

AUDIT CHAMBER OF THE REPUBLIC OF ARMENIA



CURRENT REPORT
ON
PERFORMANCE AUDIT OVER THE RA PUBLIC DEBT
MANAGEMENT

2019

Basis of the audit	The audit engagement was approved by Decision No 19/3 of the RA Audit Chamber, dated 12 September 2019
Object (the audited entity) of the audit	RA Ministry of Finance
Subject matter of the audit	Management of the RA public debt
Audited period	Period from 01 January 2017 to 31 December 2018
Engagement period	Period from 24 September 2019 to 20 December 2019
Audit methodology	<p>Within the scope of this engagement performance audit was conducted in line with the RA Law on the Audit Chamber, as well as in line with ISSAI 100-Fundamental Principles of Public-Sector Auditing, ISSAI 300 – Fundamental Principles of Performance Auditing of International Supreme Audit Institutions (INTOSAI). The audit was conducted on a system-based approach.</p> <p>The objective of the audit was to determine whether the current public debt management system of Armenia guarantees effective management of the public debt.</p> <p>Within the scope of the engagement the following audit topics were reviewed:</p> <ol style="list-style-type: none"> Whether the definition of the public debt of the Republic of Armenia and its scope of management is sufficiently comprehensive? Whether the public debt management strategy of the Republic of Armenia has been implemented effectively? Whether there has been the decent organizational structure and legal framework for the public debt management in the RA? Whether there has been an effective system of management of sub-loans, budgetary loans and state guarantees? Whether an effective cash flow management has been implemented? Whether an effective IT infrastructure for the RA public debt management has been operated ? Whether the sufficient public debt accountability has been ensured? <p><i>Within the scope of the engagement, the following audit criteria and requirements were considered :</i></p> <ul style="list-style-type: none"> - <i>The RA Law on Public Debt ;</i> - <i>RA Government Decree N 380 On approving the procedure for issuance of the RA State Budget Guarantees, dated 18 June 1998 ;</i> - <i>RA Government Decree N 168 On approving the procedure for</i>

- providing loans from the RA state budget, dated 09.03.98 ;*
- *The Debt Management Performance Assessment (DeMPA) methodology of the World Bank ;*
 - *ISSAI 5422 of the International Organization of Supreme Audit Institutions ;*
 - *Manuals of the public debt working group ;*
 - *Revised Guidelines for Public Debt Management of the World Bank and International Monetary Fund ;*
 - *Guidelines for Developing of Medium-Term Debt Management Strategy;*
 - *Stockholm Principles, International Monetary Fund ;*
 - *Principles on Promoting Responsible Sovereign Lending and Borrowing, United Nations Conference on Trade and Development (UNCTAD)*

The audit process was documented, a protocol on audit engagement was drafted, which was submitted to the audited entity in the established order. The comments (response of the audited entity) provided as a result of the engagement have been taken into account when drawing up this current report.

**Structural department
implementing the audit**

The audit was conducted by the Methodology, Analysis and International Relations Department of the RA Audit Chamber, the activities of which are coordinated by the Chairman of the Audit Chamber Mr. Levon Yolyan.

ACRONYMS

IMF – International Monetary Fund

OD – Operational Department

TSA – Treasury Single Account

ODTBA – Organizing Department of Treasury Bonds Related Activities

CB – Central Bank

WB – World Bank

RA – Republic of Armenia

RSD – Recording and Service Division

UN – United Nations Organization

MTEP – Medium-Term Expenditure Framework

ICD – International Cooperation Department

LMDSB – Liabilities Management Department to the State Budget

SRC – State Revenue Committee

LPD – Law on the Public Debt

DemPA PI – WB Debt Management Performance Assessment (DeMPA) for assessing public debt management performance through a comprehensive set of indicators

PDMD – Public Debt Management Department

SRMD – Strategy and Risks Management Division

IT – Information Technologies

MOF – Ministry of Finance

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REPORT

Public debt management is one of the most important functions of the state in the field of public finances.

On the one hand, attraction of public debt and its effective management can create serious opportunities for expanding the country's economic potential and long-term economic development, on the other hand, the manifestations of inefficiency in its management process in the long run can adversely affect the stability of the public financial system and cause losses for the public. Armenia's public debt portfolio almost doubles within the period from 2008-2018 USD 6.9 billion or 55.8% of GDP.

Being classified as a middle-income country, Armenia is no longer eligible for preferential loans from international institutions, and major lenders have revised the interest rates applied to the loans previously granted to Armenia by increasing them.

Over 80% of Armenian government debt is denominated in foreign currency, which remains the most important risk factor for Armenia's debt portfolio as a country with a small open economy.

Given that the subject of auditing has traditionally been the focus of public attention in Armenia, and no any audit of the performance of the RA public debt management has previously been conducted, as well as taking into consideration the requirements of the Financing Agreement of the European Union Budget Contribution ENY/2015/038-229 within the scope of Public Finance Policy Reform Program in Armenia, the Audit Chamber of the Republic of Armenia decided to carry out this audit, as a resulted of which the following issues in the public debt management system of the Republic of Armenia were identified:

Findings

- ***With regard to definition of the RA public debt*** – a) The de jure definition of the RA public debt, as well as the de facto definition used in public debt management, is not comprehensive enough; it did not include non-explicit contingent liabilities (in particular, the unsecured debt of public or predominantly state-owned enterprises, as well as non-state or predominantly non-state enterprises, stipulated by their strategic importance and the public interest in continuing their normal operations, the likelihood of financial intervention of the state in case of non-compliance with their liabilities is high), as a result of which, for the purposes of the audit criteria, the component of the public debt mentioned above, in fact, remained uncontrolled by the state. Discarding this component also leads to underestimated perceptions of the public and other stakeholders about the public debt of the Republic of Armenia. b) As the subject matter of the audit is the management of the RA public debt, hence, the debt of communities and the debt of the community owned enterprises were not covered by the audit, as a part of the comprehensive definition, although, in terms of the audit criteria, it should have been a part of the definition of the public sector. c) Debt Sustainability Analysis considered only standard shocks used in IMF Debt Sustainability Analysis and adjusted shocks for Armenia, while contingent liabilities of non-financial sector were not considered.
- ***With regard to organizational structure of the RA public debt management*** – a) The organizational structure of RA public debt management has been fragmented. In particular, apart from the Public Debt Management Responsible General Department, two more subdivisions have carried out public debt management functions in the MoF (International Cooperation Department and Liabilities Management Department to the State Budget); b) The organizational structure of

the RA State Guarantee Management has also been fragmented. Although Liabilities Management Department to the State Budget had the statutory functions of providing and managing the guarantees, in fact, that Department has not performed its functions with regard to external guarantees. While, on the other hand, Public Debt Management Department has been involved in implementation of these functions, having no statutory function for doing so. c) Public Debt Management Department is entrusted with the task of forecasting, implementing and accounting for membership payments to international financial institutions, which has nothing to do with public debt management. d) Notwithstanding the existence of an agency agreement signed between the CB and the Ministry of Finance, it has not been published. e) No any internal audits have been conducted in the field of the public debt management in the MoF. f) Proper segregation of duties, balancing and restraint on the functions of initiating payments on public debt, preliminary data entry of contracts into debt management system, confirmation of contractual information and finalization of the system entries were not ensured. The same official was involved in implementation of all the above functions

