Lessons learned:
Debt and Liquidity Management in the Slovak Republic

Case study

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Debt and Liquidity Management Agency

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1. Executive Summary

The purpose of this case study is to describe the changes that were applied to the debt and liquidity management in the Slovak Republic since the establishment of an independent state until the country euro zone entry. The sharing of these experiences could be an inspiration for other transition countries in regions facing similar challenges.

The case study contains mainly the following information:

- A description of the debt and liquidity management system until 2003.
- A brief description of the public finance reform in Slovakia.
- A description of the establishment of the State Treasury System and the Debt and Liquidity Management Agency.
- A description of the new debt and liquidity management system since 2004.

Debt and Liquidity Management until 2004

After creation of the Slovak Republic in 1993 it was necessary, in a relatively short time period, to transform existing and create new institutions to match the needs of the developing Slovak capital market. It was also necessary to maintain the continuously rising Government debt of the independent Slovak Republic.

The debt and liquidity management was fully in hands of the Ministry of Finance of the Slovak Republic (the "MoF"). The main goal was to ensure funds needed for realization of outgoing payments from the MoF and budgetary institutions accounts. This target could have been reached only by Government securities issuance because the MoF had no access to money market. The issuance was driven by immediate needs of the MoF without considering market conditions and development.

The MoF used only the simplest instruments – Government Bonds (the "Bonds"), Treasury Bills (the "T-Bills") and loans from the commercial banks or supranational institutions (the "Loans"). All the domestic Bonds and T-Bills were issued via auctions based on competitive bids. The auctions were realized in close cooperation with the National Bank of Slovakia (the "NBS"). The NBS also served as a paying agent of the MoF. The result of ad hoc issuance of Government securities was a lot of issues with small nominal amount and limited secondary market liquidity. There were also some Foreign Bonds issued through the syndication. No money market or derivatives instruments were used and the treatment of the risks included in the debt portfolio was completely absent.

All the MoF accounts as well as budgetary organizations accounts, which formed the State Single Account, were held with the NSB. The complicated structure of the MoF accounts with the NBS substituted the standard accounting based on analytical accounts. It was very complicated to manage daily liquidity because the online information about account balances was not available and no future cash flow prediction existed. It was necessary to keep the State Single Account in significant surplus to avoid insolvency of the MoF. On the other side the surplus of this account did not bear any interest, which caused extra debt service costs. The public sector clients' accounts were held with the commercial banks.

Public Finance Reform

The centre-right coalition formed after the National Council election in 2002 launched the most complex reform package in the history of the Slovak Republic. Important part of reforms was the Public Finance Reform with a goal to achieve public finance transparency and the significant cost-savings in public expenditures. In order to reach these targets the Government financial flows were concentrated into newly formed State Treasury (the "ST"). The establishment of the Debt and Liquidity Management Agency (the "Agency") significantly contributed to professionalization of the debt and liquidity management.

State Treasury System Project

The work on the State Treasury System Project started in 1999. A special team with support of EU experts prepared the concept of the state treasury system as well as detailed function specification for the State Treasury information system (the "ST IS"). The concept of the separation of strategic-conceptual and operational debt and liquidity management was chosen. The strategic-conceptual management remained in the competence of the MoF and the operational management was relocated to the newly established Agency. This was significantly supported by establishment of the ST. The ST is de facto an electronic bank maintaining budgetary and non-budgetary client accounts and ensuring domestic and international payments. Its controlling role is important in respect to the individual clients' budget realization as well as the state budget as a whole. The roles of both institutions were exactly defined in the Act No. 291/2002 Coll. on the State Treasury and amendments to certain laws.

2003 – First Year of the Debt and Liquidity Management Agency

In early 2003 both new institutions have come to existence. Despite the different roles of these institutions in the system, the setup of the processes and activities had been carried out in mutual accordance.

The main task for the year 2003 was to build up the Agency as a functional institution. It was necessary to establish the legal framework of the Agency by issuing of the internal regulations or directives and hire the employees with appropriate skills. The result was the Agency with the structure similar to the Treasury department of the commercial bank.

Very important was also preparation of the environment for the Agency's core activities. The redistribution of debt and liquidity management responsibilities between the Agency, the MoF, the ST and the NBS was the first major task. It was also necessary to harmonize the legislation regarding debt and liquidity management in order to avoid possible negative effect on the Agency's activity. The Agency thus prepared in 2003 proposals for legislative changes in at least 5 different laws.

The Agency was actively involved into the ST IS implementation. The problematic issues, omitted in initial analytical stage of the project had to be resolved. The settlement of the transactions concluded by the Agency, accounting of the transactions as well as foreign payments, were crucial from the Agency's point of view and incorrect setup could have had a negative impact. The Agency also worked on implementation of the FinanceKit Treasury system that is the core information system (the "IS") of the Agency. The implementation was complicated by the above mentioned problematic issues.

The "Debt Management Strategy", elaborated by the Agency in cooperation with the foreign experts and the MoF was the first document dealing with the risks contained in the debt portfolio. Based on the assumptions adopted for the coming years, clear objectives and principles for the debt management had been set. In addition, the Agency representatives were actively involved in the operational debt

management. The Eurobond issue, realized in May 2003 weakened rising tensions in the Government funding. The Agency also published a binding auctions calendar for year 2004.

Debt Management since 2004

Since January 2004 the operational management of the Government debt is fully in hands of the Agency. The Agency's main task is to ensure safe access of the State to financial markets. The Agency is acting on the market on behalf of the MoF. The Agency, among its other duties, organises and implements the State debt service, realizes the Bonds and T-Bills issuance as well as the redemption of the State debt.

The debt management has undergone evolutionary changes. The issuance of domestic bonds is in line with binding auction calendar, published in advance for the whole next year. For all new Bond issues the standard value of SKK 40 billion had been set. The individual Bonds tranches, sold by means of auctions, are fully fungible. The T-Bills are issued first into the MoF own portfolio and later, depending on the Agency's decision, sold by auctions on the secondary market or used for collateralised transactions. Agency thus significantly reduced the number of open issues and increased their size. This considerably helped the secondary market liquidity. The Agency also gradually replaced non-tradable Debt, i.e. Loans by the Bonds through the early repayment of the floating rate Loans.

The considerable progress had been achieved in respect of realization of auctions. Since January 2005 the Reuters electronic auction system, developed in close cooperation with the Agency, is used. It is based the Reuters Xtra communication platform and covers all types of auctions, including Bonds, T-Bills, REPO as well as Sell and Buy Back transactions.

Liquidity Management since 2004

The changes in liquidity management could be deemed as revolutionary. The Agency is responsible for the operational liquidity management by the execution of the financial market transaction with the financial instruments including derivatives to overcome mismatch between the revenues and expenditures of the State budget.

The MoF and budgetary organizations accounts as well as the State Single Account were migrated from the NBS to the ST. Similarly, the public institutions' accounts were withdrawn from the commercial banks in favour of the ST. Thus all the public sector clients' financial resources are concentrated in the ST. This concentration allowed the usage of public sector clients' temporarily available funds for the debt and liquidity management purposes via newly designed and implemented refinancing system. The refinancing system details are described in the *"State Treasury and Refinancing System"* chapter of the main document.

The ST is a direct participant of the Real Time Gross Settlement (the "RTGS") payment system. Monitoring of the balance of this account and sum of credit/debits is possible in real time. The Agency is managing liquidity on the ST RTGS account on the daily basis. The Agency has also a complete overview of the expected cash flow for the next three months.

Risk Management

Significant contribution of the Agency is monitoring, evaluating and managing of the risks associated with the Government debt. A new approach to debt management is based on optimizing of the refinancing, interest rate, liquidity and currency (FX) risks. The main criteria which the debt portfolio had to meet are defined in the "Debt Management Strategy", which is a fundamental document approved by the Government for the four year period.

Our Recommendations

Based on our experience with the debt and liquidity management reform in Slovakia we would like to recommend the key points required for the reform success:

- The Governmental support of the reform is crucial.
- In advance and well prepared legislative environment related to debt and liquidity management substantially helps to avoid problems and time stress in the future.
- Individual experiences of other countries with professional cash and debt management offices are inspirational.
- The information system implementation should be the last stage of the project. Everything else (infrastructure, staff, responsibilities etc.) has to be carefully prepared before, and problematic issues have to be solved.
- Good communication of the reform rationale with investors, interbank market participants, rating agencies and the World Bank/IMF is very important.
- It is necessary to form appropriate two-way co-operation with the Central Bank.

Ministry of Finance of the Slovak Republic

Slovak Aid

UNDP

2. General Environment

Creation of the Slovak Republic

The fall of communist regime in Czechoslovakia in November 1989 (the so called "Velvet Revolution") has opened a way for creation of the independent Slovak Republic. Since 1990, when the Czech and Slovak Federative Republic (the "CSFR") replaced the former Czechoslovak Socialistic Republic, toughened efforts for the tighter federation or for the two independent states.

