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**STRATEGY**

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**Central Government Debt Management Strategy**

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## 1. Goal and assumptions of central government debt management

- 1.1. Central government debt comprises of received and unpaid gross debt of central government authorities, stated in accordance with the institutional sector classification, (excluding merchants controlled and financed by central government, port and free port authorities, and special economic zones) in the following financial product categories: debt securities (excluding financial derivatives), loans and deposits, including savings bonds, guarantee deposits, as well as cash deposits and account balances of clients (excluding central government authorities, i.a. social insurance authorities, but including merchants controlled and financed by central government, port and free port authorities, and special economic zones) placed at the Treasury.
- 1.2. The Central Government Debt Management Strategy specifies the medium term central government debt management operations of the Treasury.
- 1.3. The Treasury continuously monitors the implementation process of the Central Government Debt Management Strategy and submits annual report on the execution of the Strategy to the finance minister accordingly.
- 1.4. **The goal of the central government debt management** is to ensure availability of financial resources for the refinancing of central government debt, central government budget execution and maintenance of the financial resources reserve at the lowest possible costs while hedging financial risks and taking into account the development of the Latvian economy and integration of the domestic financial market into the common financial market of the euro zone.
- 1.5. The Central Government Debt Management Strategy has been prepared on the basis of the following **assumptions**:
  - 1.5.1. Latvia will continue to implement sustainable fiscal policy in the medium term to ensure the compliance with the basic principles of the fiscal policy for the budget planning stipulated by the Fiscal Discipline Law;
  - 1.5.2. the euro zone will continue its existence and the measures aimed to strengthen the economic and fiscal integration of the euro zone countries will be implemented in the medium term;
  - 1.5.3. the long term credit ratings of Latvia will not be downgraded within the medium term;
  - 1.5.4. institutional investors' base in the Latvian domestic financial market will be maintained and broadened in the medium term;
  - 1.5.5. counterparties will offer borrowing and financial risk hedging tools at acceptable terms;
  - 1.5.6. no substantial fluctuations of the central government debt will be caused by loans of ministries and central government institutions, as well as agencies under their control (excluding institutions that are not financed from central government budget or public foundations, special economic zones, ports and free port authorities, but including the derived public persons that are partly financed from central government budget) borrowed outside the Treasury, deposits placed at the Treasury, as well as cash deposits of clients (excluding central government authorities, i.a. social insurance authorities, but including merchants controlled and financed by central government, port and free port authorities and special economic zones) placed at the Treasury and their account balances at the Treasury;

- 1.5.7. the local governments will continue to borrow mostly through the Treasury over the following years;
- 1.5.8. operation and monitoring of the fiscal risk management framework will be ensured in a manner determined by laws and regulations, limiting unpredictable influence of fiscal risks on the fiscal indices.
- 1.6. In order to comply with the best international practice, a distinction has been made within the framework of central government debt management between **central government debt portfolio management** and **central government borrowing management**.

## **2. Central government debt portfolio management**

### **2.1. Goal and basic principles of central government debt portfolio management**

- 2.1.1. **The goal of the central government debt portfolio management** is to optimise the central government debt service costs over the long term while hedging financial risks.
- 2.1.2. The central government debt portfolio is managed in accordance with the following **basic principles**:
  - 2.1.2.1. the optimum central government debt portfolio structure shall be identified taking into account potential financial risks (debt refinancing risk, liquidity risk, foreign exchange risk, interest rate risk) and the situation in financial markets; as well as counterparties' amount and term limits shall be supervised and managed in line with the Cash Management Strategy taking into account counterparty risk;
  - 2.1.2.2. financial risks shall be hedged in priority order as follows – debt refinancing risk, liquidity risk, foreign exchange risk, interest rate risk, counterparty risk;
  - 2.1.2.3. the central government debt portfolio shall be managed in a way not to exceed the costs of financial resources specified in the state budget law for the current year and for the medium term;
  - 2.1.2.4. a balance between the costs of financial resources and financial risk hedging over the long term shall be ensured, considering risk hedging as a priority by not allowing an uncontrollable increase of debt service costs;
  - 2.1.2.5. speculative transactions shall not be admitted within the framework of debt portfolio management.

