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STRATEGY
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Central Government Debt and Cash Management Strategy

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Terms Used

Financial derivative transactions – transactions whose value changes in line with changes in the value of the related asset and are affected by one or several financial risks inherent in the underlying asset, which are redistributed between the parties.

Buy back transactions – Latvian Government fixed-income securities repurchase transactions.

Counterparty – a local or foreign financial institution, or a foreign (debt management) public institution, with which the Treasury is concluding transactions.

Fixed-income debt securities – securities (treasury bills, bonds, mortgage bonds etc.) excluding subordinated debt securities, which provide certain regular income under pre-determined conditions (terms and rates, or algorithms for determining those).

Investment transactions – transactions acceptable for investment of funds within the framework of cash management.

Cash – financial resources that are available on the Treasury's cash accounts.

Credit rating – the long-term credit rating determined by the international credit rating agency Moody's Investors Service (or the rating determined by S&P Global or Fitch Ratings agencies, which is equal to the classification determined by Moody's Investors Service).

Credit risk – a possibility that a counterparty, issuer of the financial instrument and/or its guarantor may not be able to perform its liabilities within a specified time limit and in full amount.

Credit Default Swap (hereinafter referred to as CDS) – a financial instrument, providing insurance against default risk by a particular institution.

Credit Support Annex (hereinafter referred to as CSA) – an annex to the International Swaps and Derivatives Association (hereinafter referred to as ISDA) master agreement, which is used for concluding derivative transactions on the interbank market by providing/accepting financial collateral (guarantee).

Liquidity risk – the risk of insufficient cash in the accounts of the Treasury for timely execution of the financial liabilities of the central government for the full amount over the following 12 months.

Counterpart – a local or foreign financial institution, or foreign (debt management) public institution, with which the Treasury enters or is ready to enter into deposit, account balance, FX transactions, reverse repos of fixed-income debt securities, and investment transactions in fixed-income debt securities, if the transaction is made without delivery versus payment, transactions within the framework of cash management, as well as in financial derivatives and Buy back, if the transaction is performed without delivery versus payment, and transactions within the framework of central government debt and cash management.

Refinancing risk – inability to refinance the central government debt liabilities under acceptable conditions in medium term.

Delivery versus payment (hereinafter referred to as DVP) – a form of settlement for fixed income debt securities trade transactions, where securities and cash settlements are performed simultaneously, thus excluding the risk that fixed income debt securities are not delivered or cash is not paid.

Interest rate risk – a possibility that changes in interest rates may adversely affect revenues/expenditure. The risk occurs if a significant difference exists between assets and liabilities, both sensitively responding to interest rate changes.

“Buy and hold” (hereinafter referred to as buy and hold approach) – a strategy applied to investments in fixed income securities, providing for acquisition of securities with the purpose of holding them until maturity.

Stakeholders – investors of debt securities, credit rating agencies, financial institutions (including the current and potential counterparties), including (debt management) public bodies of other countries.

Central government debt – 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.e. 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.

Foreign exchange risk – a possibility that the value of assets/liabilities denominated in a foreign currency might change in a negative direction when calculated to euro as a result of currency fluctuations. Currency risk arises in the case of inconsistencies between the amounts of claims and liabilities in foreign currencies.

1. Goal of central government debt and cash management

- 1.1. Central government debt and cash management strategy (hereinafter the Strategy) determines the activities of the Treasury in the area of the central government debt and cash management.
- 1.2. **The goal of central government debt and cash management** is to ensure in a timely manner the availability of cash for financing requirement at the lowest possible debt servicing costs while hedging financial risks and at the same time contributing to the development of the domestic financial market.

