Report of the Working Group on Debt Management Office

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1 Overview

Vide Order No. 3/4/2011 - FSLRC dated 10 February, 2012, the Financial Sector Legislative Reforms Commission constituted a Working Group (WG) on debt management office (DMO), consisting of:

1. Dr. Govinda Rao Chairman
2. Shri Dhirendra Swarup Member
3. Shri Kanagasabapathy Kuppuswamy Member

The mandate of the WG was to examine the current legislative and policy framework in the field of public debt management, identify the major limitations in the existing framework and suggest necessary changes. The Terms of Reference of the WG are provided in Annexure 'I'.

The WG undertook a review of existing recommendations made by previous expert committee reports and international best practices in each of the areas under its consideration. The WG is pleased to submit its report to the Commission. Each section contains a discussion on the relevant issues identified in that area followed by the recommendations of the WG. A summary of the recommendations is contained in the executive summary of the report for ease of reference.

2 Executive Summary

It is important to have a specialized agency to manage government debt to manage the liabilities of the government in a holistic manner. The functions of debt management are divided between the government and the Reserve Bank of India (RBI) and some of the functions are not simply performed. While the RBI manages the market borrowing programme of central and state governments, external debt is managed directly by the government. There is no specialized agency to undertake cash and investment management nor are contingent and other liabilities are consolidated to get a holistic picture of total government liabilities.

The need for a specialized agency to manage government debt becomes all the more necessary to widen and deepen the debt market as we undertake further liberalization. At present, the debt market is confined to domestic players in a financially repressed environment. With liberalization when foreign investors are allowed to subscribe to government bonds, management of government liabilities will assume significant complexities which will have to be managed by a specialized agency.

A number of reports dealing with the issue of reform of debt management including the Jahangir Aziz Report (2008) have pointed out this institutional vacuum and have argued for the creation of an independent DMO. The arguments are mainly based on the gains from having a specialized agency to manage government liabilities in a comprehensive manner and to avoid conflicting roles for the RBI. In fact, the suggestion to have an independent debt management agency originally came from the RBI, though in recent times, the RBI has argued that in the prevailing situation of high fiscal deficits and debt, it should continue to perform the debt management function to ensure proper coordination with monetary management.

This WG builds on the basic recommendations of the earlier committees which dealt with debt management. We recommend fast-tracking the setting up of an independent DMO. The view taken by the members of this WG rests primarily on making a case for efficient debt and cash management and enabling the government to gain a holistic view of its liabilities. The main benefit of an independent DMO will come through the integration of debt management functions and various databases and information, which are currently dispersed. A specialized, unified and independent agency will have comparative advantage over the existing structure of a fractured and uncoordinated government borrowing program spread across various agencies.

In addition to ensuring a holistic and integrated approach to the management of government liabilities, the creation of an independent DMO will avoid any conflict between debt management and setting interest rates. This arrangement will enable the RBI to have greater degree of independence in calibrating monetary policy operations. Of course, it is important to ensure coordination between the DMO and the RBI to ensure harmony in government borrowing operations and calibrating monetary policy which should be done through constant consultation processes. Indeed there are countries with large fiscal deficits which have specialized debt management agencies either within the Treasury or independent.

This WG highlights five major issues regarding the scope of the DMO. Firstly, the WG recommends that implicit and explicit contingent liabilities should be managed and executed by the DMO. The DMO should evaluate the potential risk of these contingent liabilities and advise the government on charging appropriate fees. In addition, the government should be mandatorily required to seek advice of the DMO before issuing any fresh guarantees since this has implications for the overall stability of the debt portfolio.

Second, the DMO should adopt a holistic approach that encompasses the entire liability structure of the central government including not just marketable debt but also contractual liabilities from public accounts (such as small savings, provident fund receipts) and any other internal liabilities.

Third, the WG believes that imposing the services of the DMO on state governments might not be advisable since the management of state debt is a state subject. It recommends that at the present juncture, the DMO should be a central government agency obligated to manage only central government debt. The DMO should, however, undertake functions related to state government debt, which have implications for the central governments debt portfolio. This involves maintaining a comprehensive database of state government debt and coordinating the central governments borrowing calendar with state governments market borrowings. However, at a later stage, DMO may provide the option to the states of managing their debt.

Fourth, in regard to external debt, the WG is in favour of an integrated approach and recommends that the DMO manages the external debt for the central government. The WG believes that the current set-up of external borrowings through external assistance needs to evolve over time into the central government developing a sovereign benchmark in the external market. This would benefit the corporates approaching international markets. In order to assist the DMO in performing this role, the WG recommends that the Aid, Accounts and Audits Division (AA&A), currently under the Department of Economic Affairs (DEA), MoF should be merged with the DMO once it comes into operation.

Lastly, we turn to cash and investment management. The central government has been consistently running large fiscal deficit over the years. In this situation, cash surpluses do not arise except for very short periods due to temporary mismatches between receipts and expenditures within a given financial year. However, DMO should be tasked with the function of managing and investing surplus cash of the government whenever such a situation arises in future.

On the structure of the proposed DMO, the WG after considering various options recommends setting it up as a statutory corporation with representation from both the central government and the RBI. Further, the proposed DMO should function with independent goals and objectives while being accountable to the central government for its actions and results. There should be a mechanism for constant consultation and coordination with both the Ministry of Finance and RBI.

With reference to the organisational structure, the WG recommends a two tiered arrangement for the operations and management of the DMO. It envisions a vertical relationship between the Policy Advisory Board and the Board of Management with the latter seeking opinion of the former in matters of strategy and policy. The Board of Management should have a direct line of communication with the government. However, it should be required to consider any opinions or recommendations made by the Policy Advisory Board through a documented voting process. The duties of the Policy Advisory Board should be to provide opinions on any matters that may be referred to it by either the Board of Management or the government. In addition, the Policy Advisory Board may also make recommendations suo motu on any activities of the DMO it finds relevant. The WG is of the opinion that transparency should be embedded into the organisational structure and the proceedings and other related documents of the meetings, including dissenting opinions, should be made statutorily public, and be open to the jurisdiction of the right to information (RTI). Based on the staff size and the activities of DMOs in various countries, the WG recommends that the Indian DMO should be lean on staffing (approximately 70 staff), and should outsource a majority of its non-core activities.

3 Introduction

Before economic reforms, the Indian financial system was subject to tight regulation on portfolio choices by institutions, instruments and their pricing. In this setting, the question of an independent DMO did not surface in policy discussions. In this period, the RBI carried out the basic function of government borrowing from a captive group of investors. The function of debt management in a comprehensive sense remained unattended to. The secondary market for government securities was practically absent. Further, RBI's monetary management function was circumscribed by automatic monetisation of government deficits: monetary policy autonomy was absent since liquidity conditions were determined by fiscal policy. In this environment of a fiscal-monetary nexus, it was not possible to envision an active and independent debt management.

The debate about setting up of an independent DMO gained significance in India since the early 1990s. Financial sector reforms started taking place, gradually leading to the emergence of a competitive financial system. Borrowing by the government increasingly became market oriented. The central bank's monetary operations moved towards using interest rate as a policy instrument.

Gradually, interest rates evolved to become mostly market determined. With improvements in settlement and delivery practices, the secondary market in government securities had become active. The Ways and Means Advances (WMA) which freed monetary policy from fiscal considerations, and the rise of a flexible exchange rate which freed monetary policy from exchange rate considerations, opened up the possibility of an autonomous monetary policy that works to stabilise the business cycle.

In this new environment, monetary management, in particular, the use of interest rate instruments, may come in conflict with the debt management function of minimising the cost of government borrowings. While monetary management has become increasingly market oriented, there are questions in regard to RBI's operations and functional independence. Given that RBI is a major investor in government securities, its market interventions through open market operations, liquidity management operations through cash reserve ratio (CRR) and liquidity adjustment facility (LAF) can be clouded by debt management objectives. There is a possibility of a renewed fiscal-monetary nexus coming about through these channels. Additionally, RBI is also the banking regulator, and exercises control over investment proportions of banks in form of statutory liquidity ratio (SLR).

Although there has been increasing sophistication in debt management with the introduction of some new instruments and reforms in the market structure such as primary dealers, and clearing and settlement system, a holistic approach to debt management across government and across varied instruments of borrowing is yet to emerge. The functions of debt management remain divided between the government and RBI. No serious attention has been paid thus far to issues that are closely linked to debt management, such as cash and investment management.