On July 17th, 1992 the Slovak Parliament has adopted the "Declaration of Independence of the Slovak Nation". Only a few days later Czech and Slovak governments had agreed the federation dissolving. The goal of negotiations was to achieve a peaceful division.

In November 1992, the Federal Assembly of the CSFR has adopted the Act on the Dissolution of the Federation, on the basis of which the CSFR was peacefully separated into two independent states, the Slovak Republic and the Czech Republic, effective from January 1st, 1993.

With the effect from the same date, Slovakia has adopted a new constitution providing for the separation of legislative, executive and judicial powers. Legally, each republic became a successor to the CSFR, and federal property has been divided, with certain exceptions, on a two-to-one ratio (Czech Republic to Slovakia), reflecting the relative size of populations and economies. Separate monetary systems and currencies were introduced by each country in February 1993.

Slovak Koruna

The NBS was established by the National Bank of Slovakia Act on January 1st, 1993 from the Bratislava branch of the CSFR central bank. The NBS is constituted and operates as an independent institution, as set forth in the Slovak Constitution.

On February 8th, 1993, the independent Slovakia introduced its own currency - the Slovak Koruna (the "SKK"), replacing the Czechoslovak Koruna at par.

SKK exchange rate was set as fixed from the beginning. From July 14th, 1994 SKK exchange rate was joined to the basket containing 60 % of German Mark and 40 % of US Dollar with allowed fluctuation band. After fluctuation band withdrawal in October 1998 SKK exchange rate floated freely until November 25th, 2005.

Rise Up of the Slovak Republic Government Debt

At the time of creation the Slovak Republic inherited the debt in the total amount of SKK 96.054 billion[1] (EUR 3.188 billion) as a result of delimitation of former CSFR state financial liabilities.

This debt contained the Slovak Republic own debt of 1992 year, one third of CSFR domestic and foreign debt, government foreign liabilities resulting from political decisions of the former communist government and the special loan from Ceskoslovenska obchodna banka, following realization of general federation property dissolution agreement.

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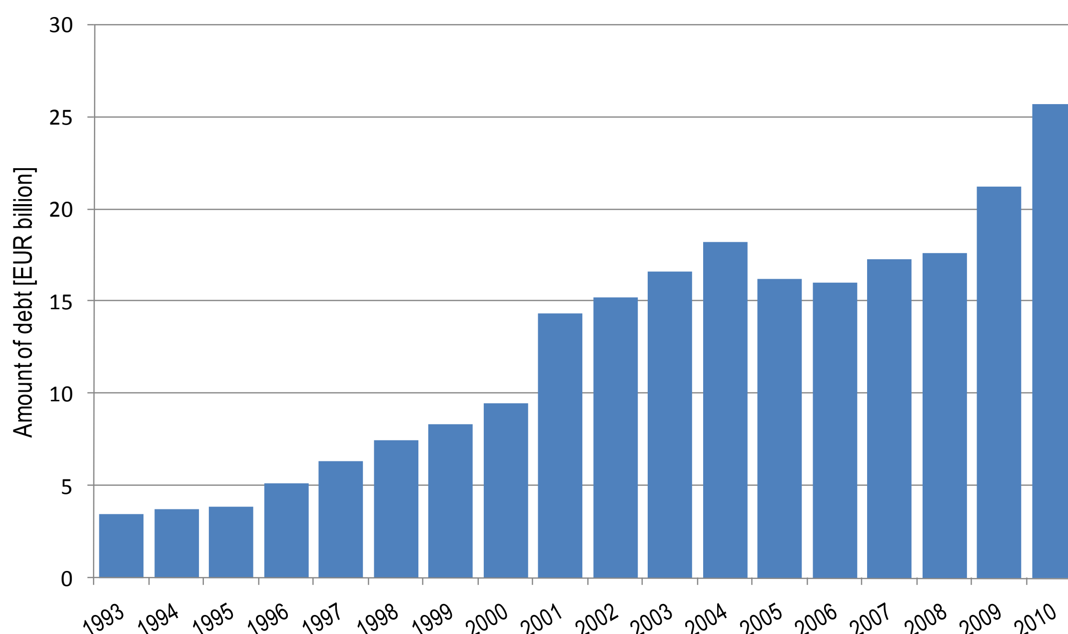
[1] Source: Proposal of „Final State Budgetary Account of the Slovak Republic in the Year 1993" http://www.nrsr.sk/dk/Download.aspx?MasterID=76162 (in Slovak language)

Budget Deficit

Since its creation in 1993, the Slovak Republic operates with the budget deficit. This leads to continual rise of the Government debt (current year deficit increases the debt next year). The Government debt reduction in years 2005 and 2006 was caused by the national property privatization revenues.

Chart 1. The Debt of the Slovak Republic



Source: Debt and Liquidity Management Agency

3. Debt and Liquidity Management in Years 1993-2003

Debt and liquidity management evolved in Slovakia since 1993 was far away from EU and OECD standards and has not met the requirements for modern debt and liquidity management in developed market oriented economy. Responsibility for the debt and liquidity management was fully in hands of the MoF.

3.1. Debt Management

The MoF used only simplest instruments containing Bonds, T-Bills and Loans. Debt management can be characterized as a passive one - securities issuance were driven only by estimated immediate needs of the State without considering market conditions and trends. The result of such issuance policy was a lot of issues with small nominal amount and poor secondary market liquidity. The issues were announced ad hoc, no issue calendar for investors existed causing a problem with the investment planning.

The MoF used only funds from issued T-Bills, Bonds and borrowed Loans to cover debt and deficit needs on the State Single Account. In line with the European Central Bank (the "ECB") regulations the NBS was not allowed to lend any funds to the MoF what meant that even in case of surplus on some accounts there was no channel to use these funds to cover debit on the other accounts. The MoF did not use any other financial transactions like money market operations (deposits, Sell and Buy back operations, REPO-transactions), swaps or other derivatives.

Instrument portfolio

Treasury Bills

Dematerialised short-term discount papers with maturity up to 1 year. The funds obtained from the T-Bills issues covered the current year deficit needs. The T-Bills were booked in the "Short Term Security Registry" operated by the NBS. Only recognized legal entities might hold T-Bills as a book-entry in a securities account. Private individuals were not allowed to hold T-Bills.

Government Bonds

Dematerialised medium and long term securities with maturity more than one year booked in the Central Securities Registry (later transformed to the Central Depository). The funds obtained from the Bond issues covered the debt needs. All entities might hold Bonds as a book-entry on a securities account.

Foreign Bonds

Dematerialised securities booked in the foreign depository, governed by foreign law, issued in foreign currency with maturity more than one year. The MoF issued Foreign Bonds by syndication. All entities might hold Bonds as a book-entry on a security account.

Loans

Non-tradable part of the debt, bilateral Loans from the commercial banks or supranational institutions like the IMF or the EBRD. The proceeds obtained from these Loans were used for the financing of the special programs and for the monetary purposes (strengthening of the State balance of payments). In the first year they could be used to cover the deficit needs.

The domestic Bonds and T-Bills were issued only through the auctions based on competitive bids. Other forms as underwriting or direct sale were possible but not used. Only the exceptions were "Restructuring Bonds" used for commercial banks bailout in 2001. These bonds replaced the toxic loans in local commercial banks portfolio.

Auctions were realized in close cooperation with the NBS. Market participants' auction bids were sent to NBS by fax and manually typed into the NBS auction software. The decision regarding accepted amount and cut-off price/yield was made by the MoF representatives. NBS served as a paying agent for the MoF. Realization of coupon payments and redemptions of Bonds or T-Bills were subject to delivery proceeds for that payment in one day advance. Foreign Bonds were issued only through the syndication.

A few facts

On March 27th, 1992 the MoF realized the first domestic Government Bond issue. Until December 31st, 2003 there were 199 issues of domestic Government Bonds with 1 to 10 years maturity realized. Average amount of one Government Bond issue was SKK 3 billion (EUR 100 million).[2]

During the same time there were 335 issues of the T-Bills with 7 to 364 days maturity realized. Average amount of one T-Bills issue was SKK 2.152 billion (EUR 71.4 million).[3]

In May 1998 the MoF realized the first foreign Government Bond issues denominated in JPY, USD and DEM with maturities 3 and 5 years. Until December 31st, 2003 there were 6 issues of foreign Government Bonds with 2 to 10 years maturity.

3.2. Liquidity Management

All the accounts of the MoF and budgetary organizations as well as the State Single Account were held with the NBS. The NBS realized all the payments from the MoF and budgetary organisations accounts. Domestic payments were realized through the local RTGS payment system, foreign payments were settled through the NBS correspondent banks. NBS accepted payment orders only in the paper form. Payment orders of the MoF regarding the debt management payments had to be signed by the Minister of Finance.

