, and counties, cities, towns, municipalities, and districts at lower tiers.

sovereign and SN DeMPA differ in critical areas. First, SN DeMPA must reflect the specific inter-governmental framework of a country. The central government may have enshrined fiscal and procedural rules for SNGs to incur debt, for example, resulting in SNGs' limited ability for fiscal adjustment, when required. SNGs may be asked to inform or report debt management activities to the central government. Another difference is that in many countries the central bank does not hold the SNG bank accounts or act as a fiscal agent for SNGs. Central banks also do not typically purchase subnational bonds for liquidity management to support monetary policy targets. Thus, the aspects relating to clarity of separation of monetary policy operations and debt management transactions have to be carefully analyzed for their relevance in the context of subnational government operations.

Similarly, SNGs do not typically have market development as a clearly defined objective of their policy. And unlike central government, SNGs frequently rely on loans from (commercial) banks to meet the financing needs, instead of accessing the domestic capital market by issuing debt securities. The SN DeMPA tool incorporates the above qualifications.

A subnational entity that has political power in a federal country often differs from a subnational entity in a unitary country in terms of ex ante fiscal rules and procedural rules for incurring debt and coordination with the central/national government. Second, different size of subnational entities will have different implications for coordination with macroeconomic fiscal and monetary policies.

Importantly, the SN DeMPA methodology is to be applied to individual SNG entities and not the entire SNG sector. It applies to SNGs with the capacity to incur debt, or that plan to do so in the short term and have debt outstanding. Therefore, even in a country where the central government on-lends to SNGs, and SNGs cannot borrow directly from financial markets, subnational DeMPA can still be applied to the SNG that has debt outstanding to the central government.

SNGs can differ significantly in terms of size and degree of autonomy from central government across countries. In some countries, SNGs are guided by borrowing rules stipulated by central or local government legislation. For example, they may only borrow in domestic currency; borrow in foreign currency only after approval of the central government; or borrow only for capital expenditure, etc. Such borrowing rules have significant implications for the conduct of debt management operations, the organization of the SNG debt management functions, and the legal framework among other SN DeMPA indicators. Thus a key issue for the SN DeMPA exercise is the degrees of freedom that the SNG operates in, and if the SNG operates within that framework with an appropriate focus.

The SN DeMPA assessment must examine the borrowing frameworks for the SNG and the intergovernmental fiscal system, including reliance on the transfers from the center, which effect the type of debt management strategy and managerial structure that is required by the SNG for DeM. The variability in size of debt outstanding and/or the number of loans or securities, together with the degree of reliance on central government funding, will have a bearing on the minimum requirements for effective DeM in some areas of the SN DeMPA exercise.

Notwithstanding, the minimum requirements will apply for all SNGs. However, for very small SNGs, such as those holding a very small number of loans or securities or whose borrowing and debt related activities are so infrequent that it is not feasible to complete an assessment, then a not rated or assessed (N/R) or not applicable (N/A) can be assigned, depending on the situation. The differences between the sovereign and the SN DeMPA tool are set out in Annex 1.

## 2 ASSESSMENT METHODOLOGY

### 2.1 SCOPE AND COVERAGE OF THE FRAMEWORK

The SN DeMPA covers subnational government DeM activities and closely related debt management functions. It assesses debt incurred by municipal owned enterprises or other public sectors entities when guaranteed by the assessed subnational government, but not otherwise. There are different tiers or types of subnational entities which include, inter alia, states and provinces within a federation, counties, cities, towns, municipalities, and districts. The SN DeMPA can be applied to any tiers or types managed by their local governments and that have capacity to incur debt. For example, if the subnational DeMPA is applied to a state within a country, then the assessment will examine the debt management and related activities of this state. Similarly, if the assessment is applied to a municipality within a federal or unitary country, then only the debt management activities of the municipality will be assessed. The fiscal relations among the tiers of the government are outside the scope of the SN DeMPA.

While evaluating SNG's DeM activities, the assessment focuses on borrowing activities, such as borrowing planning, issuance of subnational bonds and other debt securities, borrowing from external creditors (through the central government), issuance of loan guarantees to support a certain entity or projects, on-lending, and cash flow forecasting and cash balance management. The SN DeMPA, like the sovereign tool, does not assess the ability to manage implicit contingent liabilities, such as the capacity of the SNG to monitor and supervise the non-guaranteed borrowings and other activities of its public enterprises.

In addition, whereas SNGs in many countries own substantial assets, such as land, public buildings, and infrastructure assets, the SN DeMPA does not assess these assets. The scope of the assessment is contained to the direct liabilities and explicit contingent liability side of the subnational balance sheet and its associated cash flows.

Table 1 illustrates the scope of the SN DeMPA as limited to the SNG debt (an explicit direct liability) and SNG loan guarantees (an explicit contingent liability).

Table 1: Scope of SN DeMPA

	Direct liabilities	Contingent liabilities
Explicit Debt	E.g. debt (loans contracted and debt securities issued)	E.g. loan guarantees (other indemnities such as deposit insurance and other government

		insurance schemes and uncalled capital are not included in the SN DeMPA evaluation)
Implicit Debt (not covered by SN DEMPA	E.g. social security schemes and future public pensions not mandated by law	E.g. default by municipal owned enterprises including commercial banks and strategically important private firms and natural disaster

## 2.2 DEBT MANAGEMENT PERFORMANCE INDICATORS

The SN DeMPA tool assesses 31 dimensions of subnational debt management activities (and closely related areas), organized into 13 debt performance indicators (DPIs).<sup>2</sup> It aims to measure SNG DeM performance and capture the elements that are indispensable to achieving sound DeM practices (table 2). The assessment is incorporated into a Debt Management Performance Report.

Although the SN DeMPA does not offer recommendations for reforms or staff capacity and institution-building needs, the performance indicators for each dimension do stipulate a minimum level that should be met under all conditions (see section 2.3). Consequently, an assessment showing that the SN DeMPA minimum requirements have not been met indicates an area that should be considered a priority for reform or capacity building or both.

Table 2 Debt Management Performance Indicators

Number	Title
Governance and Strategy Development	
DPI-1	Legal Framework
DPI-2	Managerial Structure
DPI-3	Debt Management Strategy
DPI-4	Debt Reporting and Evaluation
DPI-5	Audit
Coordination with Fiscal and Budgetary Policy	
DPI-6	Coordination with Fiscal Policy and Budgetary Process

<sup>2</sup> The sovereign DeMPA covers 33 dimensions organized into 14 DPIs.



Borrowing and Related Financing Activities	
DPI-7	Domestic Borrowing
DPI-8	External Borrowing
DPI-9	Loan Guarantees, On-lending and Derivatives
Cash Flow Forecasting and Cash Balance Management	
DPI-10	Cash Flow Forecasting and Cash Balance Management
Debt Recording and Operational Risk Management	
DPI-11	Debt Administration and Data Security
DPI-12	Segregation of Duties, Staff Capacity, and Business Continuity
DPI-13	Debt and Debt-Related Records

## 2.3 SCORING METHODOLOGY

The scoring methodology assesses each dimension and assigns a score of A, B, or C, depending on the criteria listed. The A score reflects sound practice for that particular dimension of the indicator. The B score lies between the minimum requirements and sound practice for that aspect. A minimum requirement set out in C is considered the necessary condition for effective performance under the particular dimension being measured. If the minimum requirements are not met, then a score of D should be assigned. A score of D signals a deficiency in performance normally requiring priority corrective action.

There are situations in which a dimension cannot be assessed. These could be because (a) the dimension is not applicable when an activity is not undertaken (for example, there are no derivatives or loan guarantees are not issued), in which case the term N/A (not applicable) should be assigned; or (b) the dimension is difficult or impossible to assess due to insufficient information, in which case a designation of N/R (not rated or assessed) should be assigned.

When criteria for a specific score require certain legislation and procedures manuals to be in place, they must be followed. If that is not the case, these laws, manuals, or instructions should be considered nonexistent for the purpose of the scoring. The same principle applies to the requirement of a DeM strategy to steer daily borrowings and other DeM activities. When the strategy document in practice is not respected, the strategy should be considered nonexistent.

## 2.4 SUBNATIONAL DEBT MANAGEMENT PERFORMANCE REPORT

The objective of the Subnational Debt Management Performance evaluation is to provide an assessment of subnational government DeM performance based on the indicator-led analysis in a concise and standardized manner.

The report is a comprehensive document (25 pages to 35 pages) containing the following structure and content:

- An introduction that explains the process for undertaking the assessment and preparing the report
- A summary assessment that describes the performance assessment of all dimensions for each DPI
- If it is a follow-up SN DeMPA, a section on the SNG DeM reform process that briefly summarizes reform measures implemented by the subnational government since the last assessment as well as any deterioration in the assessed areas
- A background section providing country-related contextual information, and the SNG macroeconomic context, pertaining to DeM performance. This section should include, when relevant, the degree of decentralization; fiscal rules; the main laws governing the SNG and the evolution of subnational borrowing framework; past debt restructuring or bailouts by the central government; and any constraints on the borrowing choices available to the subnational
- The main body of the report, which assesses the current performance of government DeM on the basis of the criteria set up for each DPIs

As mentioned earlier, the report is a statement of current SNG DeM performance and does not include recommendations for reforms or action plans. If the views of the assessment team and the subnational entity on the findings of the report differ, all opinions will be reflected in the report.



countries, municipalities are political sub-divisions of states; hence municipal borrowing and debt are regulated by these states. However, a country's constitution may set limits on some aspects of subnational borrowing activities (for example, the Indian Constitution prohibits states from borrowing directly in foreign markets). In Brazil's federal political system, the sovereign Fiscal Responsibility Law governs some key aspects of states' borrowing and debt operations.

In a unitary country, the central government typically sets the regulatory framework governing subnational borrowing and debt management activities, while some debt-related activities may be regulated under the constitution. However, SNGs in unitary political systems may have considerable freedom in managing their debt activities within the broader parameters set by the central government.

The types of legislation for subnational DeM vary across countries, and can be found through different legislative documents at both the central and subnational level, such as the constitution, fiscal responsibility law, budget law, public finance law, local government law, debt management law, government securities law, etc.

Regardless of the types of legislation and the level of government passing legislation, the primary concern of SN DeMPA is whether the legal framework clearly specifies the authorization to borrow, purposes of borrowing, debt management objectives, types of debt instruments allowed, and procedural rules for DeM strategy development.

The principal DeM entity referred to in this document is the dedicated SNG entity whose prime responsibility is to undertake debt transactions, formulate and execute the DeM strategy. Within this structure, it is acceptable that some DeM activities are conducted by other entities as agents for the principal DeM entity. In these cases, the rights and obligations of the parties should be clarified, preferably in a formalized agency agreement, in local legislation, or in both.

Some small SNGs may find it efficient to combine certain DeM functions, such as back-office functions and the risk control function, with similar functions not directly related to debt management, particularly when financing transactions are few and infrequent. This would provide the scale to facilitate the segregation of responsibilities described in the DPI on segregation of duties (DPI-12), e.g. a treasury back office would process other transactions as well, such as payables and receivables, or a risk monitoring and compliance function could cover all risks and procedures in a finance department, not just those relating to debt.

Since many SNGs do not have a principal DeM entity, the SNG DeMPA is neutral with regard to the structure of DeM entities.<sup>4</sup> If an SNG has multiple DeM entities, however, it is essential that

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<sup>4</sup> Only the "A" score in dimension 1 of DPI-2 (Managerial Structure) requires the existence of a principal DeM entity,

these entities closely coordinate their DeM activities through a coordinating mechanism, such as a committee, or with the entity leading the coordinating effort. This activity is reflected in the governance indicators.

In many SNGs whose daily DeM activities have been delegated to a principal DeM entity or to different DeM entities, the local minister of finance, treasurer or equivalent political position will commonly retain the power to formally approve any borrowing and to sign the loan agreements. This approach is acceptable within the structure described earlier, provided no undue political interference exists.

## **DPI-1      LEGAL FRAMEWORK**

### **Rationale and background**

#### **Dimension 1: The existence, coverage, and content of the legal framework on authorization to borrow and undertake other DeM activities and to issue loan guarantees**

The rationale for DPI-1 is to ensure that the legal framework clearly assigns authority to borrow at the SN level, undertake debt-related transactions (such as debt exchanges and currency and interest rate swaps, where applicable), and issue loan guarantees.

The legal framework for SNG DeM comprises both primary legislation (laws enacted with approval of the parliament or congress or local legislature) and secondary or delegated legislation (executive orders, decrees, ordinances, and so forth) determined by the executive branch of government.

The legal framework should include the following:

- Clear authorization to borrow and, where applicable, undertake debt-related transactions (for example, debt exchanges and currency and interest rate swaps)
- Specified borrowing purposes
- Clear DeM objectives
- Requirement to develop a DeM strategy
- Mandatory annual reporting of DeM activities covering evaluation of outcomes against

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in line with sound international practice.

stated objectives and the approved strategy to a local assembly or similar body

- Clear authorization to issue loan guarantee (where applicable).

The following sequence is recommended to assess whether the minimum requirements have been met:

1. Check the legal decision-making process for borrowing in the domestic and external markets, such as issuing debt securities (where applicable) and concluding common loan agreements and debt-related transactions. Borrowing authorities often are vested in the local assembly (or similar body), the executive council, and the local equivalent to the minister of finance. In some countries, the SNG must receive central government approval for any or certain types of borrowing.
2. Once the approval process has been clarified, and assuming this process is adhered to, check the signing of necessary documentation pertaining to particular borrowing. Commonly, some official (or officials) has the authority to sign such documents on behalf of the government. The governor or local minister of finance (or his or her equivalent) often has this power through expressed authority in law or in his or her capacity as head of the SNG or the SNG ministry or unit that is responsible for borrowing and other DeM activities. For the loans (usually external loans) provided under the guarantee of central government or on-lent by the central government to the SNG, there should be a guarantee or subsidiary loan agreement or memorandum in place defining the terms and conditions of guarantee or on-lending. A similar approach is recommended for checking the decision-making process for undertaking debt-related transactions and for issuing loan guarantees.

To meet the minimum requirements, legislation also must specify the purposes for which the SN authorities can borrow. The main reason to include borrowing purposes in the legislation is to safeguard against borrowing for speculative investments or to finance operating deficit, or to finance expenditures that have neither been included in the annual budget nor approved by the local assembly or equivalent, in some other fashion. In such cases, SNGs may be forced to raise taxes or cut expenditures to service the debt contracted to finance such expenditures or require central government bailout. All relevant laws should be referred to in the SN DeMPA report.

Examples of borrowing purposes found in legislation are:

- to finance capital expenditure only
- to finance budget and cash balance deficits
- to finance investment projects approved by the local assembly or equivalent
- to refinance and pre-finance outstanding debt
- to finance honoring of triggered guarantees
- to mitigate the effects caused by natural or environmental disasters

For practical reasons, however, the executive sometimes delegates the borrowing authority to

implementing entities (that is, the DeM entity or entities), which contract on behalf of the SNG. This delegation is found in secondary legislation, such as executive orders, decrees, ordinances, and so forth.

A clear line of delegation is important both for internal control and for due diligence. All creditors and lenders require a legally binding and enforceable contract with the SNG in its capacity as the borrower. The same parameters apply to the issue of loan guarantees and debt-related transactions such as swaps.

