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Lot 11: Macro economy, Statistics and Public Finance Management

Request n° 2015/366005/1

Support to the Public Debt Management Department of the Armenian Ministry of Finance.

INCEPTION REPORT - FINAL VERSION

May 2016

Project financed by the European Union

Project implemented by DFC and Alternative Consulting

Support to the Public Debt Management Department of the Armenian Ministry of Finance.

Request n° 2015/366005/1

Inception Report

March 2016

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DFC CONSORTIUM

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Glossary of acronyms

AMD	Armenia Drams
BCP	Business Continuity and Disaster Recovery Plan
BO	Back Office
CBA	Central Bank of Armenia
DBPM	Department of Budget Process Management
DeMPA	Debt Management Performance Assessment
DMFAS	Debt Management and Financial Analysis System
DMOSB	Department of Management of Obligations to the State Budget of RA
DMP	Department of Macroeconomic Policy
DSA	Debt Sustainability Analysis
FO	Front Office
GoRA	Government of the Republic of Armenia
ICD	International Cooperation Department
IMF	International Monetary Fund
MO	Middle Office
MOF	Ministry of Finance
MoFA	Ministry of Foreign Affairs
MoJ	Ministry of Justice
MTDS	Medium Term Debt Management Strategy
MTEF	Medium Term Expenditure Framework
PDMD	Public Debt Management Department
RA	Republic of Armenia
UNCTAD	United Nations Conference on Trade and Development
WB	Worldbank

1. Introduction.

1.1. Project Data.

Name of the Project:

ARMENIA: Support to Public Debt Management Department of the Ministry of Finance (Yerevan).

FWC BENEFICIARIES 2013-LOT 11: Macro-economy, Statistics and Public Finance Management. EuropeAid/132633/C/SER/multi.

Execution of the Project:

DFC Consortium.

Maximum budget available: € 300,000.00

Working days: 205 working days for 2 Experts (1 Team Leader, 105 working days & 1 Public Debt Management Expert, 100 working days).
The exact days of the assignment will be determined after consultations with the PDMD and the EU Delegation.

Location:

Yerevan (Armenia), apart from the study tours (the study tours and the visiting countries will be organized as agreed with the PDMD and the EU).

Duration:

1/1/2016 to 31/12/2017.

Key Stakeholders:

Ministry of Finance (PDMD)
EU Delegation in Armenia.

General Purpose:

Supporting the Government of Armenia (Ministry of Finance, Public Debt Management Department-PDMD) to overcome the shortcomings revealed by the Debt Management Performance Assessment of 2013 (DeMPA), to fulfil the strategy objectives in order to strengthen public debt management capabilities, having regard to the specific needs of the PDMD.

Specific Objectives:

(i) Improving the legal and institutional debt management framework,

(ii) Enhancing the capacities of the Middle Office of the PDMD,

(iii) Deepening the market for Government's securities.

1.2. Status of the Project at the Time of Reporting.

First mission in Yerevan by the 2 Experts (22/2 to 4/3/2016).
Objective of the Mission: facts findings – evaluation and assessment (see 2.1. Methodology).

1.3. Preparation of the Report.

Inception Report prepared by Jean-Luc Steylaers (Team Leader) and Alessandro Scipioni (Public Debt Management Expert) at the end of the first mission in Yerevan.

Date: 4/3/2016.

2. Executive Summary & Recommendations.

2.1. Methodology.

The first task of the Mission has been to establish a methodology to reach its objectives and deliver the requested outputs.
The methodology has been discussed with (and validated by) the PDMD. It is the following.

- The first mission (22/2 to 4/3/2016) is a facts-findings mission.
The mission has made (i) a description of the present situation, having regard to the fields concerned by the key results expected and (ii) an assessment of the situation. The description and the assessments are to be found in Appendix 1.

- The second mission, scheduled from 2016, April, 25th to June, 3rd., will be focused on the validation by the major stakeholders of the assessments.

- On the basis of the validated assessments, a “battle plan” will be elaborated (during the second mission) in coordination with the PDMD, to establish an order of priorities of the areas where the mission will have to work on.

- It has already been agreed with the PDMD that, after validating the assessments and drafting a “battle plan”, the second mission will assist the PDMD in drafting a Public Debt Strategy for the period 2017-2019 (the Public Debt Strategy 2017-2019 must be elaborated by end-May).
This action is included in the component “Enhancing the capacities of the Middle Office of the PDMD”.

- The following missions will be focusing on specific areas where support is needed by the PDMD to achieve the overall objectives.
They will be designed as specific technical assistance where support is necessary (examples: reviewing the public debt law, implementing Treasury daily accurate forecasts methods and tools, etc.…).

- However, the following missions will dedicate a part of their time, if necessary, to the follow-up of the previous missions (example: addressing unforeseen bottlenecks for daily Treasury forecasts).

2.2. Executive Summary

The mission met Mr. Atom Janjughazyan, Deputy Minister Chief Treasurer, and Mr. Arshaluys Margaryan, Director of the Public Debt Management Department of the Ministry of Finance, and take the opportunity to thank them for their availability and suggestions. Agenda and other logistic issues were efficiently managed by Mr. Artur Hambardzumyan, head of the middle office, to whom the mission would like to convey special thanks.
Contact has been taken with the IMF and the WB and meetings will be organized these organizations during the next mission.

The mission has consisted in broad and more focused discussions with all the major stakeholders of the Armenian public debt – PDMD, other departments of the Ministry of Finance, departments of the Central Bank, 6 banks (primary dealers: Converse Bank, HSBC, Ameria Bank, ArmSwiss Bank, VTB Bank, Ararat Bank), 1 pension fund (C-Quadrat), 1 insurance company (Ingo Armenia), the banking association (Union Of Banks of Armenia), and the Stock Exchange (Nasdaq OMX) – in order to be able to draft a description of the current situation of the Armenian public debt market and to assess it.

A presentation on “*DMO’s: Independence and Relationships with Other Agencies*” has also been prepared and presented at the request of PDMD (see Appendix 2).

2.3. Recommendations

Nihil.

3. Review of Project Design

3.1. Policy and Programme Context

The Republic of Armenia (RA) started to accumulate its public debt since 1991. In the early years of independence, the Government of the Republic of Armenia (GoRA) attracted funds from external sources on market terms to assure energy and food security.
Armenia became in 1992 a member of International Financial Institutions (IMF, WB) and was able to attract long-term concessional loans mostly to develop economic infrastructures.

In 1995, the Government initiated the establishment of its domestic debt market by issuing T-bills.
Since 2000, 2004 and 2007, the GoRA has issued mid-term, long-term government bonds and saving bonds respectively.
As of the end of 2014, the public debt of RA consisted of three components: external loans (mostly concessional), Eurobonds and domestic debt (stemming mainly from the issuance of domestic government securities).

Public debt management issues in Armenia became evident since 2009, when according to the international financial crisis, Armenia has sharply increased foreign and domestic borrowings in order to support the economy.
As a result, at the end of 2009, public debt to GDP ratio reached 41% and 43.6% at the end of 2014, while it was only 16.4% at the end of 2008.
Before 2009, the foreign debt was concessional and almost 100% was in fixed rate.

The situation has changed dramatically after borrowing on non-concessional terms, and many issues became apparent. The deterioration of the debt outlook occurred while Armenia was in the process of graduating out of concessional lending with the IFIs due to its pre-crisis macroeconomics achievements. The Ministry of Finance needs to adapt to this new situation, including by strengthening its debt management capacity as the decisions on the financing mix become more complex.

The Government is aware of the challenges stemming from the higher debt burden and reduced access to concessional lending. In order to address the need for enhanced debt management capacity, and consistently with the commitment taken with the IMF in October 2009 under the Stand-by Arrangement, the Ministry of Finance formally adopted a time-bound Action Plan for debt Management Reform in March 2010 (“the Action Plan”).
The general objective of the Action Plan was to formulate and implement a fully-fledged medium-term debt strategy by the end of 2013 with the help of advisors on public debt management.

Significant progresses have been achieved since the adoption and later implementation of the Reform Plan for public debt management that included:

(i) purchasing and implementing the Debt Management and Financial Analysis System (DMFAS, developed by UNCTAD; the purchase of a system was a condition under the Macro Financial Assistance with the EU),

(ii) revising the organization of the Public Debt Management Department (PDMD) in order to introduce a Front, Middle and Back Offices structure,

(iii) drafting a Medium Term Debt Strategy (MTDS) and

(iv) enhancing the PDMD reporting system.

Decisive support for the implementation of the Action Plan was provided by the WB and by the EU Advisory Group in 2009-2012.
During 2012, the EU provided support to the PDMD through a framework contract that included improving the following areas: Debt Recording and Management System, PDMD internal organization, debt reports and MTDS.