This document argues that the advantage of an independent DMO lies in freeing RBI of debt management considerations when performing functions of monetary policy and bank regulation. By unifying the debt management function, and efficiently linking the cash and the investment management function of the government, there will be improved information, analysis and thus decision making. With specialised human resources at its disposal, such a DMO can contribute to a more effective interface with the market resulting in cost efficient management of government borrowings.

4 Rationale for an independent debt management office

Since the late 1990s, numerous reports have been issued by RBI and Ministry of Finance, Government of India (MoF) in addition to recommendations by various committees constituted to look at the issue of public debt management in India. All of these reports unanimously support the separation of debt management from monetary management. See the *Working Group on Separation of Debt Management from Monetary Management* (RBI, 2001), *Report of the Internal Expert Group on the Need for a Middle Office for Public Debt Management, 2001* chaired by Arvind Virmani, *RBI Annual Report for 2005-06* (RBI, 2006), Kelkar report on *Task Force on MoF for the 21st Century* (Kelkar, 2004), Percy Mistry Report on *Mumbai: An International Financial Center* (Percy Mistry Report, 2007), Raghuram Rajan report on *A Hundred Small Steps: A Report of the Committee on Financial Sector Reforms* (Raghuram Rajan Report, 2008), Jehangir Aziz report on *Report of the Internal Working Group on Debt Management* (Jahangir Aziz Report, 2008). However, it is worth revisiting the rationale for this.

A fundamental reason for the creation of an independent DMO is the need to have a specialized agency to manage government liabilities in a holistic manner without involving conflict of interest between debt management and monetary management. Fracturing the functions relating to management of government liabilities between RBI and various agencies does not enable the government to gain a holistic view of its liabilities nor does it help in efficient cash management. In addition, interest rate setting as well as use of other instruments by RBI such as CRR and open market operations (OMO) can be clouded by debt management objectives. The market may infer future monetary policy actions as a result of compulsions arising from the management of government borrowing by RBI and, therefore, debt management may interfere with monetary management.

Specifically, the objective of minimising the interest cost to the government gives RBI an incentive to set the short-term interest rate (which is the core function of monetary policy) to excessively low levels, which would generate an inflationary bias. The world over, this concern has been accepted, which has led to a separation of debt management from monetary policy. Unburdening the RBI of conflicting goals is thus desirable.

An inherent conflict in the operations of the RBI is the difficulty in distinguishing its monetary operations from its debt management operations. As an example, the liquidity augmenting measures of early 2012 were intended apparently to ease monetary conditions to enable the banking system to expand its credit portfolio to productive sectors of the economy. They also served to ease the path for government borrowing. Even if fiscal accommodation was not an objective in RBI decisions in this period, from an external perspective, this raises questions about RBI's commitment to the goals of monetary policy.

While avoiding such conflicts, it also needs to be recognised that the two functions are ultimately complementary. Therefore, the broad approach should be one with independent functioning of debt management that is consistent with fiscal and monetary policy stance and objectives.

4.1 Integration

Jahangir Aziz Report (2008) offers an elegant classification of the debt management functions of the central government spread across the various agencies and departments (Table 1). In this classification, the Front Office negotiates new borrowing; the Middle Office measures and monitors all debt and formulates policy; while the Back Office looks after auditing, accounting and data consolidation.

Table 1: Debt Management Functions of the Central Government

	Front Office	Middle Office	Back Office
Function	Implementation of debt strategy	Strategy formulation	Record keeping etc.
Domestic debt	PDO, RBI, Banks, Post Offices	IDMD, RBI, Budget Division	DGBA and CAS, RBI, CCA(F), MoF
External debt	BC and FB Division of MoF	External Debt Management Unit	AA&A

Source: Jahangir Aziz Report (2008)

While RBI manages public debt of the central and state governments, it does not perform a holistic integrated function of managing the overall liabilities. RBI manages the market loans. It decides on maturity, volume, timing and nature of instruments and method of issuance, not unilaterally but in close consultation and with the approval of the respective governments. In fact, loan notifications are issued by the governments. While external debt of the central government is outside the purview of RBI, it also does not have any say on matters relating to other liabilities. Other liabilities includes other interest-bearing obligations of the government, such as post office savings deposits, deposits under small savings schemes, loans raised through post office cash certificates, provident funds and certain other deposits. However, in order to maximise the quality of decisions about how public debt must be financed, a full picture is required about all liabilities and cashflows of the government.

A major benefit of an independent DMO would be through the integration of the currently dispersed functions of debt management along with the various databases and information in one place.

5 Scope of the debt management office

Four major issues need to be addressed on the scope of DMO's functions. These are management of contingent and other liabilities; management of state debt in addition to central government debt; management of external debt; and cash and investment management.

5.1 Contingent and other liabilities

There are two types of contingent liabilities: explicit guarantees are usually credit guarantees for private sector provision of public goods, state insurance schemes and legal claims against the state. Implicit liabilities emerge out of the state's role as a lender of last resort, bailing out state or local governments under financial stress, providing disaster relief measures, and privatisation of previously state-provided goods/services (Jahangir Aziz Report, 2008).

Contingent guarantees may be made by centre and state governments under Article 292 and 293(1) of the Indian Constitution. The Fiscal Responsibility and Budget Management Act (FRBM Act), 2003 limits the guarantees that may be given in a financial year.

Box 1: **Case Study: Dutch State Treasury Agency**

In January 2009, the Dutch State Treasury Agency (DSTA) merged with the Cash Management Division, Ministry of Finance, the Netherlands (CMD) of the Ministry of Finance. Most notable about the new DSTA was that all functions related to cash management of the central government were consolidated into one organisation. Previously, the CMD was the central treasury for all spending departments, social security funds and a large number of (semi) public organisations. All entities participating in the central treasury have the possibility to put money on deposits at the MoF and to borrow for investments. However, all organisations continue to have their current accounts at commercial banks, but only for the execution of their payment transactions. At the end of every day, all current accounts at commercial banks are pooled and regulated (that is: brought to zero). As a result, no money is held overnight at commercial banks. On a daily basis, all current accounts are cleared into the DSTA's single treasury account at the central bank. This bundling avoids simultaneous borrowing and lending within the central government. The DSTA's account at the central bank is what the dealers have to deal with on the money market, either by borrowing or lending. At the end of the day, DSTA transactions bring the Treasury account at the central bank to a level between Euro 0 and Euro 50 million. The CMD employees responsible for estimating cash flows to and from the central government update their estimates continuously to ensure that funding by the dealers is as precise as possible (avoiding excess lending and borrowing). In January 2012, the DSTA was awarded the Sovereign Risk Manager of the Year award by the London-based Risk magazine.

Source: DSTA website (`http://www.dsta.nl/english`).

In operational terms, government guarantees are approved by the DEA (Budget Division). Once a guarantee is approved by MoF, it is executed and monitored by the administrative ministries concerned. The concerned ministries are also required to report the status of the guarantee in this regard on an annual basis, until the guarantee is invoked (i.e., it falls due), or until it expires (MoF, 2010).[1]

A guarantee fee is charged on a per annum basis, but there is little uniformity across States. The fee is levied initially at the time of issue of guarantee and thereafter on outstanding amount at the beginning of each financial year. RBI's Monetary and Credit Information Review specifies the risk weights to be applied for guarantees in India, following capital adequacy norms (Jahangir Aziz Report, 2008).[2]

Given the interrelatedness of contingent liabilities and debt issuance, the Working Group opines that the DMO should undertake the management and execution of explicit and implicit guarantees. Invoking of guarantees can have a substantial impact on the risk assessment of the debt structure of the central government. The DMO should evaluate the expected net present value cost of these contingent liabilities and advise the government on charging an appropriate fees. With regards to guarantee issuance, given the implications for the overall stability of the debt portfolio, the government should be mandatorily required to seek advice of the DMO before issuing any fresh guarantees.

Last, but not least is the issue of whether only marketable debt should engage the attention of DMO or the entire contractual liabilities of governments, including small savings and provident fund receipts. While these liabilities are part of public accounts and not a part of consolidated funds, they influence the cost of raising debt and provide indirect support to governments. A holistic approach to debt management should encompass the entire liability structure of the central government including external loans, contingent liabilities and other internal liabilities. Therefore, these other liabilities should also be brought under the purview of the DMO.

[1] The administrative guidelines for grant, review, accounting and monitoring of sovereign guarantees can be found in Chapter 11 of the General Financial Rules (GFR), 2005 (MoF, 2005).