Another rationale for DPI-1 is to ensure that the legal framework, at least for the higher scores, also includes (a) clear DeM objectives; (b) a requirement to develop a medium-term DeM strategy; and (c) a reporting requirement to the local assembly on DeM activities and loan guarantees.

Common DeM objectives are:

- to meet the SNG's borrowing requirements; and
- to minimize the medium- to long-term cost, while keeping the risks in the debt portfolio at acceptable levels.

These objectives may help to anchor DeM strategies. It is preferable and increasingly common to specify the SNG's DeM objectives in the legislation.

Once the DeM objectives are set, they must be translated into an operational strategy that defines the medium-term framework under which the SNG will achieve its DeM objectives. In accordance with sound international practice, a requirement in the legislation to develop a DeM strategy has also been included in this indicator for the highest score.

Reporting to the local assembly increases transparency and strengthens accountability. This reporting requirement is commonly found in any policy-based legislation that includes longer-term objectives.

The key requirement for the evaluation of this dimension is to review the legislation to see whether it meets the requirements of the dimensions to be assessed. It is also important to determine the extent of adherence to the legislation, since it may be sound but not fully enforced. If legislation is not followed, the following indicator should be read as if the legislation were not in place.

## **Dimension 2: Extent of a legal limit for direct access to financial resources from the central bank**

The rationale for DPI-1, dimension 2 is to ensure that any borrowing by the SNG from the central bank is legally restricted, if allowed. Monetary financing of government deficits, whether by central or subnational governments, imposes undesirable constraints on monetary policy operations by increasing the money supply.

In some countries, the central bank may lend funds to the private sector and SNGs, provided these borrowers pledge collateral as security for the loans, and on terms determined by the central bank. These secured loans are not considered monetary financing in the SNG DeMPA methodology. Any right of access to financing from the central bank is normally regulated under central bank law.

### Dimensions to be assessed

The following dimensions should be assessed according to the requirements laid out in table 3:

1. The existence, coverage, and content of the legal framework for authorization to borrow, undertake other DeM activities, and issue loan guarantees
2. The extent of a limit to direct access to financing from the central bank

Table 3 Assessment and Scoring of Legal Framework

Score	Requirements
A	<ol style="list-style-type: none"> <li>1. The requirements for score B are met. In addition, the legislation requires development of a medium-term DeM strategy and mandatory annual reporting to the local assembly or similar body covering evaluation of outcomes against the approved DeM strategy.</li> <li>2. Direct access to financing from the central bank is —by law— prohibited or limited to emergency situations in which other funding operations are not viable and, when used, the tenor is limited to two weeks.</li> </ol>
B	<ol style="list-style-type: none"> <li>1. The minimum requirement for score C is met. In addition, the legislation includes clear DeM objectives and requires annual reporting to the local assembly or similar body covering the DeM activities and issued loan guarantees.</li> <li>2. The minimum requirement for score C is met. In addition, access to financing from the central bank is—by law—limited to a tenor of not more than three months.</li> </ol>
C	<ol style="list-style-type: none"> <li>1. Within the framework of the national constitution and restrictions imposed by the central government, the legislation provides clear authorization to borrow and to issue new debt, to undertake debt-related transactions (where applicable), and to issue loan guarantees (where applicable), all on behalf of the SNG. In addition, the legislation specifies the purposes for which the executive branch of government can borrow.</li> <li>2. Access of the SNG to financing from the central bank, if applicable, has a ceiling limit imposed by legislation.</li> </ol>
D	<ol style="list-style-type: none"> <li>1. The minimum requirement for score C is not met.</li> <li>2. The minimum requirement for score C is not met.</li> </ol>



## Supporting documentation for DPI-I

- A copy of all primary legislation, which should be available on the websites or in print manuals of the central government, subnational government, ministry of finance, principal or other DeM entities, or central bank
- A copy of all secondary legislation, which should be available on the websites or in print manuals of the central government, subnational government, ministry of finance, principal and other DeM entities, or central bank
- If the list of legislation is extensive, it may be sufficient to obtain a copy of the most significant or relevant laws, together with a list of all secondary legislation
- Copies of reports (including debt reports, just-in-time reports for policymakers, and copies of annual budget documents) that fulfill the legal requirements

## Indicative questions to ask

- Has the central government imposed restrictions on SNG borrowings? If so, what are those restrictions, which legislation includes these restrictions, and what are the relevant sections or clauses?
- Is there clear authorization in legislation to approve borrowings and loan guarantees on behalf of the SNG assigned to the local assembly (or similar body), the governor, the executive council or directly to the local minister of finance (or equivalent)? If so, which legislation provides authorization, and what are the relevant sections or clauses?
- Who signs the loan documents and other necessary documents related to a particular borrowing? Which legislation provides this authorization, and what are the relevant sections or clauses?
- Is there clear authorization in legislation to undertake debt-related transactions and to issue loan guarantees on behalf of the SNG? If so, which legislation provides authorization, and what are the relevant sections or clauses?
- Which sections or clauses in the legislation cover specified borrowing purposes; clear DeM objectives; a requirement to develop a medium-term DeM strategy; annual mandatory reporting to the local assembly or similar body covering DeM activities and, where applicable, issued loan guarantees? Has there been any instance in the past five years in which the laws have not been followed? If so, what were the instances, why were the laws not followed, and what were the consequences?
- Does the SNG have an overdraft or ways and means facility with the central bank? If so:
  - Is there a ceiling imposed by legislation, and what is the ceiling?
  - Does the legislation impose a tenor on the duration of this facility, and what is the

tenor?

- Has the SNG used the facility, and if so, how often, for what amounts, and for what tenors?
- When does the facility have to be reduced to a zero balance?
- How well are borrowing and transactions validated against the medium-term DeM strategy?
- A copy of the agency agreement between the SNG principal DeM entity and the central bank (if such an agreement exists)

## DPI-2      MANAGERIAL STRUCTURE

### Rationale and background

Dimension 1: The managerial structure for SNG borrowings and debt-related transactions

**The rationale for DPI-2, dimension 1 is to ensure that the managerial structure for borrowing and debt-related transactions<sup>5</sup> is effective and includes a clear division between:**

- *the political level*, namely the local assembly (or similar body), the executive council, the governor or mayor, and the local minister of finance, who sets the overall SNG DeM objectives and decides on the risk level that the government is willing to tolerate by approving the medium-term DeM strategy; and
- *the execution level*, which includes the entities responsible for implementing policy decisions and DeM strategy, and therefore reflects the organization at the execution level of DeM policy within the SNG.

The division between the political and execution levels enables policymakers to make major decisions about the overall volume of indebtedness and the acceptable risks in the debt portfolio—in terms of their effect on the budget, taxes, government spending programs, or other such fiscal indicators, while allowing technical professionals to seek the optimum risk-adjusted outcome within those parameters. This separation helps diminish the risk of fiscal or budgetary policy dominance over prudent debt management, for example, by lowering the debt interest cost in times of budgetary constraint at the expense of higher risk in the debt portfolio.

The evaluation of this dimension also includes assessment of undue political interference. An example of such interference is when a local minister of finance or equivalent presses the debt manager to borrow in the short end of the yield curve or in a low-coupon currency to reduce the short-term debt service cost at the expense of an increased risk in the debt portfolio that goes against an approved strategy. Other types of behavior that should be avoided at the political level are (a) involvement in the discussions of any cutoff price after the bids have been received in an auction of government securities; (b) selection of borrowing currencies in single loan transactions; and (c) selection of the lead manager and banks for syndicated securities issuance in the domestic capital markets, or through loans from select commercial banks.

This DPI dimension also introduced a requirement at the B level that “the borrowings and debt-related transactions be steered by a formalized medium-term DeM strategy.” The criteria for evaluating whether such a strategy exists are described in DPI-3.1 (“Debt Management Strategy”)

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<sup>5</sup> Debt-related transactions are transactions in the market, such as swaps to change the risk profile of the debt portfolio, or debt buybacks of illiquid debt securities.

and apply at the C level. This implies that at least C is required in DPI-3.1 to qualify for a B in this dimension.

Although recommended, the SNG DeMPA tool at the B and C levels does not require the establishment of a principal DeM entity or a debt management office (DMO). If the SNG has multiple DeM entities, however, it is essential that they regularly share information and periodically coordinate their DeM activities through formal mechanisms. One of the entities can be selected to facilitate coordination, or a coordination committee can be set up to share information at regular meetings. Coordination is essential to avoid over-borrowing and to keep track of debt portfolio risks. This aspect is particularly important when DeM activities are steered by a medium-term DeM strategy and an annual borrowing plan.

To receive the highest score on this dimension, there must be a principal DeM entity that is responsible for undertaking all borrowings and debt-related transactions. Under such a structure, it is acceptable if other entities act as agents for the principal DeM entity to perform some DeM activities. In these cases, the rights and obligations of the parties should be clarified, preferably in a formalized agency agreement, in secondary legislation, or in both.

## **Dimension 2: The managerial structure for preparation and issuance of SNG loan guarantees**

The rationale for DPI-2, dimension 2 is to ensure that the managerial structure for preparation and issuance of SNG loan guarantees is effective. Loan guarantees extended to third parties are explicit contingent liabilities that typically are issued to extend financial support to a certain beneficiary or project or to a specific sector of the economy. Since this is a political decision, the use of the guarantees can be decided at the political level. However, as with debt transactions, it is desirable to leave overall responsibility for the preparation and the actual issuance of the loan guarantees to one entity, that is, a principal guarantee entity responsible for

- independently assessing and pricing the credit risk;
- mitigating the financial effects of a default or trigger event;
- monitoring the risk during the term of the loan guarantee;
- coordinating the borrowings of the guarantee beneficiaries with SNG borrowing; and recording and reporting these guarantees properly.

Under this structure, it is acceptable if certain loan guarantees are issued by other entities as agents for the principal guarantee entity. For example, a designated guarantee entity may issue individual loan guarantees to support farmers under a certain guarantee scheme. In these cases, the rights and obligations of the parties should be clarified, preferably in a formalized agency agreement, in the secondary legislation, or both.

It is also desirable that decisions on individual guarantees be steered by a formal SN government policy or framework document. A formal SNG policy or framework can provide transparency on which sectors of the economy or types of projects are to be supported by guarantees, and thus helps to reduce the risk of ad hoc decisions or political favoritism. The policy or framework document could also provide criteria for assessing eligibility, including thresholds for credit risk.

A designated procedures manual may include the processes to be followed (such as those listed earlier as responsibilities of the principal guarantee entity).

Some SNGs mandate the principal DeM entity to prepare and issue the loan guarantees once the political decision to support a certain beneficiary or project by guarantees has been made. Apart from the technical skill normally found at the principal DeM entity, this approach also ensures effective coordination with SNG borrowing operations. In SNGs with few staff members adequately trained in finance, this managerial structure is particularly relevant for better coordination and beneficial use of scarce technical skills.

In the case of a more fragmented managerial structure, it is important that the entities in charge of preparation and issuance of loan guarantees regularly exchange information and closely coordinate their respective activities both between themselves and with the DeM entity or entities. This should be done through a formalized institutional arrangement whereby information flows are regularly shared.

In some instances, the legal framework authorizes the SNG to issue loan guarantees, but no guarantees have been issued for an extended period of time (more than five years). In such cases, the score N/A should be applied.

In the SN DeMPA tool, loan guarantees do not include export credit guarantees or other explicit or implicit contingent liabilities.

### **Dimensions to be assessed**

The following dimensions should be assessed according to the requirements laid out in table 4:

1. The managerial structure for SNG borrowings and debt-related transactions
2. The managerial structure for preparation and issuance of SNG loan guarantees

Table 4 Assessment and Scoring of Managerial Structure

Score	Requirements
A	<ol style="list-style-type: none"><li>1. The requirements for score B are met. In addition, borrowings and debt-related transactions are undertaken only by the principal DeM entity.</li><li>2. The requirements for score B are met. In addition, loan guarantees are prepared and issued by a single guarantee entity, which may be the principal DeM entity.</li></ol>
B	<ol style="list-style-type: none"><li>1. The minimum requirement for score C is met. In addition, the borrowings and debt-related transactions are steered by a formalized medium-term DeM strategy and undertaken without undue political interference.</li><li>2. The minimum requirement for score C is met. In addition, the decisions are steered by a formalized guarantee framework or</li></ol>

	government policy.
C	<ol style="list-style-type: none"> <li>1. Borrowings and debt-related transactions are undertaken either by the principal DeM entity or, if there is no principal DeM entity, by DeM entities that regularly exchange debt information and closely coordinate their respective activities through formal institutional mechanisms.</li> <li>2. If applicable, loan guarantees are prepared and issued by one or more SNG entities that regularly exchange information and closely coordinate their respective activities through formal mechanisms among themselves and with the DeM entity or entities.</li> </ol>
D	<ol style="list-style-type: none"> <li>1. The minimum requirement for score C is not met.</li> <li>2. The minimum requirement for score C is not met.</li> </ol>

### Supporting documentation

- The organizational chart and secondary legislation defining the entities involved in SNG DeM and the preparation and issuance of loan guarantees and their respective roles and responsibilities
- A copy of the documented and approved guarantee framework or government policy

### Indicative questions to ask

- Which entities are responsible for SNG DeM activities? What are their respective roles and responsibilities?
- What is the process, and which entity is responsible, for negotiating and contracting new debt (concessional, multilateral, bilateral, commercial, domestic, etc.)?
- What role does the local assembly or similar body, the executive council, and local minister of finance play in any new borrowing, particularly with regard to the authorization to borrow and during the contract negotiation and transacting process?
- If there are two or more DeM entities, what debt and other information are exchanged between them? How frequently is this information exchanged? Do the entities closely coordinate their respective activities to avoid excessive borrowing and keep track of the portfolio risks, and what mechanism is used for this coordination?
- Is there a documented and approved policy or framework document that specifies criteria for deciding whether guarantees are to be granted and the processes to be followed?
- Who is responsible for preparation and issuance of loan guarantees in SNG? How are these loan guarantees prepared?
- If there are two or more guarantee entities, what information is exchanged between them? How frequently is this information exchanged? Do the entities regularly coordinate their respective activities to avoid inconsistencies in approach (for example, thresholds for credit risk)? What mechanisms are used for coordination purposes?
- Are guaranteed borrowings by the beneficiary of loan guarantees coordinated with SNG borrowing, and if so, how?

## **DPI-3      DEBT MANAGEMENT STRATEGY**

### **Rationale and background**

#### **Dimension 1: The quality of the DeM strategy document**

The rationale for DPI3, dimension 1 is to ensure that the SNG has prepared and approved a medium-term DeM strategy that is based on the longer-term DeM objectives and set within the context of the SNG's macroeconomic assumptions and budget framework.

