Debt Management Reform Plan

Maldives

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ACRONYMS

BO	Back office
DeM	Debt Management
DeMPA	Debt Management Performance Assessment
DMS	Debt Management Strategy
DSA	Debt Sustainability Analysis
CSD	Central Securities' Depository
IFMIS	Integrated Financial Management Information System
FAD	Fiscal Affairs Department
FO	Front office
FRA	Fiscal Responsibility Act
GDP	Gross Domestic Product
GoM	Government of Maldives
IMF	International Monetary Fund
MMA	Maldives Monetary Authority
MO	Middle office
MoF	Ministry of Finance
MPAO	Maldives Pension Administration Office
MVR	Maldivian Rufiyaa
PEM	Public Enterprises Monitoring
PFA	Public Finance Act
PFM	Public Financial Management
PPP	Public Private Partnership
RMDMD	Resource Mobilization and Debt Management Department
SOE	State-owned enterprise
T-bill	Treasury Bill
TPAD	Treasury and Public Accounts Department
US\$	United States Dollar

Table of Contents

<i>Acronyms</i>	<i>ii</i>
<i>Executive Summary</i>	<i>iv</i>
<i>Background</i>	<i>1</i>
<i>Debt Management in Maldives: The Findings of the Debt Management Performance Assessment (DeMPA)</i>	<i>1</i>
1. The Legal Framework for Debt Management	3
<i>Sound Practices for Debt Management</i>	<i>3</i>
<i>Legal Framework in Maldives</i>	<i>5</i>
<i>Issues and Recommendations</i>	<i>6</i>
2. The Institutional Framework and Administrative Capacity	9
<i>Sound Practices for Organizing Debt Institutions</i>	<i>9</i>
<i>The Institutional Arrangements for Debt Management in Maldives</i>	<i>10</i>
<i>Issues and Recommendations</i>	<i>11</i>
3. The Management Framework for Government Guarantees and Credit-Risk Analysis	16
<i>Sound Practices for Managing Government Guarantees</i>	<i>16</i>
<i>Government Guarantees and Credit-Risk Analysis in Maldives</i>	<i>18</i>
<i>Issues and Recommendations</i>	<i>20</i>
4. The Development of the Domestic Capital Market	24
<i>Sound Practices for Capital-Market Development</i>	<i>24</i>
<i>The Domestic Capital Market in Maldives</i>	<i>24</i>
<i>Issues and Recommendations</i>	<i>26</i>
<i>Annex 1. Maldives Debt-Management Reform Plan: Logical Framework</i>	<i>31</i>
<i>Annex 2. The Guarantee Framework</i>	<i>38</i>
<i>Annex 3. Information to be Requested to Support Credit-Risk Analysis</i>	<i>40</i>
<i>Annex 4. Possible Legal Amendments</i>	<i>41</i>

EXECUTIVE SUMMARY

A World Bank mission comprising Lilia Razlog (Senior Debt Specialist), Per-Olof Jönsson, Juan Carlos Vilanova, and Xavier Werner (Consultants) visited Male, Maldives from March 20 to 28, 2019. The main objectives of the mission were to review the implementation status of the 2011 debt management reform plan and to draft a follow-up reform plan for central government debt management jointly with the Ministry of Finance (MoF). A Debt Management Performance Assessment (DeMPA) was undertaken in parallel with this mission. The team evaluated the progress made to date and analyzed the next round of planned reforms. The World Bank team wishes to thank the MoF, the Treasury, and the Maldives Monetary Authority for their active involvement in the consultations conducted during the mission.

A 2017 joint IMF-World Bank debt sustainability analysis found that Maldives is at a high risk of debt distress. Managing the fiscal risks generated by the large debt burden will require improved supervision of the public and publicly guaranteed debt stock. Over the medium term, policymakers must balance the need to increase infrastructure investment with the need to maintain debt sustainability. The real GDP growth rate reached an estimated 7.9 percent in 2018, supported by the strong performance of tourism, construction, and trade, and preliminary estimates indicate that growth accelerated to 9.1 percent, year-over-year (y/y), during the first three quarters of 2018, up from 6.6 percent during the same period in 2017. However, rapid debt accumulation, a widening current-account deficit, and low international reserves have exposed Maldives to heightened fiscal risk at a time when fiscal space is limited.

The government debt stock stood at 58.2 percent of GDP at end-2018. Domestic debt¹ equaled 33.5 percent of GDP, while external debt equaled 24.7 percent. Since 2015, external debt has been increasing as a share of total public debt, driven by a sharp increase in borrowing from the Export-Import Bank of China (China EximBank), primarily to finance housing and infrastructure projects. Issuance of external sovereign bonds also contributed to the increase of the external debt. The share of external public debt held by China EximBank rose from less than 4 percent in 2010 to about 54 percent in 2018. By contrast, the Asian Development Bank and the World Bank together account for just 18 percent of total external debt. In 2017 and 2018, Maldives placed two sovereign bonds totaling US\$350 million, which represented 36 percent of total external debt in 2018. Redemption of the US\$250 million sovereign bullet bond is due in 2022.

The mission took stock of the reforms that have been implemented by the authorities since the previous DeMPA in 2009, particularly regarding Treasury operations and back-office procedures. Treasury operations have been significantly improved by the introduction of the Integrated Financial Management Information System (IFMIS), which is now used in real time across all government agencies and covers the entire expenditure chain from commitments to final accounting. A Treasury Single Account has also been established at the Maldives Monetary Authority (MMA), and spending units have direct

¹ “Domestic debt” refers to the government securities issues by the MMA on behalf of the MoF as well as commercial loans borrowed domestically.

access to the account through IFMIS. Consequently, spending limits are managed through IFMIS and not through government bank accounts. According to the authorities, the stock of domestic contractors' arrears has been largely cleared. Cash-flow forecasting is performed daily for the entire year and is based on annual revenue forecasts from the Maldives Inland Revenue Authority. These forecasts are produced on a weekly basis and updated quarterly with information from the budget, the balance sheets of state-owned enterprises, and analyses of historical payment patterns produced by the Resource Mobilization and Debt Management Department (RMDMD).

The authorities have also improved the operational environment at the back office. In January, the back office conducts an annual reconciliation exercise for all outstanding external and domestic loans. The Public Debt Management Department at the MMA provides information on the latest auctions and payments to the RMDMD, which in turn updates the debt recording system. The RMDMD adds records of direct debt and government guarantees. The staff at the back office receives information on guarantees from both the creditor and the beneficiary, and the system is updated accordingly. Reports on debt statistics are prepared on a regular basis.

While the government has made substantial improvements in several areas of government cash and debt management, many challenges remain. Together with the authorities, the team identified four priority reform areas: (i) the legal framework; (ii) institutional structure and staff capacity; (iii) the guarantee-management framework and credit-risk assessments; and (iv) the development of the domestic securities market. Improvements in these areas will be vital to enhance the quality of public debt management and to further strengthen the MoF's capacity to fully assume responsibility for managing the government securities market. The following section details recommendations for each priority reform area.

1. The Legal Framework

The legal framework for debt management is scattered across multiple pieces of legislation. Moreover, the existing legislation does not clearly define public and publicly guaranteed debt, identify the main objectives and purposes for government borrowing, stipulate comprehensive mandatory reporting requirements, or specify audit procedures for debt-management activities. Recommendations for reforming the legal framework include:

- As part of the ongoing revision of the Public Finance Act (PFA), amend the primary legislation to clearly state the overarching objectives of debt management; define procedures for designing, approving, implementing, and reporting on the Debt Management Strategy (DMS); and regulate the handling of fees and credit risk assessment for government guarantees; and
- Approve the secondary legislation (decrees) for implementing the PFA and publish detailed guidelines on procedural rules and requirements.

2. Institutional Structure and Staff Capacity

The institutional arrangements for debt management are not fully aligned with sound practices. The RMDMD, the country’s central debt-management unit, is organized according to a front office/middle office/back office (FO/MO/BO) model. However, the responsibilities of each office are not always consistent with this model. The FO functions are conducted by multiple entities, both within and outside the RMDMD. Moreover, the MoF’s FO capacity is insufficient to fulfill its mandate. Recommendations in this area include:

- Commit to implementing a traditional FO/MO/BO model with enhanced FO capabilities, and sensitize MoF staff on the intended changes; and
- Implement the model gradually, starting with RMDMD internal procedures; ensure the appropriate distribution of staff roles; and create an annual training plan to enable RMDMD staff to execute their new functions.

3. The Guarantee-Management Framework and Credit-Risk Assessments

The stock of outstanding publicly guaranteed debt has increased sharply over the past two years. The government policy guiding the issuance of guarantees is detailed in the “Guarantee Issuance Policy,” but this policy is rarely followed in practice. For example, a guarantee fee, though stipulated in the policy, is often not levied. In addition, the quality of the policy itself requires further improvement, and the analysis of loan guarantee proposals is based largely on loan terms and lacks a solid credit risk assessment. In addition, the procedures guiding the issuance of guarantees are very limited in scope and do not include basic processes. Recommendations for improving guarantee management include:

- Develop a clearer policy for issuing guarantees that provides the necessary guidance to ensure that public resources are used efficiently to advance the government’s development priorities: the policy document should specify the issuing authority, purpose, eligibility criteria, risk-assessment processes, monitoring and recording mechanisms, auditing requirements, fee-reporting rules, limits, and dissemination protocols for public guarantees;
- Ensure adherence to the guarantee policy by developing a complete set of documented procedures and consolidating them into a procedural manual for all agencies involved in issuing government guarantees; and
- Familiarize the appropriate staff members with the latest techniques for credit-risk assessment and ensure that these techniques are applied to all new guarantees, as well as to assessments of outstanding exposure in the guarantee portfolio.

4. The Development of the Domestic Securities Market

The authorities suspended government securities auctions in 2014. Although Treasury processes have been strengthened, and the quality of cash management has significantly improved, these reforms have not reestablished the government’s capacity to engage in active debt management through domestic securities. T-bills denominated in local currency have been issued via taps, with terms fixed in advance, and other non-market-based

instruments have been issued via private placement. The government's reliance on the domestic market to conduct public debt issuance is expected to increase, underscoring the importance of financial deepening. Recommendations to further develop the domestic securities market include:

- Re-introduce market-based funding operations grounded in a reliable borrowing plan that reflects cash flow and market liquidity forecasts: complementing these operations with pro-rated allocations method at the first step of the reform process could signal increased predictability to the market through the establishment of a consistent allocation policy;
- Widen the investor base by ensuring that government borrowing activities are transparent and predictable: Maldives' foreign bond issue and solid credit ratings justify lifting restrictions on non-resident investors, though the risk of introducing foreign investors into an illiquid market should be considered; and
- Create a strategy to gradually build a yield curve and include it in the medium-term DMS: to reduce refinancing risk and build a reference yield curve over the medium-term, intermediate maturities (i.e., 2- and/or 3-year bonds) could be introduced. Future issuances should be performed via a newly established auction system and not through private placement.

These and other recommendations are detailed in the conclusions of each of the four chapters of this report. Annex 1 presents a proposed action plan based on the identified reform priorities and recommended actions. The team discussed the key findings of this report in a final meeting with the authorities, and the World Bank stands ready to provide further technical assistance to support the implementation of the next round of reforms.

BACKGROUND

Debt Management in Maldives: The Findings of the Debt Management Performance Assessment (DeMPA)

The first Debt Management Performance Assessment (DeMPA) for Maldives was conducted in 2009, and a second DeMPA was completed in March 2019.² The authorities have taken important steps to improve debt management since the first assessment, but many challenges remain. The government has implemented a series of reforms to public financial and debt management, including changes to the legal and institutional framework. Key measures include a complete overhaul of Treasury operations, the implementation of the Integrated Financial Management Information System (IFMIS) across all government entities in the capital, Malé, the establishment of a Treasury Single Account, and the development of cash-flow forecasting procedures. The coverage of the Commonwealth Secretariat Debt Recording and Management System (CS-DRMS) has also been expanded, and the CS-DRMS is now used as a central database for almost all debt obligations, except Islamic finance instruments. The results of the 2019 DeMPA shed light on these improvements and indicate areas for further action.