The MoF used quite complicated structure of the current accounts in the NBS. Each banking account had to show positive balance at the end of banking day. NBS for the payments between these accounts also required payment orders in paper form. The budgetary rules strictly separated budget deficit and the debt as well as the instruments allowed for funding such needs.

The bookkeeping of the Government debt related transactions was very simple and based on cash principle. The bank accounts with NBS were the substitution of standard bookkeeping based on the analytical accounts. The bookkeeping was realized by the manual inputs according to statements of accounts at the NBS.

It was almost impossible for the MoF to effectively manage liquidity on their accounts with the NBS. Budgetary organizations were autonomous in their expenditure management; the only limit set by the MoF was that they could spend only ¼ of budgeted deficit in one quarter, which resulted in unpredictable cash flow. Due to the obsolete NBS customer payment system the MoF had no online information about payments to/from the budgetary accounts and their account balances. This information was available in the NBS account statements received the next day.

The only way to avoid insolvency for the MoF was to keep the State Single Account in a huge surplus. It forced the MoF to issue more securities than it was urgently needed. This significantly increased the debt service costs due to the fact that, according to the NBS rules, the surplus on the State Single Account did not bear any interest.

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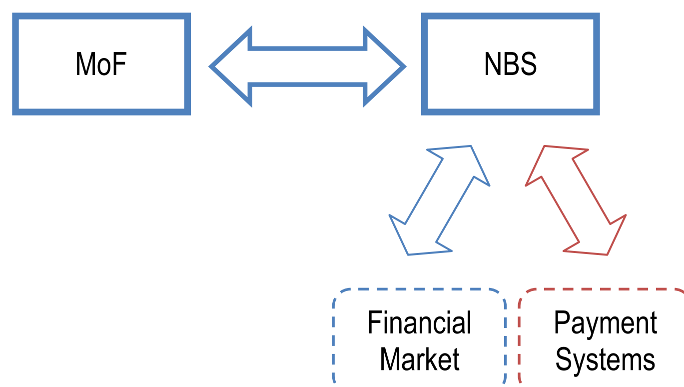
[2] The details of Government Bond issues and auction results are available at http://www.ardal.sk/_img/Documents/en/Government%20Securities/Archives%20of%20GB%20and%20T-Bills/Paid-up%20Government%20Bonds.htm

[3] The details of Treasury Bills issues and auction results are available at http://www.nbs.sk/en/statistics/data-categories-of-sdds/interest-rates/en-spp/en-spp-clenenie-podla-roku-emisie

Chart 2. Institutions involved in the liquidity management



There was no limit set for maximum positive balance of the State Single Account or other MoF accounts by NBS and each movement on these accounts caused significant banking sector liquidity as well as short term interest rate change.

The public sector clients (e.g. Social Insurance Company, Health Insurance Company etc.) accounts were held in commercial banks. Positive balance on their account also could not serve as a funding resource for the MoF. The banks used their funds for their own purposes or for buying Bonds or T-Bills and the margin (difference between the interest paid and received) remained with commercial banks.

The complicated procedure for increasing approved deficit in current year (National Council approval required) led to politically motivated efforts for moving debt service expenditures together with the related risks to the next period.

A serious problem was the fact that risk management (interest rate and FX risks) was totally absent at the MoF. The MoF was not involved in the secondary Bonds and T-Bills market and thus did not use any market instruments at all.

4. Structural Reforms

After the National Council elections in September 2002, a centre-right coalition was formed with a commitment to consolidating prior reforms and pursuing new reforms. In January 2003, changes in regulated prices and indirect tax rates came into force. The main goal was to reduce the high growth rate of consumption and to decrease the budget deficit. Later, reforms of the tax and pension systems, social security and health care (partial) were implemented by the Slovak Government.

The main features of the tax reform programme was the introduction of a flat tax equal to 19 per cent on income for both individuals and corporations, and the introduction of a unified 19 per cent VAT rate for all goods and services. In addition, in order to achieve progress in the harmonization of legislation with the EU standards, adjustments to excise taxes were also adopted.

Pension reforms included the introduction of a 3 pillar system with a "pay as you go" first pillar, a mandatory contributory second pillar involving pension savings accounts, and a voluntary "supplementary" third pillar. Reforms instituted in the social security system include legislative changes designed to discourage long-term inactivity and abuse of the system. The first phase of healthcare reform included the introduction of a system of co-payments and the reclassification of healthcare

services to facilitate greater participation in the financing of some services by patients. Remaining reforms planned by the Government include the reform of the university education system and further reforms of the healthcare system that were not fully implemented due to the political crisis within the ruling coalition.

Public Finance Management Reform

The Government had instituted reforms to public finance with the aim of significant cost-savings in public expenditures and transparency of public finance.

One of the main objectives of the public finance reform was implementation of multi-year program budgeting. Due to changes instituted in the Budgetary Rules, the budget has to be prepared for the period of, at least, three calendar years. The purpose of medium term budgeting was to strengthen the link between medium-term fiscal requirements/planning and the yearly budget. New budget regulations also tighten up conditions for usage of public resources.

The intent to improve macro-economic and fiscal analyses and prognoses led to creation of the Financial Policy Institute at the MoF.

Another important part of reform was the liquidity concentration into state treasury and professionalization of debt and liquidity management. As of January 1st, 2004 the ST started its operation whose major aim is to hold accounts for all General Government institutions. Centralization of Government financial flows through one synthetic account was adopted to ease the monitoring and liquidity management. The ST cooperates closely with the Agency whose role, amongst others, is to manage State debt and liquidity. The implementation of the ST and the Agency was supported by the EU´s PHARE project.[4]

5. State Treasury System

The ST as well as the Agency were established as part of the Public Finance Management Reform. The objectives and political decisions were adopted before the year 2000. The main reason for creation of such institutions was to concentrate all possible public finance cash flows into one system with the following aims:

- to make public finance cash flows more transparent,
- to improve the efficiency of the public finance usage,
- to improve quality of reporting,
- to store all public finance cash flows data in one database system,
- to ensure effective liquidity management and
- to contribute the effective management of the state debt.

4 The details regarding Public Finance Management Reform Project can be found on: http://www.finance.gov.sk/en/Default.aspx?CatID=120

5.1. State Treasury System Project Preparation

Since 1999 special department "State Treasury Project", subordinated directly to the Minister of Finance operated within the MoF. This team in cooperation with the external consultants prepared concept of the ST System[5] as well as detailed function specification of the IS. The document "Strategy of State Treasury System Building" was approved by the Government in April 2000. Different EU countries approaches were considered and the concept of the separate strategic-conceptual and operational debt and liquidity management was chosen. The strategic-conceptual management should remain in the competence of the MoF with the operational management relocated to the newly established Agency.

This should be supported by the second newly formed institution – the ST. The ST should have been an electronic bank (de facto but not de jure), maintaining budgetary and non-budgetary client accounts and ensuring domestic and international payments. An important aspect should be its controlling role in respect to the budget realization of individual clients as well as the state budget as a whole. An important question regarding legal forms of the newly formed Agency was not solved and remained open. In July 2002 Hewlett-Packard was selected through a public tender to be the provider of the ST IS.

5.2. Legislation Process

Because of the lack of political consensus, when it came to the legal form of the Agency (budgetary organization instituted by law versus state owned joint stock company), the National Council received the draft law, which considered only a single new institution – the ST.

In line with the achieved political consensus, the new part of law proposal establishing the Agency as a budgetary organisation has been added during the legislation process at the National Council. The Agency should take over from the MoF activities related to the operational management of debt, risk management and also be responsible for managing the liquidity of the ST System.

The final proposal of the **ST System consisted of the MoF as a body, providing the framework and fulfilling the supervisory role, the ST, which serves as a retail part of commercial bank, responsible for the payments processing and the Agency, which serves as a Treasury part of commercial bank and its duties contain debt and liquidity management activities. This "triangle" concept has remained unchanged until these days.**

On May 21st, 2002 the National Council has adopted the Act No. 291/2002 Coll. on the State Treasury and amendments to certain laws.[6] The reform of this part of the public finance has started in 2002 by passing the Act No. 386/2002 Coll. on the State Debt and State Guaranties which determined the basic institutional and political framework for this area and by passing the Act No. 291/2002 Coll. on the State Treasury.

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[5] The State Treasury System includes the MoF, the ST and the Agency. It is the system of activities ensuring centralised management of public finance and the system of relationships amongst the above mentioned entities.