- ***With regard to the debt management strategy*** – a) The primary objective of the RA Government in terms of the debt management has not been met: in the long-run the amount of the debt service showed upward trend (up by 342% in 2012-2018). b) Although the exchange rate risk has been the highest risk in the RA public debt portfolio, the benchmark indicator established on this issue - the share of the domestic debt in total debt remained unchanged at the level of 20%. Hedging instruments have not been used to fence the foreign exchange risk. Procedures for the use of derivative instruments have not been established. As of 31.12.2018, the specific weight of the RA government bonds acquired by non-residents totaled 0.6%. c) The quality of medium-term forecasts of the RA Government debt and interest payments was low (for example, in 2018 the actual amount of the debt of the Government of the Republic of Armenia exceeded the predicted 2016-2018 strategy level by 28.5%). d) There is no an imperative requirement to submit the Draft for the opinion to the Central Bank of Armenia and it has not been submitted for the opinion in 2018. e) There is no an effective system of managerial internal accountability on performance of the Strategy introduced.
- ***With regard to the state guarantee management*** – a) No information has been released on the state's guarantee policy (hence, the requirement of part 7 of Article 23 of the RA Law on Public Law), however, separate business entities have been provided with internal and external government guarantees, thereby creating unequal conditions for such businesses compared to other entities operating in the same sector and having similar financial and economic standing. b) State guarantees were situational in nature, the established common procedures were not followed. There are no procedures for provision of budget guarantees to the Deposit Guarantee Fund. c) There is no methodology for assessing credit risk and based on that methodology no assessments were carried out before and after the guarantee was provided. Therefore, the system of issuing and managing state guarantees is ineffective as it does not have effective institutional mechanisms to restrain their materiality. d) The current guarantee payment system is not linked to the credit risk. e) State guarantees database is incomplete, guarantees were not recorded in DMFAS 6 system (Debt Management and Financial Analysis System (DMFAS)), data entry procedures were missing.
- ***With regard to the management of sub-loans and budgetary loans*** – a) The budgetary lending process was situational in nature, bypassing the set of the defined common procedural arrangements, while no any sub-loan procedures were defined. b) No policies on sub-loans and budgetary lending have been published, although they have been provided. c) There is no

methodology for assessing credit risk and based on that methodology no assessments were carried out before and after the guarantee was provided. No overdraft interest rate related to the credit risk was applied. In 43% of cases, lending was carried out without the use of collateral. d) Sub-loans and budgetary loans were not recorded in the DMFAS 6 system, data entry procedures were missing.

- ***With regard to external borrowings*** – No comparative analysis of other sources of funding and justification of advantages of the loan attraction from the selected source is presented in the reference-justifications to the Draft Law of the Republic of Armenia on Ratification of the Loan Agreements attached to Drafts of the Government Decrees on the Loan Agreement, which does not contribute to the transparency of the borrowing process and does not create an informed decision-making environment
- ***With regard to cash flow management***– a) No cash flow forecasts were made on a daily basis. Weekly forecasts have been implemented for the next month. The quality of forecasts has been rather low, particularly in 2018. In 43 out of 48 weekly forecasts of Treasury Single Account inflows and in 36 out of 48 weekly forecasts of TSA outflows, the predicted indicators deviated by at least 15% from actual indicators. b) The low quality of forecasts was also due to the fact that the RA State Revenue Committee failed to comply with the requirements of the RA Government Decree No 1354-N, dated 19.08.04 with regard to providing the MoF with information on state budget revenue forecasts. c) No active cash flow management was conducted. The only instrument used was a deposit facility with the CB, while the minimum deposit period was 7 days, thus no cash flow management on daily basis was conducted through one-day transactions, which could reduce (in 2018, the average TSA balance was AMD 14.5 billion) cash balances and provide additional interest income. d) There was no formal cash flow management methodology, including thresholds of cash balances (floor and ceiling).
- ***With regard to IT infrastructure of the RA public debt management*** – a) There is no unified database in the RA MoF public debt management information system. The DMFAS 6 information system has been installed in the MoF since 2011, however, sub-loans, internal and external guarantees, as well as 21 out of 189 external loans are not registered in the system. Date on the public debt are mainly stored in Excel files. b) DMFAS system of public debt management has been deprived of technical service for the last 4 years due to the absence of a technical administrator. c) Six out of the 15 MoF staff that had access to DMFAS information system have not been trained, while 7 employees that have trained, including those who have been trained as technical administrators do not work with the system, the transfer of the institutional memory was not ensured.
- ***With regard to the legal framework regulating the sphere of public debt management of the Republic of Armenia*** – a) The primary objective of the debt management of the Government of the Republic of Armenia did not include the borrowing cost reduction requirement to balance the debt portfolio risk with acceptable levels, instead, only intention of reducing the size of the debt service was met (moreover, it is intended only to reduce and not to minimize; it is intended to be implemented only for the long term and not for the medium term, whereas the strategic debt management horizon is the medium-term horizon). b) The primary legislation of the Republic of Armenia did not provide for the powers of attracting public debt through issuance of foreign currency government bonds, their clear delegation. c) The primary legislation of the Republic of Armenia did not provide for the development of a loan program, although the MoF developed and published annual loan programs. These have not been approved by any legal act.

- **With regard to accountability of the RA public debt** - a) The primary legislation of the Republic of Armenia does not provide for a requirement to submit an independent report on the public debt to the National Assembly, instead, a requirement to submit information on the public debt and current liabilities in the annual report on the state budget execution is provided for. b) Segregated information on sub-loans per lenders and lending conditions per each lender is not published in statistical bulletins and other publications of the MoF. c) 2017 and 2018 non-financial (output) indicators characterizing implementation of the RA state budget programs did not provide sufficient coverage of the performance assessment of the public debt management functions by the MoF.

The aforementioned facts have led to risks in respect of compliance with the expenditure-based and purpose-based efficiency principles of the RA public debt management system. Taking into consideration the aforementioned issues, the RA Audit Chamber presents a number of recommendations aimed at enhancing efficiency of the operation of the RA public debt management system.

Recommendations¹

With regard to definition of the RA public debt we recommend:

- **To the RA National Assembly:** To legally introduce the concept of "*public sector debt*" and include in its definition the scope of non-explicit contingent liabilities set by the Government, as well as community debt obligations;
- To develop a register of non-explicit contingent liabilities, develop regularities on its formation, including due process information submission on non-explicit contingent liabilities;
- When applying debt management instruments, including when developing medium-term debt management strategies, when designing annual borrowing plans, to take into account non-explicit contingent liabilities, assess their probability of materialization;
- When performing debt stability analyzes, to consider the impact of contingent liabilities on the non-financial sector;
- To provide aggregated information on non-explicit contingent liabilities in published debt reports and statistical bulletins for the purpose of ensuring accountability and transparency;

With regard to organizational structure of the RA public debt management, we recommend:

- To provide and manage all government guarantees (including, external) only by one department;
- To provide clear segregation of authorities for initiating payments on public debt, preliminary data entry, confirmation of contractual information and registration finalization;
- To perform regular internal audits in the field of public debt management
- During the internal audit, to emphasize the process of complying with the recommendations submitted by the Audit Chamber;
- To assign the function of forecasting, executing and accounting of membership payments to international financial institutions to another responsible division;
- To publish the contract signed between the RA MoF and the CB.

¹ Addressed to the MoF, unless any other addressee is specified.

With regard to the debt management strategy, we recommend:

- When designing future strategies, to be guided, in the long run, by the intention to guarantee reduction of service costs of the debt;
- To discuss possibilities for raising the benchmark indicator (the share of the domestic debt in total debt) of the RA Government debt portfolio;
- To improve the quality of mid-term forecasts of the RA Government's debt size and interest payments;
- To submit the Draft Strategy to the Central Bank of Armenia on annual basis for the opinion;
- To discuss the possibility of introducing hedging instruments and developing procedures derivative instruments;
- To establish the procedure for reviewing the Strategy sooner than the defined schedule (annually), specifying the cases (thresholds of changes in milestones underlying the Strategy) in occurrence of which there will be the need for reviewing the Strategy;
- To define and publish conceptual approaches for diversification of investors in the RA treasury government bonds, including for attraction of non-resident investors;
- To introduce a regularly set internal managerial reporting system on performance of the Strategy and annual loan program through submission of summary reports.