However, the capacity of the PDMD needs to be further enhanced in order to meet the objectives set in the MTDS.
In addition, Armenia faces presently debt management challenges, as external sources of concessional loans re diminishing and there is a need of investigating and developing alternative sources of financing, as well as there is need for strengthening the PDMD capacity in public debt risks management in order to ensure fiscal and debt sustainability.

The WB and the IMF have conducted a debt Management Performance Assessment (DeMPA) mission at the end of 2013. The results have been disclosed during 2014.
DeMPA comprises a set of 15 debt performance indicators (DPIs), which aim to encompass the complete spectrum of government debt management operations, as well as the overall environment in which these operations are conducted.
According to the DeMPA results, there are many areas in Armenia's public debt management that require attention and priority for reform.

Furthermore, the GoRA has approved the 2016-2018 Medium Term Debt Strategy, that is part of the Medium-Term Expenditures Framework for the coming here years and highlights the major debt management objectives and identifies the principles, the milestones and the measures by the Government, under which the fiscal sustainability will not be put at risk.
In order to achieve the objectives of the public debt management set by the strategy, a number of actions should be implemented.

The current programme is aimed at improving the public debt management according to the deficiencies stated in the 2013 DeMPA and to the specific needs of the PDMD.

To the best of the knowledge of the mission, no other assistance (IMF, WB, UNCTAD) is provided to the PDMD by other International or Private Partners/Donors in the areas where the mission will be working.

3.2. Objectives to be achieved

General Objective:

Supporting the Government of Armenia (Ministry of Finance, Public Debt Management Department-PDMD) to overcome the shortcomings revealed by the Debt Management Performance Assessment of 2013 (DeMPA), to fulfil the strategy objectives in order to strengthen public debt management capabilities, having regard to the specific needs of the PDMD.

Specific Objectives:

(i). To revise the legal framework for PDM operations and to propose amendments to the legislation in order to approximate it to best EU/OECD practices, particularly in relation to the authority to borrow and the procedures for negotiating and contracting external loans. While all provisions are being followed, more clarity is needed with regard to legal requirements and procedures for commercial borrowing on behalf of the Government.

(ii). To promote the deepening of the domestic market by: assessing the potential demand derived from the reform of the pension system – including demand for new instruments, and assessing the benefits of issuances techniques (such as tap auctions), of revising the rights and obligations of the primary dealers and assessment of their activities, of trading new instruments (such as repos, overnight deposits and indexation-linked bonds), of proposing a revision of the market regulations/drafting new market regulations accordingly, plus supporting the PDMD in the designing of the electronic retail system referred to the international good practices that will allow to sale Government securities via internet.
Specifically, in the strategy, it was specified that it was necessary to recalculate the deficit financing by government securities taking into account pension and insurance reforms.

The debt management strategy identified the development of the primary and secondary markets, as well as the development of retail market of the government securities and installation of an electronic retail system as a top priority.

(iii). To further enhance the capacity of the newly established middle office in relation to the identification and the quantification of the risks of the portfolio, tools and processes for the MTDS formulation, the monitoring of the risks and the implementation of Treasury cash forecasts.
Enhancing the capacity of the middle office to identify and quantify the risks associated with debt management, was specified as one of the priorities in debt management strategy as was enhancing the MO's capacity of monitoring operational risks.

While there is an understanding of operational risks, a formal operational risks management framework is lacking. Business continuity and disaster recovery plans that would provide guidelines to keep the PDMD functioning in case of an emergency are also lacking. There is a need to develop documented procedures for debt management activities.

Results:

- Having found robust solutions for the debt management's shortcomings listed in the 2013 DeMPA Report as covered by the areas of competences of the mission.

- Having answered to the specific needs formulated by the PDMD.

3.3. Activities

The mission has had several broad and other more focused discussions with the PDMD (4 divisions) and staff, plus with other Departments of the Ministry of Finance (Department of International Cooperation, Division of Foreign States and International Organizations Cooperation, Department of Management of Obligations to the State Budget of RA).

The mission met also with the following organizations to discuss primary and secondary market organization and issues:

- Central Bank of Armenia (Financial Department);
- Armenian Banking Association;
- Yerevan Stock Exchange (Nasdaq OMX);
- 6 banks (primary dealers: Converse Bank, HSBC, Ameria Bank, ArmSwiss Bank, VTB Bank, Ararat Bank),
- 1 pension fund (C-Quadrat),
- 1 insurance company (Ingo Armenia),

The mission has drafted the following documents:

- Description of the current situation with regard to PDM in Armenia and assessment (Appendix 1);
- Inception Report.
- Presentation "DMOs: Independence and Relationships with Other Agencies" (Appendix 2).

3.4. Resources and Budget

Not applicable.

3.5. Assumptions and risks

Assumptions	Risks	Consequences	Probability	Gravity
Financial situation of Armenia remains stable in the ST-MT	Financial situation of Armenia gravely deteriorates in the ST-MT	Emergency of the situation overshadows the reforms-crisis	Low to medium	Very high

		management		
Policy makers agree on the reforms of the (new/amendments to) Public Debt Law	Policy makers do not agree on the (proposed) reforms	Reforms (partially) blocked	Medium	High
Minister of Finance agrees on the proposed reform of the PDMD	Minister of Finance does not agree on the proposed reforms	Reforms (partially) blocked	Medium	Medium to high
Central Bank agrees on the proposed reforms for cash management	Central Bank does not agree	Reforms (partially) blocked	Medium	High
Minister of Finance agrees on the proposed reforms for the primary and secondary markets	Minister of Finance does not agree	Reforms (partially) blocked	Low	Medium to high
The mission will be able to address all issues listed in the programme	Unforeseen bottlenecks/overwhelming technical difficulties appear	All reforms cannot be implemented- shortcomings in the programme	Medium to high (the devil is in the details)	Low to medium to high
A Treasury Direct internet platform can be implemented for Saving Bonds selling	Development, security and maintenance costs associated appear to be prohibitive	The implementation should be abandoned	Medium to high (the devil is in the details)	Low
Medium-Term Debt Strategy (MTDS) is effectively applied by authorities	MTDS document is prepared and published, but authorities do not comply with it	Debt Management Strategy remains a wishful list of recommendations	Medium to high	High
Business Continuity Plan is comprehensively implemented by authorities	Business Continuity Plan is limited to IT backups due to high implementation costs	Continuity of Ministry's activities in case of major disruptions might not be fully granted	Medium to high	Medium to high
Ministry of Finance decides terms and conditions of external borrowing	Line Ministries decide funding terms for their projects and Ministry of Finance does not have any leverage on financing decision	Ministry of Finance cannot apply its Debt Management Strategy	Medium to high	Medium to high
Internal Procedures and Guidelines are sustainable	Drafted Procedures and Guidelines do not survive to a future reorganization of the Treasury	Drafted Procedures and Guidelines are approved and then abandoned	Low	Medium

3.6. Management and Coordination Arrangements

Project Team.

In accordance with the ToR Section 3, the Contractor has engaged the following experts (hereinafter referred to as the *Project Team*) to carry out the project activities:

Expert 1: Team Leader, Mr. Jean-Luc Steylaers 105 working days
100 working days
Expert 2: Public Debt Management Mr. Alessandro Scipioni,

The experts shall ensure the delivery of all requested services. Where necessary, the Contractor (DFC Consortium) shall provide supplementary support / expertise through backstopping.

In accordance with ToR Section 4, the experts may plan several missions for successful execution of the project.

However, the number of missions may vary according to the demands of PDMD, which has expressed during the first mission a desire to limit the missions to 2 weeks each (exceptions may apply).

In the role of the Team Leader, the Expert 1 shall act on behalf of the Contractor before the Contracting Authority and the Public Debt Management Department and will be responsible for organising and managing the project activities, including:

- Ensuring overall planning of the project activities and internal coordination;
- Guaranteeing that quality assurance procedures are applied to all activities and outputs of the project;
- Ensuring that the reporting obligations are timely fulfilled under the highest standards of quality.

Mr Steylaers is contracted through his own company, SPRL PUFICO, of which he is the sole employee.

Project Management Arrangements

Pursuant to the TOR sections 4.3, 5.1 and 6.8, the following project management arrangements are in place and implemented during the reporting period:

Inception Report as a planning tool	Prior to the start of the implementation phase, the Project Team prepares an Inception Report. The report shall be first approved by the PDMD and thereafter by the Contracting Authority.
Facilitation of project implementation	The PDMD shall actively participate in all activities in order to facilitate the implementation of the project.
Intermediation	The Contracting Authority shall deal with any issue that will arise on the daily management level, if the Contractor considers it necessary for the Contracting Authority to intervene.
Progress reporting	The Contracting Authority may ask for the reports / briefing notes during the time of the assignment. Progress meetings may be held to brief on the project progress.

