Abstract

Financial derivatives used by the Treasury for the purpose of public national debt management

The Belgian Court of Audit considered that the use of derivative instruments as a component of national debt management was relevant and that it fell under the objectives set through the budget of ways and means, namely, to minimize the financial cost of national debt.

The Court analyzed the various instruments used by the Treasury from January 2002 to September 2004. These financial instruments were among the main tools used by the Treasury for the purpose of an active management of national debt and were subject to a collegial decision-making within the Strategic Debt Committee.

Hedge against foreign exchange risk
Although the amount of foreign currency debt (Swiss franks, Japanese yens or American dollars) is largely lower than the position in euros, the Treasury's exposure to foreign exchange risk is still present. This risk includes higher principal repayments or interest payments as a result of an increase in the value of a currency against the euro. It happens whenever the Treasury has to buy currencies and concerns loan issues or conversion into other currencies. To hedge against this, the Treasury enters into currency futures purchase contracts or uses options.

Another derivative is a foreign exchange swap. In this case the Treasury is committed to resell the currencies bought to repay a loan at maturity date. Swaps like these are mainly used at year end to reduce excess liquidities. They result in a temporary reduction of an outstanding currency debt.

Hedge against rate risk
Interest costs, which account for approximately a quarter of state expenditure (depreciations not included) are dependent on the amount issued and on the interest rate fluctuations in the financial markets. The main risk is that interest rates might exceed budget allocations as a result of a rate increase. In order to remove any uncertainty as to a possible rise some derivative instruments allow fixing at a prior rate the interest rates to pay for future issuances. To this end the Treasury predetermines the issue rate of some Treasury certificates and linear obligations (OLO) by way of swaps or *forward rate agreements*.

Conversely, other swaps are used to convert a fixed-rate coupon into a floating-rate one with a view to alleviating the interest cost burden. As it appears, in the event of a normal (ascending) term structure of the interest rate curve, swaps immediately result in a saving on interest costs ; this prevails throughout the swap duration, provided that short term rates always remain lower than the fixed rate to receive. The scope of this strategy is, however, limited by the general directives in respect of debt, due to the risk of interest cost increase in the event of a rate hike.

The Treasury also decided to resort to swaps in particular circumstances, such as financial investments or the issuance of very long term loans.

Conclusions
The Court ascertained that foreign exchange losses and gains for the Treasury resulting from the use of derivative instruments are negligible, given the relative stability of exchange rates between the contract signature and maturity dates. It added that this would have been different in the event of major rate instability.

From the years 2002 to 2004, the gain for the Treasury from the use of interest rate risk coverage instruments is estimated to be 237 million euros.

The Court considered that the use of derivative instruments to partly hedge against a foreign exchange rate or interest rate increase or to benefit from a possible lower rate is relevant for the purpose of national debt management and that it fell under the objectives set through the budget of ways and means (article 8, §2). It also framed recommendations regarding, amongst other things, an internal procedure book, the use of opportunity costs and the doing away with any derivative instrument of which the value of the underlying item has vanished.

The Treasury's and Finance Minister's responses are added at the end of the report.