With regard to government guarantees, we recommend:

- If government guarantees are expected to be provided during the year, to prioritize those sectors of the economy or programs for which government guarantees may be provided in the Government Debt Management Strategy;
- To refrain from providing state guarantees to address situational issues. To be guided by the set of common procedural arrangements when providing internal and external government guarantees; to establish procedures for provision of budget guarantees to the Deposit Guarantee Fund;
- To perform a risk assessment based on the credit risk assessment methodology for each of the guarantees provided (internal and external), and to reassess credit risk at least quarterly, determining the likelihood of materialization of guarantees;
- To introduce a risk-based differentiated guarantee payment system, to develop guarantee payment methodology;
- To define guarantee payment requirements in relation to external guarantees provided to local governments and the Central Bank;
- To record data on all government guarantees in the DMFAS 6 system;
- To develop data recording procedures for guarantees.

With regard to the management of sub-loans and budgetary loans, we recommend:

- To develop common regulatory procedure for sub-lending;
- To be guided exclusively by common procedures when granting budgetary loans and sub-loans, refraining from making decisions that circumvent those procedures in each individual case;
- **To the RA National Assembly:** To establish a legislative requirement to publish sub-loans and budgetary lending policies in the Government's Debt Management Strategic Programs (similar to the requirement for state guarantees, as stated in the RA Law on in the RA Law on the Public Debt);
- To develop and publish policies for sub-loans and budgetary lending;

- To perform a risk assessment based on the credit risk assessment methodology for each budgetary loan and sub-loan, as well as reassess credit risk at least on a quarterly basis;
- To introduce a risk-based upper interest rate system and its calculation methodology.
- To record data on sub-loans and budgetary loans in the DMFAS 6 system. To develop procedures for recording their data.

With regard to external borrowings, we recommend:

- To present comparative analysis on other sources of financing and justifications on advantages of the loan from the selected source in the reference-justifications to the Draft Law of the Republic of Armenia on Ratification of the Loan Agreements attached to Drafts of the Government Decrees on the Loan Agreement,

With regard to cash flow management, we recommend:

- To develop a cash flow management methodology, set cash balance thresholds
- To perform active cash flow management using one-day instruments (such as deposit auctions);
- To develop a concept for enhancing the quality of cash flow forecasts;
- To take effective steps to obtain information on state budget revenue forecasts at regular intervals.

With regard to IT infrastructure of the RA Public debt management, we recommend:

- Within the scope of DMFAS information system, in order to maintain a unified database of the government debt, as well as to ensure integrity of data, to record all liabilities and transactions on external and internal debt, as well as guarantees, budgetary loans and sub-loans in the DMFAS information system;
- To ensure availability of a qualified DMFAS Information Technology Administrator.

With regard to the legal framework regulating the sphere of public debt management of the Republic of Armenia, we recommend:

To the RA National Assembly: To establish by the law:

- Clear and explicit powers for delegation of issuance of foreign currency government bonds;
- To establish the debt service expenses into the main objective of the RA Government debt management;
- Requirement for developing an annual loan program.

With regard to accountability of the RA public debt, we recommend:

- To promote the requirement to submit annual independent reports on public debt management to the National Assembly, which should contain sufficient information that will allow the National Assembly to assess to a degree that the objectives and strategies of public debt management have been met.
- To disclose disaggregated information on sub-loans per lenders and terms and conditions per each lender
- To provide a wide range of non-financial (output) indicators characterizing the implementation of the RA state budget programs.

We recommend to develop and approve an action plan based on the recommendations of the Audit Chamber (which is also provided for by the WB DEMPA methodology DPI-5) that will contain the unit (s) responsible for each event and the implementation schedule thereof. In addition, within the framework of Article 30 (6) of the RA Law on the Audit Chamber, within the 30-day period prescribed by the law, to submit an approved action plan within the scope of written information to be submitted to the Audit Chamber.

Levon Yolyan
Chairman of the RA Audit Chamber
24 December 2019
RA Audit Chamber,
Baghramyab 19, Yerevan, Armenia

DEFINITION OF THE PUBLIC DEBT OF THE RA AND ITS GOVERNING FRAMEWORK

Audit topic: Is the definition of the public debt of the Republic of Armenia and its management framework sufficiently comprehensive?

Audit Criteria and Requirements

- *In accordance with ISSAI 5422, “The most important element for carrying out a performance audit of the public debt is that the conceptual framework includes a broad definition of debt that enables to undertake an assessment of management, vulnerability, sustainability, the actors’ competence and accountability. Conceptualization of debt must embrace total debt of central government, its organizations, its firms (state-owned enterprises), governmental financial system (development banks), the state and municipality governments, the monetary authority (Central Bank), contingent liabilities, and the potential existence of hidden liabilities”²;*
- *In accordance with Revised Guidelines for Public Debt Management of IMF and the World Bank (clause 70), “Debt managers should ensure that the impact of risks associated with contingent liabilities on the government’s financial position, including its overall liquidity condition, is taken into consideration when designing debt management strategies. Contingent liabilities represent potential financial claims against the government which have not yet materialized, but which could trigger a financial obligation or liability under certain circumstances. They may be explicit <....> or implicit, where the government does not have a contractual obligation to provide assistance, but (ex post) decides to do so because it believes the cost of not intervening is unacceptable”³.*
- *In accordance with Stockholm principles of IMF, “When determining medium-term debt management strategies, the range of risk factors considered should be consistent with broadest definition of the debt portfolio (principle 9) and the scope of debt management should be defined in a way that also accounts for any relevant interactions between the nature of financial assets, explicit and implicit contingent liabilities, and the structure of the debt portfolio (principle 1)”⁴;*
- *In accordance with the WB, public and publicly guaranteed debt (PPG) includes the long-term external obligations of public debtors, including the external responsibilities of national government, public corporations, state-owned enterprises, development banks and other mixed enterprises, political subdivisions, autonomous public bodies, as well as private debtors, payment of which is guaranteed by a public organization*
- *The public sector is defined by the IMF as a set of general government and public financial and non-financial organizations⁵;*
- *National legislation in line with international best practice on coverage of public debt, such as:*
 - *Macedonian legislation defines the concepts of sovereign debt and public debt, the first of which includes the financial obligations arising out of the debt owed by the state, public institutions and communities established by the state, and the second is sovereign debt,*

² ISSAI 5422 Standard: “An Exercise of Reference Terms to Carry Out Performance Audit of Public Debt”.

³ “Revised Guidelines for Public Debt Management”, IMOF & World Bank, 2014.

⁴ Guiding Principles for Managing Sovereign Risk and High Levels of Public Debt (Stockholm principles), IMOF, 2017.

⁵ “Public Sector Debt Statistics – Guide for Compilers and Users”, IMOF, 2013.

plus the debt of wholly or exclusively state and community owned companies, as well as the debt of the Central Bank⁶;

- *Moldovan* legislation defines public debt as the totality of domestic and external debt of the state, the Central Bank, administrative areas, of public institutions wholly or partially financed from the state or community budgets, as well as of enterprises the share of the state and/or the administrative unit of which is more than 51%⁷;
- *Slovenian* law defines public debt as a set of liabilities assumed by institutions financed by the central government or local community budget, public non-financial corporations and other state-owned enterprises (including the health insurance body and the pension fund).
- *According to the UN Conference on Trade and Development*, debtors must make public disclosures of their financial and economic standing, including, among other information, by providing data on any explicit and *non-explicit* state guarantees (*principle 11*)⁸.