[2] According to (Jahangir Aziz Report, 2008), RBI has been particularly concerned about the relationship between necessity for risk management in context of contingent liabilities, and appointed expert committees in this regard in 1998 and 2002. Recommendations of the committees included setting ceilings on guarantees, adequate risk sharing between the two parties and honouring of called guarantees. Several states now have administrative or legislative caps on guarantees (such as West Bengal, Assam, Sikkim, Rajasthan, Karnataka, Gujarat and Goa).

5.2 State loans

The Constitution of India distinguishes between the public debt of the Union government (alternatively referred to as the centre), and the various states. The power to legislate on the public debt of the Union, and foreign loans, rests with the Union itself (Article 246(1) read with Entries 35 and 37 of List I). On the other hand, state legislatures have the exclusive power to make laws regarding their respective public debt (Article 246(3) read with Entry 43 of List II).

Besides lawmaking powers, the Constitution also defines the executive powers of borrowing of the Union and the states. Significantly, the Constitution permits the Union to limit the amount and sources of state borrowing in specific aspects.

Article 293 provides that a state can borrow upon the security of its Consolidated Fund within such limits as may be fixed by the state's legislature. Such borrowing by a state may be from any source, but must be from within the territory of India. Further, if a state has any outstanding loans to be repaid to the Centre, or to which Centre is a guarantor, it has to obtain the Centre's consent before it can borrow from any other source. In addition, under Article 280 of the Constitution, the President of India appoints a Finance Commission every five years. The Commission is charged with making recommendations to the President on the distribution of the taxes between the Centre and the States and the consequent distribution amongst the States themselves.

In light of the above discussion and given that public debt of the state governments is a state subject, the Working Group feels that it imposing the debt management agency on the state governments in not advisable. It recommends that the DMO should be a central government agency obligated to manage only central government debt. The DMO should, however, undertake the following functions related to state debt that have implications for the central government's debt portfolio.

1. Maintain a database of state government debt with a comprehensive coverage including information on consolidated fund of the state, public account of the state, contingency fund of states and any additional explicit or implicit guarantees and contingent liabilities not covered in the above accounts.

2. Given the rising fiscal needs of the state governments, the DMO should coordinate the central government borrowing calendar with state gov-

ernment's market borrowings to ensure auctions of new issues are appropriately spaced.

Over time, once the new DMO develops a working framework for the debt and cash management functions for the Centre and stabilises its operations, it can also offer its specialised services to the state governments on a voluntary basis. In the meantime, the management of state debt should be the legitimate choice of state governments.

5.3 External Debt

The next issue is whether the DMO should manage the external debt. State governments cannot directly borrow from abroad and have to go through the centre as the sovereign risk is borne by the latter. While the centre is yet to issue a sovereign paper abroad, at some stage, it has to test that source. It may well be argued that this experiment may materialise soon, in view of the speed and manner in which markets are getting integrated. Considering all these, and the risk associated with debt, it cannot be viewed in isolation; thus, both internal and external debt should fall under the purview of the DMO.

External debt currently includes loans received from foreign governments and multilateral institutions. The foreign currency borrowing of the central government takes place through multilateral and bilateral agencies, and is a part of Official Development Assistance (ODA). There is no direct borrowing from international capital markets. Kelkar (2004), however, points out that this classification of external debt does not take into consideration proxy foreign exchange borrowing, which takes the form of contingent liabilities. The central government, for instance, substantially influences foreign exchange borrowing by para-statal agencies, such as State Bank of India (SBI). SBI has borrowed in foreign currency through various instruments (e.g., the Resurgent India bonds issued in 1998), and SBI's use of the funds generated through these is restricted by the centre and RBI.

Currently, the activities related to the sovereign external assistance are performed by various divisions within the MoF and RBI. These include the Multilateral Institutions Division, and the Bilateral Cooperation Division in MoF (which deal with External Commercial Borrowing (ECB), the Asian Development Bank (ADB), Europe, and Japan), and the IMF Loans division in RBI. The External Debt Management Unit within the DEA, MoF compiles and releases the statistics on India's external debt, and the AA&A,

DEA provides the Back Office support to the various activities related to India's external debt. The AA&A administers the full life cycle of an external debt agreement starting from its signature to its final re-payment.

The Working Group believes that the current set-up of external borrowings through external assistance needs to change. As the Indian economy integrates with the global economy, it believes that the central government should, over time, evaluate the cost-effectiveness of borrowing abroad and developing a sovereign benchmark in the external market. This opening up is likely to improve market discipline on government borrowing and result in lowering of the cost of borrowing. This would also enable a reduced cost of borrowing for the private corporate sector.

Managing external liabilities would, however, require increased institutional capacity. Indeed, we may go so far as to say that borrowing from abroad is ill-advised until the requisite institutional infrastructure is in place. The proposed DMO can serve as the specialised agency that will manage these external liabilities. In order to assist the DMO in performing this role, the Working Group recommends that the AA&A, currently under the DEA, MoF should be merged with the DMO once it comes into operation. This implies that the external debt management function should continue to be performed within the MoF until the AA&A is merged with the DMO.

5.4 Cash and Investment Management

The last issue relates to whether the DMO should also focus upon cash and investment management functions. Cash management and debt management are intricately related. Recent experience shows that the central government was ill-equipped to deal with the huge accumulation of cash surpluses on account of windfall 3G revenues, creating distorted liquidity and interest rate conditions as the government did not create possible avenues for investing such surpluses, as practised in other countries. Instead, the government exerted pressure on the market by pushing ahead with its net borrowing even with huge cash balances. Not only does this work at cross purposes with the objectives of handling cash and managing debt, it also adds to the cost of the government. Debt operations need to align with cash flows. Government should coordinate with the central bank very closely for this purpose, even after the proposed separation of the debt management.

Recent experience shows that the governments cash management needs sophistication and refinement. Both the receipts-side and expenditure-side of budgetary management should be looked at for striking a balance between the two. The present arrangements are not cost efficient. While some regulations and systems have been developed to handle cash deficits,[3] the present system of handling cash surpluses of state and central governments is not only complex, but also passive. It offers no incentive for governments to introduce efficient cash management practices. The system also does not allow a return flow of such surpluses to the market, except by way of increasing expenditures. As a result, such surpluses tend to be treated as exogenous to the system and the frictions are allowed to be unwound in an unplanned manner. The primary issuance of government securities follows its own calendar announced half yearly, except for occasional changes. As a result, the progressive net borrowing results in a further build-up of surplus, which intensifies the frictional factor.

Whenever there is a surplus balance in the central government account, upto a certain limit, it is invested in Government of India securities held by RBI. Thus, a substantial balance is invested in governments own securities thereby, any interest accrued is appropriated by the government itself, saving to that extent the net interest outgo on such securities held. Since this transaction is between the government and RBI, there is no flow of money back into the market. Further, since the quantum of such investments is not reported or published, it is possible that the actual reported cash surpluses of the government is mostly understated. If it is assumed that at least half of the surplus is invested in this manner, then the actual cash surplus could be at least double the reported figure.

The cash balance position of the central government is also closely linked to the state governments' balances, since the latter temporarily place surpluses with the central government. Whenever state governments accumulate surplus balances, such surpluses are invested in 14 day treasury bills (TBs) of the central government. State governments are also allowed to participate in issues of auction TBs on non-competitive basis. While this practice helps the central government to meet their need for funds in a deficit situation, when the central government is already in a surplus situation, it accentuates the problem. In the recent period, at any point of time, a huge amount of 14 day TBs remained outstanding predominantly representing state governments investments.[4]

[3] Temporary mismatches in cash flows are met through a WMA, and if necessary, an overdraft facility, between RBI and the central government. WMA ceilings are fixed through mutual agreement between RBI and government.

[4] State governments are required to park their end of day cash surpluses in 14-days Intermediate TBs issued by the central government. Interest rate on these TBs is fixed at

The frictional factors that contribute to the unintended liquidity crunch from time to time can be avoided if better cash management practices are introduced by both central and state governments attuned in harmony with their debt management practices. Country experiences would show that there are several ways of handling surplus cash balances, other than locking up of these funds from flowing back into the system. An RBI staff study (Hajra *et al.*, 2009) has explored the serious problems posed by cash surpluses, and has documented well tested practices followed by many countries. For these reasons, the DMO should integrate within its scope the cash and investment management functions of the central government and as discussed earlier, over time, should also consider offering these services to state governments.