3.7. Financing Arrangements

The project **eligible expenditure** falls under the following categories according to the project TOR (section 6.2):

- Per diems for each overnight stay on the mission in the beneficiary country and they cover all subsistence costs of the experts including meals, housing and intra-city transportation costs,
- International travel costs,
- Translation and interpretation services,
- Printing services,
- Services related to organization of 1 final dissemination seminar,
- Services related to organization of 2 study trips to Europe for 3-4 staff members in each trip,
- Visibility of the action.

The budget for reimbursable costs may not be used for the purchase of equipment.

3.8. Monitoring, Review and Evaluation Arrangements

The contract will be regularly monitored with site visits by the EU Project Manager and on the basis of the reports submitted to the EU Delegation.

Furthermore, specific performance measures will be the following:

- Outputs submitted in a timely manner (the EU Delegation has agreed that the Inception Report be submitted 10 days after the 22/2-4/3/2016 mission given exceptional circumstances).

- Satisfactory quality of the output.

- Administrative progress reports submitted regularly on the basis of the template provided.

3.9. Key Quality/Sustainability Issues

Not applicable.

4. Work Plan for the Next Period

4.1. Results to be Delivered

Programme of the Mission from April 25th to June, 3rd:

- Validation by PDMD of the descriptions and the assessments made by the first mission (February, 22th to March, 4th).
- Drafting (i) a "battle plan" in coordination with PDMD to identify/update the reform priorities and (ii) a tentative schedule for the following missions.
- Drafting a 2017-2019 tentative MTDS.

4.2. Activity Schedule

- Support to PDMD in elaborating a 2017-2019 MTDS according to good international practices (output: 2017-2019 MTDS).
- Seminar on Treasury Cash Management.
- Deepening the intelligence of the Armenian debt market (meetings with 1 pension fund, 1 broker, 1 investment company, 1 or 2 non-agent banks, meetings with several departments of Central Bank and Stock Exchange).
- Description and Assessments concerning the domestic debt market.

4.3. Resource Schedule and Budget

Not applicable.

4.4. Updated Risk Management Plan

Not applicable.

4.5. Special Activities to Support Sustainability

Not applicable.

Annex 1: Description and Assessment of the Armenian Public Debt Market.
To be validated during the second mission.

Other Annexes:

Annex 2: Presentation: "DMO's: Independence and Relationship with Other Agencies".

• Monitoring and Evaluation Plan, including revised overall targets
Not applicable.

• Updated Annual Work Plan for first year.
To be drafted during the second mission.

• Updated Annual Resource Schedule and Budget.
Not applicable.

5. Annex 1: Description and Assessment of the Current Situation of the 3 Components of the Programme

Component 1: Legal Framework for PDM Operations.

Component 1 has two sides:

(i) Revising the legal framework to reinforce the mandate and the accountability of the PDMD,

(ii) Strengthening the institutional structure of the PDMD itself.

I. Legal Framework.

The legal provisions regulating the borrowing on behalf of the Government of the Republic of Armenia (RA) are scattered among several legal and regulatory documents.

A. Description.

1. Concept.

According to Article 5, 1 of the Public Debt Law (PDL) of 26/5/2008, the debt of RA comprises the debt of the Government and the debt of the central bank (Central Bank of Armenia, CBA).

According to the PDL, both Government and CBA are entitled to contract debt and issue guarantees.

Guarantees, both internal (art. 14, 1° of the PDL) and external (art. 20, 4° of the PDL) are included in the outstanding of the debt, even if they have not been called and do not translate into an actual financial commitment of the Government.
It should be noted in this regard that guarantees are not considered as a debt security[1] and should therefore not be included in the outstanding of the public debt, even if the PDL says the opposite.

Anyway, the PDL is silent on who can guarantee a loan.
For CBA, it is clear that it is CBA.
For the State, the common practice is that the Minister of Finances ("authorized body") grants guarantees (domestic/external). This is the case in Armenia according to the Budget System Law (not the PDL), art. 11.

The PDL also includes clearly defined purposes of the public debt (including both government and CBA, art. 8 PDL), as well as main objectives for the management of the government debt (art. 9 PDL).

2. External debt.

- The new Constitution of the Republic of Armenia, adopted on December, 6, 2016, provides the mandate to conclude international agreements to the President of the country, who is also required to recommend it for ratification to the National Assembly.
The role of the Government, among others, includes implementation of unified policies in the area of loans and credits (art. 89).

- The International Agreements Law of 22/2/2007 provides further details of the government authority to enter into international agreements. Such legal provisions are applicable for external borrowing by the RA and the Government of RA from multilateral and bilateral creditors.
According to article 16, the power to negotiate and sign international agreements is given to the President of the RA, the Prime Minister and the Minister of Foreign Affairs without special authorization, while other government representatives require special authorization given by the

[1] Handbook on Securities Statistics, Ed. 2009, Part 1, BIS, ECB & IMF, 2.2 and 2.3, p. 15.

President[2] (for interstate agreements) or the Prime Minister[3] (for inter-government agreements).

Inter-agencies agreements classified as international agreements might be signed by the head of government bodies and agencies.
The borrowing authority for external commercial loans or other types of commercial borrowing of the Government that are not classified as international or inter-agency agreements, is not regulated by the International Agreements Law.

The Ministry of Justice (MoJ) and the Ministry of Finance (MoF) are requested to provide their formal opinion to the Ministry of Foreign Affairs (MoFA) on the drafts of interstate and inter-government borrowing agreements prior to proceeding with the formal negotiations.
After the negotiations are completed, MoFA requires the opinion of relevant line ministries, including mandatory opinions by the MoJ and MoF prior to submitting the final package to the President's Office for completion of the formal procedures required by the legislation (art. 11).

- Article 19 of the PDL states that "*External state debt originates on the basis of a positive conclusion of the authorized body*".

Definition of "external state debt" is provided by art. 2, 6° PDL: "*External state debt (is the) aggregate debt obligations to non-residents of the Republic of Armenia, foreign states and international organizations existing as at a certain date that have been undertaken on behalf of the Republic of Armenia and the Central Bank*".

The Authorized Body is defined by art. 2, 12° of the PDL as a "*central body of executive power of the RA that is responsible for developing and implementing the RA Government policy in the area of public finance management*".
Currently this role belongs formally to the MoF, as indicated in the MoF Charter, approved by the Government of the RA. The combination of articles 19 and 2, 6° & 12° of the PDL gives a formal right of veto to the Minister of Finance against contracting foreign debt.

However, in practice, the Minister of Finance never formally opposes the conclusion of an external loan even when the loan falls apart of the debt strategy. He might be giving negative comments but his concerns might be bypassed by the decision of the Government (usually for political reasons).
The consequence of this is that the concept of "Authorized Body" is broader than the sole Minister of Finance, and that the Government can deviate from the Public Debt Strategy.
The question therefore is what is the use of a Public Debt Strategy validated by the Government when the Government itself does not abide to it?

- When it comes to the negotiation of an external loan, the Negotiation Committee appointed by the Prime Minister is usually chaired by the line ministry, which will benefit from the loan, and not by the Minister of Finance.

- According to art. 5, 2° of the PDL, the borrowing authority on the side of the Government of RA is given to "…*the Government, state bodies and administrative agencies*… »). This article being written in general terms, it means that "state bodies and administrative agencies" can borrow foreign debt.

This is true for the "communities" too (communities are the lowest level of administrative power, being the municipalities and the villages). Article 59 of the Local Authorities Law (LAL) states that *"…the chief of community may conclude loan agreements for…, or issue securities in accordance with…*'. Limitations and ceiling apply but borrowing is not limited to domestic borrowing.
The state authorized agency (i.e. the Ministry of Territorial Administration) has to approve the borrowing.

[2] The President signs agreements on behalf of RA.
[3] The Prime Minister signs agreements on behalf of the Government of RA.

3. Domestic debt[4].

- According to art. 5, 2°, "*…the government, state bodies and agencies…and the Central Bank…*" have the right to issue domestic debt (domestic debt issued by the CBA in the framework of the monetary policy is not State debt).
This is true for the communities, too (see before, art. 59 LAL). Debt incurred by the Communities is not considered State debt according to Armenian rules (even if it should be included in the public debt according to the statistical rules of the IMF and the WB).
State debt comprises Government debt + CBA external debt.
Limits set in the PDL are applying to Government debt.

The "authorized body" (i.e. Minister of Finance) has the exclusive rights to (i) borrow resources extended to the Government by Armenian residents (art. 16 PDL) and (ii) to issue Government securities (T-bills and T-bonds) (art. 17 PDL).