[6] The current wording is available at: http://www.ardal.sk/_img/Documents/en/About%20us/Legislation/Act%20on%20ST.pdf

6. Debt and Liquidity Management Agency

6.1. Agency as a Budgetary Organization

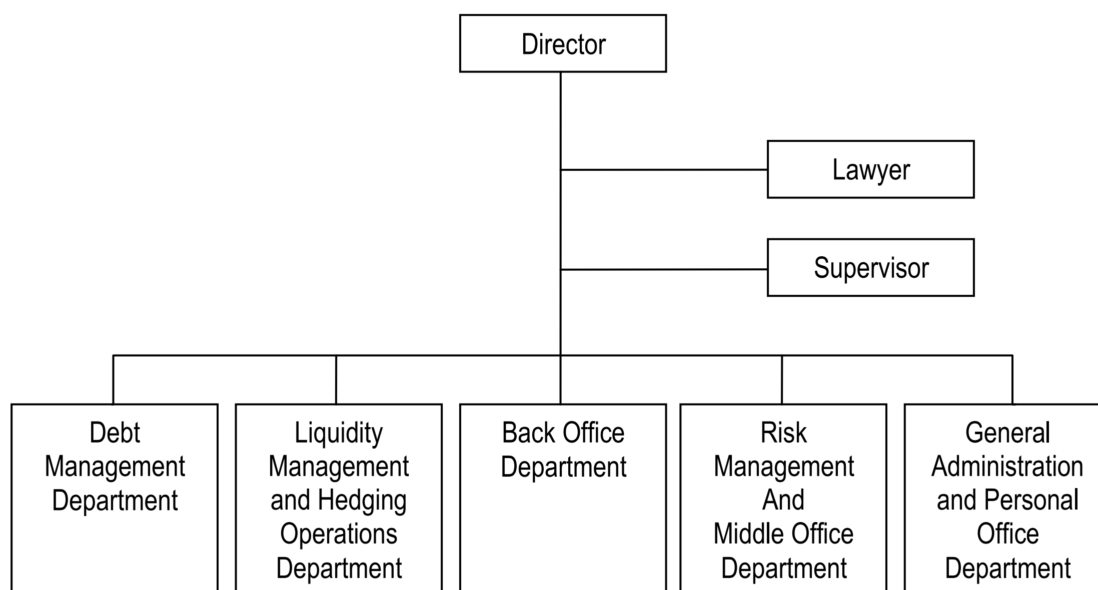
By appointing the Director of the Agency on February 1st, 2003 the Agency has come into existence. It has been established by the above mentioned Act as a new budgetary organization connected to the State budget by its revenues and expenditures through the budgetary chapter of the MoF, with the Finance Minister as a governing body. The main task for the first year was to build up the Agency as a functional institution.

In the field of human resources it was necessary to overcome the relatively complicated process of employee recruitment to civil service employment under the Act No. 312/2001 Coll. on the Civil Service. Despite the problems with limited possibilities for remuneration assessment, the Agency was able to hire personnel with appropriate technical, language skills and sufficient practical experience in the financial market.

The legal framework of the Agency was established by issuing 23 internal regulations and directives, including amendments thereto and 5 Resolutions of the Director in 2003.

The result of this process was the Agency with the structure very similar to standard structure of Treasury department in commercial bank. The Front Office consists of the two departments with self-explainable titles – the Debt Management Department and the Liquidity Management and Hedging Operations Department. The Back Office Department is responsible for settlement of the transactions done by the Front Office and the Risk Management and Middle Office Department is responsible for monitoring of risks and maintaining data in the Agency IS.

Chart 3. The structure of the Agency



6.2. Definition and Preparation of the Agency's Core Activities

Considering the establishment of the Agency and ST, it was necessary to redefine the distribution of activities and responsibilities between the Agency, MoF, ST and NBS. For this purpose the MoF Management Meeting approved the document "Proposal of the distribution of debt and liquidity management competences and responsibilities between the Agency, MoF, ST and NBS", which defines the basic activities and responsibilities of particular subjects in the process of debt and liquidity management. The agreed distribution was in line with the Act No. 572/2001 Coll. on the Organization of Government Activities and the Central State Administration.

Legislation Related to Debt and Liquidity Management

When detailed requirements for the Agency's IS had been defined it was found that some of the laws relating to debt and liquidity management were not fully harmonized. It could substantially negatively affect the Agency's core activity. It mainly concerned the temporarily free funds investment and liquidity management on the ST Single Account. The next problem was the defining of refinancing relationship between the MoF and the Treasury as well as its impact on the debt and State budget deficit for the given financial year. Other procedural issues followed the fact that the Agency activities can be considered as commercial, while from the formal-legal point of view the Agency is a budgetary organization.

Due to the above mentioned reasons, terminology unification as well as the new distribution of debt and liquidity competences and responsibilities, the Agency had prepared proposals for legislative changes regarding mainly the following laws:

- Act No. 291/2002 Coll. on the State Treasury,
- Act No. 386/2002 Coll. on the State debt and Guaranties,
- Act No. 303/1995 Coll. on the Budgetary Rules,
- Act No. 566/2001 Coll. on the Securities,
- Act No. 530/1990 Coll. on the Bonds and other relating laws.

These legislative changes were very important part of the Agency's core activities preparation.

ST Information System Implementation

ST IS implementation was divided into different modules. During 2003, the Agency was actively involved in implementation of the Liquidity and Debt Management Module. The Agency directly depends on the ST operating procedures and processes (the ST outputs directly affect the operations of the Agency). On the other hand the Agency had to follow the MoF processes, which did not have any automated information system and therefore all records were in paper form. These processes were not flexible and did not correspond with that used in commercial practice.

Within this module preparation of documents has been resolved for the process of gathering information for the management of cash flows on the Single Account. The Agency also worked on the specification of accounting procedures for accounting for transactions concluded on the interbank financial market. With respect to management of a single account balance, the Agency participated in detailed fine-tuning of the account keeping conditions with the NBS, which served as a ST correspondent bank for domestic and foreign payments realization. The Agency also cooperated in mapping and creating the ST operations to meet customer requirements, with an effort to ensure conditions similar to the commercial banking sector.

The system implementation took place in the time constraints due to the fact that the real start of the system operation was set by the law as of January 1st, 2004. Because of the initial analysis stage of the project failed to resolve several key problematic issues in the debt and liquidity management sub-project (the area of settling transactions concluded by Agency, accounting of this transactions, foreign payments), it was necessary to define these processes first and subsequently implement IS in Agency. Therefore, Agency had to significantly cooperate with ST in the processes definition area. Unfortunately, it caused delays in defining requirements for the IS of Agency.

It had been found that the detailed function specification covered even the possibility of trading with binary options, but the simple settlement of money market deals for liquidity management of the system was not considered. This settlement, together with related processes and system settings needed to be resolved shortly to not collide with the other system settings. As a result, it is still not an ideal system in which the MoF Client State Debt[7] (the "Client SD") is declared as the extraordinary significant client, but the reality does not match its needs, particularly regarding conditions for payments related to the liquidity management (it is not possible to realize payments during the whole RTGS system timeframe).

Information regarding liquidity management, public debt and State budget realization were not publicly available. No clear rules and regulations for debt and liquidity management existed at the MoF, thus it was difficult to obtain clear and accurate information to be used to set the Agency's IS for the State Single Account liquidity management purposes.

The Agency Information System Implementation

Within the ST IS, FinanceKit Treasury system had been implemented in Agency. It is a comprehensive treasury system that also supports the risk management. It fully covers the requirements of the Front, Middle and Back Office. Its flexibility supports a wide range of instruments, the required support in the field of reporting, risk management and performance measurement. All concluded transactions are recorded in this system, which also supports the settlement of transactions and risk management.

The Agency core activity also required following additional IS implementation:

Reuters Dealing 3000 - a communication system for concluding transactions on the financial market

Reuters Xtra - a comprehensive information services allowing access to financial market data

SIPS (Slovak Interbank Payment System) - local currency RTGS payment system operated by the NBS

ManEx – a part of the ST IS allowing the State budget expenditures managing and controlling. It is linked to the BIS (Budget Information System) in which budgets are assigned for individual budget chapters. The client payments are also realized through this system.

Financial Plan - software application (based on MS SQL) used for monitoring of the future ST clients cash flows, helping Agency to manage liquidity on a Single Account.

Take-over of the MoF Agenda

In connection with the redistribution of debt and liquidity management competencies and responsibilities between the Agency, the MoF, the ST and the NBS, part of the MoF agenda together with some activities should have been passed to the Agency. During the preparation of its core activities the

[7] Financial operations relating to the financing of the State budget deficit, State debt financing, risk management, investment of temporarily free funds and the refinancing transactions with the ST (refinancing system) are realized through the State Debt Client's account.

Agency provided its agenda description to be taken-over from the above institutions, as well as the exact schedule of the take-over to ensure its smooth and seamless transition. The agenda take-over was completed in December 2003.

Debt Management Strategy

The Agency elaborated in 2003 in cooperation with experts for the public finance reform the “Debt Management Strategy” and submitted it to the MoF for approval. The document was based on the actual situation of the debt portfolio and the risks associated with the debt structure. Based on the assumptions adopted for the coming years, clear objectives and principles were set in the proposed document. Best practises from other EU Debt Management Offices (the "DMO") were also taken into account. Minister of Finance subsequently submitted a comprehensive document "Strategy for debt and liquidity management for years 2004 to 2006" to the Government. This document was approved in November 2003.

