

THE DESIGN AND USE OF STRATEGIC BENCHMARKS IN MANAGING RISK

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Good morning. Perhaps at the outset I might just make some preliminary comments. First, my thanks to the World Bank team for giving me the opportunity of being here. I think Graeme and his team have done a wonderful job for all of us in setting up a fantastic program.

Second, I think it was very clear from Fred Jensen's presentation of yesterday morning that this morning's topic is both timely and relevant. It is clear from the answers to the questionnaires that had been sent out that there has been a significant increase in the number of countries using benchmarks, or some form of less formal but effective risk control guidelines as a means of putting a specific shape on debt management policy. The whole question of financial cost and risk management is one of importance to an increasing number of countries relative to the position at the time of the earlier questionnaire. I think that means we are in an area that, hopefully, will be important to a large number of people here.

Third, just by way of context for what I am going to be saying, I am part of the National Treasury Management Agency in Ireland. We were set up eight years ago, and we are a fairly independent agency. To put a little context on the situation, at that time we had a Debt-GDP ratio of just under 100 percent; some 27 percent of tax revenues were being absorbed by annual interest payments; the debt was growing rapidly, and we had also all the institutional difficulties that were mentioned yesterday by Fabio Barbosa talking about the difficulty of hiring and retaining staff. We had all those problems and a Debt-GDP ratio that was sixty percent higher than the average for the EU countries. To put it mildly, we had something of a mess. We have been using benchmarks in one manner or another, which I will come back to in more detail later, since the beginning. So we have been living with this animal for eight or nine years.

Fourth, and perhaps most importantly, I am not going to focus in great detail on the analytical methodology that we used in Ireland. That is partly because I want to focus on other issues, but it also reflects the fact that we use the same analytical framework that Peter McCray outlined.

The first point I would like to make is to distinguish between the use of benchmarks for the management of debt strategy and their use as a tool for performance measurement. Let me state that benchmarks are very powerful tools, but as with all powerful tools, if wrongly used they can do quite a bit of damage!

There are two key words in the title of this session, strategic and risk. I will talk quite a bit on both. The basic question that we always have to keep in the top of our minds is what is the strategic objective of debt management. I will say at the outset that some of

the things I will say probably sound unnecessarily obvious; I am going to put it to you that this may be so only at the superficial level. The difficulty will come when we try to put some of these things into implementation in our countries. I will come back to that a little more and tell you what I mean by that. What is the strategic objective of debt management? This is a very easy question to ask; but I think when we try to deal with some of the conflicts and tradeoffs we are going to find that it is more of a difficult question to answer.

But first, why might we have benchmarks at all? Partly, it is because in our business as sovereign debt managers we are in a slightly unusual situation of having what I will refer to as a one-sided book. In many cases where you have treasuries in a corporate situation or bank situation, the treasury manager has one side effectively given to him. It may be a bank, and therefore they have a corporate asset portfolio and there is a natural reference point. In some ways we do not have a natural reference point or we probably do but it is not obvious. The challenge is to try to see what should that natural reference point be. That is what this exercise tries to identify – a suitable benchmark. It is really to try to fill that gap because you do not have an obvious or at least initially obvious asset side to your books.

Whatever process one goes through to establish a benchmark, that benchmark effectively defines the strategy. In other words, for the risk manager or the debt manager personally the benchmark becomes the risk neutral position. If the debt manager follows the benchmark, the manager cannot be blamed for what happens. This immediately makes us realize that a benchmark will exercise a significant “gravitational pull” on the behavior of debt managers. This is what I mean by the benchmark being a powerful tool - because it strongly influences the real life behavior of the debt manager. It is a bit like the boss deciding he or she is going to go sailing around the world for eighteen months and wants to leave some strategic guidance to the people behind because he or she is going to be out of touch and does not want things to go haywire. Unless the guidance the boss leaves is well structured he or she will be better off leaving it up to the judgement of the people on the ground. If the guidance is not well suited to the environment in which the people left behind are working then we are worse off than if we had done nothing at all.