In the area of governance and strategic development, the RMDMD now produces a medium-term DMS on an annual basis. The DMS is aligned with the Medium-Term Fiscal Framework (MTFF) produced by the Fiscal Affairs Department (FAD). In early 2019, the functions of the RMDMD were reorganized according to a front office/middle office/back office (FO/MO/BO) model. The RMDMD is now responsible for the preparation, coordination, and monitoring of government guarantees in collaboration with the Public Enterprise Monitoring (PEM) agency (secretariat to the Privatization & Corporatization Board). However, fragmented and sometimes contradictory legal provisions continue to pose an important challenge. The legal framework does not specify core debt management objectives, define the purposes of borrowing, or establish reporting requirements. While the DMS is updated annually, it lacks clear targets for interest rates, refinancing, and foreign-currency risks. The organizational arrangements for coordinating and monitoring government funding operations are inadequate and not aligned with DMS targets. Annual reports on DMS implementation and debt management operations are not prepared.

Coordination with macroeconomic policy has also improved. The MoF and MMA frequently share information on actual and projected debt transactions and cash flow. Prudent legal limits have been imposed on advances from the MMA, and these limits are strictly adhered to. However, remaining weaknesses include the absence of an annual in-house debt sustainability analysis (DSA). Further improvements will be needed to ensure that high-quality forecasts of disbursement and medium-term debt-service obligations inform budget coordination.

² Because the DeMPA methodology was revised in 2015, not all indicators are directly comparable between 2009 and 2019.

Information on borrowing procedures and the terms and conditions of tap-issues (prospectuses) are available on the websites of the MMA and MoF. However, the annual borrowing plan for 2019, the auction calendar, and the terms of private placements are not publicly disclosed. Policy and procedures documents for external borrowing are inadequate. Limited analysis is conducted to determine the most beneficial or cost-effective form of borrowing (e.g., external versus domestic, guarantees versus on-lending, etc.). A switch to fixed-price taps in 2015 has prevented market mechanisms from functioning efficiently, and no periodic and systematic exchange of views with market participants takes place.

The quality of cash-flow forecasting has significantly improved. Cash flow is now forecast daily for the entire year. Monthly forecasts are also reasonably reliable. However, there is no clear link between estimated cash needs and the issuance of T-bills.

The government's debt records and operational risk management systems have been upgraded. The CS-DRMS database covers external, domestic, and guaranteed debt; it is up to date and subject to monthly backups. Government agencies have the workforce skills necessary to fulfill their debt-management roles and responsibilities, and the activities of the front and back offices with regard to external borrowing are adequately separated. However, procedures for controlling access to the debt-recording system and validating data entry are not comprehensive. The registry of government securities is not secure, as it utilizes Excel files with no access controls. The organizational structure for Islamic finance instruments is weak at both the MMA and the Back Office, and ex ante cost and risk evaluations and risk-monitoring procedures are inadequate.

1. THE LEGAL FRAMEWORK FOR DEBT MANAGEMENT

Sound Practices for Debt Management

The legal framework for public debt management comprises both primary legislation and secondary or delegated legislation. The former consists of laws enacted by the legislature, while the latter includes executive orders, decrees, and ordinances issued by the president, the line ministries, and other public agencies. A comprehensive legal framework should clearly define the roles and responsibilities of public agencies empowered to issue debt or execute other debt-related functions. Strict reporting and auditing requirements are necessary to promote transparency, discipline, and accountability. An adequate legal and regulatory foundation for debt management helps to ensure the effective management of borrowed funds and promote public debt sustainability.

The primary legislation should clearly authorize the appropriate executive-branch authority (e.g., the president, council of ministers, or minister of finance) to borrow funds and issue loan guarantees on behalf of the central government. The secondary legislation may delegate further debt-related functions to the executive agencies. The legal framework should explicitly encompass borrowing on both domestic and foreign markets and the issuance of loan guarantees. The clear delegation of authority is essential to ensure adequate internal controls and due diligence. All creditors and lenders must have legally binding and enforceable contracts with the central government in its capacity as the borrower. The primary legislation on debt contracting is normally found either in the general public finance act or in a dedicated debt law.

The primary legislation should also define the specified purposes for which the executive branch can borrow. These purposes may include, for example, financing budget and cash-balance deficits, refinancing and pre-financing outstanding debt, financing investment projects approved by the legislature, honoring outstanding guarantees, and fulfilling requirements by the central bank to replenish foreign-currency reserves or issue government securities to support monetary policy objectives. Defining borrowing purposes in the primary legislation can help prevent borrowing to finance speculative investments or expenditures that are not included in the annual budget and have not been approved by the legislature.

Furthermore, the primary legislation should set forth clear objectives for debt management and mandate the creation of a debt management strategy. It should also contain provisions on debt reporting, including the evaluation of outcomes against the government's stated objectives or the predefined goals of the debt management strategy. Debt-management objectives commonly found in modern legislation include meeting the funding needs of the central government, minimizing the cost of debt from a medium-term or long-term perspective, keeping the risks in the debt portfolio at acceptable levels (Box 1), and promoting the development of the domestic debt market. Once these objectives have been established, they must be translated into a detailed medium-term strategy backed by appropriate transparency requirements and accountability mechanisms.

Box 1: Measures of Risk in the Government's Debt Portfolio

Interest-rate risk

Interest-rate risk refers to the vulnerability of the government's debt portfolio, and the cost of government debt, to higher market interest rates when the interest rate on variable-rate debt or maturing fixed-rate debt is being re-priced. The following indicators measure the government's exposure to this risk:

- The amount of the debt stock that is re-fixing its interest rate in a given period
- The share of debt in the debt portfolio that is re-fixing its interest rate in a given period
- The average time until re-fixing for the debt portfolio, measured as the weighted average time until all principal payments in the portfolio become subject to a new interest rate

Refinancing (rollover) risk

Refinancing risk captures the exposure of the debt portfolio to unusually elevated interest rates when debt is being refinanced. In extreme cases, when this risk is too high, debt managers are unable to roll over maturing obligations. The following indicators measure the government's exposure to this risk:

- The redemption profile of the outstanding debt
- The share of the debt stock coming due within a given period
- The ratio of debt coming due to tax revenues
- The average time to maturity, measured as the weighted average time to maturity of all the principal payments in the portfolio, which indicates the average time it takes to roll over the debt portfolio

Foreign-exchange-rate risk

Foreign-exchange-rate risk reflects the vulnerability of the debt portfolio, and the government's debt cost, to a depreciation/devaluation of the domestic currency on international markets. The following indicators measure the government's exposure to this risk:

- The share of foreign-currency-denominated debt in total debt
- The mismatch between the level of foreign-currency-denominated liabilities and foreign-currency reserves
- The mismatch between the composition of foreign-currency-denominated liabilities and foreign-currency reserves

It is good practice to define government guarantees and the corresponding instruments (e.g. indemnities, letters of comfort, or primary and secondary on-lending contracts) in the regulatory framework. Guidelines for public finance or debt management help distinguish between the different types of instruments, their purposes, and their uses. It is also recommended that guarantees and the underlying loans between the borrower and the lender be designed to limit the government's risk exposure and to reserve the government's right to recourse (i.e., to retain a claim on the borrower) if the government has made payment of the guaranteed amount in whole or in part. For these reasons, it is recommended that the government's legal and financial counsel always be consulted during the drafting of the underlying loan agreements as well as the guarantee documents.

It is also common practice to require that a risk assessment be conducted before issuing loan guarantees or engaging in on-lending. Based on this assessment, a risk premium can be levied upon the beneficiary of the loan guarantee or the on-lending. If the central bank is acting as a debt-management agent, the agency relationship between the central bank and the central government should be specified in an agency agreement and published.

Legal Framework in Maldives

In Maldives, the key legal documents regulating central government debt management and related operations are the constitution, the Public Finance Act (PFA), the Fiscal Responsibility Act (FRA), and the Public Finance Regulation (PFR).³ The constitution empowers the president to borrow on behalf of the state. The PFA authorizes the lending of public funds by the president or by the minister of finance with the approval of the president.⁴ It also specifies that government borrowing, and the issuance of government guarantees, shall be based on proposals made to the minister of finance in accordance with the PFA. The minister of finance shall analyze the proposal and prepare the relevant documents for presidential approval. The PFA also requires the government to inform the legislature within 90 days regarding any new borrowing approved by the president. The report must be sent by the minister of finance to the legislature, and it must include an assessment of the borrowing proposal conducted prior to the processing of the borrowing agreement.

The FRA stipulates that the minister of finance shall present an annual statement to the legislature on the government’s medium-term fiscal and debt-management strategies. This statement shall be submitted each July and shall propose actions by the government to ensure that the public debt stock⁵ remains at a sustainable level within the period referred to in the budget statement. It shall also specify the key elements of the medium-term debt strategy, including public debt targets, both in nominal terms and as a percentage of GDP; the relative shares of external and domestic debt in the debt portfolio; current and planned measures to address debt-related risks; and plans for the utilization of borrowed funds.

Importantly, the FRA establishes recommended limits for borrowing from the Maldives Monetary Authority (MMA). The government can borrow from the central bank as an advance, on condition that the amount be repaid within 91 days and that the advance be subject to an interest rate not below the prevailing market interest rate. Moreover, such borrowing should not exceed 1 percent of the average revenue of the past three years. However, the Ministry of Finance (MoF) ceased borrowing from the MMA

³ The annual budget statement presents statistics on the outstanding stock of government debt, the expected evolution of fiscal targets for the debt-to-GDP ratio, and trends in debt-service costs, but it does not refer to borrowing plans or indicate the government’s adherence to medium-term debt management strategy targets.

⁴ See the DeMPA report for further details.

⁵ The legal framework in Maldives does not formally define “public debt,” although the term is used in the FRA and PFA.

several years ago. Finally, the FRA also establishes several recommended fiscal rules, including a debt-to-GDP ratio ceiling of 60 percent.

The PFR stipulates that all borrowing and lending by the state, as well as the issuance of government guarantees, must be processed by the MoF and submitted to the president for approval. The PFR also lists specific requirements that beneficiaries of loans, on-lending, or state guarantees should present to the MoF, including the purpose of the loan and an analysis of the borrower's repayment capacity. It also establishes requirements for reporting new loans and guarantees to the minister of finance, the president, and the legislature within 30 days of the end of the quarter.

Issues and Recommendations

The Maldives' legal framework for debt management is fragmented across multiple pieces of legislation. Moreover, the existing legislation does not clearly define public and publicly guaranteed debt, identify the main objectives and purposes of government borrowing, establish reporting requirements beyond the highest government level, or mandate audits of debt-management activities. The primary legislation vests the president with the sole authority to borrow, lend, and issue guarantees on behalf of the state, but in practice domestic borrowing decisions for the issuance of government securities are delegated to the minister of finance. The only formal reporting requirement is that the legislature must be apprised of conditions for individual external loans and government guarantees issued by the president, and neither the primary nor the secondary legislation requires that debt-management activities be reported to the legislature or mandates that debt outcomes be evaluated against the approved medium-term debt management strategy.

Several legal provisions are unclear, while others are not implemented. For example, the FRA defines "total debt" as "total loans taken from external sources and loans taken by the Government from local sources," but articles of the same law refer to "public debt" without defining that term or clarifying its relationship to "total debt." Overall, the definitions used in the legal framework are vague and leave substantial room for interpretation regarding which categories of public and publicly guaranteed debt, direct guarantees, and/or contingent liabilities are included in the debt stock. The MoF reports only direct government debt and direct loan guarantees, creating a significant degree of ambiguity regarding other liabilities.

The FRA also envisages an annual ceiling on government borrowing and the issuance of government guarantees, but no such ceiling is currently included in the budget.⁶ Although the Debt Management Strategy (DMS) is produced and approved on an annual basis, there is no evidence that decisions about actual borrowing or the issuance of guarantees are based on the medium-term priorities set forth in the strategy. Rather, borrowing appears to be largely driven by debt management decisions.

The legal framework does not include policies for the issuance of guarantees or specify the type of economic or financial analyses and risk assessments that must be carried

⁶ The legislation refers to this ceiling as an "allocation of government debt and government guarantees in the annual budget" (FRA Chapter 10).

out before a guarantee is authorized. However, there are guidelines or rules for levying guarantee fees and for issuing guarantees. A more detailed assessment of the legislative framework for government guarantees is presented in Chapter 3.

