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anagement

Request n° 2015/366005/1

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

PROGRESSION REPORT NR 1

JUNE 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.

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Progression Report nr. 1.

June 2016

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DFC CONSORTIUM

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Glossary of acronyms

AFP	Annual Financing Plan
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
PD	Primary Dealer
PDMD	Public Debt Management Department
RA	Republic of Armenia
UNCTAD	United Nations Conference on Trade and Development
WB	World Bank

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.

Second mission in Yerevan by the 2 Experts (25/4 to 3/6/2016).

The second mission has focused on the validation by the major stakeholders of the assessments and descriptions made by the first mission (the first 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 - see Annex 1 of the Inception Report).

- On the basis of the validated assessments, a "battle plan" has been elaborated in coordination with the PDMD, to establish an order of priorities of the areas where the mission will have to work on. The "battle plans" are focusing on Components 1 (Legal Framework for PDM Operations") and 2 ("Enhancing the Capacity of the Middle Office).

- The second mission has assisted the PDMD in drafting a Public Debt Strategy for the period 2017-2019 (the Public Debt Strategy 2017-2019 should have been elaborated by early June).
This action is included in the component "Enhancing the Capacity of the Middle Office".

- The second mission has also prepared a description and an assessment of the domestic debt market (Component 3), in order to promote its deepening (specific objective of the terms of reference of the project). A related battle plan for Component 3 will be drafted during the next mission.

1.3. Preparation of the Report.

Progression Report nr. 1 has been prepared by Jean-Luc Steylaers (Team Leader) and Alessandro Scipioni (Public Debt Management Expert) at the end of the second mission in Yerevan.

Date: 3/6/2016.

2. Executive Summary & Recommendations.

2.1. Executive Summary.

The second mission by the 2 Experts has been taking place in Yerevan from 25/4 to 3/6/2016.
The overall objective of the second mission was the validation by the major stakeholders of the assessments and descriptions done by the first mission (the first 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 - see Annex 1 of the Inception Report).

Based on the validation by the major stakeholders of the assessments, the second mission has focused on the following issues:

- Elaboration of a "battle plan" for the Components 1 ("Legal Framework for PDM Operations") and 2 ("Enhancing the Capacity of the Middle Office") in coordination with the PDMD, to establish an order of priorities of the areas where the mission will have to work on concerning the two components.

- Assistance to the PDMD in drafting a Public Debt Strategy (MTDS) for the period 2017-2019 (the Public Debt Strategy 2017-2019 should have been elaborated by end-May) and in presenting the best international practices in terms of drafting a MTDS (calendar, available data, timing of communication of the data, etc…).
This action is included in the component "Enhancing the capacities of the Middle Office of the PDMD".

- Preparation of a description and an assessment of the domestic debt market (Component 3 of the project: Deepening the Domestic Market), that will be discussed and validated by the 3rd. mission and followed by a "battle plan" for reforms.

- Starting to organize a Study Tour to the Irish NTMA (planned end October).

However, due to a case of force majeure, the Team leader has been forced to shorten its presence in Yerevan.
Consequently, the cash management side of the 2nd. mission has been delayed until the next mission (planned 26/8 to 16/9/2016).

The mission met Mr. Arshaluys Margaryan, Director of the Public Debt Management Department of the Ministry of Finance, and takes the opportunity to thank him for its 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.

The mission has consisted in broad and more focused discussions with major stakeholders of the Armenian public debt – PDMD, other departments of the Ministry of Finance, departments of the Central Bank, 2 banks (non-primary dealers: Areximbank and Prometey Bank), 1 investment company (Renesa), 1 insurance company (Rosgosstrakh)– in order to complete the facts findings operated by the first mission and to be able to draft a description of the current situation of the Armenian public debt market and to assess it. This has been done.

2.2. Preparation of the Report.

- 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).

2.3. 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 2015-2017 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 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.

The mission met also with the following organizations:
- Central Bank of Armenia (Financial Department and Securities Department);
- 2 banks (non-primary dealers: Areximbank and Prometey Bank),
- 1 investment company (Renesa)
- 1 insurance company (Rosgosstrakh),
- The IMF Resident Representative. A meeting with the WB was scheduled but has been cancelled because of "force majeure".