Design of a subnational DeM strategy should be separated from a debt sustainability analysis (DSA), although the information from each is complementary and provides essential information to debt managers. The subnational DSA is a key fiscal and budgetary policy tool to assess the long- or medium-term sustainability of the future debt path under certain set of macroeconomic assumptions and fiscal policy, while the DeM strategy is a plan that the government intends to implement over the medium term to achieve a desired composition of its debt portfolio, which captures its preferences regarding the cost-risk trade-offs. It operationalizes the DeM objectives and has a strong focus on managing the risk exposure embedded in the debt portfolio—specifically, potential variations in the cost of debt servicing and its impact on the budget. A DeM strategy also indicates how cost and risk characteristics vary with changes of composition of the debt portfolio. A DeM strategy should cover all SNG existing debt and projected borrowing (including from the central bank, if applicable) with a minimum of three years' scope. It should be reviewed and updated annually to assess whether the assumptions still hold in light of changed circumstances. Such a review should be undertaken preferably as part of the budget process, and if the existing strategy is viewed as appropriate, the rationale for its continuation should be stated.

The content of the strategy and risk indicators will vary depending on the stage of economic development, the sources of SNG funding, the breadth and depth of the local debt market, and the transactions used to manage SNG debt. The DeM strategy document preferably includes the following:

- DeM objectives and scope (categories of debt covered and strategy timeframe)
- Description of the market risks being managed (currency, interest rate, and refinancing or rollover risks), and historical context for the debt portfolio
- Description of the future environment for SN DeM, including fiscal and debt projections; assumptions about interest and exchange rates; and constraints on portfolio choice, including those relating to market development
- Description of the guidelines to indicate the direction of key indicators that are expected to evolve over time in line with the DeM objectives
- Description of the analysis undertaken to generate the recommended DeM strategy,

clarifying the assumptions used and limitations of the analysis

- Recommended strategy and its rationale.

The following indicators are most likely to be assessed in the DeM strategy:

- Total debt service under different scenarios, particularly sensitivity to interest rate and exchange rates volatility
- Maturity profile of the debt under different scenarios
- Strategic benchmarks, such as:
  - ratio of foreign currency debt to domestic debt;
  - currency composition of foreign currency debt;
  - minimum average maturity of the debt;
  - maximum share of debt that is allowed to fall due during one and two budget years;
  - maximum ratio of short-term (up to one year) to long-term debt;
  - maximum ratio of floating rate to fixed rate debt; and
  - minimum average time to interest rate re-fixing.

It is noted that all of these risk-based parameters may not be equally relevant to the various situations and debt composition of the SNG.

The recommendations of the DeM strategy should specify targets and ranges for key risk indicators of the portfolio and the financing program over the projected horizon. As an interim step, it would be sufficient to express the strategy as guidelines indicating the direction in which certain key indicators are expected to evolve, for example, the strategy may contain a statement that “the amount of local currency debt maturing within 12 months shall be reduced”.

The strategy essentially is a decision on the SNG’s preferred risk tolerance that must be updated to reflect changed circumstances. DeM activities should be steered by the strategy. Therefore, an annual update of the DeM strategy is required to receive the score C. An out-of-date or ineffective strategy is treated as nonexistent.

To receive higher scores (A or B), the target ranges for the risk indicators should be based on an analysis of costs and risks. This analysis should provide an understanding of the evolution of debt service flows and borrowing alternatives under the expected values of future interest and exchange rates. An analysis of less favorable environments in the domestic and external debt



market, including interest rate and exchange rate shocks, is also required. Such an undertaking should assist debt managers in selecting realistic ranges for the chosen risk indicators. A further refinement in the cost-risk analysis could be achieved through improved selection of relevant future interest- and exchange-rate scenarios, including shocks that may have occurred in the past.

SNGs with significant financial assets should take these into account when conducting cost and risk analysis. For instance, the exposure to currency risk could be significantly mitigated for governments with foreign currency assets. The manner in which assets can be included in the analysis will depend, among other factors, on the horizon for holding such assets and the SNG's ability to use them to hedge the risks of the gross debt portfolio. In addition to the cost-risk analysis and the asset position, the DeM strategy should be consistent with the macroeconomic framework and the domestic market development level (see Medium-Term Debt Strategy (MTDS) Guidance Note<sup>6</sup>).

## **Dimension 2: The decision-making process and publication of the DeM strategy**

The rationale for DPI-3, dimension 2 is to ensure that the SNG has a robust decision-making process for strategy development, and that the strategy is published.

A DeM strategy should be developed in an open and transparent manner. The principal DeM entity (or DeM entities together) prepares a strategy proposal; and the executive council, the governor or mayor, or SNG political decision-making body approves the strategy document. For extra quality assurance, the SNG may set up a specialized advisory board to comment on the draft strategy before it is approved.

Although the strategy should be specified for the medium term (with three to five years scope), it should be reviewed annually to assess The DeM strategy should be an integral part of the budget preparation process. The budget document provides the sources of financing, and these should be aligned with the analysis and recommendations expressed in the debt strategy. The annual borrowing plan should thus cohere with the medium-term debt strategy.

Once the strategy has been finally approved, it must steer the borrowings and other DeM activities; that is, the strategy provides guidance on the current DeM activities. If that does not occur, the following indicators should be read as if the strategy were nonexistent.

The following dimensions should be assessed according to the requirements laid out in table 5:

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<sup>6</sup> <http://www.worldbank.org/en/topic/debt/brief/mtds>

1. The quality of the DeM strategy document
2. The decision-making process and publication of the DeM strategy

Table 5 Assessment and Scoring of DeM Strategy

Score	Requirements
A	<ol style="list-style-type: none"> <li>1. The requirements for score B are met. In addition, the target ranges for the risk indicators are based on comprehensive analyses of costs and risks that identify the vulnerability of the debt portfolio to shocks in market rates, and these analyses are clearly described and contain clear explanations of the assumptions used and limitations used in the analyses.</li> <li>2. The requirements for score B are met. In addition, the annual plan for the aggregate borrowing position is based on the approved strategy.</li> </ol>
B	<ol style="list-style-type: none"> <li>1. The minimum requirement for score C is met. In addition, the DeM strategy has realistic target ranges for indicators of the interest rate, refinancing, and foreign currency risks, reflecting specific country and subnational contexts.</li> <li>2. The minimum requirement for score C is met. In addition, the strategy is well integrated in the SNG budget document and the medium-term expenditure or budget framework.</li> </ol>
C	<ol style="list-style-type: none"> <li>1. A medium-term debt management strategy is in place covering all existing and projected SNG debt, based on the DeM objectives. The strategy is expressed at least as guidelines for the preferred direction of evolution of specific indicators for interest rate, refinancing, and foreign currency risks.</li> <li>2. The strategy proposal is prepared by the principal DeM entity or, if there is no principal DeM entity, jointly by the DeM entities. The strategy is formally approved; and the strategy is made publicly available, including through publication on official website(s) and in print media.</li> </ol>
D	<ol style="list-style-type: none"> <li>1. The minimum requirement for score C is not met.</li> <li>2. The minimum requirement for score C is not met.</li> </ol>

#### Supporting documentation

- A copy of the most recent DeM strategy
- Monitoring reports of DeM strategy implementation
- The document that defines process of strategy formulation and approval

#### Indicative questions to ask

Has the SNG prepared and approved a medium-term DeM strategy? If so:

- How was the strategy produced?

- Which SNG DeM entities or people were responsible for producing the strategy, and what were their respective roles?
- Which entity or person authorized or approved the strategy?
- What analysis was undertaken in formulating the strategy?
- How was the analysis undertaken, which entity or person was responsible for setting economic and budget parameters, and which entity or person was responsible for debt forecasts?
- Does the strategy cover the items required to meet the minimum requirements?
- Was the strategy made publicly available? If so, when was it published, and in what format?
- How has the strategy been implemented?
- How often has the strategy been updated?

## **DPI-4      DEBT REPORTING AND EVALUATION**

### **Rationale and background**

#### **Dimension 1: Publication of a statistical bulletin on SNG debt, loan guarantees, and debt-related operations**

The rationale for DPI-4, dimension 1 is to ensure that the SNG periodically prepares and publishes a debt statistical bulletin (or its equivalent).

A debt statistical bulletin or its equivalent covering domestic and external SNG debt, loan guarantees, and debt-related operations ensures transparency of the debt portfolio and outstanding loan guarantees. Its information is vital for investors in the SNG debt. Such a statistical bulletin may be published in print media, posted on SNG official websites, or both. The bulletin should be published at least annually (preferably quarterly or semiannually) and provide information on SNG debt stocks (by creditor, instrument, currency, interest rate basis, original, and residual maturity); debt flows (principal and interest payments); debt ratios and indicators such as the share of debt to SN GDP, share of debt to revenue, share of debt service to revenue; and basic risk measures of the debt portfolio. Loan guarantees should also be decomposed by creditor, instrument, currency, interest rate basis, original, and residual maturity, and clarify how much of the loan has already been amortized. Some basic risk measures on guaranteed debt should be provided, including ratios of guaranteed loans in foreign currency to total guaranteed debt; and the proportion of the guarantees triggered over the past five years, among others.

At higher rating levels, a debt statistical bulletin or its equivalent should cover the following risk measures:

- Share of fixed rate to floating rate debt
- Share of short-term to long-term debt
- Average time to interest rate refixing
- Share of interest rate to be refixed within one year
- Share of foreign currency to domestic currency debt
- Currency composition of foreign currency debt
- Average time to maturity of the debt
- Redemption profile of the debt
- Share of debt to be refinanced within one year

## **Dimension 2: Reporting to local assembly and central government**

The rationale for DPI-4, dimension 2 is to ensure that the SNG is accountable for its DeM operations to the local assembly or similar body and to the citizens by providing frequent reports on DeM and debt-related operations and making these reports publicly available; and reports regularly to the central government if required by law and other legislation. This approach promotes transparency in DeM operations and good governance through greater accountability for the substantial responsibilities that are delegated to DeM entities.

In addition to providing full information about public debt outstanding, accountability is strengthened by submitting a detailed annual report evaluating the DeM operations, including borrowing, liability management operations such as debt exchanges, loan guarantees extended, and on-lending made to the local assembly or similar body, and then publishing the report on the SNG's website. These actions help to insure that DeM operations have been executed in accordance with any objectives set by the legislature and with the DeM strategy that was approved by the executive.

The report should include enough information to enable the local assembly or similar body to evaluate how successful the DeM operations—including new borrowings and debt-related transactions—have been in meeting the DeM objectives. If there is a principal DeM entity, this report is prepared and sent to the legislature by this entity; if there is no principal DeM entity, the DeM entities prepare this report jointly and submit it to the parliament or congress. In either instance, the report should be published on the respective entities' websites.

To receive higher scores on this dimension, the report should include information on the chosen DeM strategy, as well as an assessment of compliance with it and an explanation of potential deviations.

If there are no explicit objectives or strategy, it is possible to meet the threshold of a C score by producing an annual report that thoroughly accounts for DeM operations during the period, together with the rationale for those operations. The rationale could include how DeM operations contributed to the achievement of budget and fiscal objectives and policies. The report should also include reference to the management of risks (outlined in dimension 1), cost-effectiveness, and the judgments made in trading off cost against risk.

For scores of C and B, the annual report may be part of another document, such as a report on budget execution or notes to financial statements, provided that it fully addresses the areas identified in this description. Since in some countries, SNGs are required by law or secondary legislation to report to the central government on debt and guarantee, this threshold also ensures such statutory requirement is met.

Dimensions to be assessed

The following dimensions should be assessed according to the requirements laid out in table 6:

1. Quality and timeliness of the publication of a debt statistical bulletin (or its equivalent) covering SNG debt, loan guarantees, and debt-related operations
2. The presentation and content of an annual evaluation report to the local assembly or similar body on DeM activities and performance and report to central government (if applicable)

Table 6 Assessment and Scoring of Debt Reporting and Evaluation

Score	Requirements
A	<ol style="list-style-type: none"> <li>1. The requirement for score B are met. In addition, a debt statistical bulletin (or its equivalent), which includes main basic risk measures of the debt portfolio, is published at least semiannually, with debt data that are not more than two months old at the date of publication.</li> <li>2. The requirements for score B are met. In addition, the stand-alone annual report contains an assessment of: (a) outcomes against stated DeM objectives; (b) the chosen DeM strategy and rationale behind it; and (c) compliance with that strategy.</li> </ol>
B	<ol style="list-style-type: none"> <li>1. The minimum requirement for score C is met. In addition, a debt statistical bulletin (or its equivalent), which includes main basic risk measures of the debt portfolio, is published at least annually, with debt data that are not more than six months old at the date of publication.</li> <li>2. The minimum requirement for score C is met. In addition, the annual report (or section of a wider report) contains an assessment of how the SNG DeM activities have complied with the SNG's documented and approved DeM strategy.</li> </ol>
C	<ol style="list-style-type: none"> <li>1. A debt statistical bulletin (or its equivalent), with the main categories listed in the "rationale and background" section of this DPI (with the exception of the basic risk measures of the debt portfolio), is published annually, with debt data that are not more than six months old at the date of publication.</li> <li>2. A report (or section of a longer report) providing details of outstanding SN debt and DeM operations is submitted annually to the local assembly or similar body and is also made publicly available. If required, regular reports to central government on SN debt are provided.</li> </ol>
D	<ol style="list-style-type: none"> <li>1. The minimum requirement for score C is not met.</li> <li>2. The minimum requirement for score C is not met.</li> </ol>

#### Supporting documentation

- A copy of the most recent publication of the stocks and flows of the external and domestic

debt of the SNG

- A copy of the most recent debt statistical bulletin or its equivalent
- Copies of the annual evaluation reports
- Copies of the report to central government if required
- Copies of other reports (for example, the budgetary implementation report), which include details of DeM activities

#### **Indicative questions to ask**

- What is the process, and who is responsible for preparing, a debt statistical bulletin or equivalent debt report? How frequently is this debt information published? Is it publicly available? If so, how and in what format?
- Does the debt statistical bulletin or equivalent include:
  - information on SNG debt stocks (by creditor, instrument, currency, interest rate basis, and residual maturity);
  - debt flows (principal and interest payments);
  - debt ratios or indicators or both; and
  - basic risk measures of the debt portfolio?
- What other debt reports are produced by the SNG? Are they publicly available? If so, how and in what format?
- What is the time period or lag from the debt reporting period to the period when reliable debt reports are produced? What validation measures are used to ensure the accuracy of these reports?
- Who is responsible for authorizing the release of these reports?
- Is an annual report on DeM activities submitted to the local assembly or similar body, and is the report detailed enough to form the basis for an evaluation of the borrowing and other DeM activities?
- Does this report contain (a) an evaluation of how the DeM activities have complied with the SNG's DeM strategy; (b) the chosen DeM strategy and rationale behind it; and (c) an assessment of outcomes against the stated DeM strategy?
- Is the report made available publicly?
- Is the SNG required to report to the central government? If yes:
  - How often?
  - What information is required to be included in the report?
  - Is the report regularly submitted?

## **DPI-5      AUDIT**

### **Rationale and background**

**Dimension 1: Frequency and comprehensiveness of financial audits; compliance audits; performance audits on the effectiveness and efficiency of SNG DeM operations, including the internal control system and its effectiveness; and publication of the external audit reports**

The rationale for DPI-5, dimension 1 is to ensure that the DeM activities, policies, and operations are subject to scrutiny by the external and internal audit bodies.