Treasury bills are not listed in art. 14 of the PDL, that lists the sources of the State Domestic Debt ; one cannot presume that they are considered as "resources extended to the Government by Armenia residents" because residents are individuals (art. 2, 13° PDL) and banks (primary dealers) are not individuals.

It should be noted that "internal guarantees" are guarantees granted to a (borrowing) Armenian entity having its activities in Armenia according to Armenian law.

4. Audit and disclosure.

The PDL does not impose external audit of debt management activities, although the Chamber of Control (supreme entity for external audit) has the right to conduct such audit based on the legal provisions of the Law on Chamber of Control.

However, Article 13.1 of the PDL stipulates that the Government must provide information on public debt and current debt liabilities at the annual reporting on State budget execution to the National Assembly (NA).
Furthermore, Article 77 of the Constitution stipulates that the National Assembly shall examine the annual report on the execution of the state budget and adopt the report based on the findings of the Chamber of Control. Subsequently, information of public debt must be submitted to the NA as part of the annual reporting on execution of the State budget, and Control Chamber shall provide its findings thereto.
Pursuant to paragraph 25.4 of the RoA Budgetary System Law, the Chamber of Control must provide to the NA*: (i) assessment of trustworthiness of the figures reflected in the annual account on state budget implementation, and (ii) assessment of the level of compliance with the requirements of the state budgets law of the reporting FY.* Thus, the Chamber of Control must evaluate both the accuracy of disclosed data on State debt and conformity of debt management activities in the current year to the requirements set forth by the law.

5. Other dispositions.

Art. 12 of the PDL requires the development of a Debt Management Strategy (MTDS).
However the PDL does not require annual reporting to the National Assembly, although de facto such reports are prepared on an annual basis and are publicly available.

Other elements of the legal framework regulating government debt management are provided in the Budget System Law (BSL), Treasury System Law (TSL) and Annual budget laws.

The Budget System Law, adopted on June 24, 1997, clarifies that the MoF is responsible to carry out the management of the government debt.

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[4] CBA has the statutory right to issue T-bills. However, it has stopped the issuance since a long time.

The Treasury System Law of 27/7/2001 clearly authorizes the Treasury (Ministry of Finance) to service the Government debt as stipulated under the Annual State Budget Laws and corresponding agreements (art.19, 20, 21).

B. Assessment.

According to best international practices, the power of contracting public debt is entrusted to one person only (usually the Head of the State, who can delegate his power to the Minister of Finance), in the framework of the budget law and according to a Public Debt Strategy duly validated by the Authorities (Government, National Assembly).

In Armenia, all debt issuance functions are not centralized in the Ministry of Finance. The Minister of Finance is not the only one who can engage in public debt arrangements.

He is undoubtedly responsible for borrowing domestic debt and granting guarantees.

With regard to external debt, he is formally responsible but in fact line ministries can act against his decision. The Minister of Finance is not involved at the level neither of designing the projects' funding nor in the choice of the international creditor. When he steps in the discussion of the financial conditions of the loan, it is too late to change its design or the creditor even when the (projected) loan is not in line with the public debt strategy.

Communities can also contract themselves (domestic and external) debt without his approval (approval is given by the Minister of Territorial Administration not by the Minister of Finance, with the exception of Yerevan community according to the law on Yerevan community.
However, communities accounts are included in the TSA.
Hence can their debts have an impact on the TSA, that can finally increase the overall public debt outstanding.

As a result of these elements, the Public Debt Strategy is not that useful as it is not really enforced.

With regard to guarantees (both internal and external), the inclusion of guarantees in the outstanding of the public debt is not compliant to the international statistics rules and overestimates the figures of the outstanding of the public debt.
According to best international practices, guarantees are put "below the line", with a detailed comment for each of them detailing their specific features, risks incurred, probability of default, possible impact on the public debt in case of default, remaining amount guaranteed taking into account the amounts already reimbursed etc…

II. Public Debt Management Infrastructure.

A. Description.

The government borrowing, issuance of state guarantees, cash management and other debt management transactions are divided among several entities within the MoF of RA.

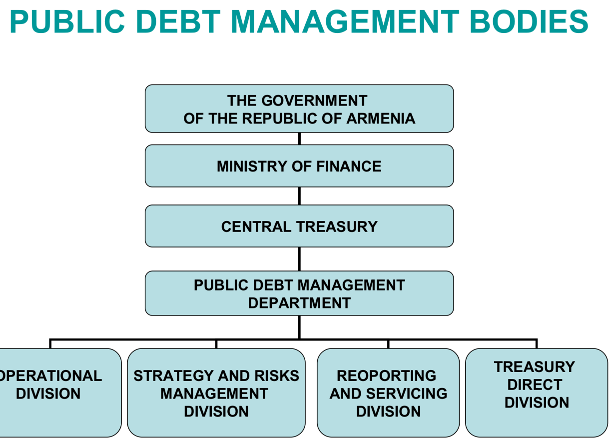
1. PDMD.

The Public Debt Management Department (PDMD), reorganized along the front, middle and back office functions in early 2012, is responsible for the management of the central government debt, including issuance of domestic debt, formulation and implementation of the DMS, government debt service, reporting of public debt, managing the retail debt program, and preparing cash flow forecasts and cash management.

In accordance with an agency agreement, the CBA administers the auctions for the MoF. The MoF (not the CBA) decides on cut-off rates and allocation. One representative of the PDMD is always present at the CBA during the auctions.

The PDMD consists of 20 staff and is divided in four divisions, according to the following scheme:

Figure 1: Public Debt Management Organization in the Ministry of Finance.



Source: PDMD (Ministry of Finance).

The denominations of the divisions are somewhat confusing. In fact, the “Operational Division” is the Front Office, the Strategy and Risk Management Division is the Middle Office and the Reporting and Servicing Division is the Back Office.

However:

- although there is formally a separation between the FO, MO and BO functions, actual transfer of responsibilities is yet to be achieved, given uncertainties in the future PDMD’ organogram according to the institutional reforms that should be implemented in the near future inside the MoF . Denominations of FO, BO and MO do not entirely reflect in the practice the current work executed by he staff;

- for skills reasons, staff formally assigned to the BO may have to be involved in FO functions given his expertise.

The PDMD responsibilities are defined in its Charter, which is approved by the Ministry of Finance.

Under the PDMD, Back Office division is in charge of recording the central government debt. The external debt records are kept in DMFAS, which was installed at the MoF in 2011. At the time of the mission, only the external government debt was recorded in the DMFAS, while domestic debt remained in an Excel spreadsheet.
However, the BO has started to record the domestic debt data from Excel sheets into the appropriate DMFAS module.
Existing practices have facilitated keeping the database current and accurate but these have not been incorporated in a written procedure manual.

Domestic loan guarantee is recorded and monitored by the DMOSB. The record is kept in an Excel spread sheet.
A report compiled by the DMOSB is delivered to PDMD on monthly basis for reporting purposes.
External guarantees, including the ones provided by the Government to the CBA loans, are not recorded by DMOSB of the MoF. The CBA keeps the records of its external debt, which is classified as part of public debt by the Law on Public Debt. The flow statistics of the CBA loans are provided to PDMD within a few days lag for public debt reporting purpose. PDMD is well aware of these loan guarantees, but the records of them are only available on Excel spreadsheets of the PDMD.
The MoF possesses all information on guarantees issued by the Government, even if the records are not kept only in BO’ DMFAS but in several other divisions of the Ministry.

2. International Cooperation Department (ICD).

In addition, some front office functions are partially executed by the International Cooperation Department (ICD) of the MoF, which is responsible for providing the consolidated opinion for borrowing from multilateral and bilateral external creditors on behalf of the MoF, in consultation with other relevant departments (including PDMD). This department is also involved in the discussions with international partners for exploring new sources of budget funding.

However, the functions of the ICD are more those of an interface between the Government and the IFIs.

3. Department of Management of Obligations to the State Budget of RA (DMOSB).

The Department of Management of Obligations to the State Budget of RA (DMOSB) is formally responsible for all functions related to preparation, issuance and monitoring of Government (state) guarantees and on-lending.

The Department consists of 10 staff in two divisions:

- Loan and guarantees division;
- Promissory notes and grants division.

In practice, this department is responsible for preparation and implementation of internal procedures related to issuance of domestic guarantees, while in case of issuance of external guarantees to the international creditors the involvement of the department was not always required.
It is also in charge of preparation and processing of the budget lending transactions and on-lending to local beneficiaries, the majority of which are SOEs.