The mission has drafted the following documents:
- Progression Report nr 1.
- Recommendations for Component 1 (Institutional Framework)
- Recommendations for Component 2 (Enhancing the Capacity of the Middle Office)
- Presentation of the MTDS
- MTDS 2017-2019 (including drafting guidelines, schedule for drafting, etc…)
- Description and Assessment of Component 3 (Deepening the Domestic Debt Market – Cash Management will be discussed during the next mission).
- Description and Assessments of Components 1 and 2, as reviewed and validated by the PDMD.

Specifically, with regard to the MTDS side of the mission, the Public Debt Management Expert visited Yerevan from 25 April to 27 May 2016. The first 3 weeks of the mission were dedicated to the elaboration of the Medium-term debt management strategy (MTDS 2017-2019) by the PDMD. The following activities were undertaken:

Week 1
- Prior to the mission, the Public Debt Management Expert send to the staff of the PDMD examples of MTDS documents published by Debt Management Offices of other countries.
- The Public Debt Management Expert prepared and presented a presentation on MTDS concepts and international best practices. The Director and the staff of the PDMD participated to the presentation.
- First comments on the MTDS documents published by the PDMD in past years.
- Review of the debt service projections prepared by the Back Office.
- Prepare with the Middle Office (MO) the inputs to the IMF/WB MTDS toolkit. Discuss inputs to the spreadsheet with the MO.

- Discuss with MO the macroeconomic assumptions to use in the MTDS toolkit. Discuss macroeconomic and budget forecasts received from both departments of the Ministry (forecasts are outdated).
- Present to the MO projections techniques for exchange rates (based on Purchasing Power Parity Theory) and for interest rates (forward curves calculation). Discuss with Front Office (FO) and MO market variables forecasts to introduce in the MTDS toolkit.
- Define the baseline scenario for projections.
- Discuss with FO and MO possible shocks scenario on market variables to introduce in the MTDS toolkit.
- Discuss with MO how to simulate a shock on macroeconomic variable with MTDS toolkit.

Week 2

- Discuss with MO alternative borrowing strategies to the current strategy.
- Define with MO the alternative borrowing strategies to be tested in the MTDS toolkit.
- Run simulations with MO on current and alternative strategies under baseline scenario and shock scenarios.
- Analyse with MO outputs of the Model for the existing portfolio focusing on cost and risk indicators (Cost-at-risk Analysis).
- Analyse with MO outputs of the Model for the simulations based on new government borrowing requirements for the period 2017-2019 and alternative borrowing strategies.
- Discuss with FO and MO main results of the simulations.

Week 3

- Review with MO the MTDS documents published in the past.
- Discuss with MO possible improvements to the document.
- Discuss with MO how to present results of the Cost-at-risk analysis in the MTDS document.
- Prepare data for the MTDS document (Tables, graphs and other figures) based on the Cost-at-risk analysis.
- Prepare a draft template of the new MTDS document (2017-2019) and submit to the MO for comments.
- Discuss possible improvements to the MTDS institutional framework and timeline of the publication of the MTDS document.

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 management	Low to medium	Very high
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	High	High
Minister of Finance	Minister of Finance does	Reforms (partially)	Low	Medium to

agrees on the proposed reforms for the primary and secondary markets	not agree	blocked		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	High (the devil is in the details)	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	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	High	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
Expert 2: Public Debt Management	Mr. Alessandro Scipioni,	100 working days

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

Deliverables of the next mission (tentatively, 26/8-16/9/2016).

- Description and assessment of Component 3 of the project (deepening the domestic debt market), validated by PDMD.
- A "battle plan" in coordination with PDMD to identify/update the reform priorities with regard to Component 3 of the project (Deepening the Domestic Market)
- A very first tentative draft of a new Public Debt Law (at least in bullet points, once PDMD has agreed on the various components of the new PDL).
- A review of the PD's status
- Workshop on cash management (including various presentations)

4.2. Activity Schedule

Programme of the next mission (tentatively, 26/8-1/9/2016)).

- Validation by PDMD of the descriptions and the assessments concerning Component 3 of the Project "Deepening the Domestic Market" made by the second mission (April 24th to June, 3rd, 2016).
- Drafting a "battle plan" in coordination with PDMD to identify/update the reform priorities with regard to Component 3 of the project.
- Organization of a workshop on cash management (including various presentations)
- Addressing issues related to (i) the institutional framework (elaboration of a first draft new Public Debt Law) and to (ii) cash management – Treasury forecasts.

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.

Annexes:

Annex 1: Report on the Medium-Term Debt Strategy (sent separately).