Accountability for SNG DeM is strengthened by regular external and internal audits of SNG DeM activities in relation to (a) the reliability and integrity of financial and operational information; (b) the effectiveness and efficiency of DeM operations, including compliance with the stated DeM objectives and strategy (if available); (c) the effectiveness of the internal control system; and (d) compliance with laws and regulations.

Standards of external audit practice should be consistent with international standards, such as those set by the International Organization of Supreme Audit Institutions (INTOSAI). Transparency and the accountability framework for DeM can also be strengthened by public disclosure of external audit reviews of DeM operations.

Financial audits seek to assess the risk of material misstatement of SNG debt information disclosed in financial reports, whether due to error or fraud, to issue an opinion on the fairness of the SNG debt assertions.

Compliance audits first identify the direct and materially significant provisions of laws and regulations, and then perform tests to determine whether DeM has complied with the legal provisions.

Performance audits are audits of the effectiveness and efficiency of the DeM operations. The effectiveness aspect involves checking the achievement of the stated objectives and the actual impact of activities against their intended impact. It also includes an examination of internal controls and management of operational risks. The efficiency aspect looks at the efficient use of resources, and includes an examination of information systems as well as performance measures and monitoring arrangements. In performance audits, the auditors first identify materially important areas of DeM that can be examined, and then select specific areas where the audit is likely to add significant value in promoting effectiveness, efficiency, and economy.

Audits of the internal control system involve assessing whether the control system is properly designed to (a) provide reasonable assurance for the SNG to achieve its DeM objectives, and (b) prevent fraud within the organization. Internal control systems that prevent fraud involve, for example, organizing a DeM unit based on segregation of duties, having sound information technology (IT) security, and having a risk control and compliance unit that frequently monitors adherence to these internal rules.



Sound practice suggests that the transparency of DeM operations is enhanced when the results of external audits are made available to the public.

## **Dimension 2: Degree of commitment to address the outcomes from the audits**

The rationale for DPI-5, dimension 2 is to ensure that the relevant SNG decision makers are committed to address the outcomes from the audits.

The goal of external and internal auditing is to promote accountability in debt contracting and management. Mechanisms should ensure appropriate responses from relevant decision makers following audit reports and the adoption of corrective measures to ensure that the outcomes from audits are addressed.

To assess requirements under this DPI, meetings should be held with representatives of both the external auditor (normally, this is the local office of the auditor general), and the internal audit function covering SNG DeM activities (normally, this is the internal audit function of the local ministry of finance or its equivalent).

## **Dimensions to be assessed**

The following dimensions should be assessed according to the requirements laid out in table 7:

1. Frequency of financial audits, compliance audits, and performance audits of the effectiveness and efficiency of SNG DeM operations, including the internal control system, as well as publication of the external audit reports
2. Degree of commitment to address the outcomes from the audits

Table 7 Assessment and Scoring of DeM Audits

Score	Requirements
A	<ol style="list-style-type: none"><li>1. The requirements for score B are met. In addition, the external performance audit reports are made available to the public within six months of completion of the audit.</li><li>2. The requirements for score B are met. All actions have been implemented within the time line.</li></ol>
B	<ol style="list-style-type: none"><li>1. The minimum requirement for score C is met. In addition, there are regular external performance audits as well as internal audits of the effectiveness of the internal control system used for the SNG DeM.</li><li>2. The minimum requirement for score C is met. In addition, there is an action plan specifying corrective measures and a time line to address the recommendations. Some actions have been implemented.</li></ol>
C	<ol style="list-style-type: none"><li>1. An external financial audit of DeM transactions is undertaken annually. External compliance audits have been conducted in the</li></ol>

	<p>past two years. Audit reports are publicly available within six months of completion of the audit.</p> <p>2. The relevant decision makers produce a management response to address the outcomes of the internal and external audits of SNG DeM activities.</p>
D	<p>1. The minimum requirement for score C is not met.</p> <p>2. The minimum requirement for score C is not met.</p>

### Supporting documentation

- A copy of audit legislation, which may be available on the government or supreme audit institution (SAI) website
- A copy of any financial, compliance, and performance audits of DeM activities undertaken within the past five years
- A copy of any follow-up response to a financial audit, compliance audit and performance audit, particularly to note the reaction and commitment to address the audit findings

### Indicative questions to ask

- Have any external financial audits been undertaken by an external auditor on DeM activities? If so, when, what was the process, what were the findings, and how have they been addressed? Have these been publicly disclosed, and if yes, where?
- Have any external compliance audits been undertaken by an external auditor on DeM activities? If so, when, what was the process, what were the findings, and how have they been addressed? Have these been publicly disclosed, and if yes, where?
- Have any external performance audits been undertaken by an external auditor on DeM activities? If so, when, what was the process, what were the findings, and how have they been addressed? Have these been publicly disclosed, and if yes, where?
- Is there an internal audit function in the principal DeM entity or the local ministry of finance? If yes:
  - What are the mandate, roles, and responsibilities of this function?
  - What internal audits are undertaken, how frequently, and what is the basis of determining the audit program?
  - Have any internal audits been conducted on the effectiveness of the internal control system for debt management operations? If so, when, what was the process, what were the findings, and how have they been addressed?
  - What is the SNG's commitment to address audit findings in the area of DeM?

## 3.2 COORDINATION WITH FISCAL AND BUDGETARY POLICY

### DPI-6 COORDINATION WITH FISCAL AND BUDGETARY POLICY

#### Rationale and background

#### **Dimension 1: Supporting fiscal policy makers through the provision of accurate and timely forecasts on total SNG debt service under different scenarios**

The rationale for DPI-6, dimension 1 is to ensure that reasonably reliable and timely forecasts on debt service are provided during the annual budget preparation process.

For budget formulation and execution, total debt service forecasts under different scenarios should be prepared for the fiscal authorities. These forecasts should be conducted based on the macroeconomic forecasts covering all existing SNG debt and active guarantees and should be available to meet the deadlines set for the budget preparation. The principal DeM entity (or the relevant DeM entities) is responsible for providing the debt service projections. The quality of such forecasts is considered “reasonably reliable” when the difference between forecasted and actual debt service outturn is less than 10 percent over the past three years. In the event of unexpected shocks, larger deviations can be accepted but should be duly justified.

In addition to debt service forecasts based on baseline assumptions on exchange and interest rates, budget authorities should also receive alternative forecasts in case those variables deviate from their expected values. For these forecasts, two broad categories of stress tests should be used: sensitivity tests and scenario tests.

A sensitivity test provides the increase in debt servicing costs for a given change in a market variable, such as a 10 percent depreciation of the local currency. A scenario test could depict a bleak macroeconomic or market situation in which interest rates increase at the time the local currency depreciates, for instance, as a result of a prolonged and severe economic downturn. These tests may be used either separately or in conjunction with each other.

During the assessment, the meeting with the budget department (or equivalent) should check the reliability of the debt service forecasts,<sup>7</sup> and whether sensitivity and scenario tests were used.

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<sup>7</sup> The team can ask for past data of three to five years for the estimated and actual debt service numbers to assess whether the forecasts were reasonably reliable or not.

## **Dimension 2: Availability of key macro variables, an analysis of debt sustainability, and the frequency with which it is undertaken**

The rationale for DPI-6, dimension 2 is to ensure that key macroeconomic variables are available and shared with the principal DeM entity (or DeM entities) and that debt sustainability analyses (DSAs) at the SNG level are undertaken and shared with the principal DeM entity (or DeM entities). Key macroeconomic variables and consequent DSAs are essential for effective analysis of the cost and risk of the debt portfolio and development of DeM strategy. Both the projections of the key fiscal variables and the DSA are the responsibility of the fiscal authority.

Key macro variables typically include actual outcomes and forecasts of real, monetary, external, and fiscal variables that allow users to assess the sustainability of the fiscal position and its sensitivity to changes in the economic environment.<sup>8</sup> The outlook on these variables defines the environment in which the debt managers operate and informs DeM strategy development.

The key fiscal variables normally include (a) the medium-term fiscal policy objectives and strategy; (b) total SNG expenses, revenues, and debt level; and (c) the medium-term plan (three or more years) for total expenses and revenues.

Fiscal sustainability assessments offer critical information to the debt manager(s). The appropriate DeM strategy depends ultimately on the SNG's tolerance for risk. The extent of debt-related risk that an SNG is willing assume may vary over time, depending on the size of its debt portfolio and its perception regarding vulnerability to economic and financial shocks. In general, the larger the debt portfolio and the economy's vulnerability to macroeconomic and exogenous economic shocks, the larger the potential risk of loss from financial crisis or adverse developments.

A DSA is undertaken to assess the medium- or long-term sustainability of the future debt trajectory. A DSA begins with a baseline trajectory for SNG public debt based on the assumptions underlying the macroeconomic framework. It then tests these baseline assumptions, and analyzes how materialization of various risks would affect the SNG debt trajectory.

It is important during the assessment to meet with officials from both the budget department and the macroeconomic unit to receive their views on the key fiscal variables.

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<sup>8</sup> The assumption regarding key macro variables should be coordinated between the budget forecasting process and debt servicing forecasts, in particular with foreign exchange and inflation rates, respectively, if there is foreign currency or inflation-indexed debt.

## Dimensions to be assessed

The following dimensions should be assessed according to the requirements laid out in table 8:

1. Support of fiscal policy makers through the provision of accurate and timely forecasts on total SNG debt service under different scenarios
2. Availability of key macro variables, an analysis of debt sustainability, and the frequency with which it is undertaken

Table 8 Assessment and Scoring of Coordination with Fiscal Policy

Score	Requirements
A	<ol style="list-style-type: none"><li>1. The requirements for score B are met. In addition, the forecasts include scenario analysis, including worst-case scenarios.</li><li>2. The requirements for score B are met. In addition, DSAs are undertaken or updated annually by the SNG.</li></ol>
B	<ol style="list-style-type: none"><li>1. The minimum requirement for score C is met. In addition, the forecasts include sensitivity analyses of the base case to interest and exchange rate shocks.</li><li>2. The minimum requirements for score C are met. In addition, DSAs are undertaken by the SNG at least once every two years.</li></ol>
C	<ol style="list-style-type: none"><li>1. As part of the SNG's annual budget preparation, reasonably reliable and timely forecasts are provided on total SNG debt service.</li><li>2. Key macro variables (actual outcomes and forecasts) are available and an analysis of the debt sustainability that has been undertaken by the SNG within the past three years is shared with the principal DeM entity (or DeM entities).</li></ol>
D	<ol style="list-style-type: none"><li>1. The minimum requirement for score C is not met.</li><li>2. The minimum requirement for score C is not met.</li></ol>

## Supporting documentation

- A copy of information shared between the principal or relevant DeM entity and the fiscal policy or budget authorities
- A copy of the most recent document detailing key fiscal variables (actual outcomes and forecasts), such as SNG revenues, expenditures, primary balance, and SNG direct and guaranteed debt, and the analysis of debt sustainability that was shared with the debt management entities

## Indicative questions to ask

- Who is responsible for preparing forecasts of total SNG debt and debt service? What

assumptions are used in preparing these forecasts, and who is responsible for setting the assumptions? Do the forecasts include sensitivity analyses of the baseline to interest and exchange rate changes? Do the forecasts include scenario analyses, including forecasts for worst-case scenarios?

- What debt and other information are shared between the principal DeM entity (or DeM entities) and the fiscal or budget authorities? How frequently is this information shared?
- Does the SNG regularly prepare and update a document detailing key fiscal variables (actual outcomes and forecasts), such as revenues, expenditures, primary balance, and debt, or undertake a DSA, or both? Is this document or analysis published and widely distributed? Are these shared with the principal DeM entity (or DeM entities)? If so, how were they used by the principal DeM entity (or DeM entities)?
- When was the DSA last conducted? What entities or people were involved in conducting the DSA, and what were their respective roles and responsibilities? Did the SNG receive any external assistance? How was the output used?
- Did the result of the DSA inform fiscal or budgetary and debt policies? If so, in what manner?

### 3.3 BORROWING AND RELATED FINANCING ACTIVITIES

#### DPI-7 DOMESTIC BORROWING

##### Rationale and background

**Dimension 1: The preparation of an annual plan for the aggregate amount of borrowing in the domestic market, divided between the debt securities and other sources; and the publication of an auction calendar for securities**

The rationale for DPI-7, dimension 1 is to ensure that the SNG prepares a borrowing plan, documents and accesses the most beneficial domestic borrowing terms and conditions, and publishes an auction calendar whenever it regularly issues debt securities (short-term bills and longer-term bonds) through auctions.

In the domestic market, the borrowing options for SNGs typically include borrowing directly from commercial or development banks by concluding a loan agreement, and borrowing from the central government, including through on-lending schemes. A key responsibility of DeM entity is to identify and assess all potential creditors and investors with their respective terms and conditions. The DeM entity should actively approach creditors offering the best terms and conditions.

Direct loans from commercial banks comprise a large source of domestic borrowing for SNGs. While assessing the terms, The DeM entity should evaluate whether the terms and conditions for commercial bank loans or credits are based on market terms, and do not favor investors in the government securities' market. Therefore, the borrowing process should include competitive selection of the qualified banking institution and formalized through an individual loan agreement.

Large borrowers such as SNGs commonly use the auction of debt securities as a funding mechanism. When using auctions, the SNG receives bids from registered bidders or dealers with which the price of the debt securities is arrived at on either a multiple-price or a uniform-price basis. International practice has shown that the issuer can benefit from providing market participants and investors with details of an auction calendar well in advance, and by acting consistently when issuing new debt securities. This approach can lead to lower costs by providing investors with greater certainty, creating a level playing field for investors, and thereby increasing liquidity and broadening the investor base.

Other funding mechanisms in the domestic market include underwriting and syndication, tap

issuance or book building,<sup>9</sup> and private placements.

SNGs should prepare an annual plan for the aggregate amount of domestic borrowing – divided by source of credit– based on the annual budget cash flow forecasts. The overall borrowing plan should preferably be broken down on a monthly basis based on monthly cash flow forecasts.

For large issuers in this market, the issuing operations should preferably be transparent and predictable. In case of regular competitive auctions, the SNG should prepare the market for the issuance by publishing a borrowing calendar in advance for wholesale instruments. Ideally, the borrowing calendar should contain dates, instruments, and indicative amounts to borrow for each instrument (on a maturity basis) for the coming quarter.

## **Dimension 2: The availability and quality of documented procedures for domestic borrowing**

The rationale for DPI-7, dimension 2 is to ensure that written procedures are available for all domestic borrowing operations.

The procedures for domestic borrowing operations should include all steps in the borrowing process. In the case of direct borrowing from commercial banks, written procedures should cover the loans' proposal format, selection criteria, format of standardized loan agreement and obligations of the lender and borrower. When auctions are used, the procedures should cover announcement of the auction, bidding time period (opening time and closing time), processing of bids, approval of auction cut-off interest rate, announcement to successful bidders and the market, and settlement of the auction. Auction procedures often will be documented in an information memorandum (or prospectus) or operating procedures that are made available to market participants. If primary dealers are used, it is important that the incentives and obligations of the dealers, as well as the eligibility criteria, be well defined and disclosed.

The documented borrowing procedures must be followed by the SNG debt managers. If that is not the case, the following indicators should be read as if the borrowing procedures were not in place.