Audit Results

1. The de jure definition of the RA public debt⁹, as well as the de facto definition used in the management of public debt, is not sufficiently comprehensive¹⁰, it did not include explicit contingent liabilities (in particular, the unsecured debt of public or predominantly state-owned enterprises, as well as non-state or predominantly non-state-owned enterprises, conditioned by their strategic importance and the public interest in continuing their normal operations, there is a high likelihood of the state intervening financially in the event of failure by these enterprises to fulfill their obligations, as a result of which the specified component considered to be part of the public debt from the point of view of auditing criteria has in fact remained unmanaged by the state (Authorized Body).

⁶ *Public Debt Law, Article 2.*

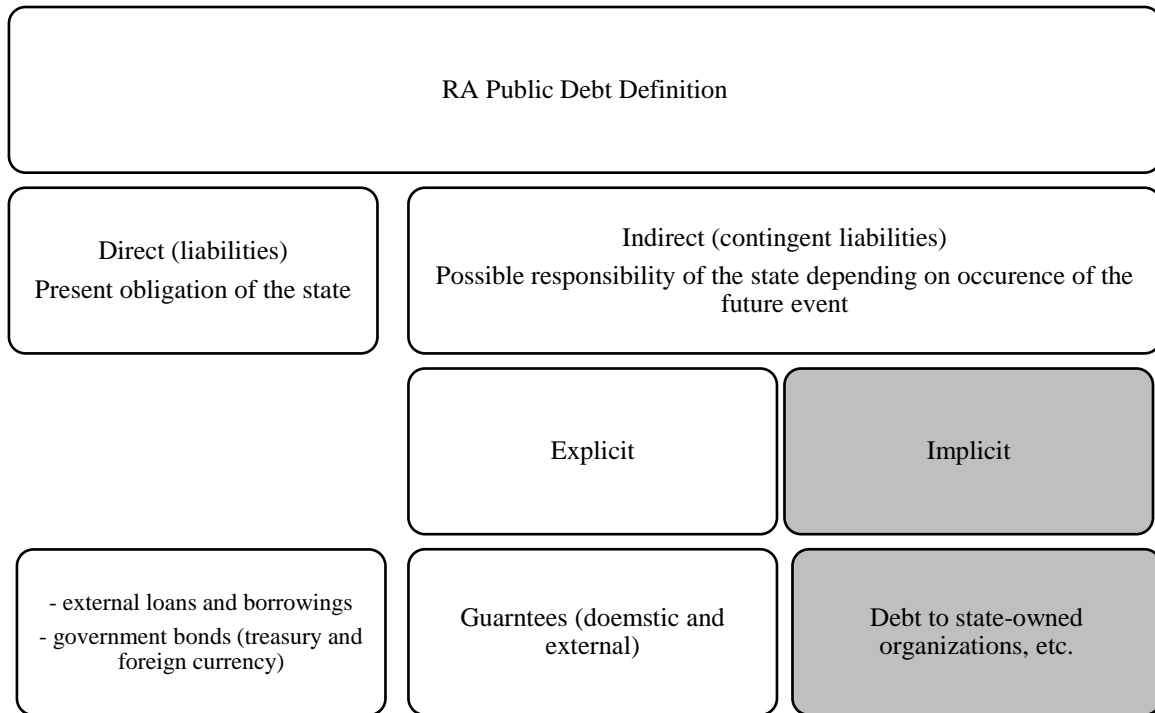
⁷ *Law no.419-XVI of 22.12.2006. Art. 2.*

⁸ Principles on promoting responsible sovereign lending and borrowing, UNCTAD, 2012.

⁹ According to the de jure definition of RA public debt, public debt is the sum of the debt assumed on behalf of the Republic of Armenia and the CBA (excluding the existing debt liabilities of the CBA to residents) and at a certain point of time the existing debt liabilities, while the debt liability is the amount (including securities placed on domestic and foreign markets) received either per the loan agreement or credit agreement and outstanding at a certain point of time, including the interest amount not settled within the specified period, as well as the amount of the provided state guarantees (Law on PB, Article 2, clause 1, 2):

¹⁰ A comprehensive definition of the public debt in terms of the public debt management, shall comprise both liabilities, as well as contingent liabilities; the definition of the RA public debt includes all liabilities (external loans and borrowings, treasury and foreign currency government bonds), while contingent liabilities, partially include only explicit contingent liabilities (guarantees) excluding implicit contingent liabilities.

Chart 1. Necessary Components for Comprehensive Public Debt Definition



The white fields are currently included in the definition of the RA public debt, while the field in grey are not included in the definition.

2. Since the subject matter of the audit is the public debt management of the Republic of Armenia, therefore, community debt and the debt of community owned enterprises have not been considered during the audit as part of a comprehensive definition, although from the standpoint of auditing criteria, it should have been a part of the public sector debt definition.
3. In designing the Government's medium-term debt management strategy, no explicit contingent liabilities were taken into account. 'Medium-term Debt Management Strategy. Analytical Toolkit Manual' developed jointly by the WB and IMF provides for implementation of the Non-Budgetary Costs Tool (Annex D) in strategy development works that also implies for inclusion of non-explicit contingent liabilities in developing the strategy
4. When publishing reports and bulletins on the debt, when calculating the risks and other indicators presented therein, non-explicit contingent liabilities have not been taken into account. This fact does not allow users of reports to get a full understanding of the full public sector debt and adversely affects the reliability of debt indicators.
5. Estimates of probability of materialization of the contingent liabilities and of the financial consequences were missing.
6. The Ministry of Finance of the Republic of Armenia did not have any information on the non-guaranteed debts of the state-owned enterprises and their (follow-up) monitoring process and results, hence, did not carry out a unified accounting of debt of the state-owned enterprises.

Response of the audited entity

In compliance with the guidelines developed by international organizations, in particular, in compliance with Guidelines for Public Debt Management reviewed in 2014 by WB and IMF present definitions, that have benchmarking and advisory nature and are not necessarily applicable to individual countries.

It is important to consider that debt management guidelines published by various international organizations are meant to assist policy makers while implementing reforms aimed at improving the quality of public debt management and to reduce the vulnerability of countries to internal and external shocks. Whereas, in developing policies, each country, taking into account these guidelines, must also take into account the particularities of that country, in particular the governance structure, the level of institution development, the direction of the economic policy pursued, and so on.

Accordingly, the countries themselves determine and define the scope of the national debt typical to their country in their national law. After clarifying the non-explicit contingent liabilities and determining their limits (in practice they can be unlimited), in future we will consider the possibility of including them in the definition of the RA public debt and in the development of the medium term debt management strategy of the RA Government

Interpretation of the Audit Chamber

Clarification of non-explicit conditional obligations and determination of their limits by the authorized body is a necessity, since, otherwise, this potential public debt component remains uncontrolled by the state, which in the long run, under the influence of certain situations, may jeopardize Armenia's fiscal stability

As part of the public debt, only the private sector debt to which the State provides a de facto guarantee (despite the lack of de jure guarantees) should be considered as part of the public debt due to the strategic importance of those private sector companies or, in the event of their insolvency, due to the unacceptability of the cost of non-intervention by the State.

We are talking about contingent liabilities that, in terms of economic content, do not differ from explicit contingent liabilities (government guarantees) and the only difference is the legal form.

In the process of public debt management and, for the purpose of the management, in promoting the definition of debt it is necessary to be guided by the principle of prevalence of the substance over form.

Accordingly, as part of the definition of the public debt, a clear, the Government-defined scope (rather than unlimited scope) of non-explicit contingent liabilities should be considered, that should be governed by the Authorized Body.

Conclusion

The definition of the RA public debt was not comprehensive enough, it did not include non-explicit contingent liabilities. In fact, they have been left unmanaged by the MoF.