Annex 2: Reforms Plans for the 3 Components of the Project.
Annex 3: 2016 Work Plan
Annex 4: Power Point presentation: MTDS Concepts.

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

• Updated Annual Work Plan for first year.
See Annex 3.

• Updated Annual Resource Schedule and Budget.
Not applicable.

5. Annexes.

Annex 1: Report on the Medium-Term Debt Strategy (sent separately).

Annex 2: Reforms Plan for Components 1 & 2 of the Project.

Component 1: Legal Framework for PDM Operations.

Introduction.

Many governments have understandable fragmentation in their financing operations arising from a legacy borrowing process, which has been constrained by the lack of available options. Less-developed countries have often had no domestic bond market and access only to very short-term domestic borrowing though commercial loans, T-Bills, and, as a the last resort, the central bank.
Availability of international financing will have been restricted to loans of a highly concessional nature since other finance was obtainable only at impossibly high interest rates. In most cases, general budget-support loans were in short supply and concessional finance was strictly tied to development projects. These restrictions resulted in government financial and negotiating skills being split, on the one hand between the capital projects teams (often situated in institutions outside the ministry of finance), and on the other hand the treasury which was managing short-term cash management operations through the T-Bill market to support budget execution.

As such countries develop, continued availability of concessional financing rules out the option of alternative types of borrowing since it is the cheapest, least risk means of funding projects. At the same time, the treasury is keen to expand and develop the government securities market where it can fund cash management operations with issuance of longer-term bills and bonds. These trends cement in place the legacy institutional structures for public financing. Whilst borrowing options remain limited, these structures operate reasonably successfully and lead to the development of individual skills and capacities, which are distinctly separate from each other. Coordination of information and operations is rare and often intentionally avoided.

With further economic development, governments are simultaneously subjected to a sharp reduction in the availability of concessional lending and an increase in other borrowing options. Development of the domestic government securities market allows access to longer-term bond issuance in greater volumes and the development of a market yield curve structure, which can be analysed for cost and liquidity. Additionally, international investors and bond markets open up financing availability at affordable market rates. These factors lead to a range of financing options becoming available to the government, each of which has a varying degree of cost, risk, and liquidity attached. The rapid increase in financing opportunities often leads countries to make exceedingly risky and incorrect decisions due to a lack of proper risk analysis.

Upgrading of Armenia's income classification has now reached the point where concessional lending will become scarce and a greater range of financing options becomes open to it.

The consequence of less concessional debt and more financing options will be the need to further strengthen public debt management in Armenia. No matter how sophisticated the analysis, where large amounts of highly concessional financing are available to a country, the optimal portfolio composition and best future debt funding will normally consist of accessing the available concessional debt to fit with the appropriate fiscal framework. When this type of financing declines, however, and credit ratings of the country improve, various credit markets become available to replace the sources of financing. These markets are, however, much more competitive and will subject the debt portfolio to a diversity of risks which modern public debt management is designed to analyse and optimise.

The long-term objective of public debt management is to manage risks relating to the entire portfolio of public liabilities (considered alongside public financial assets where possible). Such risks – liquidity, market, refinancing, credit, operational, etc. – have been described in the previous TA reports. It is clear that for this task to be performed efficiently and effectively, it needs to be managed holistically by concentrating its focus at one point, within a single organisation. Internationally, this is achieved by making the debt management office responsible for management of the integrated public debt portfolio.

The DeMPA and other TA reports have diagnosed in detail the fragmentation currently in place throughout the debt management function in Armenia.

This fragmentation creates problems of coordination, cooperation, and information sharing. The reports stress that it is important for the PDMD to establish regular coordination with other major stakeholders in formulating the MTDS.

As described in the reports, the creation of an independent borrowing program for each financing sector – domestic debt for budget deficit; domestic debt for investments; external debt for projects; and external debt for budget support – leaves no room for strategic planning. When financing of the budget deficit is determined by the budget department, and available external finance is fixed by project negotiations, the domestic borrowing requirement is simply the balancing item. This operation continues the legacy system described earlier and does not permit strategic cost-risk analysis of newly available financing options in order to create an effective MTDS.

In order for such change to occur, there needs to be a high-level ministerial decision to create a full-function debt management department. The PDMD should then be able to receive and analyse flows of information regarding the medium-term budget deficit financing requirements; the level of medium-term project financing on a concessionary basis; and the availability of alternative types of financing in domestic and external markets.