To receive the highest score, the SNG or its agent should have regular meetings with market participants to exchange views on the borrowing program and direction of domestic market

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<sup>9</sup>Tap issuance or book building will involve the acceptance of bids during a 'window' open for a set time period at rates or spreads that have been set. Where these issue mechanisms are used, the SNG should provide information to the market on the amounts to be issued and the time period. These two issue mechanisms are at times used by SNG's in early stages of market development and if present, should be assessed with similar criteria for transparency and procedures as for loans and issue of debt securities.



development.

### Dimensions to be assessed

The following dimensions should be assessed according to the requirements laid out in table 9:

1. The preparation of an annual plan for the aggregate amount of borrowing in the domestic market, divided between the debt securities and other sources; assessment of the most cost-effective domestic borrowing terms and conditions; and the publication of an auction calendar for securities if applicable
2. The availability and quality of documented procedures for domestic borrowing

Table 9 Assessment and Scoring of Domestic Borrowing

Score	Requirements
A	<ol style="list-style-type: none"><li>1. The requirements for score B are met. In addition, the auction calendar for SNG debt securities is extended to at least three months.</li><li>2. The requirements for score B are met. In addition, the documented procedure for domestic borrowing is formally reviewed and updated annually. And the SN DeM entity meets with market participants at least semi-annually to exchange views on borrowing plans and the domestic market.</li></ol>
B	<ol style="list-style-type: none"><li>1. The minimum requirement for score C is met. In addition, assessment of most beneficial domestic borrowing terms and conditions is conducted at least annually. The auction calendar for SNG debt securities includes indicative borrowing amounts. The issuance result is also publicly disclosed on the day of the issuance at the same time to all participants.</li><li>2. The minimum requirement for score C is met. In addition, the documented procedure for domestic borrowing is formally reviewed and updated every second year.</li></ol>
C	<ol style="list-style-type: none"><li>1. An annual borrowing plan for the projected aggregate amount of domestic borrowing, divided between debt securities, bank loans and other sources, is prepared. In addition, a borrowing calendar that contains issue dates and instruments for SNG debt securities for the following month that is prepared and published at least one week ahead of the start of the month if SNG regularly issues through auction in the domestic market.</li><li>2. Adequate and readily accessible documented procedures for all domestic borrowings exist. Terms and conditions and criteria for access to the primary wholesale market and if accessing loans, are provided in print media or on the official or agency's websites.</li></ol>
D	<ol style="list-style-type: none"><li>1. The minimum requirement for score C is not met.</li></ol>

	2. The minimum requirement for score C is not met.
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### Supporting documentation

- A copy of the information memorandum or prospectus for each instrument
- A copy of the operating procedures for investors or participants in the primary market
- A copy of annual borrowing plan
- A copy of the issuance program for SNG debt security announced by the principal DeM entity, the DeM entity responsible for the domestic market borrowing, or its agency
- A copy of the agenda of the most recent meeting with market participants
- A copy of operating procedures for other domestic instruments such as direct bank credit, if used

### Indicative questions to ask

- Which instruments are issued by the SNG in the domestic market, and which techniques are used to issue each instrument?
- When does the SNG announce the auction calendar, and what information is provided? How frequently is this information updated during the fiscal year?
- What are the processes, institutional or staff roles and responsibilities, and timetable for conducting auctions of SNG debt security pertaining to the:
  - announcement of the auction;
  - bidding time period (opening time and closing time);
  - processing of bids;
  - approval of auction cutoff;
  - announcement to successful bidders and the market; and
  - settlement of the auction?
- Is there an information memorandum or prospectus for each SNG debt instrument? Is it published in print, or is a soft copy available on the website? What is the content of the information memorandum or prospectus?
- Are there operating procedures or guidelines for the issuance of each SNG debt instrument?
- How often are meetings with market participants held? Which participants are invited, and what topics are discussed at these meetings?

- How is the interest rate determined, if direct bank credit is used?

## **DPI-8      EXTERNAL BORROWING**

### **Rationale and background**

#### **Dimension 1: Documented assessment of the most beneficial or cost-effective borrowing terms and conditions (lender or source of funds, currency, interest rate, and maturity) and a borrowing plan**

The rationale for DPI-8, dimension 1 is to ensure that the external borrowing operations are carefully planned and subject to a thorough analysis of the expected terms and conditions from all potential creditors and markets.

Many developing countries borrow primarily from foreign or external multilateral and bilateral sources. SNGs are often forbidden to borrow externally unless it is guaranteed or on-lent by the central government. The SNG will be eligible for funding on either concessional or market-based interest rates, depending on their respective borrowing status. The primary tasks of the principal DeM entity (or the DeM entity responsible for external borrowing) are (a) to liaise with the SNG entity responsible for formulating the project, in cases where the loan is tied to a specific project; (b) to identify the creditor that can offer the most beneficial or cost-effective terms and conditions for the external borrowing; (c) to negotiate with that creditor the terms and conditions of the loan, including currency, maturity, interest rate, and fees; (d) to liaise and coordinate with the entity or entities in the central government that are responsible for external borrowing (where the central government is involved); and (e) to finalize all loan documentation.

During the disbursement period of the loan, coordination with the creditor and the project implementing entity must occur to ensure that disbursements are completed in accordance with the loan terms and conditions and recorded in a timely manner. Since DeM strategies that rely heavily on foreign currency debt may impose high risk, it is important that the principal DeM entity (or DeM entities) responsible for external borrowings carefully assess and manage the risks associated with foreign currency debt.

Some large SNGs might also access international capital markets. Provided the SNG is legally permitted and able to access these markets, the primary task of the principal DeM entity (or the DeM entity responsible for external borrowing) is to undertake market analysis and consultation to identify the choice of market and instrument, as well as the loan terms and conditions, including price, currency, maturity, and interest rate, and to liaise and coordinate with the central government if necessary.

A fundamental requirement in the external borrowing process is to ensure that all potential external creditors and markets, including the international bond market, are identified jointly with the central government, and the respective financial terms and conditions offered by creditors and investors to the specific debtor are specified. The DeM entity should actively approach the creditors offering the best terms and conditions. A borrowing plan with expected disbursements of external borrowing should be developed. The borrowing plan will have its focus on the coming year, but the following years will also be included because external project

financing normally includes disbursements over a period of years.

The terms and conditions of the loans should be subject to a financial analysis that goes beyond only concessionality analysis. The focus should be to obtain the lowest possible borrowing costs, including grants and technical assistance, within the guidelines of the DeM strategy in terms of currency, maturity, and fixed or floating rate composition. For commercially viable projects, the total return of the projects, including financing costs, should be calculated as part of the project proposal. For these projects, the role of the debt manager is to provide full information on financing costs to those in the SNG responsible for undertaking the analysis and appraisal of public expenditure and investment. This facilitates the calculation of the yield or net present value (NPV) for the total project including the financing. The rationale is that the SNG should seek to invest as profitably as possible. A project with high direct return can also service a relatively costly financing source. Thus, the standard techniques for investment evaluation, including the expected revenues and costs for the investment as well as the financing costs, should be applied.

The creditor analysis and the borrowing plan will be subject to changes during the course of the year due to changes in the creditor offerings, the credit status, and the changes in the external borrowing requirement.

## **Dimension 2: Availability and quality of documented procedures for external borrowings**

The rationale for DPI-8, dimension 2 is to ensure that borrowing activities from external sources are well documented, covering all creditors and funding sources.

At a minimum, the documented procedures should identify the organizational entities and the key functions within them (for example, front, middle, and back office) that undertake the main processes, as described above, when mobilizing external sources of financing. The procedures should describe in detail the steps taken in all the processes, including which entities participate in loan negotiations, the financial analysis undertaken, and recording of the transactions. The financial analysis should include interest rates including fees, currency, and concessionality of the loans as well as penalty fees and other charges, the disbursement and maturity profile, and the impact on the existing debt service profile. The procedure should contain the requirement that the financial terms of loans be entered into a debt recording system on timely basis. Reading through the procedures, the DeMPA reviewer should be able to get a clear understanding of the processes and their soundness.

The documented borrowing procedures should be followed by the debt manager. If it is not the case, the indicator should be read as the procedures were not in place.

## **Dimension 3: Availability and degree of involvement of legal advisers before signing of the loan contract**

The rationale for DPI-8, dimension 3 is to ensure that sound legal features are included in the loan agreements.

Debt managers should receive appropriate legal advice to ensure that the transactions they undertake are backed by sound legal documentation. In doing so, debt managers can help SNGs clarify their rights and obligations and protect their position to the greatest degree possible in the relevant jurisdictions. Several issues deserve particular attention, including (a) the design of provisions of debt instruments, such as clear definitions of default events, especially if such events extend beyond payment defaults on the relevant obligations, for example, cross-defaults and cross-accelerations; (b) the breadth of a negative pledge clause; (c) the use of pari passu clauses; (d) the inclusion of collective action clauses; and (e) the scope of the waiver of sovereign immunity. Disclosure obligations in the relevant markets must be analyzed in detail because they can vary from one market to another.

Evidence of consultation with legal advisors submitted at various stages of the negotiation process, such as recommendations on changes in clauses, should be available.

### Dimensions to be assessed

The following dimensions should be assessed according to the requirements laid out in table 10:

1. Documented assessment of the most beneficial or cost-effective borrowing terms and conditions (lender or source of funds, currency, interest rate, and maturity) and a borrowing plan
2. Availability and quality of documented procedures for external borrowings
3. Availability and degree of involvement of legal advisers before signing of the loan contract

Table 10 Assessment and Scoring of External Borrowing

Score	Requirements
A	<ol style="list-style-type: none"> <li>1. The requirements for score B are met. In addition, assessments of the most beneficial or cost-effective terms and conditions for external borrowing that are obtainable from potential creditors and markets are undertaken before the start of each loan negotiation.</li> <li>2. The requirements for score B are met. In addition, the procedures for all external borrowings are reviewed and updated annually.</li> <li>3. The requirements for score B are met. In addition, legal advisers are consulted from the first stage of the negotiating process to the conclusion of the legal agreements related to the borrowing.</li> </ol>
B	<ol style="list-style-type: none"> <li>1. The minimum requirement for score C is met. In addition, the borrowing plan and assessment of the most beneficial or cost-effective terms and conditions for external borrowing are updated as changes in the borrowing conditions or requirements become apparent during the year.</li> <li>2. The minimum requirement for score C is met. In addition, the procedures for all external borrowing are reviewed formally and updated at least every second year.</li> <li>3. The minimum requirement for score C is met. In addition, legal</li> </ol>

	advisers are consulted during the negotiating process.
C	<ol style="list-style-type: none"> <li>1. An annual borrowing plan for external borrowing is prepared and assessments of the most beneficial or cost-effective terms and conditions for external borrowing that are obtainable from potential creditors and markets are conducted annually.</li> <li>2. Adequate and readily accessible internal documented procedures exist for all external borrowings, including from international capital markets, and contain the requirement to enter all financial terms of the loan transaction into the debt recording system within three weeks of signing.</li> <li>3. Legal advisers approve all clauses of the legal agreements before concluding the negotiation process.</li> </ol>
D	<ol style="list-style-type: none"> <li>1. The minimum requirement for score C is not met.</li> <li>2. The minimum requirement for score C is not met.</li> <li>3. The minimum requirement for score C is not met.</li> </ol>

### Supporting documentation

- A copy of the documented procedures for external borrowing
- A copy of the most recent analysis of the most beneficial and cost-effective terms and conditions
- Documentation of the involvement of legal advisers, for example, recommendations on changes to clauses submitted at various stages of the negotiation process

### Indicative questions to ask

- Which instruments are issued by the SNG in the external markets, and which issuance mechanisms are used?
- What is the basis for choosing to issue or borrow from multilateral, bilateral, and commercial sources? How are the terms and conditions set for each loan, and what scope is there to negotiate these terms and conditions?
- What is the decision-making and approval process to contract or issue each external debt instrument?
- What are the processes, institution or staff roles and responsibilities, and timetable for contracting or issuing each external debt instruments?
- When are legal advisers involved in the contracting of new loans? What is their involvement and role?
- Are technical evaluations carried out for new borrowing proposals to analyze their all-in cost as well as their effect on the currency composition, interest rate structure, and maturity profile of the overall loan portfolio?
- Does an internal borrowing plan for external borrowing exist? How often is it revised?
- Are there documented procedures for borrowing externally, including loans, international bonds, etc.? What is the content of the documented procedures?

## **DPI-9      LOAN GUARANTEES, ON-LENDING, AND DERIVATIVES**

### **Rationale and background**

#### **Dimension 1: Availability and quality of documented policies and procedures for approval and issuance of loan guarantees**

The rationale for DPI-9, dimension 1 is to ensure that the SNG has documented policies for the approval and issuance of loan guarantees and, for the higher scores, that these procedures include (a) a requirement to assess the credit risk embedded in any loan guarantee before the decision has been made to issue the guarantee, and (b) a requirement to monitor this risk during the life of the loan guarantee.

Loan guarantees represent potential financial claims against the SNG that have not yet materialized but could trigger a financial obligation under certain circumstances (contingent liability). To cover this risk, the SNG should charge a guarantee fee based on a thorough credit risk assessment. If it does not, the SNG is subsidizing the beneficiary of the loan guarantee. The establishment of a contingency fund to protect the budget in the case a guarantee is called is desirable if the SN government has little fiscal space to accommodate such risks.

Issuance of letters of comfort, letters of intent, and similar letters should be avoided as the legal status of these letters is unclear. Instead it is better to financially support a certain project or entity by direct budget means or by issuance of a legally binding guarantee that is properly entered into government accounts.

Operational guidelines for approval and issuance of loan guarantees should be in place. These guidelines should provide details of how the credit risk should be assessed, together with measures to minimize the budget effect of a default or trigger event. This risk assessment should occur before the decision has been made to support a certain activity by the use of loan guarantees.

At a minimum, the procedures for approval and issuance of loan guarantees should include (a) the purposes of the guarantees; (b) the decision-making process; and (c) procedures of monitoring. Approval and issuance procedures should be updated regularly and approved by senior management in the local government ministry of finance. For the higher scores, the procedure should contain the requirements for credit risk assessment and analysis of the financial impact if the guarantee is called. The DeMPA assessor should be able to clearly understand the processes and their soundness by reading the procedures.

It is common that the principal guarantee entity be given responsibility to assess the credit risk and keep records of all outstanding loan guarantees, normally in the debt recording and management system.

#### **Dimension 2: Availability and quality of documented policies and procedures for approval and issuance of SNG on-lending**



The rationale for DPI-9, dimension 2 is to ensure that the SNG has documented policies and procedures for on-lending of borrowed funds (domestic or external).

SNGs often support public investment programs, regional business developments, as well as the business needs of state-owned enterprises through direct lending or on-lending of borrowed funds. Such on-lending instruments are expected to provide an adequate supply of credit for the legitimate business or investment needs of the beneficiary, as defined by the respective policy. The SNG is also expected to price that credit reasonably in line with competitively determined market interest rates.

SNG on-lending is also often a substitute for guaranteeing loans that are raised directly by the beneficiary. Thus, to receive higher scores on this dimension, the procedures should include (a) a requirement to assess the credit risk before the decision has been made to on-lend these funds, and (b) a requirement to monitor this risk during the life of the on-lending. To cover the credit risk, the SNG should add a charge on the interest rate based on a proper credit risk assessment. Otherwise, the SNG is subsidizing the borrower of these funds.