Following concepts are important:

(i) "Internal (domestic) guarantees" are guarantees granted to a (borrowing) Armenian entity having its activities in Armenia according to Armenian law.
It does not matter that the guaranteed loan is either granted by a foreign creditor or denominated in foreign currencies; the guarantee will be considered an internal one. Therefore, the concept of "internal guarantee" is much broader than a guarantee granted to a loan denominated in AMD.
The procedure to grant a "domestic" guarantee is very similar to the procedure for contracting external bi/multilateral loans (there is no formal procedure in place to contract an external commercial loan – like the Eurobond).

There is currently one domestic guarantee (worth 2 millions USD) granted to an Armenian company. A second one (worth: 9 million USD) is in the pipeline.

(ii) Promissory notes are a kind of IOUs. There are 2 categories of promissory notes:

- Category 1 are the promissory notes which are handed over to individuals who have won a claim in court to be settled by the Government. Given that the amount of the claim is not included in the budget of the year[5], the concerned individual will receive a promissory note, i.e. a promise to pay next year from the Government. The promissory note can be cashed in (discounted) from a commercial bank. Outstanding is negligible (10 millions AMD as of 31/12/2015).

- Category 2 are the promissory notes given to CBA when the central bank has incurred losses for its budget year. The profit from CBA is deducted from the outstanding of promissory notes. The outstanding of such promissory notes is rolled over in November each year. Outstanding is 86 billions AMD as of 31/12/2015.

[5] There is no tracking of the overall impact on the State budget of claims to be settled in the future in courts against the Government.

4. Line Ministries.

When line ministries are preparing a project, they make a "global package", including the project's funding and the chosen international creditor.
PDMD is not involved at the level of designing the project's funding, nor in the international creditor's choice. The line ministry exclusively does this.
PDMD will of course check the financial side of the project, including the mandatory 30% grant element and will make its eventual concerns if the proposed loan is not in line with the Public Debt Strategy.
However, as already described, the Government will, or will not, accept the concerns of the Minister of Finance.

Therefore, if the Minister of Finance ends up formally signing the loan contract, the "real" issuer is the line Minister, whose choice has been ratified by the Government against the position of the Minister of Finance.

5. Operational Department (OP).

The Operational Department, which is a Department inside the Treasury, receives the payment orders from, amongst others, the PDMD.
It checks the payment orders against the budget and the quarterly budget releases and other budgets' scheduled rules (is there a sufficient budget allocation? Are the payments due? Is the payment not ahead of payment schedule? Etc…) and takes the appropriate measures if the payment order is not valid.
It has close relations with CBA that permit it to make debt payments on time.

Processing time of payment orders by OP is usually one (working) day (and less in case of emergency payments).

This Department is not really involved in the debt management processes.
Its overall role in the "payments chain" will be reviewed later in order to evaluate its role in daily cash management (Component 3).

B. Assessment.

All public debt management functions are not centralized into the PDMD.
According to best international practice, all debt management functions are to be centralized "under the same roof", which is usually the Debt Management Office (DMO), and organized along a FO, MO and BO line.

In particular:

- issuance of guarantees is the competence of DMOSB.

- PDMD steps in too late in external loans and the Minister of Finance is not always the chair of the committee in charge of negotiating external loans.

- Minister of Finance (and PDMD) have no say on the debt' issuance by communities, the volume of which will be assessed during future missions.

With regard to PDMD, the reorganization of the department along the FO, MO and BO line is still "work in progress". The denomination of the divisions does not entirely reflect staff' daily tasks and functions.

The working procedures are well established and efficient but lay largely on (good) individual interactions, not on formal (written) procedures' manuals.

Component 2: Enhancing the Capacity of the Middle Office.

As mentioned in the previous sections, the specific terms of reference of the EuropeAid project "Support to Public Debt Management Department of the Ministry of Finance of the Republic of Armenia" contains 3 main objectives. The third one consists of improving further the capacity of the Middle Office located in the PDMD. This objective implies working on the following 3 areas:

1. The enhancement of the Medium Term Debt Strategy (MTDS). It means not only strengthening the identification and quantification of the risks of the debt portfolio, but also putting in place a cost-at-risk analysis to determine the best borrowing plan possible under local constraints. This requires improving the strategy itself and also the process to elaborate and approve the strategy. The main output would be a MTDS document.

2. The strengthening of the operational risk framework.

3. The elaboration of a Business Continuity and Disaster Recovery Plan (BCP).

This section will resume current status and provide an initial assessment for each of these 3 areas.

I. Medium Term Debt Strategy (MTDS)

A. Description.

The PDL states that government must prepare a debt strategy for a period of 3 years in order to manage the debt of the Government of the Republic of Armenia. The external debt of the Central Bank of Armenia is, thus, excluded from the strategic plan.

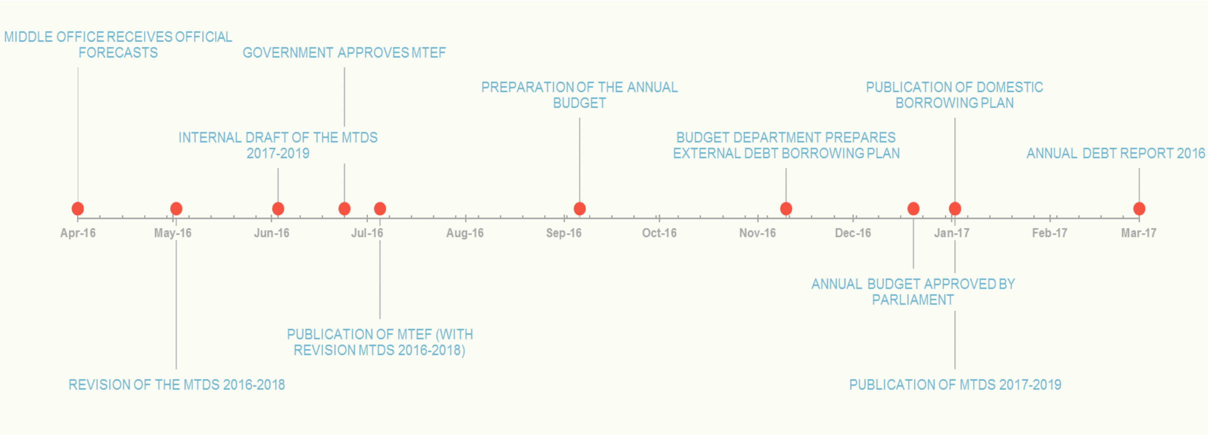
By ministerial order, the responsibility to prepare the Medium Term Debt Strategy (MTDS) lies in the Ministry of Finance and this task is a function of the Middle Office.

The article 12 of the PDL also requires the MTDS to be included in the Medium Term Expenditures Framework (MTEF) and, as a consequence, fixes the strategy period to 3 years in order to match the forecast period of the MTEF.
Among the official forecasts of the MTEF stand revenues and expenditures projections made by the Department of Budget Process Management (DBPM), as well as the projections produced by the Department of Macroeconomic Policy (DMP) for macroeconomic variables such as GDP and inflation. The latter department does not produce official forecasts for market rates (interest rates and exchanges rates) that could be shared with the PDMD.

As shown in the figure 1 below, all the projections are received in April by the Middle Office and used as inputs to prepare the MTDS, which will be included in the MTEF document, published in July.

Based on the MTEF approved by the government, Ministry will start the preparation of the annual budget to be presented to the Parliament and approved in December.
In this month, the Ministry also publishes the borrowing plan for next year, which is prepared by the PDMD. But, this plan cannot be considered a financial plan integrated with the debt strategy, because Budget department is sending external borrowing plan to the PDMD as an input of the strategy.
The article 12 of the PDL, in its paragraph 2, states that Government MTDS must contain targets indicators for the Government debt and an assessment of risks.
Currently, there are 2 main targets indicators: the average time to maturity of debt portfolio (between 8 and 11 years) and the minimum share of domestic funds to finance government deficit (25%).
The compliance of government debt management with these targets is not explicitly monitored, but debt management choices undertaken the previous year are explained in the annual debt report published around March.

Figure 2. Timeline of the MTDS elaboration compared to the MTEF process.



Source: Ministry of Finance

A Debt Sustainability Analysis (DSA) is also prepared by the Ministry (by the DMP) using the same forecasts sources, namely DBPM and DMP.
The analysis generates projections of State Debt level (including External Debt of CBA) for the next 20 years. Future levels of debt depend on fiscal policies (which are outside debt managers control) and impact debt strategy in the long run, in other words the composition of debt portfolio in the future.

The first DSA was achieved in 2011, since then, it is conducted annually to feed the MTEF.

MTDS document is shared with the CBA to receive its comments before being approved by the Minister of Finance who submits it with the MTEF to the Prime Minister Cabinet for final approval.
In this process, there is no formal Committee in charge of reviewing and presenting the MTDS to the Minister of Finance.