This information will allow the middle office (MO) to develop a MTDS model which can optimize the cost-risk trade-off between various financing options open to the government.

The results of this optimization will inform the MTDS on an annual rolling basis. As the availability of concessionary lending dries up with the accession of Armenia to middle-income status, alternative forms of borrowing become more feasible. These alternative options can be analysed accurately through cost-risk trade-off modelling and optimized within the PDMD. Modelling of this nature can also allow for non-market factors to be included such as including preferential domestic borrowing in order to develop the government securities market (rather than purely to reduce exchange rate risk).

Implementing such a change within the institutional structure of the MoF will not be simple. It will require leadership, decision-making, and extensive planning.

The first step should be to modify the legal framework to ensure that such changes are enforceable. Ensuring that the MTDS, produced and monitored by the PDMD, is the only strategic guide to debt transactions will be important in this regard.
Internationally, it is often advantageous to formulate a high-level debt management committee (DMC) to oversee the strategic plans and operations of the debt management function. Where this function is within a consolidated DMO, this is a straightforward task. In the case of the existing fragmented debt management function in the Armenia, such a committee could be a solution to the inherent difficulties in changing the institutional nature of the debt management process.

Recommendation.

The mission recommends drafting a new Public Debt Law.

This recommendation has already be formulated by the previous EUD funded TA mission to Yerevan[1] in the following terms: "*the consultants recommend that: (…) the debt strategy framework is reinforced by a revision of the legal framework in order to ensure that: a) all the debt operations are carried out consistently with the MTDS and, b) the mandate of the PDMD is consistent with the scope of the MTDS* ».

International best practice is to centralize all public debt management functions « under a same roof ». It seems difficult in Armenia for the time being to change the institutional framework for debt management and to centralize all public debt functions into the PDMD, and especially these related to external debt borrowing. Basically, this would end up stripping the line ministries from their competencies in project funding through borrowing and this is hardly doable in the current situation, even if it should be done according to best international practices.

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[1] Final Report, Support to the Public Debt Division, December 2012, Request no. 2012/288271/1, p. 29.

Second best solution is to centralize the debt functions around a tool, the MTDS.
The MTDS would provide a global framework for managing holistically all public debt portfolio risks (liquidity, market, refinancing, credit, operational, etc…). In that situation, it matters less that all debt management functions are not institutionally centralized, provided that the MTDS stem from common efforts and commitments by all stakeholders and BE ENFORCED.

In this regard, it should be noted that the MTDS currently drafted by PDMD is NOT ENFORCED and, whatever its tenor, external debt borrowing is still done on a pure opportunistic base which is the opposite of a holistic risk management.
International experience shows that opportunistic borrowing, if successful in the short-term, might anyway lead to severe budget shocks later.
The target of a MTDS and of a holistic debt portfolio risks management is precisely to AVOID future severe budget shocks provoked by opportunistic and short-view borrowing.

The major objective of the new PDL would be strengthening public debt management around the MTDS and establishing a DMC, which would be chaired by the Minister of Finance and consist of senior management members of all the institutions which have any responsibility for debt management functions.

In addition to overseeing the strategy and operations of the PDMD, the DMC would be responsible for ensuring that, while separate functions remain outside the PDMD, the Government-agreed MTDS continuously guides the operations of public debt management.
Its terms of reference, secretariat, and technical sub-committee would be provided by the PDMD.

The new PDL would also clarify and streamline the way the MTDS is drafted and approved. According to best international practices, it is usually attached to the budget and benefits, with the vote of the budget law, of the strength and the power of being approved by the National Assembly.

An MTDS is never written in marmer and could – and should- be updated and changed when there is a change in the economic and financial situation of the country (unexpected shocks, for instance). The new PDL will provide for change and updating mechanisms as well.

The new PDL would also allow for different technical reforms:
- Better defining the scope of the public debt (State debt, Government debt, CBA debt, communities debt…)
- Making clearer the definition, the role and the tasks of the “authorized body”.
- Providing PDMD with new debt management tools, especially for short-term (cash management) transactions.
- Streamlining the regime of guarantees and on-lending.
- Streamlining procedures to issue foreign commercial debt.
- Reviewing and modernizing the status of the primary dealers.
- Etc…

Component 2: Enhancing the Capacity of the Middle Office.