As in the liability management process, government assets used for lending purposes require regular monitoring. Such monitoring should include regular assessments of the repayment capacity of the loan beneficiary, risks of misguided spending, or an unexpected economic downturn.

The monitoring process would involve a detailed analysis of the documentation and collateral for the largest loans, a review of a sample of small loans, and an evaluation of loan policies to ensure they are sound and prudent to protect the public's funds.

At a minimum, the procedures for approval and issuance of on-lending contracts should include (a) the purposes of the on-lending; (b) the decision-making process; and (c) monitoring procedures. Approval and issuance procedures for on-lending contracts should be updated regularly and approved by senior management in the local government ministry of finance. For the higher scores, the procedure should contain requirements for credit risk assessment and analysis of the financial impact if the on-lending beneficiary fails to repay the loan.

**Dimension 3: Availability of a DeM system with functionalities for handling derivatives and availability and quality of documented procedures for the use of derivatives**

The rationale for DPI-9, dimension 3 is to ensure that the SNG has a debt recording and management system with proper functionalities for handling financial derivatives; that documented procedures are in place for the use of derivatives; and, to receive higher scores, there are (a) rules in place for managing the counterparty exposure risk, and (b) a separate risk monitoring and compliance unit to monitor all risks connected with the derivatives.

Derivatives used as hedging instruments, such as swaps, caps, and futures, normally entail market and credit risks as well as substantial operational risks. It is essential that these instruments are transacted within a clear risk management framework, backed by sound legal documentation,

and to have systems in place for proper recording and accounting of these transactions.

The procedures for the use of derivative transactions should include (a) the purposes of derivative transactions; (b) a clear decision-making process; (c) rules for debt database entry and accounting; and (d) involvement of legal advisers from the first stage of the negotiating process to conclusion of the legal agreements with the counterparty. To receive higher scores, the procedures should contain the requirement of managing the counterparty exposure risk.

History indicates that derivatives can create significant risks if not properly handled and that it is necessary to have a system in place for proper recording and accounting of derivative transactions.

Embedded options in certain loan agreements, such as options to change a floating interest rate to a fixed interest rate, to cap a floating interest rate, to change the original borrowing currency to another currency, and to prepay a loan before the final maturity date, are not considered derivative transactions in the SN DeMPA methodology.

Dimensions to be assessed

The following dimensions should be assessed according to the requirements laid out in table 11:

1. Availability and quality of documented policies and procedures for approval and issuance of loan guarantees
2. Availability and quality of documented policies and procedures for on-lending of borrowed funds
3. Availability of a DeM system with functionalities for handling derivatives, and availability and quality of documented procedures for the use of derivatives

Table 11 Assessment and Scoring of Loan Guarantees, On-lending and Derivatives

Score	Requirements
A	<ol style="list-style-type: none"><li>1. The requirements for score B are met. In addition, these procedures contain a requirement to calculate and charge a guarantee fee covering the credit risk, as well as a requirement for the guarantee entity to monitor the risk during the life of the loan guarantee.</li><li>2. The requirements for score B are met. In addition, these policies and procedures contain a requirement to calculate a charge covering the credit risk, as well as a requirement for the crediting entity to monitor the risks during the life of the credit.</li><li>3. The requirements for score B are met. In addition, the counterparty credit risk is quantified and managed throughout the life of the transaction.</li></ol>
B	<ol style="list-style-type: none"><li>1. The minimum requirement for score C is met. In addition, these procedures contain a requirement to assess the credit risk before a decision is made to issue a loan guarantee, as well as guidelines on</li></ol>

	<p>how this assessment would be conducted.</p> <p>2. The minimum requirement for score C is met. In addition, these procedures contain a requirement to assess the credit risks before a decision is made to support a certain activity by credits, as well as guidelines on how this assessment would be conducted.</p> <p>3. The minimum requirement for score C is met. In addition, the documented procedures include rules specifying that all risks connected with the derivatives be monitored by a separate unit responsible for risk monitoring and compliance.</p>
C	<p>1. There are adequate and readily accessible internal documented procedures for the approval, issuance, and monitoring of loan guarantees.</p> <p>2. There are adequate and readily accessible internal documented procedures for the approval and provision of credits, in the form of on-lending from external or domestic borrowing sources.</p> <p>3. There is a DeM system with functionalities for handling derivatives. In addition, there are adequate and readily accessible internal documented procedures for the use of derivative transactions.</p>
D	<p>1. The minimum requirement for score C is not met.</p> <p>2. The minimum requirement for score C is not met.</p> <p>3. The minimum requirement for score C is not met.</p>

### Supporting documentation

- A copy of the operational procedures for issuing loan guarantees including the method for calculating guarantee fees, the method for monitoring risks related to guarantees, and guidelines to analyze and potentially quantify risks related to guarantees
- A copy of the operational guidelines for on-lending, including the method for calculating on-lending fees
- A copy of the risk management framework, policies and procedures, and master derivatives agreement for transacting and managing financial derivatives

### Indicative questions to ask

- Does the SNG provide loan guarantees? If so:
  - Which entity is responsible for approving and signing loan guarantees?
  - Which entity or is responsible for assessing the credit risks before the approval of any loan guarantees?
  - Which risk mitigation tools does the SNG apply (for example, guarantee fees, guarantee limits, reporting, budget allocations, contingency accounts, covenants, and so on)?
  - Which entity is responsible for monitoring the risk related to loan guarantees, particularly credit risk?
  - Does the government charge a guarantee fee? If so, from whom (for example, sponsoring ministry or guarantee beneficiary)? How is this fee calculated, and who is

- responsible for calculating and administering the guarantee fee?
  - Does the government appropriate for risks in the budget? If so, are these budget allocations transferred to a contingency account?
- Does the SNG provide on-lending? If so:
  - Which entity is responsible for approving and signing the on-lending agreements?
  - Which entity is responsible for assessing the credit risks before the approval of any government on-lending agreements?
  - Which entity is responsible for monitoring the risk of government on-lending, particularly credit risk?
  - Does the SNG charge the borrower for the credit risk? If so, how is the charge calculated, and who is responsible for calculating and administering this charge?
- Does the SNG enter into derivative transactions? If so:
  - Which entity is responsible for negotiating, approving, and undertaking derivative transactions?
  - Which entity is responsible for assessing and monitoring the risk of these transactions? Are derivative transactions collateralized?
  - Is there a debt recording and management system for handling the derivatives?
  - Are there documented procedures for the use of derivatives? What is the content of the documented procedures?
  - When are legal advisers involved in the negotiating process of concluding the legal agreements with the derivatives counterparty? What is their involvement and role, and how much value or experience do they provide?
  - Which entity is responsible for entering derivative transactions into the debt recording or management system? Which data source is used? Who validates the data?
  - Which entity is responsible for accounting of derivatives, and which accounting rules are applied?
- Are limits imposed on the counterparty exposure risks? If so, what is the basis for setting the limits?

### **3.4 CASH FLOW FORECASTING AND CASH BALANCE MANAGEMENT**

#### **DPI-10 CASH FLOW FORECASTING AND CASH BALANCE MANAGEMENT**

##### **Rationale and background**

##### **Dimension 1: Effectiveness of forecasting the aggregate level of cash balances in SNG bank accounts**

The rationale for DPI-10, dimension 1 is to ensure that reasonably reliable forecasts of the SNG cash balance are produced and available to the principal DeM entity (or DeM entities). Some of the forecast information, such as debt servicing, will be produced by the DeM entity, while other information, such as revenues forecast including revenue transferred from the central government and locally generated, may be provided to the DeM entity by the relevant SNG authority.

It is a common procedure for local government line ministries/Treasurer (or the equivalent) to prepare monthly forecasts of the budget provision, which are used for allocating funds or providing expenditure warrants on a monthly basis. These forecasts do not take into account the timing of expenditures and collection of revenues into the SNG bank account(s). For example, the revenue collection process can have a delay before the funds are received by the SNG. To obtain reliable forecasts of the aggregated SNG cash balance, it is necessary to determine the relationship between budget cash management forecasts (normally monthly) and the impact on the SNG cash balance.

The principal DeM entity (or DeM entities) requires information on the aggregate level of overnight cash balances for borrowing planning, particularly for short-term instruments, and to ensure that the cash balance is in accordance with the level or range set by the government policy. The debt manager therefore requires accurate and timely forecasts of cash flows and the end-of-day account balances. To reduce the negative cost of carry, the SNG should aim at borrowing only when the funds are needed.

To assess whether the cash forecasts are “reasonably reliable”, the following guidelines can be used:

- Forecasts of end-of-day cash balances should be obtained from local government line ministries (or their equivalents) and SNG agencies that cover at least 80 percent of expenditures and revenues.
- Comparisons of actual outcomes against forecast are undertaken at least monthly to

identify the variance<sup>10</sup> and are used to improve the forecasting system.

- The number of instances in the past 12 months when the aggregate cash balance has fallen below a minimum balance (for example, requiring a call on the overdraft or ways and means advance) or generated excess funds that were not anticipated and therefore could not be invested can be used as a measure to assess reliability of the forecasts should be monitored.

**Dimension 2: Decision of a proper cash balance (liquidity buffer) and effectiveness of managing this cash balance in SNG bank accounts (including the integration with any domestic debt borrowing program, if required)**

The rationale for DPI-10, dimension 2 is to ensure that the cash balance is actively managed and, to receive a higher score, that short-term issuances are planned according to the cash balance forecast, if applicable.

It is important that the SNG cash balance target be set at a point that provides sufficient protection against periods of market instability and that actions be taken to keep the cash balance at this level. Excessive cash will increase the negative cost of carry (borrowing cost is higher than the risk-adjusted yield on investments), and a cash balance below the determined level will increase the vulnerability of the SNG. In some SNGs, the principal DeM entity is in charge of cash balance management. Apart from keeping this liquidity buffer on deposits in the banking system, it can also be held, in part, in highly liquid instruments, such as central government's treasury bills, if available. As with all asset management, the credit risk must be carefully assessed. Another requirement is the extent to which the management of the aggregate level of cash balances in SNG bank accounts is integrated with DeM activities such as issuing or buying back of short term debt or entering into repurchase or reverse repurchase agreements.

If the level of the cash balance is temporarily below the determined threshold, the SNG should increase its liquidity buffer by borrowing short-term debt, such as using a revolving credit facility, or issuing short-dated debt securities.

**Dimensions to be assessed**

The following dimensions should be assessed according to the requirements laid out in table 12:

1. Effectiveness of forecasting the aggregate level of cash balances in SNG bank accounts
2. Effectiveness of managing this cash balance in SNG bank accounts (including the

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<sup>10</sup> A reasonably reliable forecast would be within 10 percent to 15 percent of actual outcome.

integration with any domestic debt borrowing program)

Table 12 Assessment and Scoring of Cash Flow Forecasting and Cash Balance Management

Score	Requirements
A	<ol style="list-style-type: none"><li>1. The requirements for score B are met. In addition, the cash flow forecast for the coming month is broken down on daily basis.</li><li>2. The requirements for score B are met. In addition, the SNG undertakes transactions, such as the issuance and buyback of short term debt or entering into repurchase or reverse repurchase agreements, weekly to maintain the cash balance target set by the SNG.</li></ol>
B	<ol style="list-style-type: none"><li>1. The minimum requirement for score C is met. In addition, the cash flow forecast for the coming month is broken down on weekly basis.</li><li>2. The minimum requirement for score C is met. In addition, issuance of short-term instruments is planned according to the cash balance forecast, if applicable. And the SNG undertakes transactions (such as issuance or buyback of short term debt) monthly to maintain the cash balance target set by the SNG.</li></ol>
C	<ol style="list-style-type: none"><li>1. Reasonably reliable monthly aggregate forecasts of cash inflows and outflows and cash balances on SNG bank accounts are produced for the budget year and are made available to the DeM entity. In addition, the cash balance forecast is updated monthly.</li><li>2 The SNG manages its surplus cash (that is, cash in excess of the target) through investment in the market on monthly basis in line with appropriate credit risk limits.</li></ol>
D	<ol style="list-style-type: none"><li>1. The minimum requirement for score C is not met.</li><li>2. The minimum requirement for score C is not met.</li></ol>

#### Supporting documentation

- Evidence of aggregate daily cash balances in SNG bank accounts
- Examples of forecasts of SNG cash flows
- Examples of forecasts of the aggregate level of overnight cash balances in SNG bank accounts
- Evidence of investment of surplus cash

#### Indicative questions to ask

- Which entity is responsible for forecasting SNG cash flows and aggregate cash balances? How accurate are the forecasts? How often are forecasts prepared, and for what period are these calculated?
- Which model is used to compare the forecasts with the actual outcomes? Has the accuracy of the cash flow forecasts been improved during the last year? If not, what are

the causes for the inaccuracy?<sup>11</sup>

- How is the short-term issuance program developed? Is it linked to cash balance forecasts?
- Has the SNG set a target or range for the balance in the SNG bank account? If so, what is the range, and who decided this range? How is the range calculated?
- Which entity monitors that the cash balance is within the determined range, and what actions are taken to ensure that the cash balance is within this range? How often are actions taken to keep the cash balance within the determined range?
- How many instances in the past 12 months has the aggregate cash balance fallen below a minimum balance (for example, requiring a call on the overdraft or ways and means advance) or generated excess funds that were not anticipated and could not be invested?
- Does the bank pay interest on surplus balances? If so, what is the interest rate?
- Is the SNG able to invest surplus balances? If so, which investments are used?
- Which instruments are used to manage surplus balances or excess liquidity? How are these instruments integrated with the SNG's domestic debt issuance?

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<sup>11</sup> Whether any provisioning for the fruition of contingent liability, if it occurred, was included.



### **3.5 DEBT RECORDING AND OPERATIONAL RISK MANAGEMENT**

#### **DPI-11 DEBT ADMINISTRATION AND DATA SECURITY**

##### **Rationale and background**

##### **Dimension 1: Availability and quality of documented procedures for the processing of debt-related payments**

The rationale for DPI-11, dimension 1 is to ensure that there are documented procedures for the processing of debt-related payments, including the following requirements: (a) all payment notifications are checked with internal records before payments are made; (b) payment instructions are subject to a minimum two-person authorization process; and (c) payments are made by the due date. This set of rules and processes should be documented in a procedures manual.

Processing and controlling payments to effect settlement of government debt and debt-related transactions are key responsibilities. This settlement involves accurate, timely, and secure processing with minimal errors. In addition, there should be procedures for monitoring payment arrears and measures for controlling the level of arrears.

In some countries, the central government on-lends borrowed fund to SNG and deducts the debt service payment regularly from the central government transfer at the source. It is important for SNG to keep its own debt records and calculate the debt service payment due.

It is essential that strong controls and well-documented procedures exist for settlement of transactions. Payments must be secure with controls to ensure that a minimum two-person authorization process is used to validate and process payments.

The debt administration operations for payments should be checked by testing the validation of loan payment notifications and controls around the payment process.