In the process of negotiating multilateral or bilateral loans, line ministries are submitting to the Ministry of Finance project documents with a funding proposal from the creditor who is supporting the project. PDMD verifies the degree of concessionality of the financial terms of the loan, but there is no strict assessment of the most cost effective terms. PDMD can suggest alternative financing, but in practice it never happens. Project implementation and its funding are never dissociated.
In 2015, the Republic of Armenia has issued a Eurobond for a total amount of 500 million USD (first was issued in 2013 for a total amount of 700 million USD). Part of the proceeds of this issuance have been issued to buy back 200 million USD of the first Eurobond, thus, outstanding amount in Eurobonds is currently 1000 million USD.

The latest Eurobond issuance was not anticipated at the moment of the elaboration of the MTDS 2015-2017 in April 2014. As a consequence, external net borrowing for 2016 was estimated at 62 billion AMD.
However, when the MTDS 2016-2018 was prepared in April 2015, external net borrowing for 2016 was estimated at 100 billion AMD because Eurobond issuance was done, as it is shown in the Table 1 below. In other words, Eurobond issuance has considerably changed government debt portfolio and made the MTDS 2015-2017 obsolete.
While domestic net borrowing stayed in line with what was estimated in the MTDS 2016-2018, external net borrowing deviate sizably from the strategy.

Table 1. Government Net Borrowing according to strategy (AMD billions)

	2015 (MTDS 2015-2017)	2016 (MTDS 2015-2017)	2016 (MTDS 2016-2018)
Net borrowing	99	104	142
Domestic Net Borrowing	38	42	42
Domestic issuance			122
domestic debt maturing			60
buybacks			20
External Net Borrowing	61	62	100

Source: Ministry of Finance

The Strategy explicitly sets many objectives.
Currently, several objectives may be in conflict.
For instance, the objective of issuing new Eurobonds may prevent the objective of keeping State Debt Outstanding below 60% of GDP of previous year. According to the MTDS document 2016-2018, a 1% depreciation of AMD against foreign currencies in the debt portfolio will lead to an annual average rise of 40,5 million dollars in external debt outstanding during the period 2016-2018.
Considering external debt will represent more than 80% of public debt according to the projections, a 30% depreciation shock on AMD would mean reaching the 60% threshold on the ratio Debt/GDP even if there is no Eurobond issuance between 2016 and 2018 (ff there is a Eurobond issuance, the threshold would certainly be exceeded).

Regarding the MTDS document, there is no formal risk assumptions that explain the choice of the target indicators. Indeed, market risks are tackled in the document, but the link with the choice of target indicators and priorities of the strategy is not evident.

Generally, the MTDS document is well detailed in terms of debt portfolio data and risk indicators. However, a formal baseline scenario based on macroeconomic assumptions is missing, as well as explicit shocks scenarios. Alternatives strategies could also be added to see which strategy reacts better under shocks scenarios.

B. Assessment.

- PDMD has not much grasp on the selection of external borrowing, therefore external debt is an input rather than a variable of the strategy. In other words, the external debt is left outside of the strategy. There is no global financing plan.

- The MTDS timeline is not optimal. The MTDS for the next 3 years is prepared in the middle of the previous year. It is too early because many things can happen in the remaining 6 months before the borrowing plan for next year is prepared. Thus, this plan might change substantially from the MTDS, as illustrated by the case of the Eurobond issuance in 2015.

- Usually, budget department gives the gross financing needs for the coming years (which are available in the MTEF). Based on these needs, the PDMD will establish the strategy which determines the financing mix to close this gap, obviously under different kind of constraints. Here, the strategy is prepared before the gross financing needs are established and the strategy is not aimed at determining the financing mix.

- The domestic debt borrowing plan is not directly linked to the MTDS. The borrowing plan is used as an adjusting variable in spite of the objective to develop the domestic debt market and the target indicator which sets a minimum of 25% of domestic debt borrowing.

- The strategy selected to finance government needs is not an output of the cost-at-risk analysis of the MTDS.

- No formal ex-post evaluation of how the Ministry complied with the debt strategy is realized. However, the Annual Debt Report reports on the implementation of the debt strategy. Usually, strategy tends to be published in December with the borrowing plan for the next year, and then reviewed twice a year (once in the middle of the year with the MTEF and one at the end with the publication of the new strategy).

- A more explicit definition of the scope of the debt management strategy could be useful. It should be clearly specified if it concerns State Debt or Government Debt. Should the external debt of the Central Bank be included? If CBA external debt is only composed of IMF loans, maybe it should be excluded (currently it is excluded) because funding for special support is not a financing instrument.

- There is a need to redefine the objectives of the Debt management strategy. For example, one objective is the issuance of Eurobonds to finance state budget deficit. This should not be an objective; issuing a bond is not an objective in itself but it is a tool to reach other objectives that are to be defined in the framework of the MTDS. By setting the issuance of a Eurobond, as an objective, the Ministry is tying its hands and reducing its capacity to choose other financing instruments.

- The strategy does not respond consistently to risk assumptions. In the case of debt portfolio exchange rate risk, government will tackle it by increasing the share of debt denominated in AMD, but currently the outstanding amount of government bonds denominated in foreign currencies is growing much faster.

- In the process of determining the strategy, alternative financing strategies could help stimulate internal discussions on the benefits and disadvantages of the strategy selected, but the alternatives strategies should not be published to avoid confusing the reader. The alternative strategies are food for thought for the debt managers, but only the chosen strategy should be disclosed – and not in full details, to avoid binding the debt manager on implementation details that are not relevant to the market.

- Based on macroeconomic assumptions and market variables projections, a baseline scenario must be explicitly identified for the strategy. Several “shocks” should be applied to this scenario to test the resilience of the different strategies considered.
  Baseline scenario and “shocks” applied to it are for the eyes of the debt manager and the political authorities only; strict confidentiality is required from anyone involved in the decision making process. Try to explain to journalists that a “shock” scenario is a devaluation of the dram by 20% against the USD next year? You will set the country on fire! Good luck! Disclosure of the chosen debt strategy is a must, disclosure of the underlying shock scenarios is a madness-until the Parliament summons the debt manager to explain his choices, in case of a BIG crisis. Therefore, the necessity to carefully design the different shock scenarios.
  Assessment and validation of the debt strategy on the basis of the shock scenarios are a political decision, but the debt manager is accountable to the Parliament and to the country for the quality of the preparation of the political decision. So simple is that.

- Armenia is not eligible anymore for IDA loans, but investigation could be realized to find other multilateral funding that would be in “blend terms” rather than purely markets terms.

2. Operational Risk Framework

A. Current status.

By ministerial order, PDMD is responsible for managing operational risk. The Basel II Committee defines operational risk as "*the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events*".

Currently, PDMD has not formally identified and listed all the operational risks the department is facing (some risks have already been identified in previous TA). It did not evaluate the probability of occurrence of these risks; neither did PDMD estimate the severity of damage in case the risk materializes.
It is worth noting that an exhaustive identification and assessment of all operational risks requires considerable efforts, thus, focusing on what are the main concerns of the PDMD could save time and efforts.

An important task of the PDMD is, of course, the preparation of payments orders and settlements instructions. This is a typical task of the Back Office. When an interest payment or a reimbursement must be done, the order is prepared by a staff of the Back Office who verifies its excel spreadsheet against the entry in the DMFAS system and the creditor's invoice. The order is then send to the Head of the Back Office who validates it and verifies settlement instructions before sending it to the Central Bank.
To complete this process, 2 persons are mandatory (one to prepare the order and one to validate it). However, there are currently only 2 persons able to do it (one staff and the Head of the Back Office) and it would be a problem if one of this critical person was not available. Furthermore, the above procedure is not written in any document.

Generally, PDMD does not have documented procedures. The Middle Office has prepared a document explaining its functions and processes, but it is still a draft document. Many procedures, such as the negotiation of external loans, are simply not written.

A written procedure to access the debt recording system (DMFAS) is also missing. In fact, PDMD does not have a person in the position of DMFAS system administrator. There used to be an IT person in charge, but not anymore. Therefore, username and password were created by a trainer from UNCTAD during a short-term mission. But, these records correspond to the previous organization structure of the PDMD, as a consequence accesses to the DMFAS system must be recreated again. At the moment, only the Head of the Back Office has the administration rights on the system in order to do it.

Additionally, PDMD staff is not using full functionality of the debt recording system because only external debt is currently recorded in the database.
As a consequence, debt projections prepared by the PDMD are not realized with DMFAS software, but an internal excel spreadsheet.

This year the Back Office is planning to enter also the domestic debt records and on-lending and guarantees agreements in the debt recording system. Actually, only few staff of the Back Office have been trained exhaustively by UNCTAD on the DMFAS system.