MTDS

Currently, the elaboration of the MTDS is done in the middle of the year to be published in July for the three following years. This timeline is not optimal because many events can happen between July and December that could change baseline assumptions of the Strategy. Furthermore, the strategy is disconnected from the annual borrowing plan, which is discussed at the end of the year.

Preparing the MTDS at the end of the year will also have the advantage of obtaining the latest figures of the budget to be voted at the national assembly in December.

In order to improve the MTDS document and increase its appeal towards decision makers, the following step could be undertaken:

1. Based on the discussion with the PDMD and the Cost-at-risk analysis performed with the MO, consultants will submit a report on the MTDS that contains a draft template of the MTDS 2017-2019 (in annex) and suggestions to improve current MTDS from, both, a technical and strategic perspective. Report will be submitted by the end of May 2016.

2. PDMD staff will read the report on MTDS and provide further comments if necessary.

3. The Draft template of the MTDS will be discussed to agree (or not) on new target indicators and other technical improvement suggested in the report.

4. Draft template of the MTDS will be completed with the latest budget and macro figures when these will be received.

5. End of November / early December, consultants will come back in Yerevan. One of the topics of this future visit will be to revise the MTDS document prepared by the PDMD and suggest final modifications before the publication of the MTDS 2017-2019.

Operational Risks

Currently, the PDMD lacks of documented procedures for debt management. Previous technical assistance missions have probably tackled some of these issues, but an inventory of what has already been done in this area is not available.

It is important to note that changes in the institutional framework – like the implementation of a new public debt law or a new debt management strategy framework – antecede any modification to the procedures. Yet, this project identified several major changes to the institutional framework are needed.

In addition, inadequate procedures are not the only source of operational risk, defined as "*the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events".* Among others, obsolete information systems, insufficient training of the staff, or external incidents provoking business disruption generate operational risk as well.

Such a list of potential risks, to which the activities of the PDMD are exposed, has never been created. This step should be achieved before drafting any modification to current procedures or writing any business continuity plan.

As a result, it is important to moderate expectations of all the stakeholders of this project, regarding the documentation of PDMD procedures. At this point, it is too early to predict which procedures will be changed by the end of the project, and which will not.
Keeping in mind previous remarks, the following activities could be undertaken to start designing a new operational risks framework:

1. PDMD searches debt management procedures written by previous technical assistances (or the staff), as well as previous reports on operational risk management, and send them to the consultants (summer 2016).

2. Consultants mission to raise awareness of staff and top management on operational risk management and start identification of major risks faced by the PDMD, as well as critical processes, staff and systems (November 2016).

3. During the mission (November 2016), the most urgent issues linked to the critical business processes will be discussed to start finding preliminary mitigations measures.

4. PDMD will complete identification of sources of risks, critical processes, staff and systems in a document that will lay the foundation of the Business Continuity Plan (Winter 2016-2017)

5. Document will be reviewed by the consultants during the following mission (spring 2017). In this mission, meetings with each department of the PDMD will take place to review critical processes.

6. Based on progress made in the improvement of the institutional framework and outcomes of the meetings with the PDMD on critical processes, preliminary modifications to the procedures will be drafted.

Annex 3: 2016 Work Plan.

Four missions are (tentatively) planned until years 'end. Their dates might change according to the conveniences of the PDMD, the disponibilities of the NTMA and the experts' own agenda.

- AUGUST 2016:

Programme.

- Validation by PDMD of the descriptions and the assessments concerning Component 3 of the Project "Deepening the Domestic Market" made by the second mission (April 24th to June, 3rd, 2016).
- Drafting a "battle plan" in coordination with PDMD to identify/update the reform priorities with regard to Component 3 of the project.
- Addressing issues related to (i) the institutional framework (elaboration of a draft new Public Debt Law) and to (ii) cash management – Treasury forecasts (after the 2nd. mission workshop on cash management).

Deliverables.

- A "battle plan" in coordination with PDMD to identify/update the reform priorities with regard to Component 3 of the project (Deepening the Domestic Market)
- A very first tentative draft of a new Public Debt Law.
- A programme for drafting quality Treasury forecasts.

- SEPTEMBER 2016[2]:

Programme.

- Operational risks;
- Procedure manuals.

Deliverables.

- First concrete proposals to mitigate operational risks;
- First revised procedure manuals.

- END OCTOBER 2016[3]:

First Study Tour to Ireland (NTMA).
Topics: risk management.