## 2.2. Tasks of central government debt portfolio management

- 2.2.1. In accordance with the specified goal and basic principles of central government debt portfolio management, the following **basic tasks** have been set out in regard to central government debt portfolio management:
  - 2.2.1.1. identify the specific central government debt portfolio **parameters** for the following variables of central government debt – maturity profile, net debt currency composition, interest rate structure, Macaulay Duration, outstanding amount of the domestic debt securities;
  - 2.2.1.2. monitor and manage appropriately **the central government debt maturity profile** in order to hedge the central government debt refinancing risk;
  - 2.2.1.3. monitor and manage appropriately the **net debt currency composition** in order to hedge the central government debt foreign exchange risk;
  - 2.2.1.4. monitor and manage appropriately the **interest rate structure and Macaulay Duration** in order to hedge the central government debt interest rate risk and to optimise debt service costs over the long term;
  - 2.2.1.5. monitor and manage appropriately the **outstanding amount of domestic debt securities** in order to take advantage of the borrowing opportunities in the domestic market and to simultaneously enable the functioning of the domestic financial market by providing investors with domestic bond investment opportunities;
  - 2.2.1.6. undertake regular monitoring of the identified debt portfolio parameters and ensure necessary corrections of the central government debt structure with the use of financial risk management tools;
  - 2.2.1.7. price financial derivatives in accordance with the internationally accepted methods and match the price with the specific loan or part of the debt portfolio to which the financial derivatives have been applied;
  - 2.2.1.8. conduct sensitivity analysis of the value of the central government debt portfolio on a regular basis, using up-to-date analytical tools in order to evaluate implementation efficiency and the consistency of the specified financial risk parameters and the Central Government Debt Management Strategy;
  - 2.2.1.9. maintain and develop cooperation with internal and external financial market partners and foreign debt management offices for debt portfolio management development purposes.
- 2.2.2. The following **medium-term task** has been set – perform necessary activities to broaden the scope of the counterparties and increase cooperation limits in the field of counterparty management in order to provide excellent possibilities of transactions necessary for debt portfolio risk management.
- 2.2.3. In order to attain the goal of the Central Government Debt Management Strategy and implement its tasks in compliance with the basic principles of the central government debt portfolio management, the application of the following **financial derivatives** is allowed:
  - 2.2.3.1. foreign exchange forwards;
  - 2.2.3.2. forward rate agreements;
  - 2.2.3.3. interest rate swaps;

- 2.2.3.4. currency swaps;
  - 2.2.3.5. cross currency swaps;
  - 2.2.3.6. cash flow swaps;
  - 2.2.3.7. options.
- 2.2.4. The central government debt profile is alterable through **buyback or exchange transactions**.
- 2.2.5. In order to minimize counterparty risk, to ensure more profitable financial transaction covenants, and at the same time to broaden the scope of the counterparties and increase cooperation limits, the conclusion of credit support agreements and corresponding transactions that involve **collateral** is allowed in line with liquidity management requirements.

### 2.3. Parameters of the central government debt portfolio structure

- 2.3.1. In accordance with the prescribed central government debt management goals and basic principles, and taking into consideration central government debt composition and situation in the financial markets, the following **parameters** of the central government debt portfolio structure have been prescribed:
- 2.3.1.1. outstanding amount of domestic debt securities at the end of the year<sup>1</sup>  
not less than outstanding amount of domestic debt securities at the end of preceding year<sup>2</sup>
  - 2.3.1.2. Maturity profile (%) of central government debt not more than
 

up to 1 year	25 %
up to 3 years	50 %
  - 2.3.1.3. Minimum share of fixed rate <sup>3</sup> 60%
  - 2.3.1.4. Macaulay Duration (years) from 4.70 to 6.25
  - 2.3.1.5. Net debt<sup>4</sup> currency composition 100% euro

total allowed deviation	+/- 5%
allowed deviation for a single currency	+/- 5%
- 2.3.2. Deviation from the limits of the maturity profile, fixed rate share in the debt portfolio and Macaulay Duration is permissible if the deviation does not cause additional financial risk.