The legal framework should be strengthened by consolidating all provisions for government debt management into a single chapter of the PFA. This chapter should cover all key elements of public debt management. To comprehensively address debt management, the PFA should: (i) set forth clear debt-management objectives; (ii) require the government to formulate, approve, update annually; and implement a medium-term DMS; (iii) specify the purposes of borrowing; (iv) mandate annual reporting to the legislature on debt and debt-related activities, including guarantees and on-lending, as well as an evaluation of outcomes against the objectives stated in the DMS; (v) require legislative approval of a guarantee framework/policy to guide decisions for issuing debt instruments, including mandatory risk assessments to be conducted before the issuance of guarantees or on-lending; (vi) define the broad roles and responsibilities of the president, the Cabinet of Ministers, and the minister of finance with regard to debt management, as well as any arrangements for formal coordination between them, with further details provided in the secondary legislation; and (vii) clearly delegate authority to the minister of finance to make borrowing decisions related to the issuance of government securities, with funding requirements established in the annual budget law. These and other recommended amendments to the legal framework are detailed in Annex 4.

These recommendations are not intended to limit the president's authority over the approval of debt operations. Rather, this additional legislation would establish a framework for guiding debt-management decisions and preparing the supporting analysis. A sound legal framework would enable a more transparent delegation of authority and establish clear decision-making criteria for managing government debt.

The legal framework does not specify the rationale for providing guarantees, and there are no guidelines or criteria for government officials to determine the eligibility of guarantees. Such guidelines should clearly distinguish between similar financial instruments (e.g., letters of guarantee, letters of comfort, etc.), and they should be published. Guarantees have also been issued without prior risk assessments of either the project or the borrowing entity. Statistics on guaranteed projects are not available, and there is no formal mechanism for monitoring the performance of guarantees. A sound framework for issuing and monitoring guarantees should include a risk-assessment mechanism, policies for guarantee fees, and mandatory reporting requirements. This framework is necessary to ensure that only economically viable projects receive guarantees.

The legislation should also include contractual provisions to limit the government's risk exposure.⁷ These provisions should ensure that: (i) the government does not take risks to cover costs arising from actions taken by the beneficiary that are illegal or negligent, or from the beneficiary being legally released from its obligations; (ii) the legal framework

⁷ Some of these provisions were included in the December 2017 Government Decree (Public Finance Regulation (nr.2017/R-20)

mandates reporting on the implementation of guaranteed projects to mitigate the risk of default; (iii) the legal framework allows for possible remedial actions; (iv) each guarantee contract includes maximum financial limits on the claim; (v) guarantees are not transferable; and (vi) the government reserves the right to mitigate the costs of any future recourse through, for example, a counter-guarantee or a requirement that the public entity not engage in negative pledges.

This analysis yields two short-term recommendations and two medium-term recommendations. In the short term, the government should: (i) draft an amendment to the PFA law establishing a comprehensive framework for debt management; and (ii) draft appropriate primary legislation defining high-level objectives for debt management, establishing design, approval, implementation, and reporting guidelines of the DMS, and specifying policies for credit risk assessments and fees for government guarantees. Over the medium term, the government should: (i) produce a decree approving secondary regulations to guide the authorities in implementing the amended laws; and (ii) publish detailed procedural instructions to support the adoption of the secondary regulations.

Box 2: Formulating and Implementing Fiscal Rules

Fiscal rules are most successful when implemented by governments with a strong commitment to fiscal responsibility, robust policy credibility, and resilient institutional underpinnings. The first element depends to a degree on reform momentum. The second reflects a reputation developed by the government over time. The third element requires establishing the proper institutional capabilities to fulfill the new mandates and responsibilities created by the fiscal rule.

Fiscal rules are diverse, but they can be grouped into three categories. The most common fiscal rule is a balanced-budget rule, which constrain the size of the deficit and thereby control the evolution of the debt ratio. The second most common is a debt rule, which limits how far the sovereign's aggregate debt exposure can rise. The next most popular rule is an expenditure rule, which imposes bounds on how fast spending can grow. Finally, the least popular rule is a revenue rule, which targets a minimum amount of fiscal revenue.

Vigilance in implementation is vital to the long-term success of a fiscal rule. Policy slippages or the abuse of escape clauses can erode the effectiveness of a fiscal rule, and inadequate political commitment can lead to their abandonment. Sustained compliance is essential to the credibility of fiscal rules, underscoring the crucial importance of political will.

Public communication with stakeholders can support sustained adherence to fiscal rules over the long term. The international experience shows that inadequate transparency around compliance can weaken the government's commitment to a fiscal rule. By communicating the nature and purpose of a fiscal rule to the public and other stakeholders and regularly publishing information on compliance, the authorities can build a broad consensus in favor of sustained adherence to the rule. By contrast, an opaque, excessively complex, or poorly publicized fiscal rule may be more easily ignored or discarded.

2. THE INSTITUTIONAL FRAMEWORK AND ADMINISTRATIVE CAPACITY

Sound Practices for Organizing Debt Management Institutions

Responsibility for implementing debt management operations should be centralized in a dedicated debt office. This office should be responsible for managing external and domestic government debt and guarantees. In many countries, management of on-lending operations is also part of debt management office responsibilities. According to international standard practice, the debt office should be organized according to the financial industry's standard FO/MO/BO model. This model is widely regarded as an efficient means of dividing debt management functions and a solid foundation for robust internal controls (Figure 1).

Figure 1: Simplified Diagram of the Relationship between Processes and Responsibilities within the Debt Office

The FO/MO/BO model is based on a strict segregation of functions. The FO enters transactions in the debt system. The BO confirms these transactions and is responsible for payments, accounting, and reporting. Within the BO, there is a clear division between the staff responsible for confirming transactions and staff responsible for initiating payments. The MO is typically responsible for preparing debt simulations under various scenarios to inform the debt management strategy, forecast the trajectory of debt service, and monitor risks.

Table 1: The Division of Responsibilities under the FO/MO/BO Model

Front Office
<ul style="list-style-type: none">• Preparing the debt management strategy and updating it annually in collaboration with the MO• Preparing an annual borrowing plan and updating it on a monthly basis in collaboration with the MO and the cash-flow forecasting unit• Negotiating borrowings according to an approved borrowing plan• Producing prospectuses for domestic securities borrowing• Deciding or advising on the acceptance of borrowing proposals• Engaging with domestic and international market participants and managing investor relations• Interacting with rating agencies• Entering all loans and disbursements in the debt management system• Participating in the drafting of an annual report

Middle Office
<ul style="list-style-type: none"> • Preparing the debt management strategy and updating it annually in collaboration with the FO • Preparing an annual borrowing plan and updating it on a monthly basis in collaboration with the FO and the cash-flow forecasting unit • Preparing forecasts on borrowing and debt service to inform budget preparation • Monitoring planned and actual borrowing to ensure conformity with the approved guidelines • Engaging in operational risk management • Preparing an evaluation section for inclusion in the annual report
Back Office
<ul style="list-style-type: none"> • Confirming loans and disbursements entered into the debt management system by the FO and register other types of information in the system • Keeping timely, comprehensive, and accurate records of outstanding government debt, guarantees, and lending operations • Initiating and preparing debt-service payments • Entering information on borrowing and debt service into the accounting system • Preparing and publishing quarterly debt reports • Preparing and publishing annual debt reports in collaboration with FO and potentially the MO on an as-needed basis • Securely storing all original loan contracts and debt-administration records

The Institutional Arrangements for Debt Management in Maldives

The government has recently reorganized its debt management operations according to the FO/MO/BO model. All three offices are under the authority of the RMDMD, which is part of the MoF (Figure 2).

Figure 2: Simplified Organogram of the Ministry of Finance

However, the responsibilities of the three offices are not fully aligned, potentially undermining efficiency and weakening internal controls. The FO is responsible for relations with external lenders, including the international financial institutions (IFIs), as well as borrowing and grants management and the monitoring of externally funded projects. However, the FO is not involved in domestic loans, including securities issuance. Analyses of borrowing and guarantee proposals are conducted by the MO with limited involvement of the FO. MO and staff from the Fiscal Affairs Department (FAD), have on an ad hoc basis been involved in sovereign bond issuance. The MO is currently responsible for the analysis of credits subject to a proposed guarantee, though this duty is expected to be transferred to the FO. The BO is responsible for BO and FO duties concerning Islamic financing instruments. Finally, the Treasury and Public Account Department (TPAD) is responsible for domestic securities borrowing, but actual transactions are processed by the MMA.

Due to weaknesses in the institutional framework, multiple FO functions are conducted by other entities, both within and outside the RMDMD. The functions of the MO and BO are also fragmented across other agencies, though to a lesser degree. The authorities have taken steps to address these issues, such as making the FO responsible for entering loan transactions into CS-DRMS, with confirmation provided by the BO, in line with good-practice principles for internal control. In addition, the BO now performs accounting functions by entering the transactions into SAP (IFMIS, which should minimize the risks of misreporting transactions. The establishment of the MO itself is an important improvement, which was also recommended as part of the first debt management reform plan TA. However, the mission also recommended that grants management and project monitoring be removed from the purview of the RMDMD, but this recommendation has yet to be implemented.

Issues and Recommendations

Demonstrating a Clear Commitment to Reform

While Maldives' debt management operations have been reorganized several times, the country's institutional arrangements are still far from good practices. The country's sizeable and increasing debt stock underscores the urgency of further reforms to improve the efficiency of debt management. These reform efforts should reflect the seriousness of the debt situation, signaling to market participants the MoF's commitment to prudent debt management. In line with good-practice principles, debt management operations should be centralized within RMDMD. The RMDMD should focus exclusively on core debt management functions and not be burdened with institutional responsibilities outside this purview. The MoF should clearly communicate its intention to fully align debt management with the FO/MO/BO model, which will require enhancing FO capabilities and strengthening internal controls, inter alia. MoF staff should be sensitized on the planned changes before further organizational reforms are implemented.

Building Staff Capacity

The FO lacks the capabilities necessary to execute all its prescribed functions, and these capacities are not present elsewhere in the public administration. Aligning the structure of the RMDMD with international sound practices will require a comprehensive FO-focused training program. This program should include training in: (i) the use of Excel spreadsheets; (ii) the typical loan products offered by IFIs and bilateral creditors; (iii) domestic debt instruments and borrowing techniques, including Islamic finance instruments; (iv) loan-negotiation protocols, especially for commercial loans; and (v) basic bond-pricing mathematics.

Creating a Procedural Manual

The RMDMD's procedural manual should be revised to reflect the new division of responsibilities between the FO, MO, and BO, as well as good practices for debt management operations. The revised procedural manual should clearly assign responsibility for different functions to the FO, MO, and BO. For example, the FO's responsibility for entering transactions in the CS-DRMS should be strictly separated from the BO's responsibility for confirming those transactions in the system. Within the BO, the staff responsible for confirming transactions should be clearly separated from the staff responsible for initiating payments.

The procedural manual should define processes and operations in nine key areas. These include: (i) developing debt management strategies and debt projections; (ii) preparing borrowing plans, including debt-service projections; (iii) issuing T-bills; (iv) issuing guarantees; (v) recording, confirmation, and accounting; (vi) debt servicing and interest-rate fixing; (vii) debt reporting; (viii) other forms of reporting; and (ix) preparing contracts for domestic borrowing, domestic bonds, domestic bank credits, external commercial borrowing, sovereign bonds, commercial loans, external project borrowing, and on-lending.

Aligning the Authorizations in CS-DRMS with the Institutional Division of Responsibilities

To fully realize the benefits of the FO/MO/BO model, the CS-DRMS should be set up to reflect the segregation of duties between offices. The CS-DRMS can be aligned with the institutional division of responsibilities by clearly allocating user rights in the system and, therefore, enhancing internal controls. There are four user roles in CS-DRMS: (i) "super admin," who has the right to set up all other rights and authorities in the system: this role is allocated to the head of the RMDMD; (ii) "admin," who has the right to authorize entries and assign all related rights: his role is allocated to the head of the BO, two BO assistant debt management executives, and the head of the MO; (iii) "editor," who has the right to enter and modify information and assign all related rights: his role is allocated to the staff of the FO and BO; and (iv) "viewer," who has the right to view data but may not alter it: all staff of the RMDMD has this right.