Most principal DeM entities will have a debt recording and management system with accompanying user and technical manuals. These manuals are not sufficient to meet the minimum requirements because they are generic to the system or software and do not necessarily reflect the payment process in that country. The documented procedures must reflect the current practices and be followed. If that does not occur, the indicators should be read as if the procedures manuals were nonexistent.

To receive the highest score, the internal payment orders are prepared and issued electronically by straight-through processing. Straight-through processing is the ability to send payment instructions directly from a management information system to a secure financial messaging system (for example, SWIFT), the central bank, or commercial banks. With these electronic links in place, there is no need for reentry of data into payment systems, thus reducing operational risk and increasing efficiency. Control over the authorization of payments is maintained through

access rights to the system or database, as described in dimension 3, so that the minimum two-person check can be enforced.

**Dimension 2: Availability and quality of documented procedures for debt and transaction data recording and validation, as well as storage of agreements and debt administration records**

The rationale for DPI-11, dimension 2 is to ensure that there are documented procedures for recording and validating debt data (new debt, disbursements, and repayments) as well as for storing agreements and debt administration records, including the following requirements: (a) accuracy of debt data is ensured by segregation of responsibilities for data entry and confirmation of the accuracy by separate staff before the entries are deemed to be completed; (b) debt data are constantly validated against received payment notifications; (c) all original, signed copies of loan and derivative agreements are stored and filed in a secure location; and (d) all debt administration records are kept in a secure filing system.

An original, signed copy of each loan and derivative agreement should be stored in a secure location that will protect the documents from incidents such as theft, fire, flood, or other incidents that may damage or destroy any of these records. A copy of each agreement should be available with the principal DeM entity (or the DeM entities). All correspondence with the lender or counterparty during the life of each loan or derivative (referred to as “debt administration records”) should be kept in a secure filing system. Scanned copies of original loan agreements and all debt administration records, if backed up and stored securely, will meet the requirements for this dimension.<sup>12</sup>

It is essential that strong controls and well-documented procedures exist for maintenance of the financial records.

To receive the highest score, an independent confirmation of all data must be conducted annually with external creditors and major domestic investors or creditors.

User and technical manuals that accompany a debt recording and management system are not sufficient to meeting the minimum requirements.

The documented procedures must reflect the current practice and be followed. If that does not occur, the indicators should be read as if the procedures manuals are not in place.

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<sup>12</sup> It is also important to ensure that these backups include key documents that have been scanned and/or are maintained on the servers related to processing of DeM operations (for example, payment advices from creditors).

### **Dimension 3: Availability and quality of documented procedures for controlling access to the SNG's debt data recording and management system and audit trail**

The rationale for DPI-11, dimension 3 is to ensure that there are documented procedures for controlling access to the debt recording and management system.

The debt data in the debt recording and management system or database must be secure, the system should be located in a locked area, and access to the system by users and information technology specialists should be tightly controlled through access permissions and password controls. Access permissions for individuals should be updated on the day that their responsibilities change. To receive the highest score, the system must produce audit trails that show who has accessed the system, the time they accessed it, the level accessed, and the activities of each user. The audit trails should be monitored for exceptions at least monthly.

User and technical manuals that accompany the debt recording and management system are not sufficient for meeting the minimum requirements.

The documented procedures must reflect the current practice and be followed. If that does not occur, the indicators should be read as if the procedures manuals are not in place.

### **Dimension 4: Frequency and off-site, secure storage of debt recording and management system backups**

The rationale for DPI-11, dimension 4 is to ensure that debt recording and management system backups are made frequently and that the backups are stored in a separate and secure location.

A copy of the debt data (backups) should be made frequently and stored in a secure location outside the building in which the debt database is located. While locations such as another government building are acceptable, the house of the head of the debt management office or of the IT person is not acceptable. The storage location of the backups should be protected from incidents such as theft, fire, flood, or other incidents that may damage or destroy any of these backups. Debt data backups should be tested regularly, at least quarterly, to make sure that they can effectively be used if needed.

### **Dimensions to be assessed**

The following dimensions should be assessed according to the requirements laid out in table 13:

1. Availability and quality of documented procedures for the processing of debt-related payments and receivables
2. Availability and quality of documented procedures for debt and transaction data recording and validation, as well as storage of agreements and debt administration records
3. Availability and quality of documented procedures for controlling access to the SNG's debt data recording and management system and audit trail
4. Frequency and off-site, secure storage of debt recording and management system

## backups

Table 13 Assessment and Scoring of Debt Administration and Data Security

Score	Requirements
A	<ol style="list-style-type: none"> <li>1. The requirements for score B are met. In addition, internal payment orders are prepared and issued electronically by straight-through processing, and the procedures manual is formally reviewed at least every year.</li> <li>2. The requirements for score B are met. In addition, an independent confirmation of data is annually conducted with external creditors, and the major domestic investors and creditors and the procedures are formally reviewed at least every year.</li> <li>3. The requirements for score B are met. In addition, the systems produce audit trails that show the user's activities, and the documented procedures are formally reviewed at least every year.</li> <li>4. The requirements for score B are met. In addition, debt recording and management system backups are made daily and stored in a secure filing system before they are moved to the separate, secure location weekly.</li> </ol>
B	<ol style="list-style-type: none"> <li>1. The minimum requirement for score C is met. In addition, internal payment orders are prepared electronically, and the procedures manual is formally reviewed at least every second year.</li> <li>2. The minimum requirement for score C is met. In addition, the procedures manuals are formally reviewed at least every second year.</li> <li>3. The minimum requirement for score C is met. In addition, the documented procedures are formally reviewed at least every second year.</li> <li>4. The minimum requirement for score C is met. Debt recording and management system backups are made at least once per week and are stored in a separate, secure location.</li> </ol>
C	<ol style="list-style-type: none"> <li>1. There is an adequate and readily accessible procedures manual for the processing of debt service payments.</li> <li>2. There are adequate and readily accessible procedures manuals for debt data recording and validation, as well as for storage of agreements and debt administration records.</li> <li>3. There are adequate and readily accessible documented procedures for controlling access to the SNG's debt recording and management system.</li> <li>4. Debt recording and management system backups are made at least once per month, and the backups are stored in a separate, secure location.</li> </ol>
D	<ol style="list-style-type: none"> <li>1. The minimum requirement for score C is not met.</li> <li>2. The minimum requirement for score C is not met.</li> </ol>

	<p>3. The minimum requirement for score C is not met.</p> <p>4. The minimum requirement for score C is not met.</p>
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### Supporting documentation

- A copy of the procedures manual for processing of debt-related payments and receivables, for debt data recording and validation, and for storage of agreements and debt administration records
- Evidence of the physical storage of original, signed copies of loan and derivative agreements in a secure location, of the scanning and maintenance of such agreements in electronic form in a secure location, or of both
- Evidence of validation procedures against payment notifications
- Evidence of an independent confirmation of all data with external creditors and major domestic investors
- Evidence of a two-person authorization process
- A copy of the system access permissions and evidence of system security and access controls
- Evidence that audit trails are monitored
- Evidence of the storage location of debt recording and management system backups (the location verified by the assessors)

### Indicative questions to ask

- Does the principal DeM entity (or DeM entities) have a procedures manual for processing of debt-related payments and receivables? If so, where is it located, what is the content of the manual, and how is it updated and maintained?
- Who is involved in arranging debt service payments, and what is the authorization process? What are the procedures for debt on-lent from central government?
- Has the government met all debt service payment obligations by the due date? If not,
  - How often have payments been late, and how late have they been?
  - What were the reasons for, or sources of, the delay?
  - Were penalty charges imposed for late payment? If so, how significant were these penalty charges?
- Is there a procedures manual for the debt data recording and validation and for storage of agreements and debt administration records? If so, where is it located, what is the content of the manual, and how is it updated and maintained?
- Are debt data entries checked for accuracy before the entries are deemed to be completed?
- How often does the principal DeM entity (or DeM entities) reconcile loan data with creditors?
- Where are the original, signed loan and derivative agreements stored? Is this location

considered to be a secure location to protect these records from incidents such as theft, fire, flood, or other incidents that may damage or destroy any of these records?

- Where are debt administration records stored and filed? Is this location considered to be a secure and fireproof location?
- Are the loan agreements and debt administration records scanned? If so, where are the scanned copies stored? Do these include key documents that have been scanned or are maintained on the servers related to processing of DeM operations?
- Are there documented procedures for controlling access to the SNG debt recording and management system and payment system? If so, where are these located, what are the controls, and how frequently are they updated?
- Who sets the access levels and functions for those staff members or persons who access the debt recording and management system? Do these persons also enter data into the system?
- Are audit trails produced for the debt recording and management system and payment system? If so, who is responsible for monitoring these audit trails and the users who have accessed the system?
- Which entity is responsible for backing up the debt recording and management system? What is the process for making the backups? How often the backups are made, and where are the backups stored?

## **DPI-12      SEGREGATION OF DUTIES, STAFF CAPACITY, AND BUSINESS CONTINUITY**

### **Rationale and background**

#### **Dimension 1: Segregation of duties for some key functions, as well as the presence of a risk monitoring and compliance function**

The rationale for DPI-12, dimension 1 is to ensure that the internal organization of the principal DeM entity (or DeM entities) is based on the segregation of duties between debt managers with the authority to negotiate or contract the loan agreement and enter the contract information in the debt management system, and those responsible for (a) confirmation of contract information, and (b) initiating and processing payments. It is also to ensure that there is a separate risk monitoring and compliance function.

An efficient organizational structure should be in place across the principal DeM entity (or the DeM entities) to maintain security and control over SNG borrowing and debt-related transactions. Segregation of duties is one of the most important parts of an effective internal control system for any financial activity. Strong operational controls and well-articulated responsibilities for staff will reduce the risk of errors, policy breaches, and fraudulent behavior, which can potentially lead to significant losses to the SNG that can tarnish the reputation of not only the principal DeM entity (or relevant DeM entities) but also the whole government.

The negotiation of loans or decisions around the issuance of debt securities, whether in the domestic market or in international markets, will normally rest with the head of the principal DeM entity or higher (for example, the local government minister of finance, and Governor or mayor). These officials can formally sign the resulting agreements and other documentation and may enter contract information in the debt management system on a preliminary basis.

However, confirmation and finalization of the contract information in the system should be undertaken by other staff in the back office (by checking it against documentation provided by the creditor). Different individuals should be responsible for entering data in the debt recording system on the one hand, and checking data entries on the other. In addition, the functions of contract negotiation and contract data entry should be organizationally separated from the functions of transaction settlement (that is, initiating and processing the payment).

There should be a risk monitoring and compliance function within the principal DeM entity (or the DeM entities), often in the middle office. Its primary function is to monitor whether all DeM operations are (a) within the authorities and limits set by government policies; (b) in compliance with statutory and contractual obligations; and (c) within the risk parameters included in the approved DeM strategy and in accordance with the operational risk management plan. This function could be overseen by an individual staff member or, ideally, a specialized unit with this role and associated responsibilities.

#### **Dimension 2: Staff capacity and human resource management**

The rationale for DPI-2, dimension 2 is to ensure that a sufficient number of DeM staff are employed and are adequately trained, and that individual job descriptions have been prepared. To receive higher scores, there are code-of-conduct and conflict-of-interest guidelines, individual training and development plans, and an annual performance assessment for DeM staff.

The organizational structure and management policies should support sound human resource management practices, sufficient and adequately trained staff, and formal job descriptions reflecting current assignments. To assess whether there are sufficient DeM staff, assessors must have information on the number of outstanding loans, weekly front-office operations, daily back-office activities, and other activities DeM staff is engaged in. In some SNGs, the number of staff is likely to be small. In this case, assessing whether there are sufficient staff will come down to whether the segregation of duties criteria explained in Dimension 1 can be met.<sup>13</sup> The capacity to perform the tasks will, of course, be an important factor.

Furthermore, the debt managers should be subject to code-of-conduct and conflict-of-interest guidelines, which set out rules that staff members are required to follow, the activities that they are or are not permitted to undertake, and the requirements to disclose personal investments and financial activities.<sup>14</sup> For example, if staff members buy or sell SNG securities, this activity could be perceived as equivalent to insider trading because they may have privileged access to budgetary and other government information. These guidelines will help allay concerns that staff members' personal financial interests could undermine sound DeM practices. Preferably, these guidelines should be reviewed and updated at least annually.

Training plans should ensure that each staff member receives the training that he or she needs to perform the duties assigned.

### **Dimension 3: Presence of an operational risk management plan, including business continuity and disaster recovery arrangements**

The rationale for DPI-12, dimension 3 is to ensure that there is a business continuity and disaster recovery plan as well as, for the higher scores, documented guidelines for operational risk management (an operational risk management plan).

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<sup>13</sup> It can be efficient to combine certain DeM functions, such as back-office and risk-control functions, with similar functions not directly related to debt management, particularly when financing transactions are few and infrequent. This practice would provide the scale to facilitate the segregation of responsibilities; for example, a treasury back office would also process other transactions such as payables and receivables, or a risk monitoring and compliance function could cover all risks and procedures in a finance department, not just those relating to debt.

<sup>14</sup> A general code-of-conduct for civil servants does not qualify if such provisions are not included.



Business continuity planning allows an organization to prepare for future incidents that could jeopardize the performance of its duties, the ability to meet business objectives, and its long-term health. Such incidents include local incidents such as building fires, regional incidents such as earthquakes, or national incidents such as pandemic illnesses.

Disaster recovery is the process of regaining access to the data, hardware, and software and having the minimum number of staff necessary to recover and resume critical business operations after a natural or human-induced disaster. A disaster recovery plan (DRP) should also include plans for coping with the unexpected or sudden loss of key personnel. A DRP is part of the business continuity planning process.

If the SNG has a DRP, it is important to check that the DRP incorporates DeM operations, that staff in the principal DeM entity (or the DeM entities) are aware of the DRP and what it covers, and that the DRP has been tested to cover all relevant DeM operations.

Many different risks can negatively affect the normal operations of an organization. An operational risk assessment would determine what constitutes a disaster, which risks the organization is most susceptible to, which systems and activities are critical, and what the potential impact (financial and reputational) might be. The assessment covers incidents such as natural disasters, fire, power failure, terrorist attacks, organized or deliberate disruptions, theft, fraud, system or equipment failures (or both), human error, computer viruses, legal issues, worker strikes or disruptions, and loss of key personnel. Actions to mitigate those risks are included in an operational risk management plan.