Recommendations

We recommend the following:

- To legally introduce the concept of "public sector debt" and include the scope of non-explicit contingent liabilities defined by the Government's, as well as community debt obligations into that definition;
- To develop a register of non-explicit contingent liabilities, develop regularities on its formation, including due regular process of information receipt on non-explicit contingent liabilities;
- When applying debt management instruments, including developing medium-term debt management strategies, when drafting annual borrowing plans to take into account non-explicit contingent liabilities, as well as to assess their probability of materialization;
- When performing debt stability analyzes, to take into account the impact of non-explicit contingent liabilities;
- To provide aggregated information on non-explicit contingent liabilities in published debt reports and statistical bulletins for reporting and transparency purposes.

Audit topic: Whether debt stability analyzes took into account non-explicit contingent liabilities?

Audit criteria and requirements

The RA Government must carry out debt stability analysis on an annually .

IMF Guidance on Debt Stability Analysis.

Audit results

Debt stability analyzes did not consider customized stress tests/shocks. In terms of contingent liabilities, only the standard shock (with regard to banking system) provided for by the IMF Debt stability analysis for market-access countries (MAC DSA) Tool was considered. The standard shock calibration was not connected with the country-specific circumstances (for instance, unlimited guarantee without the collateral, set forth by the RA Law on Budgetary System, Article 11.1). Moreover, shocks to other non-explicit contingent liabilities have not been considered at all.

Response of the audited entity

In relation to MAC DSA, the audited entity made reference to the IMF Guidelines: "When the existing stress tests do not adequately reflect the country-specific risks, or where the fiscal-budget scope includes an alternative scenario, the staff should develop customized alternative debt sustainability analysis scenarios" and should conclude that "the comprehensive analysis toolkit embedded in the models of debt sustainability analysis was, in our estimation, sufficient to examine debt risks and sources of vulnerability, so it was not advisable to apply customized shocks". At the same time, in compliance with Article 11.1 of the RA Law on Budgetary System: "*The possibility of unlimited guarantees relates to the provision of budgetary guarantees to the Deposit Guarantee Fund in the event of a threat to the stability of the banking system, thus being indirectly included in the debt stability analysis as a standard shock to the banking system.*"

Interpretation of the Audit Chamber

The IMF Guidance on the Application of the MAC DSA Debt Stability Analysis provides for the possibility of incorporating non-explicit contingent liabilities when making analysis which should not be limited to the standard banking-related shock provided by this instrument¹¹. In compliance with clause 40 of IMF MAC DSA Guidance, "*The staff is strongly encouraged to identify vulnerabilities*

¹¹ Staff Guidance Note for Public Debt Sustainability Analysis in Market-Access Countries, IMF, 2013, page 25-27

and calibrate stress tests for other possible sources of contingent liabilities (for e.g state-owned enterprises, natural disasters)... Shocks for contingent liabilities of non-financial sector should be analyzed in DSA as customized scenarios” that was not realized by the MoF.

The MoF did not have full information on contingent liabilities of the non-financial sector and did not assess their impact on debt portfolio sustainability.

Conclusion

Debt stability analyzes did not take into account customized shocks of non-financial sector contingent liabilities

Recommendation

We recommend the following:

In the debt stability analyses to take into account the impact of contingent liabilities of non-financial sector and apply customized shocks to them.

LEGAL FRAMEWORK REGULATING THE PUBLIC DEBT MANAGEMENT OF THE RA

Audit topic: Is there an effective legal framework in place to regulate the public debt management of the Republic of Armenia?

Audit criteria and requirements

Primary legislation on the public debt management¹² shall:

- provide a clear and explicit delegation of powers of attraction of the public debt;
- state clear goals for attracting public debt;
- state clear goals of the public debt management, moreover, as the main goal to ensure that financial needs and payment obligations of the Government over the medium to long term are met at the lowest possible cost in line with a reasonable level of risk (*Revised Guidelines for Public Debt Management of the World Bank and International Monetary Fund - 1.1*);
- state the requirement for developing a debt management strategy;
- state the requirement for development of the loan program (WB Debt Management Performance Assessment (DeMPA) Indicator 1, ISSAI Public Sector Debt Working Group Guidance)¹³.

Audit results

The legal framework of the RA regulating the public debt sector largely meets the accepted standards, although a little bit complicated, regulations are set out in numerous laws and bylaws

¹⁴.

Primary legislation sets clear goals for attracting public debt of the Republic of Armenia

These are:

- 1) Financing the state budget deficit and ensuring current liquidity;
- 2) Supporting to the balance of payments and replenishment of reserves;
- 3) Preserving and developing the domestic public debt market¹⁵.

¹² According to the Constitution of the Republic of Armenia, state bodies and officials are authorized to perform only actions for which they are authorized by the Constitution or laws. Accordingly, within the scope of this audit topic, the delegation of public debt powers will be considered through regulations established by primary legislation (from the legislative power to the executive power).

¹³ One of the criteria relates to the requirement for the legislature to submit a mandatory annual report on public debt management activity that is addressed in Section on Public Debt Accountability.

¹⁴ Primary legislation of the RA public debt management mainly consists of the following legal acts: RA Constitution, the RA Law on the Public Debt, the RA Law on the Budgetary System, the RA Law on the Treasury System, the RA Law on International Contracts, the A Law on the Central Bank Law, the RA Law on Securities Market Law, Civil Code of the Republic of Armenia, annual laws on the state budget.

¹⁵ RA Law on the Public Debt, Article 8

Primary legislation sets clear goals for debt management.

The primary objective of the debt management of the Government of the Republic of Armenia is to provide a permanent capacity to meet the Government's financial needs, reducing the size of the debt servicing in the long run¹⁶.

However, the primary objective of the debt management of the Government of the Republic of Armenia did not include the requirement to reduce the borrowing costs to an acceptable level of debt portfolio risk, but only satisfied the purpose of reducing the amount of debt servicing (moreover, it is intended only to reduce and not to minimize, it is intended to be implemented only for the long-term and not for the medium-term, while the strategic horizon of the debt management is the medium-term horizon).

In addition to its main objective, the debt management of the Government of Armenia pursues the following objectives:

- developing an optimal government debt structure, taking into account potential risks (this objective, as discussed above, in terms of international best practice, should be a part of the entire objective, whereas it is classified as a not main objective in the RA Law on the Public Debt);
- Coordination of public debt management and monetary policy¹⁷.

The objective of the CBA debt management is to ensure realization of monetary policy and financial stability¹⁸.

Primary legislation establishes a requirement for the Government of Armenia to develop a medium-term (three-year) debt management strategy¹⁹.

In compliance with the law, this strategy is included in the state mid-term expense plan. However, the strategy focuses solely on government debt management and not on the public debt, as it does not include CBA debt management.

The RA primary legislation does not provide for the requirement of the loan program development, although MoF has developed and published annual loan programs.

The latter have not been approved by any legal act:

The primary legislation of the Republic of Armenia stipulates clear and explicit powers of attraction of the public debt under foreign (bilateral) and international organizations (multilateral) international loan agreements.

According to the Constitution of the Republic of Armenia, international treaties providing for financial obligations to the Republic of Armenia are ratified by law – by the National Assembly, upon the recommendation of the Government.

In addition, in compliance with the Constitution, the President of the Republic of Armenia is vested with the power to conclude international treaties in cases and in the manner prescribed by law, upon the recommendation of the Government, while the National Assembly is vested with the power to exercise parliamentary oversight over the use of loans and credits from foreign countries and international organizations. Relations with international treaties are further regulated by the RA Law on International Treaties, which stipulates that international treaties²⁰ without the authorization letter have the right to execute the RA president upon recommendation of the Government, the Prime-

¹⁶ RA Law on the Public Debt, Article 9, clause 2

¹⁷ RA Law on the Public Debt, Article 9, clauses 2 and 3

¹⁸ RA Law on the Central Bank, Article 11.1

¹⁹ RA Law on the Public Debt, Article 12

²⁰ An *international agreement* is a written agreement between the Republic of Armenia and the other Contracting Party (s) (i.e. a foreign state, international organization) and governed by international public law, irrespective of its name. The Armenian party is the Republic of Armenia, represented by the Government of the Republic of Armenia, Ministries, the Government and the bodies under subordinate to the Prime Minister, as well as other state bodies empowered to conclude an international agreement by the laws regulating their activities.