The transaction flow for a new external loan is as follows. After signing a new loan agreement, the FO first produces a physical term sheet for the loan. The term sheet is

checked and signed by BO. The FO enter the loan details in the CS-DRMS. The entry is checked by the BO against the term sheet and the loan agreement, and the check is noted in the term sheet. The entry is then displayed in the CS-DRMS as “pending authorization.” The head of the BO authorizes the entry against the term sheet and the loan agreement, and the status of the entry becomes “active.” At this point, the details of the loan cannot be modified by the FO. Disbursements are entered into the system by the BO and are authorized by BO staff with “admin” authority, i.e., the head of the BO or the assistant debt management executives. The details of domestic securities (mainly T-bills) are entered manually in the CS-DRMS by BO staff based on reports from the MMA, and these entries are authorized by the BO’s assistant debt management executives.

Debt service projections are based on an annual report produced by the BO. It shows the details of the debt service projections. The BO checks creditor invoices against the report and against the CS-DRMS. The BO produces a physical payment order and enters the transaction into IFMIS. The payment order is checked by both the assistant debt management executives and the head of the BO. The documents are submitted to the MoF’s Finance and Accounting Section, which signs the documents and authorizes the payment in IFMIS.

The main problem with this transaction process is the broad authority granted to the “admin” role. As noted above, this role devolves on the head of the BO, the BO’s two assistant debt management executives, and the head of the MO. The “admin” can enter data for a loan, modify those data, and also authorize it. It may be preferable for the “admin” role to exclude editing functions, as is typical in commercial systems. This would require that all loan entries, including disbursements and domestic borrowing, be entered by the FO, which is also a best practice in commercial systems. An alternative means of entering domestic transactions is through an automatic uploading protocol with built-in securities features. For data that must be entered by the BO, (e.g., data on exchange rates), the responsible BO staff should have “editor” instead of “admin” rights, and these rights should be granted with caution. For instance, if there are errors in the database concerning the terms and conditions of a loan and a staff member with “admin” authority has approved changes to the database, those changes should be entered by the FO, not the BO.

Transferring Responsibilities

Based on the revise procedural manual and the prospective adjustments to user authorities in the CS-DRMS, the RMDMD should perform a gap analysis to identify how its current procedures deviate from sound practices. These gaps may indicate areas in which responsibilities should be transferred (Figure 3). In some cases, current procedures should be moved to another section in the same department or to other departments or ministries. For example, since the MoF’s Corporate Affairs Department has formal responsibility for matters of protocol, official contacts with the creditors could be managed by this department. A project-monitoring unit has been established at the Ministry of Planning and Infrastructure and is currently developing and implementing software to facilitate its operations. This unit could assume responsibility for monitoring externally financed projects, which is currently under the purview of the RMDMD. The gap analysis should also identify debt management operations currently outside the RMDMD, such as

those being conducted by TPAD, and consider centralizing them in the RMDMD. Once a gap analysis has been undertaken, and after agreeing with other departments and ministries on how to allocate responsibilities, the RMDMD should draft modifications to its mandate and prepare new job descriptions.

Figure 3: Indicative Areas for Transferring Responsibilities

The process of drafting and adopting a new mandate and new job descriptions will likely be lengthy. The process would be managed by the MoF’s Human Resource Department and would involve the Minister of Finance, the President, and the Civil Service Commission. However, a revision of procedures *within* the RMDMD could be implemented under the current mandate. This revision should be based on an internal process for transferring and receiving the current procedures between administrative units within the RMDMD. When the new mandates and job descriptions have been approved and adopted within the RMDMD, the lengthier process of transferring responsibilities between other departments and ministries can begin.

The analysis yields seven recommendations, all of which can be implemented in the short to medium term. To strengthen Maldives institutional framework and administrative capacity for government debt management, the authorities should: (i) commit to implementing a standard FO/MO/BO model with enhanced FO capabilities and sensitize MoF staff on the planned changes; (ii) develop a training program focused on FO activities to support the new organizational structure; develop a revised procedural manual that reflects the standard FO/MO/BO model; (iii) revise the authorization process for the CS-DRMS users, e.g. by reallocating editing authority to the “admin” role; (iv) perform a gap analysis to determine which procedures should be moved to other units with the RMDMD or to other departments and ministries, and identify debt management operations conducted in other departments or ministries that could be centralized in the RMDMD; (v)

develop and implement a process for transferring procedures between units within the RMDMD; (vi) begin the process for transferring responsibilities to and from departments and ministries outside the RMDMD; and (vii) draft and approve new mandates and new job descriptions based on the revised allocation of responsibilities.

3. THE MANAGEMENT FRAMEWORK FOR GOVERNMENT GUARANTEES AND CREDIT-RISK ANALYSIS

Sound Practices for Managing Government Guarantees

Government guarantees can be a useful tool to channel financial resources to development priorities by improving the loan terms and conditions available to guarantee recipients. The recipients of government guarantees are often specialized enterprises engaged in public works and thus playing an important role in delivering certain public services. While government guarantees can serve a unique strategic purpose, they can also be a major source of fiscal risk.

International sound practices require a clearly defined and transparent legal and regulatory framework to govern the issuance of government guarantees. Transparency can help strengthen discipline and accountability and mitigate the fiscal risk associated with guarantees. Guarantees management should be grounded in a consolidated policy document that defines: (i) the authority to issue guarantees and their purpose; (ii) eligibility criteria for guarantee applicants; (iii) the type of risk assessment required before a guarantee is issued; (iv) the fees to be charged to all guarantee recipients; (v) the reporting, monitoring, auditing, and publication requirements associated with guarantees; and (vi) the limits on issuing guarantees.

Several approaches can be used to define eligibility criteria for guarantee applicants. If guarantees are statutorily restricted to state-owned enterprises (SOEs) and/or subnational governments, the authorities may prepare, publish, and regularly update a list of SOEs and or subnational governments that are eligible for guarantees based on their financial strength. The government agency sponsoring the guarantee may also be requested to demonstrate that the project cannot be financed without government assistance and that the cash flow generated by the project will be adequate to cover the repayment of the debt plus interest and operating costs. To be eligible for a guarantee, the project and its economic assessment should be demonstrably linked to priorities in the national development plan.

Guarantees themselves must also be subject to a rigorous ex ante evaluation. Before approving a guarantee, the authorities should ensure that: (i) the guarantee complies with the law; (ii) the project benefiting from the guarantee has been chosen in the normal planning process, and the company undertaking the project has been chosen in a fair competition; (iii) the government has acted to limit the cost and risk of the guarantee and, if appropriate, will charge a fee for it; (iv) the guarantee does not breach any budget limits; (v) the guarantee has greater net benefits for the country than alternative uses of the government's money, including other kinds of subsidies; and (vi) the guarantee is transparent and well targeted, and the guarantee contract will be made public, along with a description of its possible fiscal implications.⁸

Sound credit-risk assessments are necessary for guarantees to function properly. There are different techniques for credit-risk assessment, but all require an in-depth

⁸ Government Guarantees. Timothy C. Irwin. The World Bank. 2007. Page 111

knowledge of the beneficiary’s financial strength. In addition, the project’s feasibility must be analysed, with a detailed cash-flow analysis that specifies any critical financial assumptions. Some analytical tools use macroeconomic scenarios, sectoral models, and performance indicators or other statistical data to calculate the probability of a default. A credit-risk analysis for government guarantees should encompass: (i) macroeconomic risks, including overall expected economic growth; (ii) industry-wide risks, including industry-specific growth trends, market-structure and competition indicators, and the industry’s cyclicalities; and (iii) a firm-level risk assessment, including the scale, scope and diversity of the company, its operating efficiency, profitability, and financial risk profile, including a cash-flow model.

Risk assessments must estimate the “averaged loss” for each scenario in the cash-flow model. The averaged loss is the basis for calculating the required guarantee fee. The averaged loss reflects the probability that the actual outcome will be worse than projected outcome in each scenario, and the “potential loss” indicates the size of the anticipated deviation in nominal terms. The process for calculating the averaged loss involves six steps: (i) create a series of scenarios of increasing severity; (ii) use the cash-flow model to estimate the potential loss in each scenario; (iii) estimate the probability of the actual outcome being worse than the scenario; (iv) take the difference between the probability of a scenario and the probability of the next most severe scenario: this is the probability that the loss will be in the range between the two scenarios; (v) multiply the scenario’s potential loss by the probability of the loss being in this range; and (vi) sum the probability-weighted losses to obtain the averaged loss (Table 2). The concepts of averaged loss and potential loss apply to both individual guarantees and portfolios of guarantees.

Table 2: Example of the Estimation Process for Averaged Loss

Scenario	Traffic Volume Relative to Plan	Potential Loss (EUR)	Probability of Actual Outcome Being Worse than Scenario	Probability of Loss Being in this Range	Probability Weighted Loss (EUR)
#0	100%	0	80%	40%	0
#1	85%	0	40%	25%	0
#2	70%	12	15%	10%	1.20
#3	55%	140	5%	4%	5.60
#4	40%	356	1%	1%	3.56
Averaged Loss			10.36		

To mitigate the possibility of financial claims arising from the triggering of government guarantees, the government should charge a guarantee fee that reflects the outcome of the credit-risk assessment. If this fee is smaller than the averaged loss⁹

⁹ The more technical statistical term for Averaged Loss is Expected Loss. However, “Expected” may suggest referring to a most likely outcome rather than the mean. Therefore, the term “Averaged” is less misleading to non-technical audiences. The Averaged Loss quantity is the mean loss amount on the guarantee, averaged over all possible outcomes and weighted by the probability of each level of loss.

estimated for the guarantee, the government is effectively subsidizing the beneficiary of the loan guarantee. According to international sound practices, such differences between the averaged loss and the guarantee fee should be treated as a subsidy, and a payment should be made from the budget into a dedicated fund¹⁰ to cover the future costs of the guarantee.

Establishing a contingency fund or guarantee fund can help protect the budget against the risk of guarantees being called. This type of fund has two components: (i) the sum of averaged losses, which will be fully used to pay for called guarantees; and (ii) the potential loss, which represents a hedge against the losses that could occur in worse-than-expected circumstances. According to sound practices, the average-loss component of the account should be fully funded, while the additional potential-loss component should be consistently monitored to ensure that the government has sufficient resources, or borrowing capacity, to cover potential losses in a worst-case scenario.

The risks to the government arising from on-lending are largely the same as those arising from loan guarantees. On-lending creates a potential contingent liability, or contingent loss of an asset. Therefore, the risk-assessment and approval processes for guarantees and on-lending should be harmonized.

Regular reporting and strong transparency and accountability mechanisms are crucial to effectively manage guarantees. The International Public Sector Accounting Standards and other best-practice guidelines recommend that countries disclose guarantees in their budget documentation and their reports to the legislature. These reports should also include information on the type of guarantee (e.g., the creditor, residency classification, instrument, currency, interest-rate basis, and original and residual maturity), the beneficiary, and the amount outstanding at the beginning and end of the reporting period, as well as the amount already amortized. Some basic risk data should also be included, such as the guaranteed-debt-to-GDP ratio, the ratio of guaranteed loans in foreign currency to total guaranteed debt, and the share of total guarantees triggered over the past five years.

Implementing a guarantee policy requires a documented set of procedures. These procedures should detail all the responsibilities of the involved staff and institutions. A procedural manual should clearly indicate the steps for all key processes in the guarantee-management cycle, including: (i) checking compliance with existing policies and regulations; (ii) assessing credit risk; recording, reporting and disseminating information on outstanding guarantees; (iii) monitoring credit risks and updating risk evaluations for both the stock of outstanding guarantees and the flow of new guarantees; and (v) guarantee calling and recovery procedures.

Government Guarantees and Credit-Risk Analysis in Maldives

The outstanding stock of government-guaranteed debt has increased significantly over the past two years and reached 11,499 million Maldivian rufiyaa (MVR) at end-December 2018 (Table 3). The Housing Development Corporation (HDC), the State

¹⁰ The authorities must decide whether to make this fund a notional account or a cash account.

Trading Organization (STO), and the MMA are the biggest beneficiaries of government-guaranteed debt. Total outstanding loans on-lent to SOEs at end-December 2018 amounted to MVR 2.291 billion. Fenaka Corporation, Maldives Airports Company Limited (MACL), and the HDC are the biggest beneficiaries of government on-lent debt.