- DECEMBER 2016:

Programme.

- Drafting an MTDS for the period 2017-2019
- Going further with regard to a new Public Debt Law

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[2] Subject to confirmation by mid-August.
[3] Subject to approval by Irish NTMA.

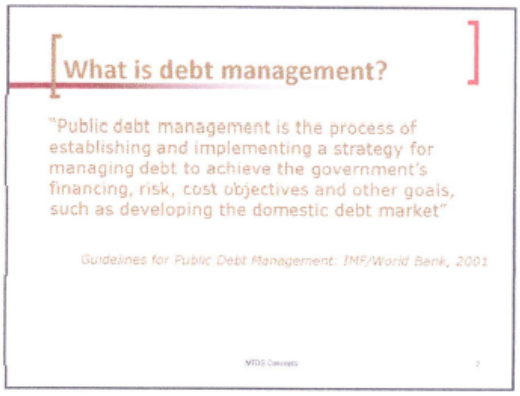
- Supporting the PDMD in drafting quality Treasury forecasts.

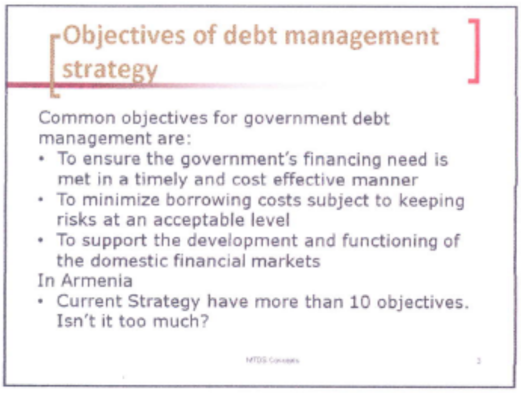
Deliverables.

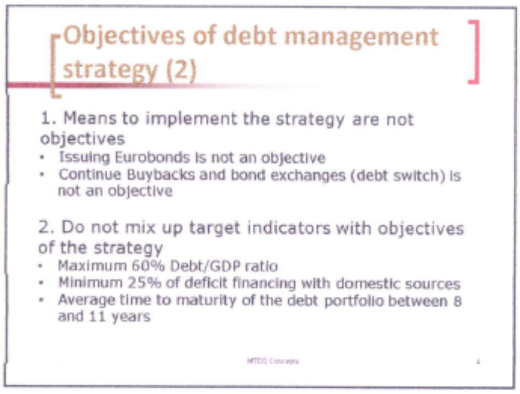
- A validated 2017-2019 MTDS (if possible, attached to the budget and presented to the Parliament).

- A first draft Public Debt Law, to be further discussed and analysed in 2017.

Annex 4: MTDS Presentation







Objectives of debt management strategy (3)

- Objectives are distinct from the strategy itself
- Most frequent objective is "minimize borrowing costs subject to keeping risks at an acceptable level"
- The strategy is the plan on how to achieve these objectives
- Strategy specifies what "acceptable level of risks" is, and why

Scope of debt management strategy

- Debt management should cover all central government liabilities. Then, it could also include explicit contingent liabilities
- The exact definition of the scope will depend on the degree to which the Debt Manager can influence the risk exposure of the specific portfolio

In Armenia

- Current scope of the MTDS is Government Debt
- External Debt of the CBA is excluded from strategy. Should it be like that?
- Usually, Central Bank Debt is excluded from MTDS

Debt management vs. Debt Sustainability

Debt Management Strategy

- Look at the Composition of Debt Portfolio
- Cost at Risk Analysis of the Debt Portfolio
- With a given Primary Balance →What are costs and risks of different financing options?

Debt Sustainability Analysis

- Look at the general level of Debt
- It is a fiscal issue, government revenues and expenditures
- To obtain sustainability → What should be the required Primary Balance?

Links - Fiscal Policy and Debt Management

Source: Joint IMF/WB MTDS

Macro Assumptions and Baseline Scenario

- Macroeconomic Department should send to the Debt Manager the official forecasts for macro variables in line with Medium Term Fiscal Framework (MTFF or MTEF)
- Budget Department send deficit to finance according to projected revenues and expenditures in line with MTEF
- Macro Assumptions (GDP, Primary Balance, etc.) are inputs of the MTDS
- Macro Assumptions (including forecasts for interest rates and exchanges rates) establish the Baseline Scenario of the Strategy

Identification of main risks

Having established the baseline, we need to ask what are the most likely risks (deviation from baseline).