Minister, the RA Minister of Foreign Affairs, as well as in the cases defined by the law, officials authorized to represent the Republic of Armenia in bodies established by the founding documents of international organizations with membership of the Republic of Armenia.

Other officials may be authorized to sign an international agreement by the Prime Minister or the Minister of Foreign Affairs.

The Ministry of Finance of the Republic of Armenia is the authorized body for executing the international loan agreement²¹ and for implementing into force procedures thereof. The Ministry of Finance of the Republic of Armenia presents a recommendation to the Prime Minister on signing the loan agreement.

The draft loan agreement is subject to an inter-governmental agreement, within the scope of which conclusions/opinions and comments are sought from the RA Ministry of Foreign Affairs, the RA Ministry of Justice, the RA Ministry of Finance and other relevant bodies.

If, for the purpose of putting into effective the international loan or grant agreement a legal opinion is required by that agreement certifying the compliance with internal procedures that are essential for making that loan agreement to become effective, the Ministry of Foreign Affairs of the Republic of Armenia shall apply to the Ministry of Justice within 3 business days after submission of the required documents under the international agreement by the competent authority. which, within 3 business days, submits the legal conclusion in the form prescribed by the contract

The authorized authority shall submit a draft Government Decree on approving the recommendation for signing the international agreement to the RA Government.

Mutual consent of the draft international loan agreement with the other Contracting Party shall be carried out by the authorized authority in coordination with the Ministry of Foreign Affairs of the Republic of Armenia²².

In compliance with the RA Law on the Public Debt, the domestic public debt is assumed by the authorized body of the Government (RA MoF), as well as that the exclusive right to issue government treasury bonds belongs to the authorized body²³.

Unlike the government treasury bonds, the RA primary legislation²⁴ did not provide for the powers for attracting public debt, as well as their clear delegation through issuance of foreign currency government bonds (as of 31.12.18 they accounted for 15.7% of the debt of the Armenian government).

As of December 31, 2018, the external debt portfolio of the RA Government included the public debt attracted also from foreign commercial banks, although the Armenian legislation does not provide for clear and obviously defined authority for attracting loans from commercial banks at the time of attraction.

Due to the fact that the aforementioned lenders are not subject of international law, the loan agreements executed with them were not considered international agreements in accordance with the Law of the Republic of Armenia “On International Agreements” at the time of their execution, hence procedures provided for by the law were not applicable to them.

²¹ *International Loan Agreement* is an international agreement on loan, borrowing, as well as on providing or receiving a guarantee by the Republic of Armenia.

²² Given that the definition of international loan agreements also applies to guarantees, the above regulations also apply to agreements on granting external guarantees that are considered international agreements. In addition, pursuant to Article 11 (3) of the RA Law on the Budgetary System, the budgetary guarantee note (the guarantee) is drawn up in a separate document and is signed only by the head of state authorized body or his / her acting official.

²³ RA Law on the Public Debt, Article 2, clause 5 and Article 17, clause 1.

²⁴ The primary legislation of the Republic of Armenia includes the Constitution of the Republic of Armenia and the laws of the Republic of Armenia. According to the Constitution of the Republic of Armenia, state bodies and officials are authorized to perform only actions for which they are authorized by the Constitution or laws (Article 6, Part 1).

At the same time, no clearly defined legal procedures were in place for concluding such non-international treaties. Under these conditions, the aforementioned loan agreements, in the form of a protocol decree, were submitted by the Ministry of Finance to the Government of the Republic of Armenia for approval.

As of 31 December 2018, external guarantees that are not considered international treaties were also granted, though no clearly defined granting and explicitly specified powers were provided for thereof by the RA primary legislation.

Response of the audited entity

It is worth to mention that under the absence of legal acts establishing procedures for concluding non-international treaties with foreign commercial banks and other financial institutions that are not considered parties of an international treaty, before the new law on International Treaties has become effective (enacted on 09.04.2018), though there were not clearly defined legislative regulations and before execution of such agreements, the entire sets of draft documents were submitted to the RA Government for approval.

At the same time we would like to inform that a draft RA Government Decree on Establishing Procedures for Execution of a Document of an International Nature without Legally Binding Power was developed by the Ministry of Foreign Affairs of the Republic of Armenia, that per the representation of the Ministry will be adopted in the near future.

It should also be noted that within the meaning of the new law on International Treaties, contracts concluded with entities that are not subject of international law may also be considered international treaties to which inter-governmental procedures defined by the law will be applied.

The main goal and objectives of the RA Government debt management as set forth by the RA Law on the Public Debt shall be treated in a totality. The identification of the main objective is more due to the emphasis on the importance of providing a permanent opportunity to meet the Government's financial needs.

As for the requirement to balance risks at an acceptable level, the definition '*Optimal debt structure of the government taking into account potential risks*' set forth in the RA Law on the Public Debt completely covers that requirement.

Interpretation of the Audit Chamber

In the absence of clear legislative regulations, before execution of agreements, the submission of draft sets of documents to the approval of the RA Government does not meet audit criteria. Moreover, the approval of the Government was bound not by the Government decrees, but protocol decrees.

The reference to the draft Government Decree on Establishing Procedures for Execution of a Document of an International Nature without Legally Binding Force with regard to the subject matter is not clear, since, in compliance with the RA Constitution and legislation, international treaties assuming financial commitments for the Republic of Armenia, such as loan agreements, are ratified by the law in the National Assembly. Whereas, the aforementioned draft decree regulates the procedures for signing declarations, memoranda and similar documents that do not generate any financial commitments to the State Budget of the Republic of Armenia that have international nature with no legally binding force.

The new Law on International Treaties did not apply to loan agreements already signed during the audited period.

The concepts “primary objective” and “objectives” of the RA Government debt management are clearly defined by the RA Law on the Public Debt that obviously specifies clear hierarchy of objectives where the primary objective prevails over the non-primary objectives. While, balancing risks at an acceptable level should not be a part of the non-primary objective, instead it should be a part of the primary objective.

Conclusion

The primary objective of the debt management of the Government of the Republic of Armenia did not include the borrowing cost reduction requirement to balance the debt portfolio risk with acceptable levels, instead, only intention of reducing the size of the debt service was met (moreover, it is intended only to reduce and not to minimize; it is intended to be implemented only for the long term and not for the medium term, whereas the strategic debt management horizon is the medium-term horizon.

Unlike government treasury bonds, the primary legislation of the Republic of Armenia did not provide for the powers of attracting public debt through issuance of foreign currency government bonds, their clear delegation.

The primary legislation of the Republic of Armenia did not provide for the development of a loan program, although the MoF developed and published annual loan programs. These have not been approved by any legal act

Recommendations

We recommend the following:

To define by the law:

- clear and explicit powers, delegation thereof for issuance of foreign currency government bonds;
- within the scope of the primary objective of the RA Government debt management, to set goals for minimizing debt servicing costs, targeting the medium term as well as ensuring acceptable levels of debt portfolio risk;
- requirement for elaborating an annual loan program.

ORGANIZATIONAL STRUCTURE OF THE DEBT MANAGEMENT

Audit topic: Whether there is a unified organizational structure for the debt management?