While the governments cash flows can be regarded as exogenous, refined cash management practices in coordination with debt management can minimise frictions caused by such movements. The present system functions passively with too much complexity, and causes frictional problems that also strain RBI's liquidity and interest rate management.

The next issue concerns the efficient management of cash balances across various departments and ministries of the central government. The current practice on disbursement of funds to various departments and ministries of the central government is based on a lump-sum transfer. Once Parliament passes the Appropriation Bill, MoF distributes the funds to the individual ministries for the whole year. A large part of these funds is held as surplus cash at individual ministries. This results in inefficient cash management for the central government as a whole. This is because the central government might be required to borrow in the market in a deficit situation even while some of its ministries hold on to surplus balances. To avoid such an inefficient system of cash management, the Working Group recommends that the Appropriation Bill should include provisions whereby the annual funds to be given to a ministry should be divided into multiple tranches throughout the year in consultation with the relevant ministry. Additionally, to avoid simultaneous borrowing and lending, the central government could also consider maintaining a single account owned by MoF and held with RBI where the current account balances of all departments and ministries in the central

1% lower than the Bank Rate of RBIs. These surplus cash balances of state governments have increased steadily from Rs. 7,184 crore in March 2004 to Rs. 1,03,100 crore in March 2011 amounting to 1.3 per cent of gross domestic product (GDP) for 2010-11. Such huge accumulations in 14-days TBs pose a risk for the central government due to its short term maturity profile. If the state governments unexpectedly draw down on these balances, then the central government might be required to refinance this cash shortage from new borrowings (MoF, 2012).

government are netted out on a daily basis. The Group realises that this would be a resource incentive function as it requires that the DMO engage with individual ministries and build a functional relationship with them. In light of this discussion, it is recommended that the DMO should take on cash management operations only at a later stage when it has built on the operational capacity and has been successfully undertaking the debt management function for the central government.

International experience also shows that cash management typically migrates to the DMO at a later stage than debt management because of the day-to-day and dynamic nature of this function. In the United Kingdom (UK), for example, the DMO began actively managing cash only in 2000, two years after it was instituted. The DSTA only recently took on the role of cash management when it merged with the CMD (see Box 1).

6 Structure

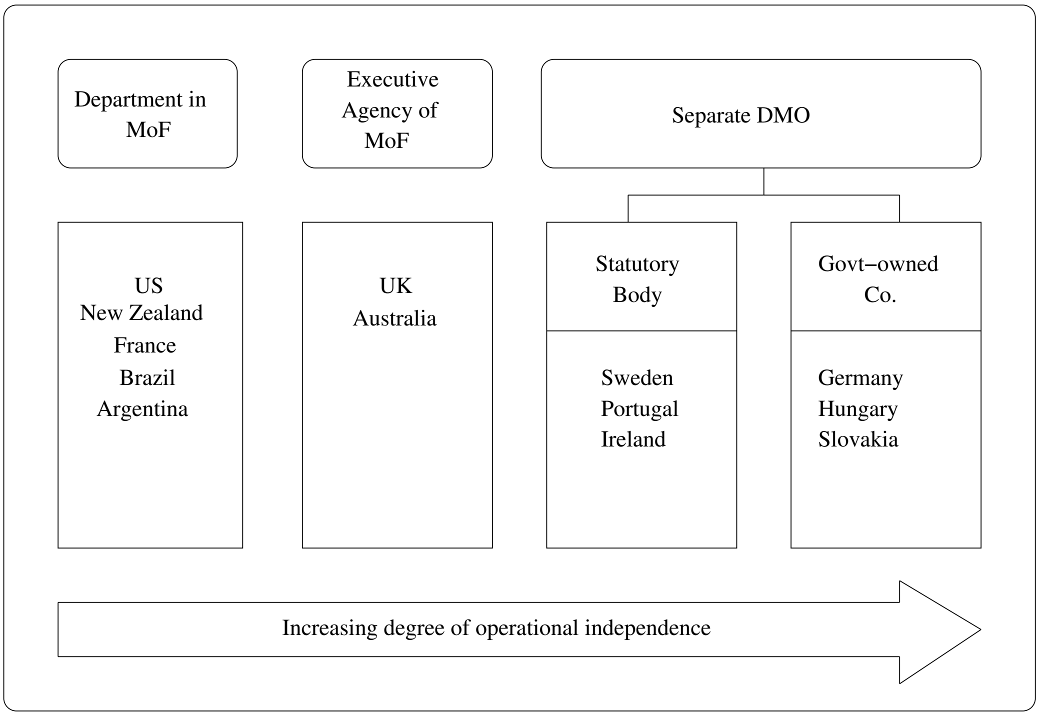
The Working Group believes that in order to achieve sound and efficient debt management, an economy needs an entity that is exclusively tasked with the function of debt management, with well-defined objectives, and access to information from all the sources within the government's financial institutions that are likely to impact the performance of that function. When envisioning the debt management authority that India should have; multiple issues need to be considered: its location, whether it needs to be placed as a department within RBI, MoF or as a statutory entity at an arm's length from both RBI and MoF; its relationship with other institutions in the government; its funding sources; and the actual objectives, functions and powers that are consolidated with the creation of such a authority.

The structure of the DMO discusses the location, objective, functions and powers of the DMO. These four issues are discussed below.

6.1 Location

Given the rationale for an independent DMO outside RBI as discussed in Section 4, it is important to understand the extent of operational independence that the DMO should enjoy under the central government.

Based on a review of international experience, Jahangir Aziz Report (2008) offers the following map of how operational independence changes, depending on where the debt management authority is located (Figure 1).



Source: Jahangir Aziz Report (2008)

Figure 1: Possible locations of a debt management office (DMO)

A public debt management authority that is under direct ministerial supervision of the MoF in the form of an agency or division benefits from tight interaction between ministerial decision-making, fiscal policy, and budgeting. In addition, such an agency will also be subject to more stringent accountability mechanisms. This, however, will imply that the MoF has operational control over the DMO. A major criticism for this kind of set-up is that the government is likely to enforce non-market decisions on the securities market given that it is the majority stake-holder in the public sector banking units. This arrangement is likely to increase the possibility of heightened financial repression rather than ameliorate the situation.

To the extent the new DMO is at an arms length from MoF, such ownership conflict can be reduced. As an example, the MoF report (Jahangir Aziz Report, 2008) concludes that India's public debt management authority needs to be at arm's length from MoF. It provides several additional reasons. First, the authority must be equipped to serve both central and sub-national governments, which may not be possible if located within a central government ministry.[5] Second, it must be isolated from any political processes that may otherwise influence its functioning. Third, the functions of public debt management are specialised and require dedicated staff that are equipped with, and build, expertise over time, which will not be possible under conventional government processes including its human resource management process. Fourth, creating a separate authority to deal with public debt management is an opportunity to remove the difficulties associated with the present system, which include unclear lines of accountability, lack of functional independence, conflicts of interest and undefined objectives.

Jahangir Aziz Report (2008) also studies the trade-offs between creating a statutory body for managing public debt versus other types of entities (such as an executive agency, a company, or a trust). In this regard, it concludes that there is merit in creating such an authority through statute, which confers upon the authority operational flexibility, skilled staff and expertise, and the power to pursue independent objectives without any conflicts, while simultaneously remaining accountable for its decisions and actions in a reasonable manner.

Wheeler (2004) lists the essential provisions that must be contained in a statute establishing a public debt management authority. Such a statute should:

- Outline the functions and responsibilities of the agency.
- Empower the minister of finance to delegate responsibilities to the chief executive of the agency.
- Specify the role and composition of any governing board (e.g., board of advisers) and the procedures relating to compensation and appointments.
- Outline the responsibilities of the chief executive or the head of the organisation, including responsibilities regarding personnel issues.
- Empower the governing board to employ any officers.
- Specify the reporting requirements in relation to the Minister of Finance and the Parliament.
- Indicate the need for transparent and independent auditing arrangements.

[5] The DMO should not be prevented from doing so if it enters into a bilateral agreement with a particular sub-national body, at a later stage.

- Address code of conduct related issues such as obligations with respect to secrecy, disclosure requirements, and avoidance of conflict of interest.

Institutionally, it is very important that the relationship between the central government, RBI, and the DMO be considered in designing the organisational structure of the DMO. The DMO needs to function independently, maintaining an arms-length association with both the central government and RBI. The Working Group, therefore, recommends a statutory corporation with representation from both the central government and RBI. The Working Group further recommends that the proposed DMO should function with independent goals and objectives while being accountable to the central government for its actions and results.