RISK SOURCE	IMPACT ON	DEBT-RELATED RISK
GDP decline	Taxes and revenues	Weak debt repayment capacity
Deterioration fiscal position	Primary balance	High financing needs
Current Account Deficit & FDI reduction	Balance of Payments	Need for external financing (private / public)
Inflation and credit rating	DX interest rates	High DX debt service
Currency depreciation	Exchange rate	High FX debt service
sudden stops of flows (reversal)	Balance of Payments	Limits the choice of financing sources
	Exchange rate	High FX debt service
Terms of Trade	Commodities prices Exchange rate	High FX debt service

Shock Scenarios

- Shocks Scenarios are deviations from the Baseline Scenario considered by the MTDS
- Typical shocks are depreciation of local currency or increase in interest rates. But, how to determine their magnitude?
- Historical Data can help determine the magnitude of the shock but can also consider stress tests: events with low probability but high impact

Existing Debt Portfolio

- Existing Debt Portfolio is an input and a constraint for debt management strategy
- Fiscal Balance is the result of economic performance

  Primary Balance
  - Interest payments
  = Fiscal Balance
  - Principal payments
  = Funding needs

- Principal Payments is the consequence of Existing Debt Portfolio

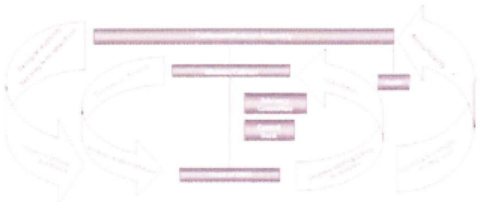
Alternatives strategies for new borrowing

- Identify financing strategies which will best mitigate vulnerabilities of existing portfolio
- Current strategy is the benchmark strategy → need to know if doing what you do currently is the best option
- Corner Strategies as theoretical exercise: what if government borrows 90% Domestic and 10% External or vice versa
- But preferred strategies must be realistic.
- Simulations with new instruments: what if government issue an Eurobond or longer domestic debt instruments?

Inputs and Outputs of the MTDS

Source: Joint IMF/WB MTDS

MTDS is a process, not only a document



Source: Joint IMF/WB MTDS

What kind of target indicators?

Targets are set on the desired debt portfolio composition. For example:

- External / Domestic percentage range
- Fixed / Floating percentage range
- Target Debt Stock range at the end of the period
- Maximum Debt Service percentage compared to outstanding
- Average maturity of the debt portfolio (range between min and max)
- Maximum % of debt portfolio maturing in 12 months.

Long-term indicators vs. Next year targets

- Brazilian Treasury

Indicators	Long Term Limits	
	Target	Range
Profile (%)		
Fixed Rate	45	(+/- 2)
Inflation Linked	35	(+/- 2)
Floating Rate	15	(+/- 2)
Exchange Rate	5	(+/- 2)
Maturity Structure		
% Maturing in 12 months	20	(+/- 2)
Average Maturity	5.5 years	(+/- 0.5)

Indicators	2014	Limits for 2015	
		Min	Max
Stock of FPD (R$ billion)			
FPD	2295.9	2450	2600
Composition (%)			
Fixed Rate	41.6	40	44
Inflation Linked	34.9	33	37
Floating Rate	18,7	17	22
Exchange Rate	4,8	4	6
Maturity Structure			
% Maturing in 12 months	24	21	25
Average Maturity	4,4	4,4	4,6
Average life (years)	6,6		

Specific targets vs. Targets range

Indicators (3 months moving average)	2016
Share of foreign currency debt	35%
Currency mix of foreign currency debt	Euro 100% (-5%)
Fixed/Floating mix (Share of Fixed)	61-83%
Duration of local currency debt	3 years +/- 0.5 y

Source: Debt Management Outlook 2016, Hungary

Detailed targets vs. general orientation

Indicators	2016
Share of inflation linked debt in krona	20%
Average time to Maturity of inflation linked debt	6 - 9 years
Average time to Maturity of krona debt instruments up to 12 years	2.6 - 3.6 years
Outstanding benchmark for instruments longer than 12 years	SEK 70 billion
Exposure to foreign currency should decrease, but cannot exceed	SEK 30 billion
Average time to Maturity of foreign currency debt	0 - 1 years

Source: : Guidelines for central government debt management 2016, Sweden

Thank You...

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