Audit criteria and requirement

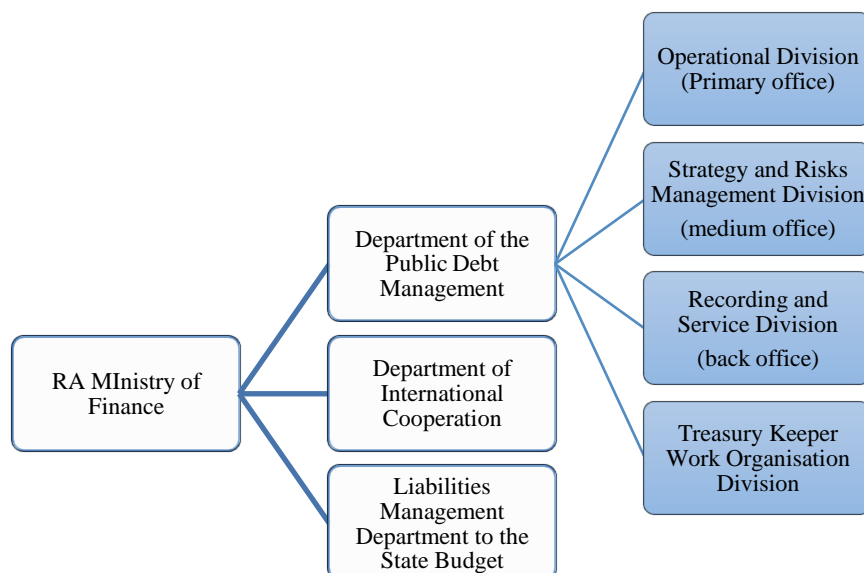
- Debt assuming and debt related transactions must be made by a single debt management organizational unit;
- Guarantees should be prepared and issued by a single organizational unit, which may also be the single debt management unit;
- Internal audits to evaluate the effectiveness of the internal control system of debt management should be conducted on a regular basis;
- Availability of a formal contractual relationship between the Government and the Central Bank (WB DeMPA DPI- 2, 5, 7, 13).

Audit results

The main functions of the public debt management of the Republic of Armenia are implemented by the Department of the Public Debt Management within the structure of which, in line with international best practice, the functions of the primary, secondary and back offices are operated²⁵.

Although the main responsible unit of public debt management is the Department of the Public Debt Management, two more departments of the RA Ministry of Finance – the Department of International Cooperation and the Management Department of Liabilities to the State Budget implement functions in relation to public debt management, in particular :

Chart 2. Debt Management Organizational Structure



- **Among the functions of the Department of International Cooperation are:** *Coordination* of preparation work for receiving loans and grants from foreign countries and international organizations, including review, summarizing and presentation of project proposals submitted

²⁵ The Department of the Public Debt Management has 20 employees.

by other state agencies, preparing necessary agreements, conducting negotiations, ensuring necessary procedures for signing those agreement, presenting conclusions on financial commitments required for ratification and approval procedures, collection of documents required by the RA Law on International Treaties and provision of established procedures ;

- **Among the functions of the Management Department of Liabilities to the State Budget are :** Management of guarantees, budgetary loans and sub-loans (organization of the granting process thereof, accounting, performance assurance, (follow-up) monitoring, etc.)

The organizational structure of the RA State Guarantee Management is also fragmented. Although the Management Department of Liabilities to the State Budget is delegated to carry out functions of organizing, documenting (including, organization of provision of guarantees, development of the loan, pledge and other draft contracts, as well as the contract approval process), recording, ensuring, and monitoring the process of granting guarantees, in fact, the Management Department of Liabilities to the State Budget does not carry out the delegated functions in terms of external guarantees, on the other hand, these functions are implemented by the Department of the Public Debt Management having no statutory function for carrying out those functions.

Instead, the Department of the Public Debt Management is entrusted with the task of forecasting, executing, and accounting of membership payments to international financial organizations, which has nothing to do with public debt management. Moreover, the Department of the Public Debt Management has no any statutory function to implement these functions.

There is an agency agreement between the Central Bank and the Ministry of Finance that is not publicized.

No internal audits of public debt management activities, systems and control procedures were carried out in the MoF.

Response of the audited entity

Currently, the possibility of carrying out the functions of organizing, formulating, accounting, executing and monitoring the process of providing external and internal guarantees within a single subdivision under the existing resources is discussed.

Interpretation of the Audit Chamber

The fact recorded by the Audit Chamber was, in fact, accepted by the audited entity.

Conclusion

The organizational structures of public debt and government guarantees management have been fragmented. Publicity of agency agreement signed between the MoF and the CBA was not ensured. No internal audits were conducted in the area of public debt management

The Department of the Public Debt Management has implemented the function of forecasting, implementing and accounting of membership payments to international financial organizations not related to public debt management.

Recommendations

We recommend the following:

- To provide and manage all government guarantees (including external) only by one department;

- To perform regular internal audits in the area of public debt management; to emphasize the process of compliance with recommendations of the Audit Chamber during the internal audit;
- To assign the function of forecasting, executing and accounting of membership payments to international financial institutions to another responsible subdivision;
- To publish the contract signed between the RA MoF and the CBA.

Audit topic: Whether there was a clear segregation of duties for debt formation and for debt servicing?

Audit criteria and requirements

- There should be a clear organizational segregation between the staff responsible for preliminary entry of the contract data into the credit negotiation and debt management system, and (a) those responsible for approval of accuracy of the contractual information and finalizing recording in the system, and (b) payments initiators and processors.

Audit results

The same official was involved in several duties at the same time, such as, the process of *initiating* payments on public debt, approving the initiation of payments, the process of preliminary *entry* of the contract data into the debt management system, confirmation of accuracy of the contractual information and in finalization of recording in the system that did not ensure proper segregation of duties, balancing and restraining.

Response of the audited entity

In terms of debt management, it is important to segregate between the authority for attracting loan resources (debt formation) on the one hand and servicing and repayment of that debt on the other.

Accordingly, segregation of duties is made in the Recording and Service Division of the Department of the Public Debt Management. Upon availability of human resources, an attempt has been made to segregate the work so that every recording/ payment made directly or indirectly is verified/approved by another employee, ensuring a "four eye" principle and minimizing operational risks as much as possible. The following should be detailed:

- Records related to loan contributions are indirectly reviewed by an expert responsible for servicing function by reconciling the calculation made by himself/herself of the amount subject to payment with the information reflected in the payment order;
- Registration of lending terms is finalized only after consideration by relevant staff;
- Payment orders are drawn up by a junior expert and approved by his/her supervisor.

Based on the segregation of duties, one of the leading experts is responsible for drawing up loan contributions schedules, organizing the contribution process, and accounting for actual payments to be made. While the other leading expert is responsible for drawing up service and repayment schedules, calculating amounts payable and for making payments.

And, of course, all the work listed is coordinated and approved by the head of the division.

Loan terms are entered into databases by the head of the division, after which each of the leading experts reviews the recorded information on its responsibilities and discusses it with the head of the division. Only upon completion those functions, the entered information is completed by the head of division. As for the loan servicing payments, the leading expert calculates the amount to be paid,

based on the terms of service and the contributions made, calculates the amount payable, combines it with the payment request received from the lender, and generates the draft payment order in 'Treasury Operating Day' software and saves it in the program. It is then reviewed/matched and approved by the head of the department or the head of the division.

As it is obvious from the aforementioned description, the duties and authorities of employees of the Recording and Servicing Division of the Department of the Public Debt Management are segregated as much as possible.

Interpretation of the Audit Chamber

The same official (head of the Recording and Service Division of the Department of the Public Debt Management) was involved in several duties at the same time, such as, the process of *initiating* payments on public debt, approving the initiation of payments, the process of preliminary *entry* of the contract data into the debt management system, confirmation of accuracy of the contractual information and in finalization of recording in the system. Hence, the Audit Chamber reaffirms the fact the insufficient segregation of duties from the point of

Conclusion

Segregation, balancing and restraining a number of essential duties was not ensured.