6.2 Organisation

The Working Group recommends that the operations and management of the DMO be handled through a two-tiered arrangement. At the top of the chain, there should be a Policy Advisory Board, comprising of experts in finance and law, selected from various domains. The composition of the Policy Advisory Board is proposed as follows:

1. The Chairperson: an independent member.
2. A representative of RBI: not lower in rank than that of Deputy Governor.
3. A representative of the Government of India: not lower in rank than that of Secretary to the Government of India.
4. Two other independent members.
5. The Chief Executive of the DMO: who shall act as the convenor of the Policy Advisory Board, but shall not have any voting rights.

The Policy Advisory Board is expected to advise and issue opinions on any matter related to the objectives and functions of the DMO that is referred to it by the DMO or the Government of India. It is also expected to advise and provide its opinion on the financing plans submitted by the DMO to the Government of India, as well as the DMO's annual report, whenever such opinion is sought. The Board must meet at least once in three months to review and ratify the borrowing programme for the upcoming quarter.

The Policy Advisory Board is expected to issue its opinion by way of a consensus decision. Enforcing a consensus requirement is also a way of ensuring that there is coordination between the members of the Board. Ideally, the Chairperson of the Board shall be obliged to seek consensus from Board members. Only if no consensus is possible, should the Board resort to voting procedures. In such a scenario, opinions of individual dissenting members should be documented and placed on record. The functioning of the Policy Board is expected to follow standard practices of legal process as regards appointments, vacancies, meeting procedures, terms and conditions of appointment, resignation and future employment. The Policy Board is not expected to have any executive control over the day to day management of the DMO.

The supervision and control over daily operations and management shall vest in the hands of a Board of Management in the DMO. The composition of the Board of Management is similar to the Advisory Board, except on an operational level, as follows:

1. The Chief Executive of the DMO: also the Chairperson of the Board of Management.
2. A representative of RBI: not lower than the rank of Executive Director or equivalent.
3. A representative of the Government of India: not lower than the rank of Additional Secretary to the Government of India.
4. Two independent members.

This Board of Management is expected to exercise general superintendence over, and manage the administration and business of, the DMO. The rules and procedures followed by the Committee are also, like the Policy Advisory Board, expected to follow standard process. The appointment of the Chief Executive of the DMO should be open and transparent. The Board of Management should meet more frequently than the Policy Advisory Board, and take operational decisions, which affect the daily affairs of the DMO.

The Working Group envisages that the DMO will be a lean organisation, with limited staff on its rolls. It expects that all non-core responsibilities will be outsourced to appropriate service providers, and the expertise and functions present within the DMO will be limited and focused on the narrow mandate of the organisation.

Figure 2 provides a draft structure of what the verticals in the DMO should look like. The DMO should have five main tasks:

1. Portfolio services: This will include teams working on cash manage-

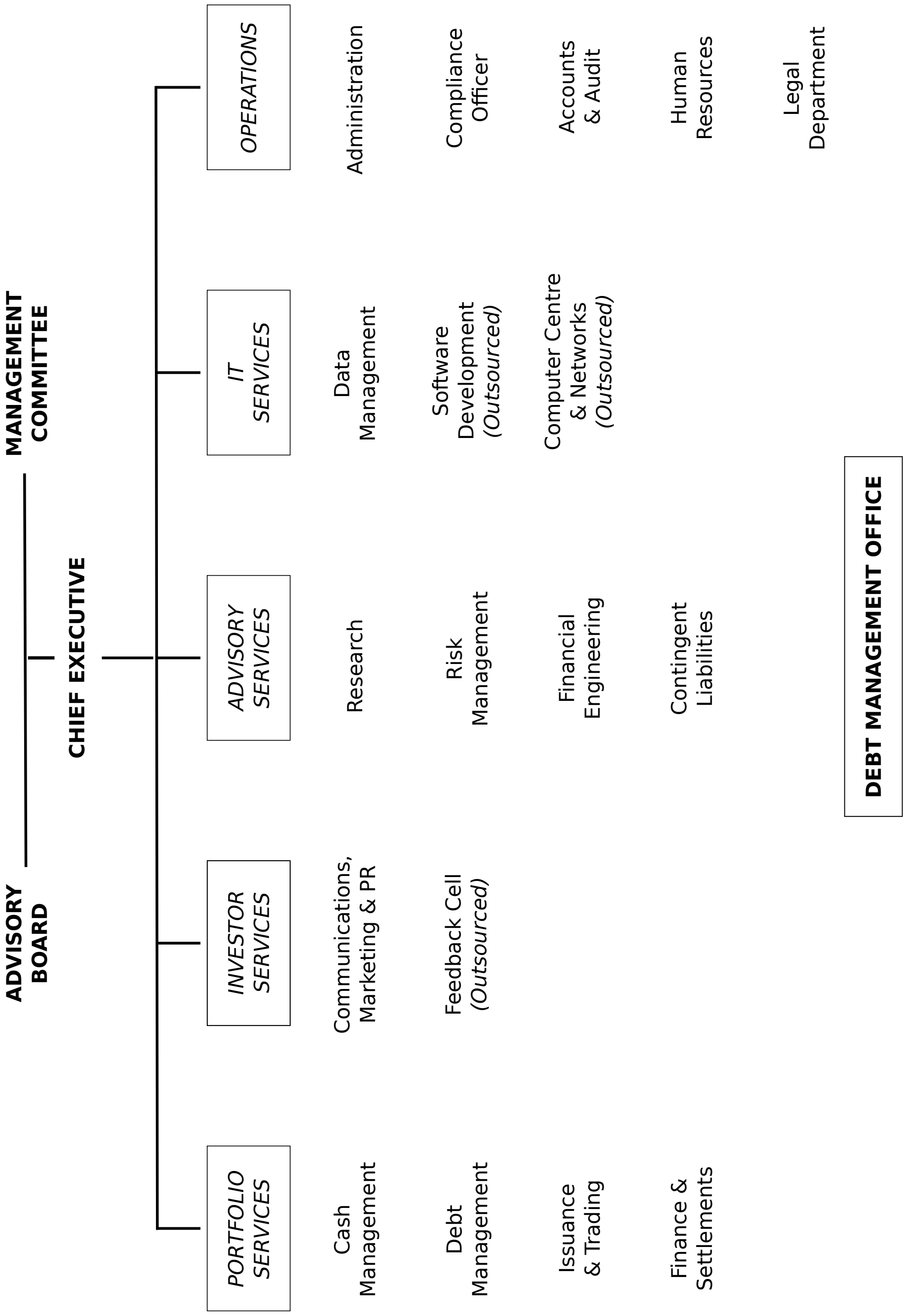


Figure 2: Structure of the debt management office

ment, debt management, issuance and trading, and finance and settlement.

2. Investor services: This will include teams handling communications, marketing and public relations. It should also have a feedback cell, which is equipped to handle any concerns with the activities of the DMO. It may be feasible to outsource the feedback cell management.

3. Advisory services: This will include teams working on research and analysis, risk management, financial engineering and market development, as well as studying contingent liabilities.

4. Information technology (IT) services: This will be part of the back office operations of the DMO, but will be central to the DMO's activities in every way. It will involve data management (which includes collection, management and dissemination of data), software development, and the computer centre and networks. It is possible to outsource software development and network handling.

5. Operations: This will involve the support services required to ensure that the DMO keeps running, such as administration, legal, human resources, accounts and audit cells. Another key team working within the operations vertical will be the compliance officer who is responsible for ensuring that the DMO's activities and actions are in consonance with the rules and regulations set down by the relevant prudential regulator, RBI and any other agencies.

As regards the optimal number of staff, the Jahangir Aziz Report (2008) offers a comparative analysis of the staff size of DMOs in various jurisdictions: New Zealand (20) and Australia (30) have relatively small number of staff; Brazil (90), Colombia (87), and the United Kingdom (80) have about 3-4 times that; and Portugal (110) and Sweden (120) have relatively large DMOs. In view of the range of functions it is expected to perform, the Working Group recommends that the Indian DMO should have a staff size of approximately 70. A larger number of employees may be more challenging to handle, and may affect the organisation's performance.