So what are we talking about in terms of debt management objectives and risks? I think most of us will agree that the objective is to minimize cost over time subject to a number of risks and constraints. This is really where we get into the essence of trying to find a suitable benchmark. As the graph suggests, these different criteria or parameters are often pulling us in different directions. You cannot ride two horses in opposite directions at the same time. So we are into choosing. The process therefore is one of trying to work through this reconciliation of conflicting objectives and constraints. A very important point, in my experience, is the need for this process to be worked through quite explicitly. One of the great benefits of having a benchmark process, in my view, is that it takes these conflicting objectives - liquidity risk, debt refinancing risk, lengthening the maturity structure of the debt - and forces them explicitly from under the table onto the table. It is a compromise, a tradeoff process. Therefore, it is important that people at different levels in the debt management process in your country finally engage in the process. If you do not

end up with something that can be written down in plain English and clearly signed off by appropriate levels of senior management, then I will put it to you that you do not have a real benchmark. In other words, if it is a real benchmark it should be possible for the debt manager to be benchmark neutral and for that to be acceptable in terms of the policy objectives of your country. If you do not work through this process of engaging senior management and getting clear sign-off, then you will find that people will exercise 20/20 hindsight on you. For it to be a real benchmark, it has to be worked through that process.

Putting this into practical application is where it gets more difficult. Clearly we come back to the basic issues of debt management. We have to define cost, risks, time horizon, and other objectives and constraints. We talked about this quite a bit yesterday, and as I said, we use a similar analytical model to that outlined by Peter McCray. So when we are looking at cost, when we analyze what the benchmark should be in Ireland, we are thinking of cost in terms of total returns. We are not looking at an accounting definition of cost in a single year time horizon, which can be influenced by timing factors, accounting conventions and so forth. We are looking at a real internal rate of return type cost. As regards risk we are, as in the Australian model, looking at risk in terms of stability of debt-service cost in order to avoid a roller coaster of fiscal debt-service cost. Reflecting the fact that we are not in a business that is likely to go away in the very short term, we are not trying to maximize short term results. We are looking at this cost/risk tradeoff over a medium term horizon. So in analyzing the numbers and running the model, we take a five year term horizon. I think, as Peter mentioned, one of the useful things about the analytical model is that it allows you to see what are the implications of these various ways in which you define the parameters so that you can change the definitions and see how that will change your answer. This testing of the sensitivity of results to the specification of cost, risk, etc, is very useful in stimulating an awareness of importance of clear agreement on objectives.

An important element, as far as we are concerned at the Irish Debt Agency, is the second point on the chart – the importance of robustness. We hear a lot of talk about being on the efficient frontier and about optimal portfolios. At least for us it is important that we build in robustness into the exercise. We are not necessarily looking to have the most efficient portfolio in a particular scenario, but rather to have a portfolio structure that behaves well across a range of scenarios.

The benchmark is primarily used for the definition and articulation of this “strategic direction,” this reconciliation of these conflicting objectives that we talked about. It can also be used for the measurement of the performance of portfolio managers. I think it is important to emphasize the role of a benchmark as a tool for debt management strategy first, and then to think of it as a possible tool for measuring extra value added. I think the first is the more important issue, and I would say that in our case, putting it bluntly, we did not get the relative priorities right on this one eight or nine years ago, in that part of the price that was extracted by the Department of Finance for setting up an independent debt management agency was an excessive emphasis on performance measurement rather than on debt management strategy. It did not do any real damage because the actual portfolio structure was not an inappropriate portfolio structure. However, it took a little while to get

people focusing first of all on the really important question of “where we are going”; the significant but less important question is “how fast we are running”. First of all you want to make sure you are running on the right road. If one does use a benchmark for performance measurement as well as for the strategic planning of the portfolio, that in my view reinforces the gravitational pull that I mentioned earlier. You will find that the portfolio managers pay even more attention to exactly what the benchmark is doing. Therefore, there has to be the ability to be fully benchmark neutral, and there has to be transparency, which implies you have to be even more sure that the benchmark is appropriately structured.

In structuring the benchmark, I think it is important to distinguish between a benchmark being sensible and being complex. Fancy analytical models have their place; they can be very useful but they are not always necessary and certainly in themselves serve no function whatsoever. None of us are in academic research, that is not our business. Our business is to solve problems. I take the view that our job is to keep very tight focus on the practical issues. The use of models has to serve that need rather than to become an end in itself. I think it is important when thinking about going down this road that one does not get bothered that there are some fairly fancy looking models around. A lot of the issues and a lot of the benefit are in just working through a more common sense approach.

Lastly, with the clock ticking against me, a quick word on the role of the benchmark vs. the role of the portfolio managers. The benchmark, like I said, basically sets the strategy. The portfolio managers look to add value by outperforming the benchmark. They can do this by taking market risk relative to the benchmark and also by looking for risk free opportunities to save money. This is really where the potential value of using the benchmark as a performance measurement lies as it can be used to provide an incentive for your portfolio managers to get out and look for more aggressive pricing opportunities; by measuring their performance they can actually see quantitatively the benefits to the bottom line of more aggressive pricing negotiations. Finally, because the benchmark is strategically structured it is something which one might review every year, but generally it does not have to be changed frequently. Thank you very much.