



THE BERMUDA CHAMBER OF COMMERCE

Developing a Strategy to Manage Bermuda's Public Debt

Overview

The Bermuda Chamber of Commerce believes there is an opportunity while the Government of Bermuda's debt level is still relatively modest and it maintains its high credit rating, to create a Public Debt Management Strategy ("PDMS") Advisory Board. The purpose of such a Board would be to provide the Minister of Finance with strategic, unbiased and knowledgeable advice on the government's existing and future borrowing requirements. The International Monetary Fund and the World Bank consider such boards as international best practices for sovereign debt management as they promote transparency and confidence among both creditors and citizens.

The benefits of a PDMS and an associated Advisory Board would include:

- A long-term view on public debt, insulated from economic and political cycles
- A reduction in the public debt and debt service costs over the medium and long term
- Making Bermuda a more attractive jurisdiction for foreign investment and international business
- Establishment of a Risk Management Framework to manage risk and cost trade-offs
- International credibility generated by employing recognised best practice
- The foundation needed to potentially develop domestic debt markets
- A partnership between government and the private sector, to bring the best local expertise to the table

Background

Since the 2005/2006 budget the Government of Bermuda has incurred annual fiscal deficits and has funded these deficits on an ad hoc basis by borrowing both domestically and internationally using a variety of different credit products at

different interest rates and terms. This is unprecedented for Bermuda as historically the government only borrowed to finance capital projects, not to fund budget shortfalls. It is uncertain whether or not these budget deficits will become structural and continue into the foreseeable future or whether they will be eliminated once the international business sector begins to expand again. What is certain however is that the existing level of accumulated public sector debt will not be paid off entirely within the next 20 years and therefore will continue to affect future government budgets and the overall economy.

Indeed, Bermuda's public debt introduces an element of sovereign risk for entities that currently operate in Bermuda as well as potential entities that are examining Bermuda as a jurisdiction to operate from. It would be to Bermuda's advantage to have a comprehensive PDMS in place to inform creditors, rating agencies, as well as international business and citizens about its short, medium and long objectives and plans going forward.

Public Debt Management and its Importance

The primary objective of establishing a PDMS policy framework is to ensure that the financing of government's requirements and its payment obligations are satisfied at the lowest possible cost over the medium to long term, and that they are consistent with best practices in risk management. As witnessed in the current and ongoing Euro zone debt crises, sovereign debt default has severe economic consequences that can lead to business and banking insolvencies, high unemployment and social instability. Judicious risk management of public debt is of critical importance in order to avoid dangerous debt structures and levels that could limit a government's ability to repay lenders. Risk management of public debt addresses the following risks:

- Market Risk
- Rollover Risk
- Liquidity Risk
- Operational Risk – (reputational, natural disasters, legal)

Establishing a Risk Management Framework

As mentioned earlier, while the primary objective of a PDMS is to deliver a low cost financing solution for government, this must not be done by taking on excessive risk. For example, short-term duration and variable interest rate debt currently offer low debt service costs, but are also greatly exposed to both interest rate and rollover risks. These risks diminish substantially with longer term duration and fixed interest rate debt. A critical element of a PDMS is the development of a Risk Management Framework that would allow policy makers to manage the trade-offs between cost and risk.

An important element of debt risk management is the modelling of different economic scenarios and structural stress testing. These mathematical tools would help quantify the impact on both the expected debt service costs of government debt and real economic losses under different market scenarios including a default or economic crises. The process assists in identifying those potential risks and developing a macro strategy to deal with such scenarios in times of severe financial turmoil.

Potential to Expand Domestic Capital Markets

Another objective of PDMS in the context of Bermuda would be the development of a domestic debt market, crucial to deepening and expanding our local capital markets.

A PDMS would assist government policy makers and their stakeholders in the following ways:

- Monitor and evaluate inherent risks of debt structure.
- Identify financial risks and other risks characteristics of government revenues and cash flows, and advise on government borrowing decisions.
- Advise on the impact of different government policies that could distort “private vs. government” decisions.
- Assess the risk of issuing debt on international markets
- Advise on a cost-effective cash management policy to ensure debt repayments are met on time and with a high degree of certainty.
- Assess the risks associated with the issuance of short-term and floating rate debt.

The other obvious benefit of a PDMS for Bermuda is that it could be the basis for the development of domestic capital markets of which government securities are pivotal. The details of a domestic securities market are beyond the scope of this discussion but would have to review and address a myriad issues including:

- A revised and updated legal framework for securities issuance.
- Development of an appropriate regulatory and supervisory environment.
- Assess and introduce suitable trading arrangements – custody, clearing and settlement of securities.
- Develop a system of market makers to enable buyers/sellers to transact efficiently at fair value prices.
- Create regulations that encourage participation by foreign investors.
- Create appropriate channels of distribution i.e. auctions, syndications, primary dealers.

Some of these functions may be achieved by leveraging off the existing international standing and infrastructure provided by the Bermuda Stock Exchange.

Conclusion

The Bermuda Chamber of Commerce believes that now is the time to set a long term strategy and framework to manage Bermuda's public debt. A PDMS could offer a number of economic benefits to Bermuda, including the reduction of debt service costs and making Bermuda a more attractive jurisdiction for international business and investment.

We believe that a partnership between the Bermuda Government and leaders of the private sector would bring the right expertise to the table to create a PDMS and enable the most successful outcome for Bermuda.

A PDMS Advisory Board in other jurisdictions typically includes senior representatives of the central bank, treasury and finance ministries, as well as academics. Clearly that could not be the case for Bermuda. Here, the Ministry of Finance would be the logical leader, assisted by the Bermuda Monetary Authority, the Bermuda Stock Exchange and experts from the banking, investment and legal communities.

We would be keen to open a dialogue with the Ministry of Finance on how a PDMS could offer a successful, long term solution to the important issue of public debt, and how this could be implemented in Bermuda.