The DMO must have the authority to recruit staff of the highest quality. Therefore, both selection processes and salary structures must be within the control of the DMO itself. This is similar to practices followed in Australia, New Zealand, Sweden and the UK. For instance, the Swedish DMO is free to set the salaries within the means of its budget; and the UK DMO has been delegated authority for resourcing, pay, pay bargaining and setting terms and conditions of appointment for its staff (Jahangir Aziz Report, 2008).

6.3 Objectives

Indian debt is primarily domestic in nature and is largely financed through financial repression. Going forward, as the level of financial repression eases in the economy, the government would increasingly need to depend on the market rates of interest. In the opinion of the Working Group, the DMO should coordinate and ensure a smooth transition to the market determined cost of borrowing such that either the cost or the risk associated with the government portfolio does not explode.

The Working Group, therefore, emphasises the importance of clearly outlining the objectives of cost minimisation and risk management for the government debt managers and the inherent short-run trade-off between these two objectives. A precipitous fall in the short-term interest rates could incentivise the government debt manager to issue more short-term debt than long-term debt. In the absence of adverse-shocks this might be a reasonable strategy for debt management. However, adverse global or domestic shocks such as volatility in international financial markets, changing political environment at home, or weak macro-performance can all result in a re-assessment of the country's credit-rating making it increasingly difficult for the sovereign to service its debt. This strategy of moving to short-term debt can result in higher re-financing costs, increase in taxes, fall in spending and/or even a sovereign default.

In addition, the Working Group feels that development of government securities market should be an integral function of the DMO given the importance of a well functioning securities market in carrying out its primary functions of debt and cash management. This becomes all the more important given that the market for government securities is not yet substantially developed in India, despite significant progress since the 1990s.[6]

Keeping in mind the above discussion, the Working Group is of the opinion that the objective of the DMO should be defined to *meeting the financial needs of the government in an efficient manner at all times with an acceptable risk-return trade-off over the long run. A secondary objective should be the development of the government securities market.* This should incorporate minimising the long-term cost of financing government debt while limiting the risk exposure of government portfolio with a prudent degree of

[6] Developments since the 1990s include the banning of issuance of *ad hoc* treasury bills, passing of the FRBM Act, emergence of market driven interest rates, reduction of SLR, new operating procedure for monetary policy, setting up of a primary dealer system and focusing on the development of the secondary markets

risk management.

It should be noted here that the development of government securities objective should not be confused with powers to change policies in the securities market. The DMO should pursue its development objective while staying within the boundaries set by the concerned regulator.

6.4 Functions

The discussion in this section focusses on what tasks should be performed rather than how those should be performed. In doing so, the Working Group acknowledges that the legislation framing the functions of the DMO should be kept flexible enough to allow for the evolution and the changing structure of debt management in India over time. As noted by Kelkar (2004), *"it is imperative to seek every institutional innovation which can yield even the slightest improvements in... public borrowing, or slight improvements in risk management"*.

It is important to note that RBI shall continue to have the regulatory control over money and government securities markets and would also be expected to continue and retain other agency functions such as maintaining the depository, managing the settlement system and conducting auctions on behalf of the DMO. In a nutshell, the DMO should evolve into a policy oriented institution leaving the operational part to RBI as a banker and fiscal agent to the government.

The key function of the DMO would be to undertake debt and cash management for the central government. In addition to these, the various functions of the DMO that are discussed in this section are classified under management of contingent liabilities, data dissemination, development of government securities market, and management of information systems and communication. These functions of the DMO are analysed below.

6.4.1 Debt and risk management

The DMO should advise the central government on the composition of debt instruments including the proportion of domestic to foreign debt instruments and the debt sustainability analysis (DSA).However, the final decision should rest with the Budget Division in the central government and the DMO should be responsible for executing the remit from the central government.

Over the medium term, the DMO's focus is likely to shift towards building voluntary demand for government paper. It may consider options such as issuing inflation-indexed bonds, dollar-denominated debt or short-term nominal debt. These instruments will help to address market concerns regarding inflation, exchange rate and credit risk, respectively. Deploying these instruments in appropriate combinations would help to develop different segments of the market. Over the longer term, as statutory holding requirements decrease and capital controls lift, demand for sovereign rupee bonds is likely to increase in both domestic and foreign markets. This would allow the government to move towards issuing long-duration, rupee denominated, fixed-rate bonds.

The debt management functions of the DMO may include:

1. To get projections of revenue and expenditure of governments and assess the resource gap in terms of borrowing requirements of both central and state governments.

2. To decide on the mix of short term and medium to long term borrowings consistent with the evolving interest rate structure and liquidity conditions.

3. To decide the maturity, type and mode of issuance of debt in the market and issuance of the optimal annual borrowing calendar for the central government. This should be done keeping in mind the investor preferences and the objective of debt management that is to meet the financial needs of the government in an efficient manner over the long run.

4. Developing a framework that helps to identify the risks inherent in the debt portfolio such as those associated with debt management operations, refinancing, contingent liabilities, impact of sovereign credit ratings issued by credit rating agencies, global and domestic business cycle risks. IMF Forum (2010) notes that, *"The range of risk factors considered should be consistent with the broadest definition of the debt portfolio and the associated range of potential scenarios."*

5. To decide on policies and operations on external debt and managing sovereign borrowings from abroad.

6. Wherever feasible, the DMO should establish limits for various categories of risk and overall risk and seek to insure against these risks inherent in its portfolio.

7. To evolve policies on managing other liabilities of governments such

that the interest rate structure of government debt as a whole is consistent with cost of incurring those liabilities.

8. Advise the government on medium term and long term debt strategy.

9. Monitor developments in the government securities market and the wider economy.

10. Coordinate with the fiscal and monetary policy functions.

11. Actively engage with credit rating agencies and the private sector and build relationships with market participants.

Given that the DMO would be one of the largest players in the central government securities markets, the agency should be mindful of its behaviour as its actions will be interpreted as powerful signals being sent to the market participants. In light of this, the agencies' actions need to be carefully calibrated and its market behaviour should be guided by the following principles:

1. The DMO should not appear opportunistic in domestic bond markets. It should focus on predictability and consistency in its market signals, and avoid deviating from the announced calendar in light of profit-making. The DMO should pre-announce all participation in markets.

2. As far as possible, the DMO should focus on issuing plain vanilla instruments, especially in its early stages. Once the DMO is able to establish a trustworthy relationship with both domestic and foreign market participants and is perceived as a reliable and consistent market participant, it could experiment with new instruments.

3. The DMO can trade opportunistically in international financial markets as it is just one market participant among many.

6.4.2 Cash management

The two main components of cash management are cash forecasting and cash balancing. Cash forecasting involves:

1. Participating actively in the forecasting of expenditure and revenue, including longer-term half-yearly or annual forecasts and the shorter monthly, fortnightly, weekly or even daily internal forecasts. This can be achieved via close coordination with the Budget Division in the Ministry of Finance and the Treasury departments of state governments and state-owned enterprises.

2. Integrating forecasts of receipts and payments with other information on cash flows, notably those generated by financing decisions - bond issuance and servicing - and by the cash manager's own transactions.

Cash balancing involves:

1. Coordinating the matching of day-to-day expenses and revenues. This includes maintaining a regular channel of communication with the government's banker (RBI) to estimate end-of-day balances.

2. Targeting an appropriate end-of-day balance in the Treasury account, implementing a remit from the MoF regarding managing idle balances. In certain situations this might also involve management of permanent or structural cash surpluses such as those generated by the disinvestment proceeds or the auctioning of national resources such as coal blocks and telecom licences.

In addition to the primary functions of cash forecasting and cash balancing, the cash management functions of the DMO might also include the following:

1. To manage cash balances of the central government in coordination with debt management in such a manner that situations of unduly large deficit or surplus situations do not occur, and when they occur, plan for borrowings and investments in coordination with the government.

2. To develop an efficient government accounting system and a framework for monitoring government's cash flows- both spending patterns and forecasting revenues.

3. To assess the daily offsetting liquidity injections or withdrawals needed to counter the governments' daily operations of cash injections into or withdrawals from the domestic banking system.

4. To maintain a database of the actual cash balances and the liquidity requirements of various government departments and ministries including forecasts of spending and revenue patterns at a high frequency that gets updated frequently. The debt manager need not be required to collect this data directly and should instead be given access to this data by the Ministry of Finance that usually collects this data on detailed cash flows.

5. Advise the central government on measures to promote efficient cash management procedures. Such measures could include contracting out of day to day banking business to commercial banks with a view to lowering fees and availing a wider range of banking services and impo-

sition of sanctions or provision of incentives for adopting best practices in working capital cycles.