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<sup>1</sup> outstanding amount of securities issued under Latvia's legislation;

<sup>2</sup> deviation is acceptable if, having a negative net issuance in the current year, it is compensated with the corresponding amount by increased planned borrowings in domestic market in the next year;

<sup>3</sup> fixed rate central government debt with a maturity over one year;

<sup>4</sup> central government debt at the end of the period less the amount of loans and receivables, where impairment loss of guarantees are not taken in account (including Treasury's cash accounts, investments in deposits and fixed income securities, loans, receivables (including receivables of derivative financial instruments which are not classified as risky from credit risk perspective)), and increased by provisions of guarantees as well as liabilities of derivative financial instruments which are not classified as risky from credit risk perspective.

### 3. Central government borrowing management

#### 3.1. Goal and basic principles of central government borrowing management

- 3.1.1. **The goal of central government borrowing management** is to ensure continuous borrowing opportunities in the international and domestic financial markets on optimal terms and conditions.
- 3.1.2. Central government borrowing is managed in accordance with the following **basic principles**:
- 3.1.2.1. selection of the borrowing strategy and its conditions shall be aimed at a balance between (in priority order) central government debt refinancing, resource provision for financing of the budget execution, facilitation to comply with debt covenants set in the Fiscal discipline law, maintenance of the financial resource reserve and fulfilment of the central government debt structure parameters;
  - 3.1.2.2. activities in domestic and international financial markets shall be performed professionally, transparently, purposefully and timely, and contractual obligations shall be fulfilled in the due term and amount;
  - 3.1.2.3. when planning borrowing activities, attention shall not be focused on the comparative short term advantages of borrowing conditions of each specific transaction, but rather on the development and enhancement of long term borrowing opportunities in financial markets;
  - 3.1.2.4. when choosing debt instrument and its conditions, the attention shall be focused on borrowing opportunities in public financial markets, while bilateral loans and loans from international financial institutions shall be considered as additional borrowing opportunity;
  - 3.1.2.5. the most favourable terms and conditions for each borrowing transaction shall be ensured while considering the basic principles of central government debt portfolio management and investor base diversification;
  - 3.1.2.6. resource and liquidity management shall be performed in accordance with the Cash Management Strategy;
  - 3.1.2.7. in order to achieve the best possible terms and conditions for transactions, financial derivatives may be applied simultaneously with initial borrowing transactions.

#### 3.2. Tasks of central government borrowing management

- 3.2.1. In accordance with the specified goal and basic principles of central government borrowing management the following **basic tasks** have been set out:
- 3.2.1.1. develop and, if necessary, revise the medium term Borrowing Plan;
  - 3.2.1.2. define benchmarks for borrowing costs and evaluate the efficiency of the borrowings made in financial markets against the defined benchmarks;
  - 3.2.1.3. maintain permanent offer of medium term to long term financial instruments in the domestic financial market by expanding with the support of primary dealers offering a variety of instruments in accordance with the demand of institutional and retail investors, in order to take advantage of the borrowing potential in the

domestic market and to simultaneously enable the functioning of the domestic financial market;

- 3.2.1.4. manage the sovereign credit rating determination process in Latvia, which ensures the active involvement of appropriate representatives and provides a unified opinion on the situation in Latvia;
  - 3.2.1.5. maintain and develop cooperation with domestic and international financial market partners, investors and foreign country debt management offices for borrowing management and for the purpose of improving Latvia's 'borrower's image';
  - 3.2.1.6. make public announcements on the basic statements of governmental borrowing plans and in accordance with the situation in financial markets; whenever possible, provide information about planned issues of government domestic securities for a possibly longer time period;
  - 3.2.1.7. continuously evaluate efficiency of the central government borrowing management by considering its specific character and best international practice.
- 3.2.2. The following **medium term tasks** have been set out:
- 3.2.2.1. foster development of the domestic financial market in order to promote its gradual integration into the single financial market of the euro area;
  - 3.2.2.2. broaden the investor base with borrowings in the international financial markets, maintaining regular communication with the investor community in order to promote appropriate investor diversification and financial risk limitation in long term perspective.



#### **4. Concluding remarks**

- 4.1.** Annul the Central Government Debt Management Strategy No. 38 approved on 2 April 2015.

Treasurer

K. Āboliņš