Finally, a code of ethics and conflict of interest guidelines, specific to the PDMD, are missing. There is a code of ethics for civil servants (no English translation available) at the general level of the government, but it might be too wide-ranging to cover what is needed for the PDMD. Regarding conflict of interest, a preliminary appraisal seems to indicate that PDMD business processes might contain several conflicts. For example, the Back Office is performing also Front Office functions such as supporting the FO in the process of negotiations of external loans. It is a remainder of the old structure of the PDMD where the divisions were divided into external and domestic debt instead of Front, Middle and Back Office.

B. Assessment.

- The lack of documented procedures is not simply a problem to train new comers. It generates an important operational risk. For example, if a financial loss results from an incorrect handling of a transaction, it would be difficult to identify responsibilities among the participants to the process.

- In order to document procedures, many steps are necessary before writing the documents. The most time-consuming task would be to review current business processes of the PDMD. For instance, if a control point is missing when the department is performing a transaction, it could increase the risk of fraud.

- Generally, best practices recommend to establish a list of risks (what can go wrong) and associate a list of possible outcomes (financial loss, fine from authorities, deterioration of Ministry's reputation, etc.), then valuing possible risk mitigation measures, and only in the end writing procedures and policy guidelines. Applying this type of exhaustive methodology will certainly require considerable efforts which could be overwhelming for the department and not in line with the limited project resources. Therefore, a tradeoff should be found between the number of activities undertaken in order to write procedures and policy guidelines, and the scope covered by these documents. Prioritization in tackling the different operational risks will also be discussed.

- Improper segregation of duties between the different divisions of the PDMD exists. Additionally, strengthening of control points in the workflow might be necessary. However, a complete reengineering of business processes of the PDMD is outside of the scope of this project. Nevertheless, an improvement of the most critical processes of the PDMD seems required.

- The debt database is not integrated. Domestic debt and on-lending and guarantees agreement are recorded in excel spreadsheets, while external debt is registered in the DMFAS system. This situation increases the risk of computational errors and complicates debt portfolio analysis.

- Accomplishment of certain tasks of the PDMD might be at risk when few critical staff are not available. Training plans and formal nomination of back up persons seem to be missing.

3. Business Continuity and Disaster Recovery Plan (BCP)

A. Current status.

In case of major disruption, the PDMD has to be organized in a way that ensure the continuity of the services it provides in the name of the Republic of Armenia. For example, in case of an electricity shortage in the building, debt service payments must be executed anyway, otherwise penalties would be charged by creditors.

Generally, the risks faced by an institution, as well as the severity of damage in case the risks would materialize, the probability of occurrence of these risks and the mitigation measures to reduce the impact of disruptions, are documented in a Business Continuity and Disaster Recovery Plan. The Plan should also include recovery processes, command center to decide actions to be taken in case of disruption, critical staff, systems and processes, alternative site and materials to ensure continuity, evacuation maps, regular testing and training of staff, etc.

Currently, neither the PDMD, nor the Ministry has a BCP.

Several measures are taken to mitigate mainly IT failure events. For instance, spreadsheets containing debt records are regularly saved in flash drives and working files are generally saved on a network drive. But, there is no written guidelines from IT department regarding files storage and security.

The maintenance of the network drive is managed by IT Department. The server is located in the same building in a room which is not securitized or flood/fire proof. There is no backup server, backups are made physically and kept in the same room as the server.

Staff access to the network drive is not restricted. It already happened that files stored in this network drive have been accidentally lost du to the failure of a server.

Original loan agreements are stored at the Ministry of Foreign Affairs. Copies of the agreements are available to the Legal Department of the Ministry of Finance and to the Back Office division; these copies are also scanned and stored electronically. For the PDMD, the Back Office is in charge of storing documents related to debt management (like copies of loans agreements) in file cabinets which are locked but are not fire proof.

The Back Office is responsible for maintaining the debt database. Excel spreadsheets containing debt records are backed up in flash drives on a daily basis. The debt recording system is also backed up on a daily basis by IT department, but backups are kept in the same room where the server is located.
On-lending and guarantees agreements are recorded in an Excel database which is administered by the Department of State Budget Operations Management. IT Department keeps a daily backup of these database in the same room as DMFAS and domestic debt database.

The auction system is managed by the Central Bank of Armenia (CBA), which is in charge of maintaining also the Registry of domestic debt holders. CBA has an alternate datacenter located outside of Yerevan and an alternate operations center. However, CBA alternate operations center is not equipped with any system or database used by the PDMD.

B. Assessment.

- In case of a major disruption that would prevent access to the building for several days, like an earthquake or fire damages, PDMD would hardly have the capacity to ensure the continuity of its business. The lack of a BCP is a major concern.

- Definitive loss of several debt operations records already happened. PDMD is working on recovering these historical records, notably by checking against creditors records.

- Several critical processes such as government securities auctions are managed by the CBA and, thus, could be restored quickly in case of disruption. But, there are probably critical processes at risk in case of major disruption and the PDMD might not be aware of it.

- Absence of a backup server located in a separate building is a severe risk to the integrity of PDMD critical systems.

- Lack of an alternate operations room equipped with the main necessities to ensure continuity of PDMD business is a severe risk to a quick recovery of PDMD activities in case of disruption.

- Business continuity is currently considered as a simple methodology on how to back up important files. There is a need to raise awareness of staff and top management on what business continuity really means. In particular, it implies a significant work before writing the BCP in order to identify major risks faced by the PDMD, as well as critical processes, staff and systems. Regarding the BCP manual, it should be considered has an “alive” document that needs to be reviewed and improved on a regular basis.

Component 3: Deepening the Domestic Market.

Component 3 has the following sides:

(i). Working of the primary and secondary markets.

(ii). Cash management.

(iii). Impact of the pension's reform on the debt market.

(iv). Retail market.

The 3rd. component will be developed after the second mission (22/5/2016 to 3/6/2016).

6. <u>Annex 2:</u> Presentation: “DMO’s: Independence and Relationship with Other Agencies.

Debt Management Offices: Independence and Relationship With Other Agencies

Presentation to Ministry of Finance,
EUD Mission to Armenia,
Jean-Luc Steylaers,
Yerevan, 1/3/2016.

1

Main Themes

1- Circumstances under which the move to a DMO is desirable
2- Implications of where the debt management function is located
3- Relationship with other Agencies

2

Plan of Presentation

- Historical background
- Rationale for creating a DMO
- The 3 types of DMOs
- Assessment
- Trend to expand the missions of DMOs

3

Historical Background

- DMOs are not a recent development (eg.: SNDO, NZDO)
- Today almost all mature countries have a DMO
- The first DMOs have often been created in times of crisis (Sweden, New Zealand, Belgium)

4

Rationale for Creating a DMO (1)

1- Operational Efficiency

2- Transparency and Market/Investors Relations

3- « Expertise Culture »

5

Rationale for Creating a DMO (2)

Operational efficiency

- Centralization decreases debt management risks
- Centralization decreases debt costs
- Centralization permits a global debt management (LT vs. ST, Domestic vs. Foreign debt).

6

Rationale for Creating a DMO (3)

Transparency and Market/Investors Relations

- Centralization provides transparency for investors (both foreign and domestic).
- Centralization develops the relationships with market participants (Primary Dealers a.o.)

7

Rationale for Creating a DMO (4)

« Expertise Culture »

- Centralization provides for economies of scale.
- Centralization is the cornerstone of a « Public Debt Management » culture.
- Centralization offers to the Government an outstanding financial tool – investing in Public Debt Management is like investing in education, roads, health a.o.