6.4.3 Contingent liabilities

The DMO should incrementally take on the various functions associated with the management of contingent liabilities (CL).Some of these functions are listed below:

1. Develop and maintain a database of the existing contingent liabilities of the central government including both explicit and implicit liabilities.

2. Use appropriate models to evaluate CL and price the expected costs and risks associated with the realisation of these liabilities in net present value terms.

3. Advise the central government on policies and guidelines for the issuance of government guarantees and on matters such as making budget allowances for the expected losses from the explicit contingent liabilities and recapitalisation of public sector enterprises keeping in mind a risk management policy framework.

4. Implementing and executing the guidelines set by the central government for the issuance and claims of contingent liabilities.

5. Communicating the nature and volume of these contingent liabilities to the public in order to increase both transparency and accountability.

6. Record and report central government guarantees and other contingent liabilities.

7. Record and report guarantees and other contingent liabilities of sub-national governments that eventually might have to be borne out by the central government.

8. The realisation of contingent liabilities is counter-cyclical and adds to the financial burden of the central government especially at a time when the government is in a crisis situation. Given this, the DMO should advise the government on making provisions for contingent credit lines with bilateral and multi-lateral agreements and establish similar credit lines with international agencies such as the World Bank, International Monetary Fund (IMF), Asian Development Bank (ADB) and others.

Management of contingent liabilities is a specialised function that involves undertaking risk-assessment of clients. Given this, the DMO should be allowed to contract out in part or in entirety the management of contingent liabilities to outside agencies if it chooses to.

6.4.4 Data dissemination and communication

The Working Group believes that the DMO should supplement and enhance data collection and dissemination that is currently being undertaken by RBI and MoF. The DMO should make this data accessible to the market. In particular it should do the following:

1. Link to existing sources of data.
2. Identify gaps and work with public and private institutions to fill them.
3. Synthesise data for market participants where relevant.
4. Collect and disseminate data on its own performance and operations.

6.4.5 Developing a government securities market

In order to perform efficiently its primary functions of debt and cash management, the DMO would need to ensure a deep and liquid secondary market in government securities. This involves the following functions:

1. Advising the market regularly on introduction of new instruments for government market borrowings such as index-linked/ inflation-linked securities, foreign currency denominated debt, debt swaps and any other portfolio operations as per the need of the hour and as allowed by the state of financial innovation of the day.
2. Maintaining liquidity in the government securities at various points on the yield curve.
3. To promote and diversify the primary market in government debt including development of a retail base for government debt and operational systems that make it more accessible to foreign investors.
4. To coordinate the operations of primary market agents like primary dealers.

5. To conduct research on matters relating to government debt and disseminate periodic information and data to stake holders and the general public in a transparent manner.

6. Engage closely with market participants, understand their needs, and foster demand for government securities.

7. As a public sector entity that understands the markets, the DMO should be an important voice on legal and institutional reforms.

It needs to be kept in mind that while fulfilling these function, the DMO does not have the powers to directly change any policy related to market conduct or issuance. The DMO at all points in time must comply with the directives of the primary securities market regulator.

6.5 Managing information systems and communication

The DMO should develop, maintain and manage information systems that would be essential for this agency to efficiently carry out its operations. In addition, the Working Group feels that the DMO should undertake a proactive role in communicating any changes to its operational framework for debt management to the investors. Managing Information Systems (MIS) and communication may include:

1. Development of MIS for debt recording and portfolio management systems.

2. Preparation of a manual on government securities.

3. Liaisons with credit rating agencies to identify and address emerging concerns.

4. To undertake timely and proactive market communication of debt and cash management strategies in order to enable investors to form informed expectations regarding their investment decisions that further facilitates the smooth undertaking of management operations including issuance of primary securities.

5. To create a platform for an on-going engagement with the investors in order to solicit their views to identify potential vulnerabilities and new opportunities, and to offer instruments that better match the investors' needs.

6. An annual debt management report to Parliament.
7. Internal reports for senior policy makers.

6.6 Powers

In order to ensure that the DMO efficiently carries out the above functions it must also be given requisite powers to perform these functions. However, it is noted that these powers should not be seen in isolation and should be tied to the DMO's responsibilities towards its clients.

The DMO should have the ability to charge fees for its services, which should be structured in a way that addresses the authority's expenditures, including salaries and benefits.[7] Jahangir Aziz Report (2008) also suggests that the authority should have the ability to draw upon the resources of the central government should the need arise, by way of loans or grants given to it by the Centre, but that any excess funds (beyond a defined cap) in the authority's corpus should get credited to the Consolidated Fund of India.

Further, the Working Group agrees with the Jahangir Aziz Report (2008) that the DMO should have the power to call for information relevant to its functions, the power to transact as an agent and the power to contract with service providers. These powers are discussed below:

6.6.1 Power to call for information

The DMO should be empowered to call for any information from any source, essential for it to perform the functions of debt and cash management. In particular, the authority should be empowered to obtain the following information, and any additional information that it seems necessary, from relevant sources:

- Onshore and offshore liabilities.
- Central government liabilities (contingent liabilities).
- Cash balances of central government ministries.
- Sub-national debt.

[7] Jahangir Aziz Report (2008) points out that RBI already charges the central and state governments' fees for debt management services, and it is useful to consider this existing fee structure when determining similar fees for the new authority.

- Guarantees by sub-national governments.

6.6.2 Power to transact as an agent

The DMO should be given the power to act as the agent of the central government, state governments, local authorities, statutory corporations, or any other person or authority as the central government permits, for making transactions on behalf of the principal. The DMO should have explicit authority to transact for the Centre and States, to reassure market participants of its bona fides, particularly foreign investors who may be unfamiliar with Indian institutions and markets.

The Working Group believes that the DMO should also be empowered to act for a range of other public entities, so that it is able to advise, consult or offer services to them as it develops expertise and capacity. However, it should be required to act only for the central government as that is its primary role.

7 Transition

The process of creating the DMO involves a series of actions, besides passing a legislation through Parliament. This ranges from setting up the necessary infrastructure, hiring staff, building database management systems, and handing over existing roles and responsibilities from RBI and (MoF). The Jahangir Aziz Report (2008) provides a detailed discussion on managing the transition, which this section significantly borrows from.

Before commencing any processes relation to debt management itself, the central government needs to recognise that creating this agency is a narrow and independent activity that requires focussed and dedicated attention from MoF. Accordingly, a separate team (comprising of about three individuals) should be created within MoF, who do not have any departmental or other agency affiliations, and who should be entrusted with the sole responsibility of pushing the draft legislation through Parliament, as well as setting up the DMO, from the act of identifying premises to setting up IT systems to establishing outsourcing relationships. If MoF does not wish to create a separate team, the Middle Office (Debt Management) as it exists today could well play this role, and pilot the DMO project to fruition. However, the Middle Office may require additional resources, including staff, to complete this exercise. In the absence of a dedicated team, the implementation of this project will either languish or be handed over to an existing overburdened department within MoF, which may affect the speed and efficiency with which the DMO can be set up.

This team should be given budgetary assistance. This budget should ideally be provided by MoF, which may be through an interest-free loan to the DMO for a defined period, if considered appropriate. This loaned amount can be repaid once the DMO begins to earn income through the fees it charges. This budget should be used to handle the following tasks:

1. Identifying and setting up office premises;
2. Establishing the Policy Advisory Board and the Board of Management;
3. Identifying staffing requirements and creating an organisation chart;
4. Establishing a process to recruit staff;
5. Identifying and creating outsourcing relationships for carrying out non-core activities.[8]

Once the team is identified, the DMO should begin its existence as a *non-statutory body*. This report assumes that it will take 18 to 24 months for the DMO to transition from a non-statutory body to a statutory organisation. In the interim transition period, pending its statutory existence, the DMO should focus its attention on limited activities: training staff and building expertise; developing IT infrastructure; and honing research and analytical skills.

- *Human resource management and training*

  From an operational point of view, the duties carried out by two existing teams within MoF – the Middle Office and AA&A– should be subsumed within the DMO from the first day of its existence. The DMO should refrain from engaging in actual debt or cash management activities. It should commence these activities only after it acquires statutory recognition. In this scenario, it is expected that the DMO shall undertake mainly data collation and strategic and advisory activities to begin with. In the course of time, ideally within 18-24 months, the DMO should have enough human and technical expertise to deliver on its actual mandate, of meeting the debt requirements of the

[8]The Jahangir Aziz Report (2008) points out that internationally, *"A wide variety of tasks performed by the DMO are outsourced to external agencies. These outsourced tasks range from canteen and security, to financial services, to database development and management, to research."*

Government of India. Subject to the legislation having been passed by Parliament and notified by government, the DMO's actual work can then begin.