Table 3: The Evolution of Government Debt and Guarantees, 2014-2018

IN MVR millions	2014	2015	2016	2017	2018
Government Debt	31.324,00	33.297,00	38.129,00	43.785,00	48.007,00
External	10.746,00	10.204,00	11.727,00	16.677,00	20.343,00
Domestic	20.578,00	23.093,00	26.402,00	27.108,00	27.664,00
Government Guarantees	1.136,00	1.384,00	3.130,00	1.846,00	11.499,00
External	589,00	439,00	2.117,00	778,00	10.497,00
Domestic	547,00	945,00	1.013,00	1.068,00	1.002,00
As percentage of GDP					
Government Debt	55%	54%	56%	58%	58%
External	19%	17%	17%	22%	25%
Domestic	36%	38%	39%	36%	34%
Government Guarantees	2%	2%	5%	2%	14%
External	1%	1%	3%	1%	13%
Domestic	1%	2%	1%	1%	1%
GDP	56.867,00	61.566,00	67.837,00	74.866,00	82.504,00

Source: RMDMD, Ministry of Finance

The process of applying for a government guarantee is described in the RMDMD's procedural manual. When an SOE requires a guarantee, it must first submit a request to the MoF along with information on the loan and the financial soundness of the SOE. A description of the process and the list of required documents are available to all borrowing entities. Between 2012 and 2017, the RMDMD was responsible for this process. In 2017, responsibility was temporarily transferred to the Public Enterprises Monitoring (PEM) agency (secretariat to the Privatization & Corporatization Board), but in early 2019 it was returned to the RMDMD's FO. After assessing the guarantee request, the FO submits a recommendation to the minister of finance regarding whether or not to issue the guarantee, but the president gives final approval. As of end-2018, the government had issued 24 external guarantees with a total original outstanding value of US\$1.38 billion and one domestic guarantee with a value of MVR 3.0 million.

The government has an official policy guiding the issuance of guarantees,¹¹ but it is not followed closely. In principle, SOEs and firms registered or re-registered in Maldives may apply for guarantees to implement projects that have been prioritized by the government. In practice, however, the government generally approaches SOEs and encourages them to undertake specific investment projects, with a government guarantee offered as an incentive. This approach limits, albeit very liberally, the sectors in which a guarantee can be issued (e.g., tourism and social housing), and the portfolio of guaranteed projects is effectively determined by policymakers, not by the outcome of the project analysis. The RMDMD's MO reviews the financial terms of loans to ensure that the interest rate (the effective interest rate including the all in cost of financing excluding the variable

¹¹ The Guarantee Issuance Policy was published on 13 August 2017.

component) between the company and the financing entity in the loan agreement does not exceed 3.5 percent.

The guarantee policy's guidelines include the list of documents that applicants should submit with their request for a guarantee. A financial assessment of the requesting company is undertaken by the PEM and submitted to the RMDMD's FO. The project's feasibility study is reviewed and assessed by the line ministry in charge of the sector. In several recent instances, the MoF has approved guarantees that both the RMDMD and PEM advised against issuing. Furthermore, the policy mandates that guarantee applicants pay three fees: (i) a guarantee fee equal to 1 percent of the total amount guaranteed, which must be paid prior to the guarantee's issuance; (ii) an additional one-time fee of MVR 170,000 (about US\$11,000) to cover the cost of due diligence and administration; and (iii) an annual fee equal to 0.25 percent of the guaranteed amount to cover the cost of ongoing administration. In practice, however, the MoF has never requested that any of these fees be paid. Upon the issuance of guarantees, no contract is signed between the MoF and the beneficiary, and it is assumed that the policy will guide the financial relationship between the two parties. Therefore, there is no contractual obligation on the part of the beneficiary to pay any guarantee-related fees to the government. Finally, the policy contains no mention of monitoring, recording, reporting, auditing, limits on issuance, or dissemination requirements.

Under the guarantee policy, both the creditor and the beneficiary are required to inform the government of any problems affecting the repayment of the debt. In practice, every time an SOE has been unable to make payments, the government has provided a capital injection or other form of support to enable the SOE to service its financial obligations.

Some of procedures for issuing guarantees are contained in a manual prepared by the RMDMD,¹² but the manual is very limited in scope and does not include details on several basic processes. The section on guarantees is just one page long, and while it lists the steps applicant must follow, it does not include any specific procedures for granting different types of guarantee or describe how to conduct guarantee-specific analysis. Furthermore, the RMDMD and PEM lack the technical capacity to perform the required risk analysis for guarantee requests.

Issues and Recommendations

The government must develop a modern and robust guarantee policy backed by a clear and enforceable set of procedures for issuing government guarantees. The policy document should provide the necessary guidance in terms of the authority to issue guarantees, their purpose, the eligibility criteria, risk-assessment protocols, fees, monitoring, recording, auditing, limits on issuance, and dissemination requirements. A detailed procedural manual would guide staff through the process of: (i) checking compliance with existing regulations; (ii) conducting credit-risk assessments of both the project and the guarantee beneficiary; (iii) recording, reporting, and disseminating

¹² This manual was produced in January 2018 and updated in February 2019.

information; (iv) monitoring outstanding guarantees and updating credit-risk analysis of the stock of outstanding guarantees and the flow of new guarantees; (v) assessing and levying all guarantee-related fees; (vi) implementing calling and recovery procedures; and (vii) signing guarantee agreements.

A credit-risk analysis focused on the borrower's capacity to repay should be performed before every guarantee is issued, and the current practice of issuing government guarantees to nonperforming borrowers should be discontinued. If the result of a risk analysis is unfavourable, or if the beneficiary has previously shown that it cannot pay its liabilities on time, but there is a compelling national interest in implementing a certain project, the government may consider providing a subsidy or transfer instead of issuing a guarantee or on-lending. In these cases, a directly budgeted subsidy would be more appropriate from a technical standpoint, less expensive, and less administratively cumbersome. Using subsidies or transfers instead of guarantees or on-lending would also enhance budgetary transparency and make it easier to assess the fiscal impact of the decision and compare it against other expenditure priorities.

The government should strengthen its procedures for recording and reporting on outstanding guarantees and their underlying credit risks. Information on outstanding guarantees must be effectively compiled and verified for use in risk assessments, risk management, and stakeholder outreach. The government should produce periodic reports on outstanding credits subject to government guarantees.

Regularly monitoring outstanding guarantees is necessary to accurately assess their potential impact on the fiscal accounts. Regular and reliable credit risk assessments of outstanding guarantees can provide a sound basis for implementing appropriate corrective actions as necessary. These assessments should include an estimate of the credit-risk exposure in the portfolio and propose corresponding changes in credit risk fees, overall limits, or other variables.

Applying credit risk fees can also compensate the government for the staff time and resources employed in the process of granting the guarantee and help mitigate the risk of default. Credit risk fees should be effectively invoiced, collected, and reconciled. These fees should be calculated based on the actual credit outstanding, with invoices sent to the beneficiary and/or the creditor. Collected fees could be deposited into a contingency fund to hedge against default risks.

The MoF should develop or adopt a set of standard models for assessing the averaged loss and potential loss arising from guarantees. Example models were delivered to the MoF as part of recent World Bank technical assistance. Each guarantee should initially be assessed through a standard model. If details of the guarantee do not fit the standard model, the model may be adapted to suit the specifics of the guarantee. The standard model can also be used to check the results derived from another model (e.g., if the project sponsor's financial model was used to estimate the risk).

To obtain relevant inputs for the models, the MoF's macroeconomic modelling group could be asked to provide a range of four to ten scenarios of increasing severity to be

used to stress test the cash flows of the guaranteed recipients. In addition to current macroeconomic variables, the cash-flow models will also require scenarios for microeconomic variables (e.g., passenger demand in the transportation sector). The macroeconomic modelling group could extend their scenarios to include some of these additional factors. The scenarios should be updated on a quarterly or annual basis.

After approving a guarantee, there must be a mechanism to provide an early warning to the Treasury of any problems that may require it to intercede and make a payment.

The guarantee recipient must produce regular reports on its financial health and the likelihood that it will be able to make the next payment. This information should be provided in time for the Treasury to plan remedial actions if a payment is likely to be needed (i.e., two to four weeks before each payment is due). The update may consist of detailed financial information, color-coded indicators, or simply a formal statement from the beneficiary as to whether it believes Treasury assistance may be needed.

The application of the above risk models will help the authorities determine whether to accept a guarantee proposal and, if so, which guarantee fee to charge.

The models and underlying data should be managed carefully so that the results can be easily traced back to the models and the assumptions used. Each model should contain an “info” page that tracks all changes, with information on the affected data, a description of the change, who made the change, and a link to the changed cell. The distribution of results should include the date, name, and version of the model, as well as the scenario and the underlying data used. A standard format with the same colors and layout should be used for all models, including one input page for each scenario and one output page for the respective government payments. A software package should be used to back up and log all versions of the models, creating a central repository that allows users to trace back to earlier versions of the model.

The technical capacity of the staff involved in the issuing process should be strengthened. To carry out the necessary assessment of the company’s financial standing and the financial terms of the loan, the staff in charge of the guarantee process should be familiar with the approaches employed to conduct such analysis. The RMDMD’s renewed responsibility over the guarantee-issuance process should be complemented by training in risk-assessment techniques, including the estimation of averaged loss and potential loss, and by rigorous monitoring of the underlying fiscal risk in the guarantee portfolio.

The analysis yields three recommendations, all of which can be implemented in the short to medium term.

The authorities should: (i) develop a clear policy for issuing guarantees that defines the authority to issue guarantees, their purpose, the eligibility criteria, risk-assessment protocols, fees, monitoring, recording, auditing, limits on issuance, and dissemination requirements and implement all necessary measures to enforce strict compliance with this policy; (ii) create a new procedural manual that details all major processes involved in the issuing of government guarantees, including checking compliance with existing regulations, conducting credit-risk assessments of both the project and the company, recording, reporting, and disseminating relevant information, monitoring outstanding guarantees and updating credit-risk analyses of outstanding guarantees and guarantee flows, assessing and collecting credit-risk fees, implementing

calling and recovery procedures; and signing guarantee agreements; and (iii) train the relevant staff in the latest techniques for conducting credit-risk assessments of new guarantees and of the outstanding exposure in the guarantee portfolio.

4. THE DEVELOPMENT OF THE DOMESTIC CAPITAL MARKET

Sound Practices for Capital-Market Development

Domestic capital markets can serve as an important and stable funding source for both the public and private sector. A well-developed domestic capital market also facilitates the efficient allocation of financial resources. Moreover, capital markets are critical to effective monetary policy, as they enable the monetary transmission mechanism to function, and they can play a key role in risk management

The government is typically the single biggest borrower in the domestic capital market. The government can contribute to the market's development by ensuring that its domestic borrowing activities are conducted exclusively through market-based issuing techniques, such as competitive tap issues, auctions, and syndications. Because these techniques leverage competition between lenders or buyers of government securities, the resulting prices and interest rates reflect market dynamics and serve as benchmarks for the private sector.

A well-functioning capital market requires openness and transparency. All government borrowing should be undertaken in a public and predictable manner. Regular meetings should be held with market participants to exchange views on the direction of the borrowing program and on issues associated with domestic debt-market development.

The Domestic Capital Market in Maldives

Maldives' domestic capital market is an important funding source for the government. At end-2018, outstanding domestic debt constituted 46 percent of the government's total debt portfolio, up from 42 percent at end-2008, the reference point for the previous DeMPA. Between 2017 and 2018, net domestic borrowing ticked up by a modest 5 percent, while net external borrowing rose by 73 percent, and government-guaranteed debt increased sharply by 267 percent. Consequently, the share of domestic debt in total debt fell from 64 percent in 2016 to 46 percent at end-2018.

The government issues three types of securities: T-bills, Treasury bonds, and Islamic securities. T-bills with maturities of 28 days, 91 days, 182 days, and 364 days are issued on a discount basis. Treasury bonds are issued with medium- and long-term debt maturities (5-8 years), bullet redemptions, bearing quarterly, and semi-annual or annual coupons. Islamic securities (*mudharabah*, *murabaha*, and *sukuk*) are designed to comply with sharia principles by using profit-sharing or cost-plus financing as an alternative to interest and by refraining from investment in activities forbidden by Islamic law. Islamic securities in Maldives are exclusively issued on a private-placement basis.