2. 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 of the central government debt portfolio.
- 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 defined taking into account the financial risks (liquidity risk, debt refinancing risk, interest rate risk, foreign exchange risk) and the situation in financial markets; as well as counterparties' amount and term limits shall be supervised and managed with consideration of counterparty credit risk;
 - 2.1.2.2. the costs of funding and financial risk hedging shall be balanced over the long term, setting as a priority risk hedging and prevention by not allowing uncontrollable increases in debt service costs;
 - 2.1.2.3. only such transactions are acceptable for debt portfolio management, which are at the same time based on known or forecasted cash flows and assumptions on interest rate trends;
 - 2.1.2.4. methods and technologies recognised by international financial practice, and, where applicable, legal advice shall be used for 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 **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 debt securities held by domestic financial market investors;
 - 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. manage appropriately the **supply of fixed income securities to the domestic market investors** in order to use the borrowing potential capacity in the domestic market and to simultaneously advancing the domestic financial market functioning by providing investors with investment opportunities in domestic fixed income securities;
 - 2.2.1.6. undertake regular monitoring of the identified debt portfolio parameters and, through the use of financial derivatives, new borrowings or debt buy back /

exchange transactions, ensure the necessary compliance of the central government debt structure with the Strategy;

- 2.2.1.7. assess the efficiency of financial derivatives in accordance with the internationally accepted methods by comparing with the specific part of the debt portfolio which the financial derivatives have been linked to;
- 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 update of the specified financial risk parameters and the Strategy;
- 2.2.1.9. assess the optimisation opportunities of the central government debt servicing costs on a regular basis, using the buy back and/or exchange transactions.

2.3. Parameters of the central government debt portfolio structure

2.3.1. In accordance with the prescribed central government debt management goal and basic principles, and taking into consideration the 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 central government securities distributed for initial placement by domestic financial market investors at the end of the year is not less than the outstanding amount at the beginning of the year¹
- 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 share² of fixed interest rate
 - 60%
- 2.3.1.4. Macaulay Duration (years)³ from 5.0 to 9.0
- 2.3.1.5. Net debt⁴ currency composition 100% EUR
 - total allowed deviation +/- 5%
 - allowed deviation for a single currency +/- 5%

2.3.2. Deviation from the limits of the maturity profile, minimum fixed rate share in the debt portfolio and Macaulay Duration is permissible if the deviation does not cause additional financial risk.

¹ – deviation is acceptable if, having a negative net issuance in the current year, it is compensated with the corresponding amount in the medium term Borrowing Plan by increased planned borrowings in domestic market in the next year.

² – fixed rate central government debt with a maturity over one year.

³ – during the period of low interest rates mainly focusing on loans with longer maturities, hedging the risk of debt service cost increases over the long term, while during the period of high interest rates focusing on loans with shorter maturities, reducing the debt service costs in the medium term by accordingly increasing/reducing the Macaulay Duration (years) within the acceptable limits of the Strategy.

⁴ – 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 and liquidity management

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

- 3.1.1. **The goal of central government borrowing and liquidity management** is to ensure timely and full availability of financial resources for covering the financing requirement, by maintaining continuous borrowing opportunities in the international and domestic financial markets on optimal terms and conditions.
- 3.1.2. Central government borrowing and liquidity are managed in accordance with the following **basic principles**:
- 3.1.2.1. maximum flexibility shall be maintained for the selection of borrowing terms (time of borrowing, currency, amount, maturity) by ensuring compliance with liquidity risk management and central government debt portfolio structure parameters;
 - 3.1.2.2. 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;
 - 3.1.2.3. when choosing debt instruments and their conditions, borrowing opportunities in public financial markets shall be preferable over bilateral loans and loans from international financial institutions shall be considered as an additional borrowing opportunity;
 - 3.1.2.4. borrowing transactions shall be made by ensuring a balance between borrowing terms and diversification of the investor base, while improving the liquidity of debt securities and taking into account the basic principles and tasks of central government debt portfolio management;
 - 3.1.2.5. when borrowing non-euro currencies, ensure simultaneous use of financial derivatives for central government debt portfolio management purposes;
 - 3.1.2.6. methods and technologies recognised by international financial practice, and, where applicable, legal advice shall be used for borrowing and liquidity management;
 - 3.1.2.7. the borrowing potential in the domestic financial market shall be used, and simultaneously with issuance of central government debt securities as benchmarks, the functioning of the domestic financial market shall be promoted by accepting higher borrowing costs than in the international financial markets;
 - 3.1.2.8. borrowing in advance (ensuring pre-funding) and simultaneous cash investments are allowed where financially effective at the moment of the decision and/or Treasury's forecasts indicate that it is cost-effective from the debt management perspective;
 - 3.1.2.9. activities in domestic and international financial markets shall be performed professionally, transparently, purposefully and timely, and contractual obligations shall be fulfilled in due time and amount.