Accounts Transfer to the ST

Until 2003, the banking services for the state budget were provided by the NBS. In connection with the transfer of these services within the ST it was necessary to prepare the entire MoF debt and liquidity management system for the one-year transitional period. During this period the gradual transfer of all clients’ accounts from the NBS to the ST was realized.

This transfer had been divided into 4 stages, the client MoF was in the second stage involved. In this context, it was necessary to prepare the transfer of bank accounts and the Client SD start-up. The debt management transactions as well as liquidity management of the State Single Account are realized through the Client SD accounts. The major part of the clients’ accounts was transferred to the ST in the third stage on June 30th, 2004.

Agency's role in Debt Management in 2003

The Agency during take-over of the agenda in 2003 from the MoF was actively involved in debt management. Agency representatives participate in auctions of Bonds and T-Bills in the NBS. Successful EUR 750 million Eurobond issue, realized with the strong participation of the Agency in May 2003, weakened the pressure on domestic Bonds yields rising. The Agency prepared and in December 2003 published a binding schedule for issuing Government securities in 2004. Publication of this binding schedule was highly appreciated by the investors.

7. Debt Management since 2004

Since January 2004, in line with the approved redistribution of competences, the operational management of the Government debt is fully in hands of the Agency. Agency's main task is to ensure safe access of the State to financial market. A new approach to debt management had been defined by:

- effort to harmonise with EU capital market standard procedures and standard instruments,
- Bond issues size and maturities standardisation,
- lower number of outstanding Bond issues,
- transparent intentions and behaviour,
- clear, transparent and sufficiently in advance announced issuance calendar,

- smoothing of debt maturity profile and
- improvement of issuer – investor communication (regular meetings with primary market participants).

Debt Management

In accordance with the schedule of auctions published in 2003, the Agency launched issuance of domestic Bonds. The previous method of issuing Bonds and T-Bills where each auction represents one issue was changed.

For all the new Bond issues the standard value of SKK 40 billion was set. All the details of each Bond, including the maximum issue size are defined in the Issue Conditions of particular Bond. During the Issue period the amount is gradually increased by the auction sales (tranches) of up to maximum size. Individual tranches are labelled by letters of the alphabet and bonds of all the issue tranches are fungible, i.e. have the same characteristics (e.g. ISIN, maturity). All such issued bonds are registered in the Central Securities Depository and listed on the Bratislava Stock Exchange main market.

In 2004, the Agency continued to issue T-Bills in the unchanged way when each auction represented one issue. A radical change has occurred since early 2005. T-Bills are issued first to the MoF own property account in the Central Depository (by transfer from issuer´s account to owner´s account). The Agency, according to its decision may to sell them on the secondary market by auction or by direct bilateral trade with the investor. Such issued bills can also be used in repo transactions with banks, hence serving as a liquidity buffer.

The Agency thus gradually restructured portfolio of domestic Bonds and T-Bills. The aim was to reduce the number of open issues and increase their size. This contributed significantly to the secondary market liquidity.

Table 1. The Government Bonds Portfolio Structure Change

GOVERNMENT BONDS	01.01.2004	01.01.2011
Outstanding Amount (EUR billion)	10.21	23.65
Number of Issues	32	23
Average Amount of Issue (EUR million)	319	909

Source: Debt and Liquidity Management Agency

Table 2. The T-Bills Portfolio Structure Change

TREASURY BILLS	01.01.2004	01.01.2011
Outstanding Amount (EUR billion)	3.91	1.26
Number of Issues	21	2
Average Amount of Issue (EUR million)	86	630

Source: Debt and Liquidity Management Agency

From January 2006 the Agency took over the NBS role of the MoF paying agent for domestic Bonds. The Agency is thus responsible for realization of coupon payments and redemptions of domestic Bonds. Such payments are based on the last owners' information provided by the Central Depository.

Pressure of the Agency and market participants to the Central Depository led to significant improvements in conditions for securities settlement. A very important change was the abolition of separation of the instruments allowed for funding the budget deficit and the debt.

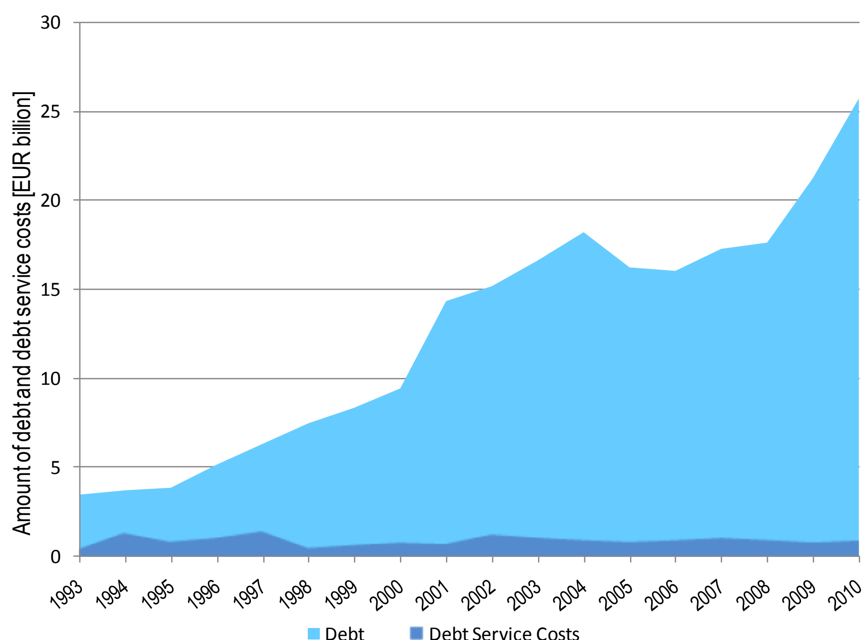
At the same time the Agency gradually replaced non-tradable debt, i.e. Loans by the Bonds. This was realized through the early repayment of floating rate Loans if the banks were not willing to modify the conditions so that the costs of the Loan meet the costs of the Bonds with corresponding maturity. Similarly, the Agency tried to ensure that interest costs on new Loans were not worse than the conditions under which new Bonds can be issued.

Table 3. The Debt Portfolio Structure Change

DEBT PORTFOLIO	01.01.2004	01.01.2011
Share of Non-Tradable Debt	19.5%	4.7%

Source: Debt and Liquidity Management Agency

Chart 4. The debt and debt service costs (expenditures)



Source: Debt and Liquidity Management Agency

Along with issuing of domestic Bonds the Agency has issued "foreign" Bonds. The aim was to create a euro benchmark Government Bond yield curve via one issue each year as a preparation for entering the

euro zone. The secondary target was to broaden investor base and to be included as a country in economic researches to stay in sight of foreign investors. The proceeds from such issues were converted into SKK with the NBS or used for repayment of EUR debt. Each issue had to be consulted and agreed by the NBS with respect to losses in the NBS books that resulted from the gradual strengthening of the SKK exchange rate against EUR. On the other hand, such exchange rate development caused foreign exchange gains in the books of the MoF.

Debt and Liquidity Management Committee

In accordance with the government-approved document "Debt Management Strategy for Years 2004 - 2006" the Committee for Debt and Liquidity Management (the "Committee") had been established. The Committee is a consultative body of the State Secretary, responsible for the area of debt and liquidity management (the "State Secretary"). The Committee members are defined in the Committee Statute, approved by the State Secretary. Originally the members were the representatives of the MoF, the Agency, the ST and the NBS.

The Agency, within its scope and responsibilities for the operational Government debt management defined in the Act, had to follow the decisions of the State Secretary. His decisions are usually based on recommendations of the Committee. The Committee is also the controlling body for the Agency's activities. The Agency is obliged to provide the Committee with the report about its activities, debt portfolio development and liquidity outlook on a monthly basis.

Auction System

The realization of the auctions itself has undergone considerable development. In 2004, the auctions continue to be realized in the NBS, where the banks send their bids by fax. The decision on the amount allotted had been made by the responsible representative of the Agency. Since its creation, the Agency sought to introduce an electronic auction system. The original intention to use the auction system in the Bloomberg system failed on the business policy of this company. Therefore the more complicated way of completely new auction system development had been chosen.

In January, 2005 the Reuters electronic auction system was implemented. This system had been developed in close cooperation with the Agency. It is based on PowerPlus (MS Excel with Reuters add-in) and uses a Reuters Xtra communication platform. For each primary market participant Reuters created a pair of pages in Reuters Xtra system. The first page is participant "bidding page" where the auction participant places his customers as well as own orders. The second page is ARDALs "result page" where the correct bids are mirrored and necessary data for the auction are displayed. Access to such pair of pages is strictly limited only to two institutions - Agency and the respective participant. Data from the bidding pages are continually imported into an auction application created in Visual Basic. After auction evaluation the successful bids are exported to the result pages of successful participants. This auction system is very complex and all the types of Bonds (fixed, float and zero coupons), T-Bills, REPO and Sell and Buy Back auctions are supported.