Instruments with maturities shorter than one year represent 54 percent of outstanding domestic debt. T-bills account for 95 percent of domestic government debt, and the overwhelming majority of T-bill issuance is denominated in MVR, though some outstanding securities are denominated in US dollars or MVR-payments linked to the US dollar (Figure 4). The government's reliance on short-term T-bills leaves the debt portfolio

highly exposed to interest-rate volatility. As of end-2018, one-third of the government's debt stock was due for refinancing within 12 months.

Figure 4: Short-Term Domestic Debt by Instrument and Maturity, End-2018

Source: MMA

The remaining 46 percent of the government's debt stock consists of long-term domestic debt instruments. A 50-year Treasury bond issued by the MMA account for 49 percent of all outstanding long-term bonds,¹³ while the Pension Recognition Bond¹⁴ and several 5- to 8-year maturity pension bonds issued by the Maldives Pension Administration Office (MPAO) represent the other 51 percent.¹⁵ When the two large one-off bond issues are excluded, the average time to maturity of the domestic debt portfolio drops from nine years to one year.¹⁶

A 2015 Agency Agreement designates the MMA as the agent for the issuance of government securities. This agreement affirms the government's primary responsibility for managing its debt and cash flow. The MMA is also designated as the fiscal agent and registrar for all government securities issued, and it operates the central register of ownership.

In principle, funding operations can take place via auction, tap, or private placement, but in practice MVR-denominated T-bills are typically issued via taps, with terms fixed in advance. All other instruments are issued on a private-placement basis, with terms negotiated privately between the subscriber and the government. Funding operations are usually announced by the MMA each Wednesday following a formal funding request from the government. The following day, the MMA informs the government of preliminary interest, and the actual funding operation takes place three days later on Sunday morning. The bidding period closes at noon, after which the amounts offered for each maturity are presented to the government. The MMA then informs investors and the government of the results and publishes the auction's outcome on its website the same day. The authorities plan to move from weekly to biweekly funding operations during 2019.

¹³ The authorities converted the MMA's outstanding debt into a 50-year Treasury bond in December 2014.

¹⁴ In 2009, the government issued this bond to the MPAO to settle pensioners' retirement rights claims

¹⁵ The government's debt portfolio also includes long-term commercial loans, but they represent just 0.07 percent of the domestic debt stock.

¹⁶ See the MoF's *Public Debt Bulletin*, Issue 2, December 2018.

The market-based auction system, in which eligible investors are invited to submit competitive bids, has not been used since June 2014. Since then, weekly funding operations have been convened via fixed-rate taps with fixed interest rates for each maturity. Since November 2015, the rates have been fixed at 3.50 percent for 28-day, 3.87 percent for 91-day, 4.23 percent for 182-day, and 4.60 percent for 364-day T-bills. Eligible participants in funding operations include commercial banks operating in Maldives, SOEs, and firms established under the laws of Maldives. Transferability is limited to these eligible participants.

The investor base is highly concentrated, with a limited number of parties holding most of the government’s short-term and long-term securities. At end-2018, commercial banks held 64 percent of short-term government debt (Table 4). The small domestic banking sector includes just eight operational banks and is dominated by the Bank of Maldives Plc, State Bank of India, and, to a lesser extent, HSBC Holdings Plc. The MPAO holds about 32 percent of short-term government debt. The remaining 4 percent is split between SOEs, private investors, the MMA, and other financial corporations, including local insurance companies, a housing-development company, and a leasing company. At end-2018, the MPAO and MMA held all long-term government bonds.

Table 4: Holders of Treasury Bills and Islamic Finance Instruments, End-2018.

	MVR (million)	Share (percentage)
Commercial Banks	9,605	64.0
MPAO	4,782	31.9
Other Financial Corporations	235	1.6
SOEs	201	1.3
Private Investors	100	0.7
MMA	90	0.6
Total	15,014	100

Source: MMA, MPAO

The government’s current book-entry and payment systems are outdated. Government securities are issued in book-entry form, with the MMA acting as the registrar, and all records of the registry system are kept in Excel spreadsheets. The MMA is currently developing an upgrade to the central depository system as part of a new trading platform. This upgrade will assume all registry functions and is expected to be operational by the end of 2019.

Issues and Recommendations

As the government’s financing requirements continue to rise, its reliance on the domestic capital market is likely to increase. The credit-rating agency Moody’s changed Maldives’ ratings outlook from “stable” to “negative” in July 2018. One of the reasons cited for the downgrade was the risk that the outstanding foreign bond maturing in 2022 would have to be refinanced via the domestic market if the bond’s refinancing on the international market were to fail or if the cash buildup in the Sovereign Development Fund were to stall. In this context, the government is working with various stakeholders to develop the domestic capital market. Some of the major challenges, such as the concentrated investor base, are structural and may require significant time to overcome. However, the government can also directly address the high level of refinancing risk and

the lack of competitive pricing of government securities. Given the importance of the domestic capital market to the government, policymakers should consider taking a more active role in its development, especially on a technical level.

Reintroducing Market-Based Funding Operations

Competitive auctions give the government better control over its cash balances in line with good-practice principles. Because the government has kept the interest rate on T-bills fixed for the last few years, policymakers have had no control over the proceeds of funding operations in the primary market. Market forces were further restricted by the government's decision to always accept all bids from market participants, even if the bid amounts surpassed the amount offered. To deal with erratic tap results, the government had to keep additional cash buffers with the MMA and arrange overdraft facilities with commercial banks.

Reintroducing market forces by fostering an environment of competitive auction market-rate bidding entails risks for which the government must be prepared. The authorities should consider establishing a front office dedicated to domestic market operations and market development, staffed by specialists from the RMDMD and TPAD. This office should also work to improve coordination between domestic and external borrowing and ensure adherence to the medium-term risk framework, and it could help the government formulate priorities based on a detailed strategic plan for capital-market development that includes the reintroduction of competitive auctions and possibly the introduction of different auction methods. A training program may be necessary to build the capacity of the staff for this new office, and study tours could enable the staff to exchange experiences with debt officers in other countries, with a focus on market-based issuance and trading platforms and other aspects of capital-market development.

In parallel, the government should develop a detailed and accurate internal borrowing plan based on future cash needs. This plan should be updated on a weekly basis throughout the fiscal year, and it should serve as an essential component of the internal decision-making process for funding operations. The design of the borrowing plan should account for expected market liquidity. The plan should be based on a policy of meeting as much of the government's borrowing requirements through market-based operations as possible so as to maximize the share of domestic borrowing that takes place via competitive and transparent auctions. Issuance via private placements should be avoided.

Once accurate internal borrowing plans have been created, the amounts offered for each tranche should be published prior to each funding operation. These amounts should reflect the government's cash needs instead of the maturing tranches, as has been the practice in recent years. The government's preparations for market-based issuance should include a risk assessment and a plan to address any expected challenges. The authorities should consider adopting strict regulations to reduce the risk of collusion in the country's concentrated capital market, such as a code of conduct to be signed by all participants in the auctions. Other measures that could help prepare both the government and market participants to engage in competitively priced auctions include:

- *Prorating oversubscribed taps.* This requires a reliable borrowing plan based on realistic forecasts of cash flow and market liquidity. Consistently prorating allocations can bolster market confidence while improving predictability.
- *Reducing the frequency of funding operations from weekly to bi-weekly to monthly.* Less-frequent auctions oblige both the government and market participants to focus on cash-flow management, a requirement for pricing auctions. Over the medium term, conducting fewer auctions could also increase activity levels and promote price formation in the secondary market.
- *Experimenting with offering only one or two maturities per tap.* Instead of offering all maturities at every tap, offering only one or two maturities (e.g. 28 and 364 days) could avoid dilution by bundling the available demand, which will be especially important if demand weakens.
- *Offering only one popular maturity for the first competitively priced auctions.* The authorities could also consider imposing a pre-announced rate cap during the initial stages of the reintroduction of the auction system.
- *Replacing the current multiple-price auction system with uniform price auctions.* Under the current system, successful bidders pay the interest rate stated in their respective bids. Under the revised system, all successful bidders would pay the same price, which would be the cut-off price at which the market clears the issue.

Enhancing Market Engagement

To implement any of the adjustments described above, the authorities must closely coordinate with market participants. Government borrowing activities should be transparent and predictable. To give investors more time to plan their investments, the government should issue an annual borrowing plan at the beginning of each year that specifies the anticipated issuance amounts for each instrument. A more detailed borrowing calendar should be published each quarter stating the auction dates, the instruments on offer, and possibly the auction method. The government should adhere to all previously published information on its borrowing activities to build trust and credibility. For this reason, quarterly calendars usually refrain from specifying the exact amounts on offer at upcoming auctions for each tranche, as these amounts are subject to change.

As the government's agent, the MMA has been the primary day-to-day point of contact for market participants. Because the government is ultimately responsible for its own funding, the authorities should consider more actively engaging with market participants at the technical level via the front office. This approach is used in many other countries and may also be a suitable model for Maldives. The MMA is responsible for monetary policy, and it supervises most market participants. In this context, the following actions should be considered:

- *Arranging face-to-face meetings with market participants to introduce the 2019 borrowing plan and the new code of conduct.* The authorities could develop a regular schedule of meetings with market participants to exchange views about market developments, especially the introduction of the auction system.

- *Transferring responsibility for gauging the interest of participants in funding operations once a tap or auction has been announced from the MMA to the government.* Direct information sharing may contribute to a better understanding of the liquidity constraints facing market participants and could improve the borrowing calendar.

Widening the Investor Base

Given the concentrated market structure, the process of widening the investor base will likely be gradual, but the government can take steps to support market development at the margin. The authorities could make retail investors eligible to hold and trade government securities, and they could offer securities in smaller denominations. In addition, national savings certificates, mutual funds based on T-bills, and special distribution channels targeted at retail investors could help attract retail funds. However, broader retail involvement would require upgrading the current book-entry system. Given Maldives' foreign bond issue and its relatively strong rating from international credit-rating agencies, restrictions on nonresident investors could be removed, though the risk of introducing foreign investors into an illiquid market should be considered.

Developing a Plan to Build a Yield Curve and Integrate It into the Formal Medium-Term Debt Strategy

To reduce refinancing risk in the short term and build a reference yield curve over the medium term, the authorities could introduce securities with intermediate maturities. For example, 2- and/or 3-year bonds could be offered despite the higher interest rates they would entail. The currently outstanding bonds with 5- to 8-year maturities have been placed directly with the MPAO. Subsequent issuances should be performed through a newly established auction system and not via private placement. The MPAO may be amenable to rolling over a share of its T-bill portfolio to slightly longer maturities, given sufficiently attractive terms. Interviews with representatives of the two largest banks in Maldives suggest that the absence of a liquid secondary market is perceived as a major impediment to hold longer-term bonds.

Initiatives to promote secondary trading are underway, but the development of an active secondary market may take time. One approach to making longer-term bonds more attractive to commercial banks would be to require them as collateral for MMA liquidity facilities, either via short-term repos or open-market operations. As the MMA is currently allowing for ample liquidity in the banking system, this policy may not be needed at present. However, the potential future requirements of such a policy should be accounted for when upgrading the infrastructure and the policy environment. The tradeoffs between reducing refinancing risk, building a reference curve to support the development of the capital market, and mitigating the impact on borrowing costs should also be carefully assessed and used to inform the medium-term debt strategy.

This analysis yields four general recommendations, the first of which is to reintroduce market-based funding operations. In the short to medium term, the authorities should: (i) establish a front office dedicated to domestic market operations and market development and staffed by market specialists; (ii) develop individual and group training programs for

the front-office staff; (iii) set priorities for the development of the domestic capital market and formulate a plan to reintroduce auctions that includes a risk-assessment policy; and (iv) create an accurate internal borrowing plan based on future cash needs to serve as the basis for future market-based issuance. Over the medium term, the authorities should: (i) draft a code of conduct to be signed by all auction participants; (ii) prepare the market for competitively priced issuance by making well-coordinated adjustments to the funding operation; and (iii) offer only one popular maturity for the first competitively priced auction.

The second general recommendation is to enhance market engagement. Over the short term, the authorities should: (i) publish an annual borrowing plan and update it for each upcoming quarter; and (ii) create a more detailed borrowing calendar. Over the medium term, the authorities should: (i) organize periodic face-to-face meetings with key market participants to discuss the government's market-development strategy; and (ii) consider transferring responsibility for gauging the interest of participants in funding operations once a tap or auction has been announced from the MMA to the government.