There must be close collaboration between DMO and its counterparts in other jurisdictions. It will be immensely useful for the Indian organisation to learn about the daily activities at these international debt management offices, particularly at the staff level. The Jahangir Aziz Report (2008) suggests an internship exchange process which will allow an exchange of staff between these organisations. This will allow staff from India to learn about other offices, as well as staff from elsewhere to learn about the challenges faced in India, and advise on how these can be best addressed.

- *Putting IT systems and databases in place*

  The DMO should operate as a paperless office. Its systems should be fully IT-enabled, and its information and database should be fully digitised and electronically accessible. Wherever engagement with other government agencies requires the DMO to use paper-based documentation, it should convert it into digital format at the earliest instance. The IT infrastructure and capabilities of the DMO should at a minimum adhere to the standards laid down in the electronic service delivery policy of the government.

  Central to the DMO's operations are databases that will contain comprehensive information about the debt and contingent liabilities of its client. The databases can be created with expertise from professionals located outside the DMO, who may also be given charge of periodic maintenance checks. These databases should also be made accessible to the bond market. This is easiest done through a website portal, which will also serve to be the public face of the DMO. This portal and the DMO database must also have a robust feedback and response mechanism, which ensures that users are able to express their concerns with the quality of data, make requests for specific information, and be confident of receiving satisfactory responses in good time.

- *Research and analysis*

  Besides the participants in the bond market, the databases must be used most frequently by the research and analysis wing of the DMO. This research and analysis wing will be staffed and designed in a manner that best understands the needs of the DMO, and responds to the changing contours of the business of debt management. It is entirely likely that a significant portion of this wing operates through outsourcing relationships, which must be established at the earliest.

In the case of contingent liabilities, the DMO must have access to a complete database of outstanding liabilities/guarantees from a national perspective. This database may take longer to create because of the present disaggregated sources of such information. Once the database is created, DMO should understand these liabilities comprehensively, including aspects of their pricing and risk management, which will feature in the overall debt management strategy that it follows.

In the course of transitioning to a full-fledged statutory DMO, the agency should begin providing advice on contingent liabilities being created by various government ministries, departments, and organisations. The DMO may not play this advisory role for contingent liabilities right from the first day of its existence. This report presumes that the DMO will have the capacity and resources to process the data relating to contingent liabilities only after about a year's existence as a non-statutory body. When equipped, the DMO's advice should include a comprehensive risk assessment of the liabilities being created on the government exchequer. The advice should also include recommendations on the appropriate pricing of the issuance. When the DMO becomes a statutory organisation, these services should be provided for a fee, and should be mandatorily sought before any such debt is issued. Processes for seeking such advice should also be standardised, based on the engagement the DMO will have had in the interim with various government ministries.

Once staff are in place, and its databases are functioning, the DMO must map out in detail the operational aspects of the market mechanisms of bond issuance and trading. The DMO also needs to be tracking the evolving financial policy map in the country, and must be prepared to respond to any changes that are instituted by the central government. This will include developing a strategic roadmap to embrace a larger audience base for the bond market than exists today.

Once the DMO acquires statutory status, in its first year of operations, the Jahangir Aziz Report (2008) advises that the DMO must engage with the Budget Division, MoF, in the following activities:

1. Prepare a medium-term debt management strategy consistent with the upcoming budget.
2. Participate in the budget process, contributing feedback from the debt

management perspective into budget decisions.

3. Prepare a financing plan for the budget, which is sent to MoF as a proposal.

4. On its part, MoF should respond with the financing remit for the year, containing instructions for the DMO, including the bond issuance calendar for the coming 12 months.

Thereafter, in subsequent years, this needs to be an iterative process, where the DMO will evaluate its previous strategies, review and revisit the strategy in context of the next budget, and prepare fresh financial plans. There should be a robust feedback loop between client and service provider, where the central government and the DMO have regular conversations to critically assess the previous year's process, with a view to improving future strategy and management.

The DMO's function of cash management will require greater operational consolidation than exists in India today. It requires information about the cash-flows of various departments and ministries in government. The DMO needs to get involved with each government ministry on an individual basis. If the working group expects *debt management* to commence only 18-24 months after the DMO's creation, it expects *cash management* will take longer. Only once it has developed a strong engagement with individual ministries should the DMO take on the cash management function. In the initial stages, the DMO should restrict itself to observing the cash balances of the ministries and advising them on efficient cash balancing and cash forecasting methods.

The database and management aspects of handling external debt will be addressed with the merging of AA&A with the DMO. It is advisable that the role of sovereign bond issuance in the foreign market should get delegated to the DMO, as this will be the sole agency with comprehensive expertise and information about the country's debt requirements.

While the core of the DMO's work will involve issuing purely rupee-denominated securities, it is expected that the bond market will expand (because of the changing rules around financial repression and other related financial policy decisions) and will be offered more choices about their bond purchases. Consequently, as Jahangir Aziz Report (2008) recommends, the DMO needs to work to become accessible to both domestic and foreign buyers of bonds. Similarly, DMO should consider a programme for issuing a basket of products which would include foreign currency bonds, and inflation indexed bonds. This may require advising and working with central government on the policy changes required to increase the bases (e.g., remove barriers faced by households and firms to participate in the bond market). Throughout this process, there must be a constant assessment of the actual costs of borrowing for the central government, and once the markets for the various products have stabilised, the DMO must arrive at an appropriate combination of these products to ensure that costs are minimised.

Acronyms

AA&A Aid, Accounts and Audits Division. 6, 15, 16, 36, 39

ADB Asian Development Bank. 31

CMD Cash Management Division, Ministry of Finance, the Netherlands. 12, 19

CRR cash reserve ratio. 8, 10

DEA Department of Economic Affairs. 6, 12, 15, 16

DMO debt management office. 4–9, 11, 13–16, 18–23, 25–40

DSTA Dutch State Treasury Agency. 12, 19

FRBM Act Fiscal Responsibility and Budget Management Act. 12, 26

GDP gross domestic product. 18

IMF International Monetary Fund. 31

LAF liquidity adjustment facility. 8

MIS Managing Information Systems. 33

MoF Ministry of Finance, Government of India. 9, 12, 15, 16, 18–21, 30, 32, 35, 36, 38, 39

ODA Official Development Assistance. 15

OMO open market operations. 10

RBI Reserve Bank of India. 5–11, 13, 15–19, 22, 23, 25, 27, 30, 32, 34, 35

RTI right to information. 7

SBI State Bank of India. 15

SLR statutory liquidity ratio. 8, 26

TB treasury bill. 17, 18

UK United Kingdom. 19, 25

WG Working Group. 4–7

WMA Ways and Means Advances. 8, 16

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A Annexure I: Terms of Reference

The Terms of Reference of the Working Group shall be as follows:

1. Critically evaluate the case for separation of the DMO from the RBI. In this context, focus on the conflicts of interest between the RBI's monetary policy, supervisory and regulatory objectives and the debt management objectives of minimizing the borrowing cost and the development of a government bond market. This analysis may be carried out in the light of new developments.
2. Determine how to setup the DMO under the FSLRC legal architecture, keeping in view FSLRC's work on independence, transparency and accountability.
3. Specify the work required in the DMO on databases. This requires consolidation of all information on assets and liabilities along with contingent liabilities into a single centralized database.
4. Specify in greater detail the consolidation of the functions of several dispersed debt management departments within the RBI and MoF into a single agency.
5. Issues related to placing the cash management function in the DMO:
   (a) Specify the cash management functions of the DMO.
   (b) Study international best practices on how DMOs and the Treasury cooperate on cash management.
   (c) Draft law which places the cash management function in the DMO.
6. Sub-national debt: As long as states are indebted to the central government, the states are required to seek the permission of the central government to borrow. The nature of assistance that the DMO may offer to these sub-national governments in managing their debt needs to be explored.
7. Review the 2008 report and draft Bill on establishing a National Treasury Management Agency chaired by Dr. Jehangir Aziz, from the above perspectives.
8. Any other matter the working group may consider relevant.