Loans

Conclusion of the Loan contracts is still in the responsibility of the MoF. The Agency reviews only the business conditions of the Loan during the negotiation process, i.e. mainly the repayment schedule and the interest rate of the Loan. The aim is that the conditions of the Loans received were much like the Bonds.

Primary evidence (the hard copies of the Loan Agreements) is kept at the MoF. The Agency receives a copy of the Loan Agreement and ensures the correct inputting of the Loan into the Agency IS. The Agency is responsible for repayment of the Loans principal and interest.

Budget of Client State Debt

The Agency in accordance with the budgetary rules prepares budget of the Client SD for the following three years. The expenditures and revenues associated with the debt service are planned. This budget is one of the inputs for the Budgetary Section of the MoF as part of the State Budget preparation process.

The preparation of the State Budget proposal for the next fiscal year begins in February. The starting point is politically taken decision about next fiscal year budget revenues and expenditures based on macroeconomics and tax forecasts. According to the forecast of interest rates (all forecasts are provided by the Financial Policy Institute of MoF) and the situation on the securities market, the Agency simulates coverage of the Client SD financial needs for the next 3 years. The budget for the first year is binding; the budgets for the next two years are for information purposes only.

Subsequently, in two rounds the Budget proposal is adjusted by market developments, realized securities issues and other factors taken into account. In October or November the budget for next fiscal year is approved by the Government and the National Council.

Bookkeeping

One of the major tasks of the Public Finance Management Reform Project was to ensure the accrual-based accounting. It was necessary to adjust the bookkeeping for meeting this goal. All transactions related to debt and liquidity management are accounted by the MoF on cash and accrual basis. Data for the bookkeeping are automatically sent to the MoF in the form of accounting data batches from the Agency IS.

8. State Treasury and Refinancing System

8.1. State Treasury

The ST is an institution that collects the public sector clients' financial resources. The ST provides retail banking services for its clients - keeps accounts, settles payments and supplies cash operation. The clients obliged to have an account with the ST are strictly defined in law (Act No. 291/2002 Coll. on the State Treasury). There are two main client categories - the budgetary clients connected to state budget by its expenditures and revenues and the public sector clients. The MoF as a client of ST has also its Single Account in the ST. For selected institutions it is also possible to become a voluntary client of ST.

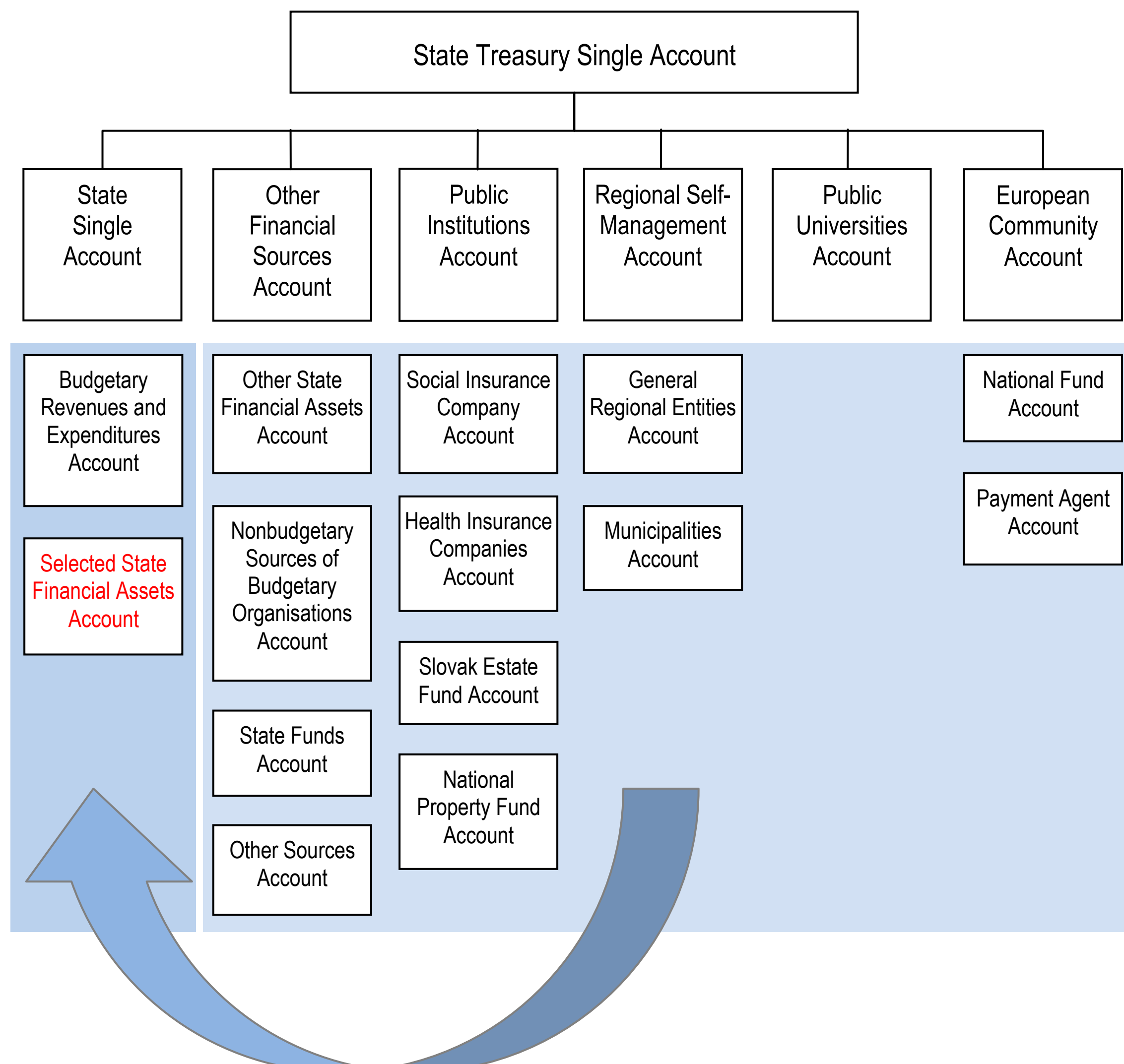
The basic ST product is the current account, from which the payments are realized. The accounts are divided into budgetary and non-budgetary. The budgetary accounts do not bear any interest. The non-budgetary accounts can be interest bearing. The ST offers for clients with non-budgetary resources (voluntary clients, public sector institutions - health and social insurance etc.) the possibility to deposit temporarily free funds in the form of term deposits. The Agency in cooperation with the ST sets weekly the standard interest rates for a standard period for deposits in the amount up to SKK 10 million (EUR 0.332 million). The deposits exceeding this limit are subject to individual rates, based on the current market deposit rates for the relevant period. Because of the ST does not have access to online information about market situation, the Agency provide the ST with these rates.

8.2. State Treasury Single Account and State Single Account

To understand the system of liquidity management, it is necessary to explain the structure of the accounts which form a State Treasury Single Account. State Single Account is the sub-account of the State Treasury Single Account. All operations related to debt and liquidity management are made from/on the Client SD account, which is part of Selected State Financial Assets Account. The balance of this account consists of the sum of the deficits/surpluses of the previous years (the current year deficit/surplus is expressed as the Budgetary Revenues and Expenditures Account balance) and financial resources for the coverage of all deficits/surpluses, including the current year.

The State Single Account must have zero or positive balance at the end of the day. The positive balance of the Selected State Financial Assets Account covers the negative balance of the Budgetary Revenues and Expenditures Account where the current year deficit/surplus is realized.

Chart 5. The structure of the State Treasury Single Account



The objective of the liquidity management is that at the end of each day both accounts, i.e. State Single Account and State Treasury Single Account has to show the positive, respectively zero balance. The Client SD, whose account is part of the Selected State Financial Assets Account, is the only ST client of which the account balance may be negative during the day.

In case of a zero or positive balance of State Treasury Single Account and the negative balance of the State Single Account at the end of the day, the refinancing system is automatically activated.

8.3. Refinancing System

One of the fundamental ideas why the ST System has been created is to allow the usage of public sector clients' temporarily available funds for the debt and liquidity management purposes. The first condition was to withdraw these funds from the commercial banks and collect them at one place under the MoF control. This objective was achieved by formation of the ST. Then it was necessary to create the mechanism by which these funds could be moved to the MoF account. The ST, because of holding both the MoF and the public sector clients' accounts, could play an intermediary role. The funds transfer (refinancing system) is realized in the form of deposit deals between the ST and the MoF.

Technically the refinancing system is realized in two separate phases. In the first phase all term deposits of the ST clients with the ST are transferred to the MoF. The deposit deals between the ST and the MoF are realized under the same conditions as the original deals between the ST and its clients.