3.2. Tasks of central government borrowing and liquidity management

- 3.2.1. In accordance with the specified goal and basic principles, the following **tasks** have been set for central government borrowing and liquidity management:
 - 3.2.1.1. organise the borrowing activities in accordance with the medium-term Funding Plan;
 - 3.2.1.2. ensure, within liquidity management, continuous borrowing opportunities;
 - 3.2.1.3. define benchmarks for central government borrowing and evaluate the efficiency of the borrowings made in financial markets against the defined benchmarks;
 - 3.2.1.4. maintain a regular offer of Government securities in the domestic financial market, i.e., offering bonds to institutional investors and, with the support from primary dealers, assessing the range of financial instruments offered, and, in addition, ensure an offer for individuals in the domestic financial market;
 - 3.2.1.5. make the medium-term borrowing strategy public and, in accordance with the situation in financial markets, provide as much information as possible about the auction plans of central government securities in the domestic market.

4. Cash investment

4.1. Goal and basic principles of cash investment

- 4.1.1. **The goal of cash investment** is to ensure financially effective cash management in accordance with the basic principles of investment, providing liquidity risk management and complying with the most profitable investment terms for acceptable investment transactions.
- 4.1.2. Cash investment shall be based on the following **basic principles**:
- 4.1.2.1. cash management shall only be performed by the Treasury and the transfer of funds for management by another manager shall not be acceptable;
 - 4.1.2.2. a balance between the hedging of liquidity and financial risks and maximum profitability shall be ensured for cash investment, considering hedging of liquidity and financial risks as the most important;
 - 4.1.2.3. within the framework of cash investment, to perform only such transactions, which can be registered and objectively evaluated by means at the Treasury's disposal;
 - 4.1.2.4. within the framework of cash investment, only such transactions shall be acceptable which are at the same time based on known or predictable cash flows and assumptions on interest rate trends;
 - 4.1.2.5. to achieve the cash investment goal, transactions where the term is greater than 3 months shall only be acceptable under the condition that the positions established by them can be liquidated;
 - 4.1.2.6. when making an investment in a non-euro currency and acquiring that currency for an investment transaction, the use of financial derivatives for currency risk management shall ensure simultaneously with the initial investment transactions;
 - 4.1.2.7. when performing a transaction, the most beneficial transaction terms shall be ensured, using the transaction term inquiry method for the conclusion of transactions (except for transactions on the regulated market – stock exchange and specialised trading platforms, providing an automatic comparison of profitability of transaction terms), except for cases where investment of funds is determined by other basic principles and pre-agreed with the Minister of Finance;
 - 4.1.2.8. simultaneous cash investment and borrowing within the framework of liquidity management is acceptable where financially beneficial at the moment of the decision and/or Treasury forecasts show that it is profitable from the overall perspective of cash management;
 - 4.1.2.9. the principle of preservation of cash shall be followed, not allowing the entire cash flows received from investment to be less than the initial investment amount, except for a financial market situation where the financially most profitable investment transaction available has negative profitability;
 - 4.1.2.10. investments in fixed-income debt securities shall only be made within the framework of buy and hold approach generating certain profitability at the end date of the investment.

4.2. Cash investment tasks

- 4.2.1. In accordance with the specified goal and basic principles, the following **tasks** have been set for cash investment:
 - 4.2.1.1. to comply with the parameters of investment structure;
 - 4.2.1.2. define benchmarks for cash investment transactions and regularly evaluate the investments made in the financial markets against the defined benchmarks.
- 4.2.2. For the achievement of the goal and implementation of tasks of cash investment in compliance with the basic principles for cash investment, **use of** the following **investment transactions** shall be acceptable:
 - 4.2.2.1. deposits for definite or indefinite period of time (term or deposits on demand), incl. account balances;
 - 4.2.2.2. investments in fixed-income debt securities;
 - 4.2.2.3. transactions with fixed income securities buying and repurchase;
 - 4.2.2.4. buy-back transactions.