The third general recommendation is to widen the investor base. Over the medium term, the authorities should: (i) make retail investors eligible to hold and trade government securities; (ii) offer securities in smaller denominations; and (iii) develop a revised policy on international investors.

The fourth general recommendation is to develop a plan to build a yield curve and integrate it into the formal medium-term debt strategy. Over the medium term, the authorities should: (i) introduce securities with intermediate maturities, such as 2- and/or 3-year bonds, preferably via a newly established auction system; and (ii) ensure that upgrades to the auction mechanism and trading platform meet future government requirements and are implemented as soon as possible.

ANNEX 1. MALDIVES DEBT-MANAGEMENT REFORM PLAN: LOGICAL FRAMEWORK

Issues/ Project Components	Actions	Indicative Timing	Expected Outputs of the Actions	Budget	Expected Outcomes of the Project Components	Lead Entity
1. Legal and regulatory framework						
No delegation of borrowing power to issuance of government securities	An executive order to delegate borrowing power from President to MOF to issue government securities within legal limits established in the Annual budget	2019	Executive order issued and published	Internal	Formalized delegation of borrowing role of the MOF	DMD/ Legal department
Fragmented and incomplete legislation relating to government debt management	RMDMD produces draft debt management chapter and proposal to amend debt component in the PFA in consultation with MoF legal department	2019	Draft debt chapter	Internal/P MF/DMF	Enhanced legal control of, and accountability for government debt management	DMD/ Legal department and AG Office
	RMDMD shares the draft for consultation with AG	2020	Revision of draft chapter for compatibility with the existing legal framework	MOF and Attorney General Office		
	Amend the draft after review, in consultation with the WB debt expert	2020	Prepare final draft of debt chapter	MOF/ RMDMD		
	Submission of the amended PFA to President and Cabinet for approval	2020	Draft PFM law submitted	Cabinet/P resident Office		

The Public Finance Regulation (PFR) alignment to revised legal framework for debt management	RMDMD to revise and produce draft amendment of the PFR in line with the revised PFA	2020	Prepare amended PFR	Internal/P MF/DMF		MOF/ RMDMD
	Submission of the amended PFR for approval to the Minister	December 2020	Revised PFR approved	MOF/ RMDMD		MOF Legal department
Issues/ Project Components	Actions	Indicative Timing	Expected Outputs of the Actions	Budget	Expected Outcomes of the Project Components	Lead Entity
2. Institutional set-up and capacity building						
Establishment of a RMDMD with efficient and secure transaction processing	2.1 Clearly communicated commitment to implement a traditional FO/MO/BO model with enhanced FO capabilities and sensitize the MOF staff on the intended changes	2019	Official Order signed by the Minster	Internal	A fully operational modern functioning DMO established	RMDMD
	2.2 Develop a training program supporting the new organization, e.g. <ul style="list-style-type: none">• Training in Excel• Training in typical loan products offered by IFIs and bilateral creditors• Training in domestic debt instruments and borrowing techniques, including Islamic Instruments• Training in loan negotiations, especially commercial loans• Training in basic bond pricing mathematics	2019	Training program implemented	Internal and PFM project		RMDMD, PFM unit
		2020				
		2019-2020				RMDMDM D, TPAD

	2.3 Develop a procedures manual according to the traditional FO/MO/BO model	2019-2020	Draft procedures manual produced	Internal and PFM project		and PFM unit
	2.4 Develop a new set of authorization for users of the CS-DRMS according to the model, e.g. remove editing authority for the admin role.		User authorities modified	Internal		RMDM, IT section
	2.5 Identify current procedures that should be moved to another section in the department and to other departments/ministries, e.g. grants and project management. Also identify DeM operations conducted outside RMDMD and consider including them in the department	September 2019	A document on how and when to rearrange the responsibilities for the different functions within RMDMD produced	Internal		RMDMD
	2.6 Develop a program for handing over and receiving the current procedures to/from other sections within RMDMD	September 2019	Procedures that should be transferred documented	Internal		RMDMD
	2.7 Start implementing the new organization gradually	September 2019	Some of the procedures implemented according to the draft Procedures Manual			RMDMD
	2.8 Identify need for modifications of mandate for RMDMD and job descriptions and draft and get	June 2020	A new mandate and new job descriptions approved	Internal		RMDMD, other department HR

	approval for a new mandate and new job descriptions. Approve the Procedures Manual 2.9 Remaining procedures allocated according to the Procedures Manual and Job descriptions	4Q, 2020	The new organization fully operational The new organization fully implemented	Internal Internal		RMDMD
Issues/ Project Components	Actions	Indicative Timing	Expected Outputs of the Actions	Budget	Expected Outcomes	Lead Entity
3. Guarantee's management framework and credit risk analysis						
Inadequate quality of government policy for guarantee management	Policy document provides guidance in terms of purpose, eligibility and criteria, risk assessment, fees, monitoring, recording, limits on issuance, and dissemination, among others	Submitted to management: 1Q 2020	Detailed policy document is prepared, approved by President and becomes effective.	Internal / DMF/PFM	Policy document guides guarantee management	RMDMD
Inadequate procedures guidelines for guarantee management	Procedures manual guides staff when processing guarantees, including: <ul style="list-style-type: none"> - Checking compliance with existing regulations, - Conducting credit risk assessment (industry and company), - Recording, reporting and dissemination, - Monitoring evolution: credit risk update, outstanding and flows, - Assessing and charging credit risk fee, - Calling and recovery procedures, Signing guarantee agreement with beneficiary	2Q 2020	A set of detailed procedures are developed covering all key processes	Internal / DMF/PFM	Procedures provide effective implementation of guarantee's policy	RMDMD

Lack of technical capacity to undertake a credit risk assessment	Train staff on methodology to undertake a credit risk assessment to cover: - New requests Outstanding exposure	2019, on-going	Staff undertakes an accurate assessment of guarantee requests.	Internal / DMF/PFM	Risk assessments are conducted	RMDMD and PEM
Issues/ Project Components	Actions	Indicative Timing	Expected Outputs of the Actions	Budget	Expected Outcomes	Lead Entity
4. Domestic Debt Market Development						
Establish pro-active government involvement on a technical level in the development of the domestic market and make preparations for introducing market-based issuance	Form a government front-office with market specialists dedicated to domestic market operations and market development. - Appoint a dedicated team with market specialists from RMDMD and TPAD - Evaluate current capacity and develop individual & group training programs - Exchange experiences with colleagues of debt offices of other countries on domestic market development, including market-based issuance- and trading-platforms Make an own domestic market development plan and set the government priorities (with the support of MMA)	Have a plan with priorities ready and approved, 1Q 2020	A dedicated front-office team appointed, a training plan approved and a policy on domestic market development agreed	Internal and PFM	Aligned government action plan to implement market development in place	Cash Flow Committee -CMC (Financial Controller/ RMDMD/TPAD)
	Establish an accurate borrowing plan for government securities based on cash flow forecast needs to prepare for market-based issuance: - Develop a detailed and accurate periodic (yearly, monthly, weekly) borrowing plan and make it part of internal decision-making for funding operations	Be ready for announcing offered amounts equal to required	Accurate borrowing plan Policy paper on private placements approved	Internal /PFM project	Government has the technical capability to determine borrowing requirement which will be a requirement for future auctions	CMC

	<ul style="list-style-type: none"> - Start with offering amounts in each tranche that are equal to expected cash needs (instead of maturing tranches) - Reduce private placements: channel borrowings as much as possible through the market operations 	amounts, 1Q 2020	Offered amounts reflect expected cash needs			
	<ul style="list-style-type: none"> - Prepare for market-based issuance - Develop a plan to re-introduce auctions and include risk assessment and solutions to overcome impediments - Develop code of conduct to be subscribed by all market participants of funding operations 	Plan approved, 1Q 2020 Code of conduct approved, 1Q 2020	1 Plan to use market-based issuance Code of conduct	Internal /DMF/PF M project	The government is well-prepared to take on the risks associated with market-based issuance	CMC
	<ul style="list-style-type: none"> - Gradually allow market forces and move to auction: - Experiment with pro-rating when taps are oversubscribed - Reduce the number of funding operations (from weekly to bi-weekly to monthly) - Experiment with not offering all maturities at every tap, but instead only one or two specific maturities (say 30- and 365-day) - Based on experience of previous steps, experiment with re-introducing auctions (for example for one popular maturity). 	2Q, 2020	Evaluation of different market actions Re-introduction of auction with one maturity	Internal	The government is well-prepared to take on the risks associated with market-based issuance	CMC
	Establish exchange of views between front-office and market participants <ul style="list-style-type: none"> - Arrange face-to-face meetings with market participants to introduce 2019 borrowing plan and exchange views about market development (and test introduction of auction) - Develop policy to meet key market participants periodically 	1Q, 2020	<ul style="list-style-type: none"> • Meetings with market participants have been made 	Internal	Better understanding of market-liquidity which will be important when moving to market-based issuance	CMC

	<ul style="list-style-type: none"> - Widen investor base - Prepare plan to attract retail investors (with support of MMA) - Allow retail investors to trade government securities 	1Q, 2020	<ul style="list-style-type: none"> • Plan top access retail <p>Prospectus changed regarding eligible holders of government securities</p>	Internal	Widen investor base at the margin	CMC/MMA
	<ul style="list-style-type: none"> - Ensure upgrade auction- and trading platform meets government requirement and is rolled out as soon as possible - Set-up regular periodic meetings to discuss progress - Agree on milestones and deadlines 	2Q, 2020	<ul style="list-style-type: none"> • Milestones and deadlines are agreed with MMA <p>Regular periodic meetings on technical level take place</p>	MMA	The government taking the lead as upgrading the current platform is an important requirement for the development of the market.	CMC/MMA

ANNEX 2. THE GUARANTEE FRAMEWORK

Guarantees are one means to implement government policy – as is direct government funding or PPPs – and they represent a potential claim on government resources. Guarantees should be considered as finance only for activities or projects that have been evaluated and included in the list of eligible projects in line with the established investment selection procedure. On-lending operations should be subject to similar considerations. The guarantee and on-lending management process should ensure that:

- Government resources are used efficiently and effectively and in line with the government's policy priorities.
- Contingent liabilities from government guarantees are identified, recorded and quantified and that the magnitudes are controlled, to ensure sound macroeconomic and fiscal management.

A comprehensive legal and regulatory framework for issuing guarantees and providing funds through on-lending arrangements should be developed and approved. The legal framework should clearly assign the responsibility for managing government guarantees and on-lending contracts. It is further suggested that the legal framework includes a policy statement setting out in which cases guarantees/on-lending or other forms of government support should be used. Such clarity helps to explain the rationale for use of guarantees, for example market failures, as well as minimize possible market distortions.

Detailed procedures should be developed for the key processes in guarantee and on-lending management. The procedures, which should be developed within the overall legal and regulatory framework, including the guarantee/on-lending policy document, should contain guidance on:

- Preparation and issuance of new guarantees/on-lending, including checking compliance with regulations, credit risk assessment and risk sharing including a credit risk policy;
- Recording and reporting of on-lending, outstanding guarantees and the underlying credits;
- Credit risk assessment of outstanding guarantees/on-lending;
- Credit risk fee and guarantee fund administration;
- Calling and recovery procedures.

Preparation and issuance of new guarantees/on-lending

The objective of the process for providing new guarantees/on-lending is to ensure that government resources are used efficiently and effectively and in line with the government's policy priorities. This should be ensured by incorporating the guarantees/on-lending process in the overall resource allocation process. A credit risk policy, under the overall guarantee/on-lending policy, should be developed. It should include how to submit the proposals within the overall 5-year plan, provisions of detailed information on the beneficiary's financial position and a cash flow analysis of the project, credit risk analysis techniques and the determination of the credit risk fee, among others.

Recording and reporting of on-lending, outstanding guarantees and the underlying credit

The objective is to ensure that information on outstanding guarantees is effectively compiled and verified for use in the risk assessment, for the management of these risks and for

presentation to various stakeholders. The processes should include quarterly requests on outstanding credits subject to government guarantees from domestic financial institutions and external banks, and verification with the beneficiary.

Credit risk assessment of outstanding guarantees/on-lending

The objective should be to have a regular and effective credit risk assessment of outstanding guarantees, which in turn provides a basis for implementation of appropriate actions. The assessment should include estimation of the credit risk exposure in the portfolio, and a regular report produced proposing e.g. changes in the credit risk fees and overall limits.