Subsequently, in case of negative balance of the State Single Account, shortly before standard ST IS end of the day, the cash pooling procedure is automatically activated. The Client SD account is credited by overnight deposit transaction with a goal to balance State Single Account to zero. This deal is realized under the current market conditions (overnight index BRIBOR, later EONIA minus agreed margin).

Initially, the temporarily short-term funds not transferred to the MoF through the refinancing system were placed on the market on behalf of the ST in the structure, which roughly corresponded to the time structure of the ST client's deposits. The two entities acted on the market – the MoF, on whose behalf the Agency was able to borrow short-term deposits and the ST, on whose behalf the Agency placed short term deposits. The open interest position partially remained with the ST.

Since February 28th, 2006 the system has been changed to simplify the liquidity management and to ensure higher transparency of the financial flows. The entire ST position (i.e. the balance of the ST clients' accounts) is moved to the MoF. All the risks are transferred to the MoF, on behalf of which the Agency acts. There is only one entity, the MoF, realizing all the transactions types, acting on the market.

The MoF through the refinancing system receives a significant volume of short-term resources, which can cover needs of the deficit and debt. The fact that it is about 10-15% of the overall debt portfolio, significantly reduce the short-term securities issuance needs.

It is important to note that the refinancing system works automatically only in the domestic currency. In other currencies it works only on request because the Agency is managing only the State Single Account liquidity in foreign currency. The ST is still using obsolete foreign payments system (internet banking application of the commercial bank) for the clients' payments instead of a standard correspondent banking system based on nostro accounts and SWIFT communication. The ST Single Account liquidity in the foreign currency is thus managed by the ST itself.

9. Liquidity Management since 2004

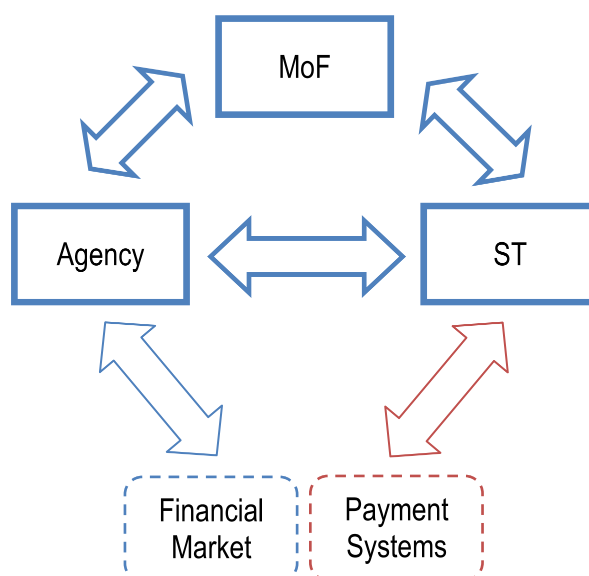
The liquidity management system had undergone revolutionary change. From January 1st, 2004 the Agency is fully responsible for the liquidity management. The goal of liquidity management is to set the balance of State Treasury Single Account to zero. The Agency is allowed to conclude all the standard money market deal types for the liquidity management purposes.

During the first year expenditures and revenues of the State budget were realized through the client accounts held both with the ST and the NBS. To ensure liquidity on both accounts the Agency had to be thoroughly familiar not only with the processes and operation of the ST, but also with the specifics of payment system in the NBS. The focus had shifted gradually to the ST after client accounts migration from the NBS.

Until February 28th, 2006 the Agency had performed transactions (money market deals) with the banks on behalf of two entities – the MoF and the ST. The ST is not de jure bank (not regulated by the Banking Act) and had no rating. In addition, the binding declaration of the State that would guarantee the obligations of ST against commercial banks did not exist. Therefore, the commercial banks were willing to take deposits from the ST (these deposits are considered as the primary sources) but had a serious problem to lend money to the ST. Based on this all the borrowings were realized on behalf of the MoF. This caused artificially increased expenditures of the MoF in situations when the Agency had to borrow funds on behalf of the MoF which have been previously placed on behalf of the ST.

Different liquidity management philosophy had been introduced from February 28th, 2006. The Agency realizes all transactions on behalf of the MoF, which is acceptable for banks as counterparty for all types of transactions, including derivatives. Clarification of the financial flows in the ST System significantly simplified the budgetary process. Banks had welcomed this change because it had facilitated settlement and eliminate the errors that result from the deals with two different counterparties.

Chart 6. Institutions involved in the liquidity management



The payments in domestic currency are made from/on the ST account, which is part of the NBS payment system. This account is a mirror of the ST Single Account, the only difference is a tiny balance of ST accounts with commercial banks, serving for the foreign payments purposes. The ST and the Agency has an access to RTGS payment system SIPS, later Target2 (Trans-European Automated Real-time Gross settlement Express Transfer system). Monitoring of the balance of this account and sum of credit/debits is possible in real time.

The liquidity management of the ST system requires very good information about estimated future financial flows of Client SD and other ST clients. All information about expected future flows of Client SD is available in the Agency core IS, FinanceKit (later Wallstreet Suite). The ST provides the Agency with information about expected future flows of its clients through the financial planning.

Financial Planning

Financial planning is one of the ST duties in respect to the Agency stipulated in law (Act No. 291/2002 Coll. on the State Treasury). The data about ST clients' cash flow are important part of cumulated cash flow of the ST System as a whole.

Initial set up of the ST financial planning, when budgetary clients were required to plan their expenditures for the following week and next 3 months has proved unsuitable. Conditions for budgetary payment (expenditure) realization were to be planned. Clients indicated plans contained the entire unspent budget for the current year to avoid the risk that their payments would not be realized. That expenditures plan was inapplicable for liquidity management, as included overstated expenditures, which did not correspond with reality.

Since January 1st, 2006, the ST clients are no longer been obliged to plan their budgetary expenditures. Clients can thus realize its budget expenditures up to approved yearly budget of the given client. Only payment in the amount greater than SKK 5 million (EUR 0.17 million) has to be announced in advance. The expenditures plan is created by the ST itself on the basis of historical time series data and communication with the clients. Budget revenues, mainly the tax revenues, are planned also by the ST on the basis of information from the Tax and Customs Offices and the Institute of Financial Policy of MoF. Financial planning thus reached a much higher level and the Agency is provided with data in 3 months horizon in excellent quality. It helps the Agency to effectively manage liquidity and be prepared for next clients' cash flows to cover future needs of the whole system securely.

Financial Plan

Data from the Agency core IS and Financial Planning together with the information about expected inflows from planned issues of the Bonds, T-Bills and Loans are presented in one application (Financial Plan). The Agency thus has a complete overview of the ST System cash flow for the next three months. Three months horizon is considered as sufficient for the liquidity management.

For the liquidity management purposes the Agency use the standard money market instruments, namely deposits, repo or Sell and Buy Back transaction and FX swaps. According to the expected position the Agency concludes money market transactions with counterparties in order to get the ST Single Account in Target2 to zero at the end of the business day.

Deal Processing

Transactions (deals) with counterparties are concluded by the Agency Front Office Traders, in accordance with the approved limits (if applied). Transactions could be done through the Reuters

Dealing, phone, e-mail or could be the result of an auction, syndicate or direct sale/purchase of securities. The deal is immediately after conclusion entered into the system through the interface or manually. Front Office Trader is responsible for the correct input of the deal into the system.

Consistency of the deal details in the system and on the deal ticket is checked by the Back Office staff. In accordance with the cash flow of the deal, the settlement of the payments, respectively the securities transfer is the responsibility of the Back Office.

The payment or securities transfer order is automatically generated by the system at the value date of such order or transfer. Immediately after processing by the Back Office employees the payment order is sent to the ST payment system. Property transfer order is sent to the Central Depository.

The data in the system are maintained by the Middle Office Department employees, who are also responsible for the risk management. Database of transactions and cash flow provides sufficient data for analysis of the positions and related risk.

10. Risk Management

Significant contribution of the Agency is monitoring, evaluating and managing of the risks associated with the Government debt. In the past, this area had not been treated in any way. A new approach to debt management is based on optimizing of the refinancing risk, interest rate risk, liquidity risk and currency (FX) risk.

- **re-financing risk -** the risk that the State would not be able to refinance the maturing debt, or would be able to do that only at out of the market conditions,
- **interest rate risk -** the risk of increased expenditures on debt portfolio's due to the adverse changes in interest rates,
- **liquidity risk -** the risk that the State would not be able at a given time meet its obligations,
- **FX risk -** the risk of increased State expenditures, due to exchange rate changes.

10.1. Treatment of Risks Included in Debt

The general policy objectives in the area of debt and liquidity management are expressed as follows: “To ensure liquidity and access to market for financing the needs of the State by a transparent, prudent and cost saving method, provided the risks included in the debt are maintained at an acceptable level.”