### Dimensions to be assessed

The following dimensions should be assessed according to the requirements laid out in in table 14:

1. Segregation of duties for some key functions, as well as the presence of an operational risk monitoring and compliance function
2. Staff capacity and human resource management
3. Presence of an operational risk management plan, including business continuity and disaster recovery arrangements

Table 14 Assessment and Scoring of Segregation of Duties, Staff Capacity, and Business Continuity

Score	Requirements
A	<ol style="list-style-type: none"><li>1. The minimum requirements for score B are met. In addition, there is a separate unit responsible for risk monitoring and compliance that reports directly to the head of the relevant DeM entity.</li><li>2. The requirements for score B are met. In addition, there are individual training and development plans and annual performance assessments for debt management staff.</li></ol>

	3. The requirements for score B are met. In addition, there is an operational recovery site that is tested at least annually.
B	<p>1. The minimum requirements for score C are met. In addition, there is clear organizational separation between staff responsible for loan negotiation and preliminary contract data entry and those responsible for (a) confirmation of contract information and finalization of records in the system, and (b) initiating and processing payments. There is at least one staff member responsible for risk monitoring and compliance.</p> <p>2. The minimum requirement for score C is met. In addition, there are code-of-conduct and conflict-of-interest guidelines in place that are reviewed and updated as needed. Staff has been trained on the provisions of the above guidelines upon joining the DeM entity (or entities) and at least every two years thereafter.</p> <p>3. The minimum requirement for score C is met. In addition, documented guidelines exist for operational risk management.</p>
C	<p>1. There is clear separation between staff responsible for loan negotiation and preliminary contract data entry and those responsible for (a) confirmation of contract information and finalization of records in the system, and (b) initiating and processing payments.</p> <p>2. There is sufficient and adequately trained staff with formal job descriptions reflecting their current tasks.</p> <p>3. There is a written business continuity and disaster recovery plan, which has been tested in the past three years.</p>
D	<p>1. The minimum requirement for score C is not met.</p> <p>2. The minimum requirement for score C is not met.</p> <p>3. The minimum requirement for score C is not met.</p>

### Supporting documentation

- An organizational chart setting out all the entities involved in DeM and their respective roles and staff responsibilities
- A sample of job descriptions for staff involved in DeM activities
- A sample of individual training and development plans
- A sample of performance assessments
- A copy of the code-of-conduct and conflict-of-interest guidelines
- A copy of the business continuity plan and DRP
- A copy of an operational risk management plan or guidelines
- Terms of reference or job descriptions for the risk monitoring and compliance function

### Indicative questions to ask

- What are the roles and responsibilities of the staff members in the principal DeM entity

(or DeM entities)?

- Who has the authority to negotiate and transact on behalf of the SNG? Who is responsible for settling the transactions, arranging payments, and recording debt data? Are these functions performed by different staff members, by separate divisions, or both?
- Are there staff members responsible for monitoring government DeM operations to ensure that such operations are within the authorities and limits set by government policies and comply with statutory and contractual obligations? Is this work reinforced by the organizational structure and by job descriptions for the staff members responsible for risk monitoring and compliance?
- Does the principal DeM entity (or DeM entities) have a separate unit for risk monitoring and compliance? If so, where is it located, how many staff members are involved, and how actively do they monitor the risks?
- How many professional staff members are in the principal DeM entity (or DeM entities)? How long have the staff members been employed in their current DeM activities? What are the qualifications of staff members?
- What is the situation regarding staff recruitment and retention? What is the level of staff turnover?
- Do all staff members have clear job descriptions or terms of reference? If so, how frequently are these job descriptions reviewed and updated?
- Do staff members have individual training and development plans? If so, how are these plans formulated, and what are the policies and budget for training?
- What training have staff members received? When and where was this training conducted or provided?
- Is staff members' performance assessed? If so, how frequently? What is the process?
- Do staff members have code-of-conduct guidelines, conflict-of-interest guidelines, or both? If so, who is responsible for preparing and monitoring the guidelines? Are staff members trained on these guidelines?
- Is there a business continuity plan and DRP? If so, is there an alternative recovery site for relocating the business, and where is it located? When was the plan last tested? How was the test conducted?
- Are there documented guidelines for operational risk management? What risks are covered in these guidelines?

## **DPI-13      DEBT AND DEBT-RELATED RECORDS**

### **Rationale and background**

#### **Dimension 1: Completeness and timeliness of SNG records on its debt, loan guarantees, and debt-related transactions**

The rationale for DPI-13, dimension 1 is to ensure that the SNG has complete records of its debt, loan guarantees, and debt-related transactions, such as currency and interest rate swaps.

Sound practice requires a comprehensive debt management system that records, monitors, settles, and accounts effectively for all SNG debt and debt-related transactions. This system should provide for an accurate, consistent, and complete database of domestic, external, and guaranteed debt. It forms the base for all DeM activities, including the cost-risk analysis of the debt portfolio, DeM strategy development, borrowing plans, and debt service.

For disbursing loans, which are commonly used for project financing, it is important that the actual disbursement be recorded without delay. Recording disbursements in a timely manner will allow for the accurate calculation and planning of interest payments

#### **Dimension 2: Complete and up-to-date records of all holders of SNG securities in a secure registry system, if applicable**

The rationale for DPI-13, dimension 2 is to ensure that there is an accurate and secure registry system for SNG debt securities issued in electronic form.

A secure registry system is essential for any debt securities issued in electronic form (often referred to as “dematerialized,” “book-entry,” or “scriptless” securities). Instead of keeping debt securities in paper or physical form in a secure location, the investors in these securities now rely completely on an electronic registry system to keep track of their legal title to these instruments and for the payment of interest and principal on due dates. Thus, the registry system must be very secure. Because the ownership of SNG debt securities may change daily through transactions in the secondary market, there must be robust processes in place for the timely, accurate, and secure updating of the registry. In many countries, the registry system will be developed, maintained, and managed by the central bank. In some countries, the registry system is provided by an external party such as commercial banks or Computershare (a private company).

To assess the completeness and security of the registry system, the following should be considered:

- Identification of the entity responsible for managing and maintaining the registry system and its location
- Assessment of registry system management, the resources available, and the management procedures, including controls for maintaining the system

- Assessment of the settlement process for government securities
- Frequency and nature of the audit of the registry and registry system

A nominee account (that is, accounts in the name of local custodian bank on behalf of its clients) is acceptable. Also, the registry should ensure that holders of government securities are regularly provided with statements of their holdings. Internal or external performance audits of the registry system should be undertaken, which examines internal controls and management of operational risks. (See description of audits in DPI-5.)

### Dimensions to be assessed

The following dimensions should be assessed according to the requirements laid out in table 15:

1. Completeness and timeliness of SNG records on its debt, loan guarantees, and debt-related transactions
2. Complete and up-to-date records of all holders of SNG securities in a secure registry system, if applicable

Table 15 Assessment and Scoring of Debt and Loan Guarantee Records

Score	Requirements
A	<ol style="list-style-type: none"> <li>1. The requirements for score B are met. There are complete debt records within a one-month lag.</li> <li>2. The requirements for score B are met. In addition, settlement for SNG debt securities is made on a delivery versus payment (DVP) basis.</li> </ol>
B	<ol style="list-style-type: none"> <li>1. The minimum requirement for score C is met. There are complete debt records within a two-month lag.</li> <li>2. The minimum requirement for score C is met. The audit is conducted annually.</li> </ol>
C	<ol style="list-style-type: none"> <li>1. There are complete records within a three-month lag for SNG domestic, external, and guaranteed debt, as well as all debt-related transactions.</li> <li>2. SNG debt securities are dematerialized and kept in a central registry that has up-to-date and secure records of all holders of SNG securities. It is subject to an audit of internal controls and management of operation risk every two years.</li> </ol>
D	<ol style="list-style-type: none"> <li>1. The minimum requirement for score C is not met.</li> <li>2. The minimum requirement for score C is not met.</li> </ol>

### Supporting documentation

- A copy of a sample of reports that have been generated from the debt recording or management system to ascertain how up to date the debt records are

- Copies of the recent disbursement and payment notices
- Evidence that records in the registry system have been reconciled and audited

**Indicative questions to ask**

- What debt recording and management system is used?
- Does the debt recording and management system capture all debt transactions and loan guarantees?
- What is the time period or lag from the time a loan is disbursed to the time the disbursement is entered into the debt recording and management system?
- How does the registry system operate?
- How frequently are registry records reconciled and audited?
- Does the registry system allow nominee accounts?
- What physical security is in place for the registry system and registry operations?
- Has the registry system been audited to assess the effectiveness of the internal control system and security of the data?
- Does the registry regularly provide statements of holdings to investors (or allow electronic access to the same)?
- Have major holders of SNG securities experienced any problems with the accuracy or timeliness of registry services?

## ANNEX 1: DIFFERENCES BETWEEN THE SOVEREIGN AND THE SUBNATIONAL DeMPA TOOL<sup>15</sup>

Dimension (dim)	Rationale	Sovereign DeMPA	Subnational DeMPA
DPI-1 Legal			
DPI-1 dim 1: Existence, coverage and content of legal framework.	Authorization to borrow and to issue loan guarantees, purposes for borrowing, debt management objectives, and reporting requirement to the local assembly.	Clearly specified that certain key provisions should be included in the primary legislation.	The same existence, coverage and content of legal framework for DeM are required. However, the specification that certain key provisions should be included in primary legislation has been removed. This can be either in the primary or the secondary legislation.
DPI-1 dim 2: Extent of a legal limit to direct access of resources from the central bank	Whenever possible, the subnational government (SNG) should avoid direct borrowing from the central bank. Monetary financing of government deficits, whether at the level of central or subnational government, imposes undesirable constraints on monetary policy operations by increasing the money supply.	Covered under DPI-7 on Coordination with Monetary Policy, dim 3.	As the indicator assessing “Coordination with Monetary Policy” is not relevant for SNGs, it has been dropped from the subnational DeMPA tool. However, in case SNG has access to central bank funds, the issue is assessed in this dimension.
DPI-2 Managerial Structure			
DPI-2 dim 1: Borrowing and debt-	Clear division of political level and the entities implementing the debt management strategy;	Included	Included

<sup>15</sup> The sovereign DeMPA methodology refers to the one revised in June 2015.

Dimension (dim)	Rationale	Sovereign DeMPA	Subnational DeMPA
Related transactions	carry out debt management (DeM) without undue political interference; coordination of DeM		
DPI-2 dim 2: Loan guarantees	Coordination and risk assessment of issuance of loan guarantee by technical staff.	Included	Included
DPI-3 Debt Management Strategy			
DPI-3 dim 1: Content	Quality	Included	Included. For SNGs there are no requirements to describe measures aimed at supporting domestic debt market development.
DPI-3 dim 2: Decision-making	Process	Included	Included. There is no requirement to obtain the views of the central bank.
DPI-4 Evaluation of Debt Management Operations			
DPI-4 dim 1: Quality and timeliness of the publication of a debt statistical bulletin.	Publish debt data regularly with international standard to enhance transparency.	Included	Included with some modifications (e.g. no requirement for residency classification).
DPI-4 dim 2: Evaluation of debt management operations and reporting to the central government	Accountability process should be there.	Submit annual report to Parliament on debt data and activities.	This is similar with the need to submit to the local legislature or council. Reporting to the central government is assessed if required.
DPI-5 Audit			
DPI-5 dim 1: Frequency	Accountability strengthened by regular audits and transparency enhanced if audit reports are disclosed.	Included	Included
DPI-5 dim 2: Appropriate response	Adopt corrective measures to strengthen the accountability.	Included	Included
DPI-6 Coordination with Fiscal and Budgetary Policy			
DPI-6 dim 1: Provision and quality of debt-service	For effective fiscal policy there should be reliable debt service forecasts.	Included	Included



Dimension (dim)	Rationale	Sovereign DeMPA	Subnational DeMPA
forecasts			
DPI-6 dim 2: Availability of information on key macro variables, and DSA	Share information and conduct debt sustainability analysis.	Included	Included
DPI-7 Domestic Borrowing			
DPI-7 dim 1: Market-based mechanisms to issue domestic debt; the preparation of annual borrowing plan and the publication of a borrowing calendar	Market based borrowing, proper borrowing planning and market predictability.	In the sovereign DeMPA tool, DPI-7 deals with coordination with monetary policy, which was considered not relevant for the subnational DeMPA tool, hence dropped.	Domestic borrowings are based on the borrowing plan.
DPI-8 dim 2: Availability of documented procedures for all domestic borrowing operations	Sound practice. Reduce human errors and makes the processes more robust.	Included	Stress the existence of borrowing procedures for all domestic borrowing instruments.
DPI-8 External Borrowing			
DPI-8 dim 1: Preparation of borrowing plan and assessment of terms and conditions	Ensure borrowing in a cost-effective manner.	Included as DPI-9	Included
DPI-8 dim 2: Documented procedures for all external borrowings	Sound practice. Reduce human errors and makes the processes more robust.	Included as DPI-9	Included
DPI-8 dim 3: Degree of involvement of legal advisers	Sound legal features.	Included as DPI-9	Included
DPI-9 Loan Guarantees, On-lending and Derivatives			
DPI-9 dim 1: Loan guarantees, availability and quality of documented policies and procedures	Control and risk monitoring of loan guarantees.	Included as DPI-10	Included and additional attention given to the letter of comfort.

Dimension (dim)	Rationale	Sovereign DeMPA	Subnational DeMPA
DPI-9 dim 2: On-lending, availability and quality of documented policies and procedures	Control and risk-monitoring of on-lending.	Included as DPI-10	Included. This focuses on the funds borrowed by the SNG to on-lend to its enterprises or local governments.
DPI-9 dim 3: Derivatives, availability and quality of documented policies and procedures	Control and risk-monitoring of derivatives if used.	Included as DPI-10	Included
DPI-10 Cash Flow Forecasting and Cash Balance Management			
Effective cash flow forecasting	Make sure financial obligations are met when falling due.	Included as DPI-11 on frequency and length of cash balance forecast	Same requirements
Effective cash Balance management	Actively manage cash balance to maximize profit within preset risk indicators.	Included as DPI-11 on frequency of investment and short-term transaction	The requirement of integration with domestic borrowing program is moved to score B and relax requirement of transaction frequency.
DPI-11 Debt Administration and Data Security			
DPI-11 dim 1: Availability and quality of documented procedures for the processing of debt-related payments and receivables	Control and procedure for processing debt service transaction.	Included as DPI-12	Included
DPI-11 dim 2: Availability and quality of documented procedures for data recording and storage	Control and procedure for debt data recording and storage.	Included as DPI-12	Included
DPI-11 dim 3: Availability and quality of documented procedures for controlling access to data recording and	Ensure data security by controlling access to debt data recording and management system.	Included as DPI-12	Included

Dimension (dim)	Rationale	Sovereign DeMPA	Subnational DeMPA
management system			
DPI-11 dim 4: Frequency of backups and secure storage of these backups	Ensure data security by secure backing-up procedures.	Included as DPI-12	Included
DPI-12 Segregation of Duties, Staff Capacity, and Business Continuity			
DPI-12 dim 1: Segregation of duties and presence of a risk monitoring and compliance function	Reduce operational risk by separation of key functions and effective risk monitoring.	Included as DPI-13	Included and keeping in mind that there may be fewer staff at the subnational level and combined functions.
DPI-12 dim 2: Staff capacity and human resource management	Staff capacity and code-of-conduct.	Included as DPI-13	Included
DPI-12 dim 3: Operational risk management plan, including business continuity, and disaster recovery arrangements.	Reduction of operational risk, and to ensure business continuity in event of serious incidents.	Included as DPI-13	Included
DPI-13 Debt and Loan Guarantee Records			
DPI-13 dim 1: Complete and timely records of all debt and loan guarantees.	Accurate, complete and timely debt records.	Included as DPI-14	Included and reference to past debt relief is removed.
DPI-13 dim 2: Complete and timely records of holders of debt securities in a secure registry system	Secure registry system ensures accurate and up-to-date records of security holders.	Included as DPI-14	Included and requirement to access to residency of holders is removed.