5. Financial risk management

- 5.1. **The goal of financial risk management** is to permit no uncontrolled increase of government debt service costs and to hedge the default risk of transactions concluded within the framework of the Strategy.
- 5.2. Financial risks shall be managed in accordance with the following **basic principles**:
- 5.2.1. the counterparty credit risk is managed by imposing restrictions to the investment structure prescribed by the Treasury's internal regulations;
 - 5.2.2. the currency exposure of net currency debt is managed to restrict currency risk;
 - 5.2.3. the interest rate structure and Macaulay Duration are managed in order to hedge the central government debt interest rate risk;
 - 5.2.4. the central government debt maturity profile is managed in order to hedge the central government debt refinancing risks;
 - 5.2.5. within the framework of liquidity risk management, identify factors which may cause liquidity risk, and take timely measures to eliminate the liquidity risk by ensuring availability and sufficiency of funding for the execution of financial liabilities;
 - 5.2.6. counterparty transactions on the non-regulated market (over-the-counter or across organised trading platforms), wherever possible, shall be made on the basis of the mutual agreements concluded.
- 5.3. In accordance with the goal and basic principles of financial risk management, the following **tasks** have been set for financial risk management:
- 5.3.1. to determine and update restrictions for the cash investment structure, as well as to control performance thereof;
 - 5.3.2. to undertake counterparty credit risk evaluation on the basis of credit rating and other risk assessment criteria used in the international financial management practice (e.g., CDS and secondary securities' market spreads, financial analysis indicators etc.);
 - 5.3.3. in order to minimize credit risk, determine, observe and monitor:
 - 5.3.3.1. permissible types, limits, volumes and term limits of counterparty transactions;
 - 5.3.3.2. regional and sectoral/industry issuer limits for investments in fixed-income debt securities;
 - 5.3.3.3. credit rating category limits for counterparties and investments in fixed-income debt securities;
 - 5.3.4. to determine liquidity ratios for liquidity risk management and ensure their execution in accordance with the Treasury's Regulations for Liquidity Provision;
 - 5.3.5. to determine the central government debt portfolio structure parameters for refinancing, currency and interest rate risk management, and ensure their compliance in accordance with Paragraphs 2.2.1.2–2.2.1.4;
 - 5.3.6. to assess the need for an additional cash reserve to be maintained in the medium term in addition to liquidity ratios, taking into account the fiscal risks and the central government debt refinancing risk, and to include that reserve in the Funding Plan for the medium term.

- 5.4. In order to attain the goal and implement of financial risk management and implement its tasks, **the application** of the following **financial derivatives with or without collateralisation of guarantees** is allowed:
- 5.4.1. foreign exchange forwards;
 - 5.4.2. forward rate agreements;
 - 5.4.3. interest rate swaps;
 - 5.4.4. currency swaps;
 - 5.4.5. cross-currency and interest rate swaps;
 - 5.4.6. cash flow swaps;
 - 5.4.7. options.
- 5.5. In order to minimize counterparty risk, ensure more profitable derivatives covenants, and at the same time broaden the scope of the counterparties and increase cooperation limits, the entering in the corresponding transactions that involve collateral is allowed in line with liquidity management requirements.
- 5.6. Financial risks affecting cash management and central government debt management shall be reviewed on a regular basis.

6. Stakeholders relationship management

6.1. Goal and basic principles of debt securities investor relations management

- 6.1.1. **The goal of debt securities investor relationship management** is to promote diversification of the central government debt securities investor base, thus limiting the refinancing risk in the long term.
- 6.1.2. Debt securities investor relationship management shall be based on the following **basic principles**:
 - 6.1.2.1. transparency and regularity of information is ensured: availability of updated, verified and reliable information about Latvia, promoting its trustworthiness as an issuer in the international financial market;
 - 6.1.2.2. ensuring targeted selection of range of debt securities investors and respective communication process with them.

6.2. Tasks of debt securities investor relationship management

- 6.2.1. In accordance with the goal and basic principles of debt securities relationship management, the following **tasks** are set for debt securities investor relationship management:
 - 6.2.1.1. ensure regular and updated publications about central government debt management, informing them in addition about developments and trends in the Latvian economy, financial and fiscal data and current events in debt management matters;
 - 6.2.1.2. conduct regular assessment of the government debt securities investors, to ensure a predetermined approach in targeting existing and potential investors/ community acquiring bonds from similar issuers, and organise face-to-face meetings and teleconferences with them;
 - 6.2.1.3. cooperate with other government/ public authorities for the implementation of joint activities abroad, aimed at promotion of Latvia as a safe and secure place for foreign direct investment.