Based on that, the three general principles for the debt management had been defined:

1. Any increase of the debt must be transparent and must have clear rules. It is necessary to eliminate uncontrolled and uncontrollable growth of the debt.
2. In active debt management, mid-term and long-term targets should be preferred to short term savings. Short term “savings” may not be at the expense of higher costs or higher risk of costs in the future.
3. The debt management should be based on the principle of optimum risk. It means the active debt management should be based on quantification of the difference between the potential loss from not managed risk and costs incurred for elimination thereof.

The document transforming these principles into general rules for the debt management had been elaborated.

10.2. Debt Management Strategy

Debt Management Strategy is the fundamental document defining the framework of the debt management for the four year period (one National Council electoral term). It is based on the definition of criteria, which the debt portfolio must meet. This document is prepared by the Agency in close cooperation with the MoF and approved by the Government.

There were three Strategies worked out until now. The criteria which the debt portfolio should meet have undergone significant changes.

Debt Management Strategy for 2004-2006

This first complex material regarding risks included in debt portfolio was based on analysis of debt portfolio in 2003 and experience of the EU countries with similar structure of the debt. The following benchmark targets in compliance with EU experts' recommendation had been defined:

- to achieve and maintain an average residual maturity of government debt portfolio in range from 4 to 6 years,
- to achieve average duration of government debt portfolio at the level of approximately 4 years

The additional target of maximum amount of SKK 100 billion (EUR 3.32 billion) of debt maturing in one year had been set. The next target was to reach the ratio of 75% to 25% in favour of securities with fixed yield. The same ratio should be reached in favour of debt in domestic against foreign currencies (mainly EUR). Very important was significant reduction of indebtedness of the State by uncontrolled provisioning of state guaranties for commercial credits of the state bodies.

Debt Management Strategy for 2007-2010

In this strategy, the benchmark portfolio indicators had been changed in accordance to experiences from the previous years. In order to maintain the refinancing and interest rate risk on acceptable level the cumulative maturity and refixing indicators were imposed. The average residual maturity and average duration remained the secondary indicators and served for information purposes only.

In respect of the refinancing risk, the strategic target was the observance of the cumulative maturity limit in one year on the level of 22.5% of the aggregate debt, and the cumulative maturity limit for the next following 5 years on the level of 60% of the aggregate debt.

In case of the refixing risk, the benchmark limit for refixing of the government debt in the first year was set on the level 25% of the aggregate debt and on cumulative basis for 5 years on the level of 65% of the aggregate debt.

Debt Management Strategy for 2011-2014

The first change against the previous strategy is unification of benchmark criteria values. Both refinancing risk and refixing risk have the same values. Cumulative maturing as well as refixing debt in one year shall be kept at around 25% of the total debt. Similarly cumulative maturing and refixing debt in five years shall be around 65% of the total debt.

The second change is in perception of parameters limit value. Meaning of the limit has changed from "up to" (range zero to limit value) on actual "tightly around" (range is near set value). Such way defined criteria are better expressing approved risks and related cost.

10.3. Other Limits and Operational Risk

Other limits that affect the Agency's activities are credit limits. These limits are set in line with a methodology approved by the Committee and express the maximum amount of funds that can be deposited with a particular counterparty at the given time. In addition, the Agency had set limits that determine the maximum volume of transactions concluded by individual traders for the different instruments.

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems failure or from external events. To avoid such a loss the detailed internal working procedures within the Agency have been worked out and their implementation is regularly checked. The huge progress had been achieved also in respect of IS security and accessibility.

11. Euro zone Entry

The integration efforts of the Slovak Republic were completed by the euro zone entry on January 1st, 2009. The fundamental document which governed the euro conversion was the general Act No. 659/2007 Coll. of November 28th, 2007 on the Introduction of the Euro Currency in the Slovak Republic and amendments to certain law.[8]

11.1. Agency and Euro Conversion

Entry into the euro zone has significantly affected the activities of the Agency. The Agency had to prepare the euro conversion of the Agency's IS. According to stipulations of the general law, the Agency was responsible for the re-denomination of the Government Bonds and T-Bills from SKK to EUR. Nominal value of one piece of already issued securities (originally SKK 100,000 or 1 million.) has been converted into EUR 3,319.39 or 33,193.92. The nominal value of one piece of newly issued securities was in accordance with the practice of the European bond market set at 1.00 EUR, with the minimum Issue Size of EUR 1.5 billion.

Another change is related to registration of the T-Bills. The NBS decide in the first half of 2009 to discard Short Term Securities Register, where T-Bills had been registered. It forced the Agency to register the T-Bills in the Central Depository. This caused a change in the processes of the Agency in relation to settlement of the T-Bills.

All the T-Bills and Bonds are eligible assets for the ECB monetary policy operations, e.g. are accepted by the ECB as collateral instruments. Joining the euro zone increased considerably the demand of foreign investors for the Slovak Government Bonds. It also opened the possibility of cooperation with foreign DMOs in the field of liquidity management through the short-term money market deposits.

11.2. End of Slovak Koruna

On November 25th, 2005 the SKK after seven years ended floating exchange regime and joined the ERM II exchange rate mechanism. Central parity of SKK against euro was set at market rate level 38.4550 EUR/SKK. SKK used in ERM II standard fluctuation band ±15 per cent around the central parity.

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[8] The full wording is available at http://www.nbs.sk/_img/Documents/_Legislativa/_BasicActs/General_Act_web.pdf

The gradual strengthening of SKK/EUR exchange rate caused two moves of the central parity to level 30.126 SKK/1EUR. On June 3rd, 2008 the Finance Ministers of the Member States of the European Union at the EU Council for Economic and Financial Affairs (ECOFIN) in Luxembourg, approved the entry of Slovakia into the euro zone on January 1st, 2009.

On July 8th, 2008 Finance Ministers of the EU decided that the final exchange rate for the SKK against the euro is 30.126 SKK/1 EUR, the current value of the central parity.

The Slovak Republic has entered the euro area on January 1st, 2009. On January 16th, 2009 the dual circulation of SKK and EUR had finished.

12. Conclusion and Recommendations

The reform of the debt and liquidity management as part of the Public Finance Reform significantly contributed to the macroeconomic stabilization of the Slovak Republic, decreased tension in the public finance and accelerated fulfilment of the euro zone entry conditions.

The formation of the ST System allowed centralization of the public sector client's sources and its usage through the refinancing system for the debt and liquidity management purposes. It significantly weakened the pressures in the Government securities issuance and it enabled the cheaper funding of the State.

Shift to the active debt and liquidity management was supported by creation of the Agency. The new approach to the debt and liquidity management has brought the following positive aspects:

- consistency between the broader views and objectives of the Government and the debt and liquidity management,
- transparency of the State debt and liquidity management process,
- rationalization of the expenditures relating to the state debt financing,
- flexibility in decision-making, possibility of operative responding to the fast-changing conditions on the financial markets,
- independence from political influence in debt management and
- optimization and monitoring of the risks included in the debt portfolio.

Thanks to the observance of debt portfolio structure in accordance with the parameters defined in the Debt Management Strategy together with the synergic effect between debt management and liquidity management the Agency had been able to keep debt service costs for a long time at about the approximately same level despite continuously rising amount of the debt.

Correct set up of the debt portfolio indicators and importance of their adherence had been confirmed by the financial crisis. The smooth redemption profile of debt portfolio did not create excessive pressure for the new debt issuance. The possibility of using short-term funding from the ST minimize the necessity to enter the financial market under unfavourable conditions and allowed seamless financing of the Slovak Republic needs in the financial market even during the financial crisis.

Our Recommendations

Based on our experience with the debt and liquidity management reform in Slovakia we would like to recommend the key points required for the reform success:

- The Governmental support of the reform is crucial.
- In advance and well prepared legislative environment related to debt and liquidity management substantially helps to avoid problems and time stress in the future.
- Individual experiences of other countries with professional cash and debt management offices are inspirational.
- The information system implementation should be the last stage of the project. Everything else (infrastructure, staff, responsibilities etc.) has to be carefully prepared before, and problematic issues have to be solved.
- Good communication of the reform rationale with investors, interbank market participants, rating agencies and the World Bank/IMF is very important.
- It is necessary to form appropriate two-way co-operation with the Central Bank.

13. Glossary of Acronyms

MoF – Ministry of Finance of the Slovak Republic

NBS - National Bank of Slovakia

ST – State Treasury

IS – Information System

ST IS – State Treasury Information System

RTGS – Real Time Gross Settlement

FX – Foreign Exchange

IMF – International Monetary Fund

CSFR – Czech and Slovak Federative Republic

SKK – Slovak Koruna

EU – European Union

OECD - Organisation for Economic Co-operation and Development

ECB – European Central Bank

EBRD – European Bank for Reconstruction and Development

EUR – euro

DMO – Debt Management Office

ISIN - International Securities Identification Number

BRIBOR – Bratislava Interbank Offered Rate

EONIA - Euro OverNight Index Average

SWIFT - Society for Worldwide Interbank Financial Telecommunication

Target2 - Trans-European Automated Real-time Gross settlement Express Transfer system