8

The 3 Types of DMOs (1)

Institutions involved in government debt management, issuance and market supervision			
	Government debt management	Issuance of government securities	Market supervision
EURO AREA			
Belgium	Belgian Debt Agency	Belgian Debt Agency	Banking, Finance and Insurance Commission; Securities Regulation Fund
Germany	German Finance Agency	German Finance Agency, Bundesbank	Federal Financial Supervisory Authority; Trading Surveillance Fund
Ireland	National Treasury Management Agency	Ireland acting through the National Treasury Management Agency	Irish Financial Services Regulatory Authority
Greece	Public Debt Management Agency; Public Debt Division Ministry of Finance	Public Debt Management Agency (PDMA)	Committee for Control and Supervision of Primary Dealers
Spain	Treasury Dept (Ministry of Economy and Finance)	Treasury Dept (Ministry of Economy and Finance), Bank of Spain	Bank of Spain and CNMV [illegible] market supervision
France	Agence France Trésor	Agence France Trésor	AMF
Italy	Ministry of Economy and Finance – Department of Treasury (Public Debt Directorate)	Ministry of Economy and Finance – Department of Treasury [illegible] Bank of Italy [illegible]	Bank of Italy [illegible] Consob [illegible]
Cyprus	Central Bank, Ministry of Finance	Ministry of Finance, Central Bank	Central Bank, Cyprus Securities & Exchange Commission
Luxembourg	Trésorerie de l'Etat	Trésorerie de l'Etat	CSSF, Luxembourg Central Bank
Malta	Ministry of Finance, Treasury Division (Debt Management Directorate)	Treasury Division, Ministry of Finance	Malta Stock Exchange (MSE), Malta Financial Services Authority (MFSA)
Netherlands	Dutch State Treasury Agency	Dutch State Treasury Agency	Financial Markets Authority
Austria	Austrian Federal Financing Agency	Austrian Federal Financing Agency	Financial Market Authority (FMA)
Portugal	Portuguese Government Debt Agency (IGCP)	Portuguese Government Debt Agency (IGCP)	Portuguese Central Bank (only T-bills); Portuguese Securities Market Commission (T-bills and T-bonds)
Slovenia	Ministry of Finance of Slovenia	Ministry of Finance of Slovenia	Agencija za trg vrednostnih papirjev (Agency for Securities Market)
Finland	State Treasury, Finance division	State Treasury, Finance division	Finnish Financial Supervision Authority

The 3 Types of DMOs (2)

NON-EURO AREA			
Bulgaria	Government Debt and Financial Markets Directorate, Ministry of Finance	Ministry of Finance - Government Debt and Financial Markets Directorate (issuer), Bulgarian National Bank [illegible]	Ministry of Finance and the Bulgarian National Bank [illegible]
Czech Republic	Debt and Financial Assets Management Department of the Ministry of Finance	Debt and Financial Assets Management Department of the Ministry of Finance	Central Bank, Prague Stock Exchange (T-Bonds trading)
Denmark	Government Debt Management at Danmarks Nationalbank and Danish Ministry of Finance	Government Debt Management at Danmarks Nationalbank	The Danish Securities Council, the Danish Financial Supervisory Authority, and Copenhagen Stock Exchange
Estonia	Ministry of Finance of Estonia	Ministry of Finance of Estonia	Financial Supervision Authority of Estonia
Latvia	The Treasury of the Republic of Latvia	The Treasury of the Republic of Latvia on behalf of Ministry of Finance	Financial and Capital Market Commission (FKTK)
Lithuania	Ministry of Finance	Ministry of Finance, Bank of Lithuania	Bank of Lithuania, Lithuanian Securities Commission
Hungary	Government Debt Management Agency Ltd. (AKK)	Government Debt Management Agency Ltd. (AKK)	Hungarian Financial Supervisory Authority (PSZAF)
Poland	Financial Assets and Liabilities Department, Ministry of Finance	Financial Assets and Liabilities Department, Ministry of Finance	Ministry of Finance (MTS Poland), National Depository for Securities (OTC T-bonds trading), Central Bank (OTC T-bills trading)
Romania	Ministry of Economy and Finance	Ministry of Economy and Finance and National Bank of Romania	National Bank of Romania
Slovakia	Debt and Liquidity Management Agency (ARDAL)	Debt and Liquidity Management Agency (ARDAL)	National Bank of Slovakia
Sweden	The Swedish National Debt Office (SNDO)	The Swedish National Debt Office (SNDO)	The Swedish Financial Supervisory Authority (Finansinspektionen)
United Kingdom	UK Debt Management Office (UKDMO), Bank of England	UK Debt Management Office (UKDMO), Bank of England	Financial Services Authority (FSA)

The 3 Types of DMOs (3)

- **Separate legal entity** under the MoF
  - Eg.: Sweden, Ireland, Austria, Portugal, Germany
- **Specific department of the MoF**
  - Locally removed from the MoF
    Eg. : UK, Cyprus
  - Not locally removed from the MoF:
    Eg.: Belgium, Finland, France
- **Specific case: Central Bank is the DMO**
  - Eg.: Danemark.

The 3 Types of DMOs (4)

❖ **Separate legal entity: distinctive features.**

- **Administrative and financial autonomy**
  - Within the guidelines set by the Minister
  - No need for further authorization
- **CEO directly responsible to the Minister**
- **Staff subject to private labour laws**
  - Exception: Sweden

The 3 Types of DMOs (5)

❖ **Specific department of the MoF.**

DMO = Executive agency of the Treasury
CEO = Usually responsible to the Minister through the administrative channels

DMOs may or may not:

- **Be responsible for their own budgets**
  - Yes: France & UK
  - No: Belgium & Finland
- **Be allowed to hire staff from the private sector**
  - Yes: France, UK, Finland, Belgium
  - No: Netherlands

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The 3 Types of DMOs (6)

❖ **Central Bank is DMO.**

- **Not usual in mature countries** (exception: Danmark, but...)
- **More usual in maturing countries** (ex.: India)
- **Result of internal struggles:** overall trend initiated by the MoF to centralize debt management in one place (DMO) but not always successfull: Central Bank resists the move and keeps issuing debt (Tunisia, Jordan).
  - **Sometimes a question of confidence/credibility** (investors have more trust in the CB than in the MoF).

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The 3 Types of DMOs (7)

DMOs may or may not:

- **Have different staff regimes**
  - Yes: France & Belgium (public sector and private sector regimes)
  - No: UK (all civil servants)
- **Be geographically located inside or outside the premises of the MoF**
  - Inside the MoF: France (Bercy), Belgium (Administration of the Treasury)
  - Outside the MoF:
    - UK: MoF in Whitehall, DMO in the City
    - Germany: MoF in Berlin, Finanzagentur in Francfort
    - Cyprus.

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Assessment (1)

❖ **Separate legal entity.**

- **Advantages:**
  - Operational and budget independence
  - => easier creation of specificity
- **Drawbacks**
  - Loose working relationship with the administration
  - Creation needs an act of Parliament
  - Administrative hassle of managing a company

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Assessment (2)

❖ Specific Department of the MoF

- **Advantages:**
  - Public service ethos and political antennae
  - Closer communications
  - Creation by executive decision
- **Drawbacks**
  - Less operational independence
  - Career structure opportunities
  - Pay scale?
- **Geographical location** influences
  - Speed of creation of specificity (business culture)
  - Quality of communications

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Assessment (3)

❖ Central Bank is DMO

- **Advantages:**
  - Central Bank Ethos
  - Pay scale of CB
  - Creation agreement between MoF and CB, usually made possible through CB Law (CB = Financial Agent of the MoF)
- **Drawbacks**
  - CB focus is not similar to MoF focus
  - CB ethos
  - Interest conflicts between CB (monetary policy) and MoF (fiscal policy)

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Assessment (4)

- No one size fits all
- Influence of legal tradition (Code Napoléon vs Common Law)
- Whatever the structure chosen, it must be
  - **Clear and unambiguous** (resistance to change)
  - **Politically robust** (accountability of the Minister)

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Trend to Expand the Missions of DMOs (1)

Widespread trend to expand the missions of DMOs in various directions

❖ **Financial territory**

- Supply of Treasury services to other public sector entities (deposits and loans)
- Risk management
  - Government contingent liabilities
  - Public sector foreign exchange risks
- Asset management
  - On-lending the proceeds from bond issuance
  - Funds management
  - Securitization
  - Project financing

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Trend to Expand the Missions of DMOs (2)

- **Other fields**
- Hedging the Government exposure to the energy market (oil & electricity)
- DMO acting as State Claims Agency
- Varia

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Trend to Expand the Missions of DMOs (3)

Illustration: NTMA (Rep. of Ireland).

- **Financial activities: NTMA manages**
- the National Public Debt (including retail)
- the balance in the Exchequer Account at the CBI
- the borrowing on behalf of the Housing Finance Agency
- the Central Treasury Service
- the assets of the Social Insurance Fund (€ 3.3 bn at end 07)
- the assets of the Dormant Account Funds (€ 205 million at end 07)
- the NPRF (Fund's value at end 07: € 21 bn)
- the assets of the Education Finance Board Fund
- the FX currency requirements of the Department of Foreign Affairs (since June, 2007)
- activities in the field of Asset Covered Securities

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Trend to Expand the Missions of DMOs (4)

- **Other fields:**
- The National Development Finance Agency discharges its functions through the NTMA
- The NTMA is designated as the State Claims Agency
- The NTMA is the Government's purchasing agent for the acquisition of carbon credits for the purpose of compliance with the State's Kyoto obligations (since 2007)

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Trend to Expand the Missions of DMOs (5)

Where should we stop?

- Some projects have failed
  Management of the balance sheet of the global economy
- Some suggestions have been opposed by DMOs
  Meeting the re-investment needs of pension funds

Danger zone

- Governments using DMOs to artificially clean up public accounts
- Interest conflicts (ex.: between debt manager and pensions' assets manager)
- Loss of focus on public debt management (core business)

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Thank you ...

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