6.3. Goal and basic principles of credit rating agencies relationship management

- 6.3.1. The **goal** of credit rating agencies relationship management is to coordinate the process for assigning the credit rating and promote the development of credit rating.
- 6.3.2. Credit rating agencies relationship management is based on the following **basic principles**:
 - 6.3.2.1. Provision of transparent and regular information: provision of timely, updated, verified and reliable information to credit rating agencies about Latvia in order to ensure that complete and accurate information is reflected in the reports published by credit rating agencies on the assigned credit rating;
 - 6.3.2.2. Ensuring a coordinated approach for submitting information and opinions drawn by national authorities to credit rating agencies.

6.4. Tasks of credit rating agencies relationship management

- 6.4.1. In accordance with the goal and basic principles of credit rating agencies relationship management, the following **tasks** shall be set for credit rating agencies relationship management:

- 6.4.1.1. organise regular visits of representatives of credit rating agencies to Latvia and evaluate conformity of draft reports by credit rating agencies to the information provided previously;
- 6.4.1.2. in cooperation with members of the working group (consisting of representatives from Ministries and national authorities) on the improvement of cooperation with international credit rating agencies, established by the Prime Minister, to inform the Cabinet of Ministers on recommendations and the required actions to improve the credit rating, as well as factors that may downgrade the credit rating;
- 6.4.1.3. maintain active contractual agreements with credit rating agencies, agreeing on mutually beneficial terms and conditions and credit rating assigning fees;
- 6.4.1.4. ensure and coordinate submission of actual information about the economy of Latvia, financial and fiscal data and debt management matters to credit rating agencies.

6.5. Goal and basic principles of financial institutions relationship management

- 6.5.1. The **goal** of financial institutions relationship management is to ensure that the extensive range of permanently available, trustworthy and reliable financial institutions are available for cooperation with the Treasury, in order to ensure competitive terms for executing financial transactions.
- 6.5.2. The financial institutions relationship management shall be based on the following **basic principles**:
 - 6.5.2.1. transparency and regularity of information ensured: ensuring the availability of updated, verified and reliable information to the existing and prospective financial institutions for cooperation with the Treasury about the economy of Latvia, financial and fiscal data and debt management matters, and promoting its trustworthiness as an issuer in the international financial market;
 - 6.5.2.2. coordinated action ensured in expanding cooperation with the financial institutions the Treasury is currently cooperating with and establishing contractual relations with financial institutions with which the Treasury could potentially cooperate in the area of public debt and cash management.

6.6. Tasks of financial institutions relationship management

- 6.6.1. In accordance with the goal and basic principles of financial institutions relationship management, the following **tasks** are set within financial institutions relationship management:
 - 6.6.1.1. maintaining regular communication with the current financial institutions, and providing them with regular and updated information about the central government debt management;
 - 6.6.1.2. examining regularly the potential for increasing cooperation in the area of central debt and cash management with the current financial institutions;
 - 6.6.1.3. expanding the range of financial institutions for cooperation in the area of central government debt and cash management, by informing the prospective financial institutions about the required actions for establishing contractual relations and developing cooperation in the identified areas;

- 6.6.2. Internationally acknowledged relationship management methods and technologies shall be applied in the area of financial institutions relationship management;
- 6.6.3. Maintaining cooperation with debt management institutions of other countries to share experience and information, as well as for closing of possible transactions.

7. Final provisions

- 7.1.** The Treasury regularly follows up the progress of Strategy implementation and submits to the Minister of Finance annual reports on the implementation of the Strategy.
- 7.2.** Where circumstances occur, under which central government debt and cash management is not possible in compliance with the Strategy and require immediate action as a result, derogations from the Strategy shall be allowed in agreement with the Minister of Finance.
- 7.3.** The Central Government Debt Management Strategy No. 108 of 31 October 2016 shall be considered null and void.
- 7.4.** The Cash Management Strategy No. 49 of 27 April 2016 shall be considered null and void.

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