Credit risk fee and guarantee fund administration

Credit risk fees should be effectively invoiced, collected and reconciled. This includes calculating the risk fee on the basis of the actual credit outstanding and sending invoices to the beneficiary or the creditor. In the event that the creditor is invoiced it will in turn charge the beneficiary of the guarantee.

Calling and recovery procedures

The objective is that obligations are duly honored, and recourse claims effectively managed, thereby preserving the credibility of the government. The procedures should include being informed in advance by beneficiaries of any expected payment problems, allowing the ADP to analyze and propose measures based on the options available, e.g.

- Assisting negotiations between the creditor and the beneficiary to restructure the loan;
- Budget transfers to the beneficiary to ensure that it can service the loan;
- Servicing the loan on behalf of the beneficiary temporarily or permanently;
- Taking over the loan;
- Paying the guarantee.

The recourse claim should be actively managed. It includes consultation with the Attorney General on the options, aimed at protecting the government's interest while honoring the government's obligations, as well as recording of the recourse claim in the ADP systems.

ANNEX 3. INFORMATION TO BE REQUESTED TO SUPPORT CREDIT RISK ANALYSIS

The following should be requested from the project sponsor or guarantee beneficiary for analysis of the guarantee proposal by the government to make an informed decision about the credit risk and potential losses:

- A model giving a projection, over the life of the guarantee, of cashflow estimates for gross income, gross costs, net operating income, debt service payments, cash reserves and payments from the government. These line items should be broken down to show the underlying assumptions, for example the volume of sales and the price per sale. As regards debt, the currency should be shown as well the extent to which the rate is fixed.
- Ideally, a full feasibility cashflow model should be delivered to the Treasury so that the Treasury can conduct its own scenario tests. If it is not possible to obtain the full model, cashflows should be provided for the base case and for several stress cases as proposed by the Treasury.
- In addition to the cashflows, the sponsors should be asked, in their professional opinion, what factors could affect the financial health of the project and industry experience for the variation in those factors. (For example, what is the average construction cost over-run for this type of project?)
- In addition, the sponsors should be asked to list all the circumstances which may lead to the government being asked for payments. This is because in some cases, project documents are very complex and there being multiple ways in which the government may be asked for payment. In order to ensure that there are no hidden or obscured ways, the sponsors should list all government liabilities in the project documents. The sponsors should be aware that in the event of a subsequent request for payment through an unanticipated and undocumented channel, there may be controversy regarding whether the government should make the payment or not.

ANNEX 4. POSSIBLE LEGAL AMENDMENTS

Rationale

1. This annex identifies the essential provisions to be included in the Government Debt Management Chapter of the amended Public Finance Act and discusses the boundary between primary and secondary legislation.
2. There are differences of practice between countries, which will be reflected in the coverage of the legislation. The most important perhaps is whether the legal system derives from a common law tradition, in which decisions by courts are explicitly acknowledged to be legal sources; or if it is based on civil law (partially applied in Maldives¹⁷) in which the sources recognized as authoritative are primarily those in legislation. Practices also vary regarding the boundary between primary and secondary legislation, and the extent to which the roles and responsibilities of officials are specified in legislation.
3. The discussion below highlights the main issues that arise whatever the specific country context. There are, however, further considerations affecting the drafting of such legislation. Innovation in financial markets, a volatile external environment, and changes in the government's fiscal stance all mean that debt managers need to be flexible and responsive. This cautions against adopting overly detailed and prescriptive primary legislation, and instead favors more emphasis on the secondary legislation and/or strong ex-post accountability. Again, the balance will be subject to the respective roles of the executive and legislature as understood in the country context.

Essential requirements

4. The World Bank's Debt Management Performance Assessment (DeMPA) methodology identifies the legal framework as one of the indicators in judging a country's performance against internationally recognized standards. Box 1 summarizes the essential requirements, with a brief commentary. A brief mention should also be made of the following two choices that have to be made:

- **The role of parliament:** It is strongly recommended that parliamentary control does not extend to individual borrowing decisions.¹⁸ Parliament should be reassured by sound legislation and a strong governance framework with clear objective setting, borrowing authority, reporting, accountability and audit provisions. The publication in statute of the **high-level debt management objective** is an important part of this understanding, by identifying the benchmark against which the executive is held accountable. Parliament may also have the opportunity to discuss the debt strategy, perhaps as part of the annual budget discussions, as well as **to vote on the annual borrowing resolution or budget ceiling**.
- **Borrowing limits:** Some debt management or PFM laws include limits on borrowing, although they are arguably more relevant within the context of a Fiscal Responsibility Law. Including such ratios in primary legislation can in fact be problematic. If they are too low, they may constrain maneuverability at the time of financial stress given the time lags involved in passing new legislation. If they are too high, they may not be meaningful. An alternative and preferable approach, and one more in line with practice in Maldives, is that an annual borrowing limit is set consistently with the financing requirement implied by the annual budget. Indeed, it would be good practice to publish the debt management strategy and annual financing plan at the same time as the annual budget.

¹⁷ Maldives has an Islamic religious legal system with English common law influences.

¹⁸ There are exceptions to this recommendation include parliamentary approval for external loan agreements that are classified as treaties. In Maldives, the Constitution explicitly delegates borrowing powers to the President.

Box A3: Primary legislation: essential requirements

- *Set out the authority to borrow* (in both domestic and foreign markets), undertake liability management operations or other debt-related transactions (such as debt restructuring and potentially also swaps), and issue loan guarantees. Although parliament will usually have the ultimate power to borrow on behalf of central government, it should not be involved in individual debt management operations. The first level of delegation of the borrowing power therefore occurs from the parliament down to the executive branch (the President in the case of Maldives). Further delegation (possibly defined in secondary legislation) within the executive branch of government takes place to the Minister of Finance and the debt management entity. These powers should be exclusive. There should be a single borrowing authority, not multiple authorities.
- *Set clear debt management objectives*: These are important to ensure that there is accountability and formal objectives against which the government's performance can be assessed.
- *Specify borrowing purposes* to guard against the risk of abuse. The delegation of the borrowing power is often restricted by a statement of the purposes for which the executive can borrow or by a limit on the annual net borrowing or the outstanding debt (or both). What this might mean in practice is discussed below.
- *Require the preparation of a debt management strategy*, as the practical expression of the high-level objectives. For Maldives, this requirement has to be added to the Debt Management Chapter of the PFA, rather than FRA.
- *Mandatory reporting to the parliament* (at least annual) on debt management activities, including an evaluation of outcomes against stated objectives and the determined strategy.
- *Determine audit requirements*; an external audit will usually be the responsibility of the country's supreme audit institution.
- Other provisions will be needed, e.g. on the scope of the debt department, controls (if any) on other public sector borrowing, establishing a permanent authorization for debt servicing payments and equal treatment for all investors, and necessary powers to obtain information.

Detailed provisions

5. Guidance on detailed provisions consistent with the broad requirements set out in Box 1 is available. The Commonwealth Secretariat for example has prepared a guidance note, which includes a number of country examples (including from within the region).¹⁹

6. It should be stressed that many of the provisions that apply to debt should also apply to guarantees or other contingent liabilities. The authority to issue guarantees, and the nature of the obligation, must be clear. This authority should be complemented by powers to charge guarantee fees. In the event of debt assumption when such guarantees are called, some countries also spell out the powers of the government to recover payments from the beneficiary's financial assets or revenues. Quantitative limits may also be set for guarantees. Again, the annual budget law may be

¹⁹ Arindam Roy and Mike Williams "Government Debt Management: A Guidance Note on the Legal Framework".

(Commonwealth Secretariat, 2010), at

http://www.thecommonwealth.org/document/235301/government_debt_management__a_guidance_note_on_the.htm.

Also of potential relevance is Elsie Addo Awadzi "Designing Legal Frameworks for Public Debt Management" (IMF, Working Paper WP/15/147); this paper is more detailed and written from a legal rather than a policy perspective, but it has a large number of other references. See: <http://www.imf.org/en/publications/wp/issues/2016/12/31/designing-legal-frameworks-for-public-debt-management-43045>.

the most appropriate vehicle for these limits. However, despite an existing legal requirement, this is currently not the case.

7. In line with recommendations, many countries' public debt laws set out the permissible purposes of borrowing. The intention is usually to constrain debt, to prevent profligacy or abuse as well as to reflect the government's priority in the use of resources for developmental objectives. Some countries have a policy that allows borrowing only to finance capital expenditure, although there may be provisions for short-term instruments to be used to meet temporary budget deficits. However, if the allowed purposes are to be included, they must be drawn sufficiently widely to cover a number of technical cases. A possible list is in Box 2. 20

Box A4: The purposes of borrowing

- Borrowing to finance the deficit – where this is acceptable policy
- Borrowing to refinance, prepay or buyback outstanding debt
- Borrowing to finance the investment program
- Support to the balance of payments of the country or the foreign currency reserves
- Fostering the development of the financial markets
- Supporting monetary policy objectives (e.g. issuing T-Bills at the request of the central bank in order to drain liquidity)
- Pre-financing or temporary financing of the liquidity connected with cash flows (i.e. as part of cash management)
- Payment upon issued sovereign guarantees and restructuring of public sector debt
- Financing on-lending (subject to agreed limits or purposes), which is not otherwise included in the budget (e.g. on-lending of a project-related loan to sub-nationals or public enterprises)
- Protection or elimination of effects caused by natural or environmental disaster

8. Several other debt-related matters are sometimes covered in primary legislation:

- Public Debt Committee (PDC). If it is decided to set up a PDC, or similar institution, with decision-making powers, it should be given a legal basis. Even if it serves only an advisory role, it might be advisable to provide for such a committee in legislation to ensure cooperation and coordination of all concerned. Although the high-level purpose of a PDC might be laid out in primary legislation, detailed terms of reference would be included in secondary legislation or administrative decisions. More generally, the legislation could also include powers for the ministry to set up internal policy committees or external advisory committees; but should allow for terms of reference and membership to be promulgated separately.
- Cash management. Provisions related to the Treasury Single Account and cash flow forecasting (including the powers to require budget units and revenue departments to supply forecast information) is normally covered by the budget or financial administration legislation. However, legislation may need to facilitate active cash management. This would include authorising the Treasury or Debt Management Unit to place surplus cash in the money markets and to issue short-term borrowing instruments to cover cash shortfalls. These instruments are repo (in more developed markets) and T-Bills. There should therefore be no restriction limiting the use of T-Bills to debt management purposes only.
- Expenses. Unless it is already clear, legislation should specify that all expenses in relation to borrowing etc. are to be accounted for as proper charges on the budget. These should

²⁰ Some countries include a catch-all provision; thus the Public Finance Management Act 1999 of South Africa adds “any other purpose approved by the National Assembly by Special Resolution” (Section 71).

normally go through the budget, and not simply be netted off receipts. They may include payments to those advising on a securities issue as well as other administrative costs.

Secondary Legislation

9. The issues that might be covered by secondary legislation vary greatly. An indicative list is provided in Box 3. It is not exhaustive but intends to offer a list of issues covered by secondary legislation in a selection of countries.

Box 5: Secondary legislation: some issues

- The terms of reference and procedures of the public debt committee or equivalent
- Arrangements for the conduct of auctions of government securities
- The scope and arrangements for any secondary market operations, such as repos, securities lending transactions, outright sales, bond conversions or switch auctions. (A value for money requirement or cost saving constraint may be imposed.)
- Arrangements, if they exist, to control (or “queue”) the timing of bond issuance by non-government borrowers
- The “contracts” with market makers
- Arrangements for the conduct of (or constraints on) cash management operations
- Procedures for handling project-related loans and credits (including project appraisal requirements). Associated with this are procedures for the granting of guarantees; and procedures for extending on-lending, including scrutiny powers²¹
- Procedures for debt servicing and redemptions
- Procedures relating to settlement, registration and the use of a local depository (although these may be covered by other legislation that applies to all securities)
- Arrangements for managing sinking funds, guarantee funds etc.
- The roles, tasks and accountabilities of the DMO and/or the ministry with debt management responsibilities
- The roles, tasks and accountabilities of senior officials and the procedures for their appointment.
- The organisational structure of the DMO
- Detailed reporting or publication requirements

²¹ See the World Bank’s July 2017 Comments on the Proposed Decree for Procedures for Issuance and Management of Debt and Guarantees