Recommendation

We recommend the following:

- To ensure a clear segregation of duties for initiating payments on public debt, preliminary entry of data, confirmation of contractual information and finalization of recordings.

DEBT MANAGEMENT STRATEGY

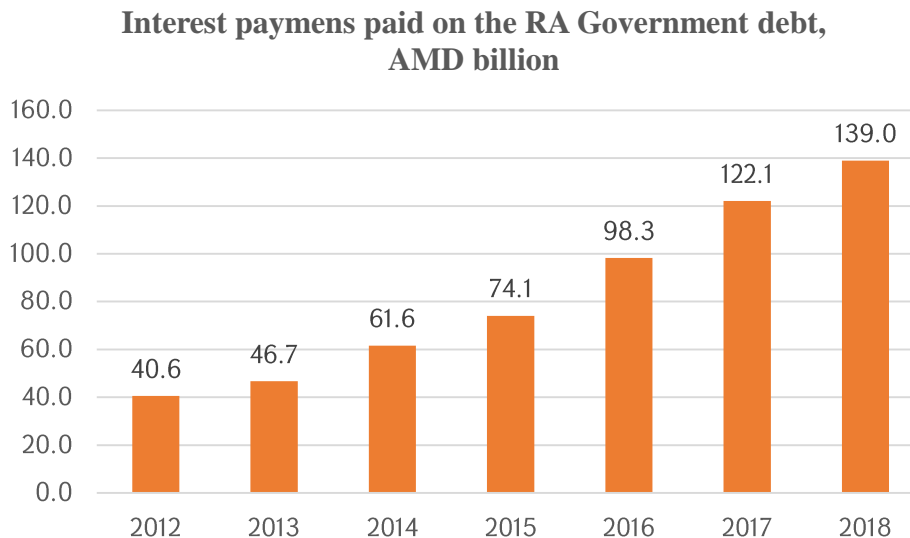
Audit topic: Whether the targeted effectiveness of public debt management has been ensured?

Audit criteria and requirements

- The primary objective of the debt management of the Government of the Republic of Armenia is to provide a permanent capacity to meet the Government's financial needs, *reducing the size of the debt servicing in the long run.* (RA Law, Article 9, clause 2)

Audit results

For the purpose of ensuring the main objective of the RA Government debt management as set forth by the law, the RA Government develops and realizes debt management strategies. However, in the long run, the amount of the debt service of the Government has not shown a downward trend, as shown in the chart below.



Conclusion

The main objective of the RA Government debt management has not been met. In the long run, the size of debt service has shown an upward trend (in the years 2012-2018, it has increased by 342%).

Recommendation

We recommend the following:

- When designing future strategies, to be guided by the milestone to guarantee the long-term debt service cost reduction trend.

Audit topic. Whether there are there any proper procedures for the Armenian Government for developing the debt management strategy?

Audit criteria and requirements

- Debt management objectives should be strictly clarified;
- The scope of the debt management should be clarified (as a matter of principle, the scope should cover the entire public non-financial debt, in particular central government, communities and non-financial public corporations);
- Even if the scope is narrow, the information on the complete balance sheet of the Government should be sought to collect, namely with regard to the main financial assets and liabilities, as well as the main contingent liabilities that will allow to assess vulnerability of the overall debt portfolio vulnerability and to strengthen the proper strategy analysis;
- The possibility of materializing contingent liabilities under certain scenarios should be assessed, hence debt managers should be well aware of the nature of those liabilities;
- The current debt management strategy needs to be clarified (is the starting point of the analysis against which alternative strategies should be tested), provide detailed information on the existing debt, its structure, the costs and risks thereof;
- To identify the vulnerability sources of the existing debt portfolio and to clarify whether the strategy should seek to change the characteristics of the existing debt portfolio, such as reducing certain risks;
- To identify and analyze potential sources of funding, their financial (including cost and risk) characteristics, available funding, and potential circumstances of hindering that funding;
- To conduct forecasts and risk analysis in key policy areas (fiscal, monetary, external, market);
- To identify structural factors that may affect debt in the long run;
- To develop alternative strategies and rate them based on the cost-risk characteristics;
- To get feedback from bodies implementing fiscal and monetary policy;
- There should be proper procedures for clear and transparent reporting on effective strategy development, *periodic review of the strategy*, emerging risks, monitoring of interest expenses, other commitments to influence government budget position, monitoring of the strategy performance and strategy outputs;
- All the debt assumed must be consistent with the debt management goals and strategies;
- The strategy should be reviewed regularly, for example, annually or more frequently if macroeconomic or market conditions have drastically changed;
- There should be an effective system of internal accountability²⁶.

Audit results

The process of developing the Draft Strategic Plan for Debt Management of the Government of the Republic of Armenia was realized per the following principles:

²⁶ *Developing a medium-term debt management strategy framework (MTDS) – updated guidance note for country authorities, WB & IMOF, 2019; WB DEMPA DPI-3; UNCTAD Principle 13:*

1. The basis for development for the Draft Strategic Plan for Debt Management of the Government (hereinafter referred to as the Draft) is Article 12 of the RA Law, and due to which it is involved in Medium-Term Expenditure Framework ;
2. The Division of the Strategy and Risk Management of the Department of the Public Debt Management of the RA MoF is the responsible body for development of the Draft;
3. The drafting process of the Draft starts upon publication of the RA Prime Minister's decision to launch the budgeting process of the Republic of Armenia, by which the Medium-Term Expenditure Framework schedule is approved;
4. Following the publication of the Prime Minister's decision to commence the budgeting process of the Republic of Armenia, in order to comply with the assignments set forth by that decision, the Order of the Minister of Finance of the Republic of Armenia on approving the schedule of activities to be carried out in the Ministry of Finance shall be published, setting out the schedule for drafting the Medium-Term Expenditure Framework and activities of the MoF subdivisions;
5. After drawing up the draft per the Medium-Term Expenditure Framework schedule, it shall be submitted to the Budgetary Unit of the MoF for including into the Medium-Term Expenditure Framework;
6. The draft document consists of the following sections: Introduction, Objectives and Scope of the RA Government Debt Management Strategy, Development trends in the Debt Management of the Government of the Republic of Armenia since the beginning of the recent year, Description of the RA Government Debt Portfolio and Cost and Risk Analysis of the Existing Debt Portfolio, as well as the Government's three-year debt management strategy, that includes: Macroeconomic Assumptions and Key Risk Factors, Milestones and the Implemented Measures, Benchmarks, Selection of the RA Government Debt Management Strategy, Cost-risk analysis of the Selected Strategy, Sensitivity Analyses;
7. Development of the Draft enables control over the marginal threshold indicator (Government debt / GDP ratio) specified in Article 5, clause 6 of the RA Law on the Public Debt;
8. The Department of Macroeconomic Policy and the Department of the Budgeting Process Management of the Ministry of Finance are also involved in the development of the draft document.
9. The CBA submits its opinion on the draft document, *as required*.
10. The Department of Macroeconomic Policy provides actual and forecasted macroeconomic indicators, participates in introduction work and provides feedback on the Draft. The Department of the Budgeting Process Management provides the actual and forecast state budget indicators and gives an opinion on the Draft document.
11. The data used in the DMFAS 6 Electronic Debt Registration and Accounting System, data of the Recording and Service Division of the Department of the Public Debt Management, database of the Operational Division and the Treasury Keeper Work Organization Division are used in the process of development of the Draft.

Implementation Stages of the Process

12. All divisions of the Department of the Public Debt Management are involved in development work of the Draft. The Strategy and Risk Management Division is responsible for drawing up the Draft, the Division of Recording and Service is responsible for provision of data on the existing debt that are derived from DMFAS 6 program, as well as from other database in several other

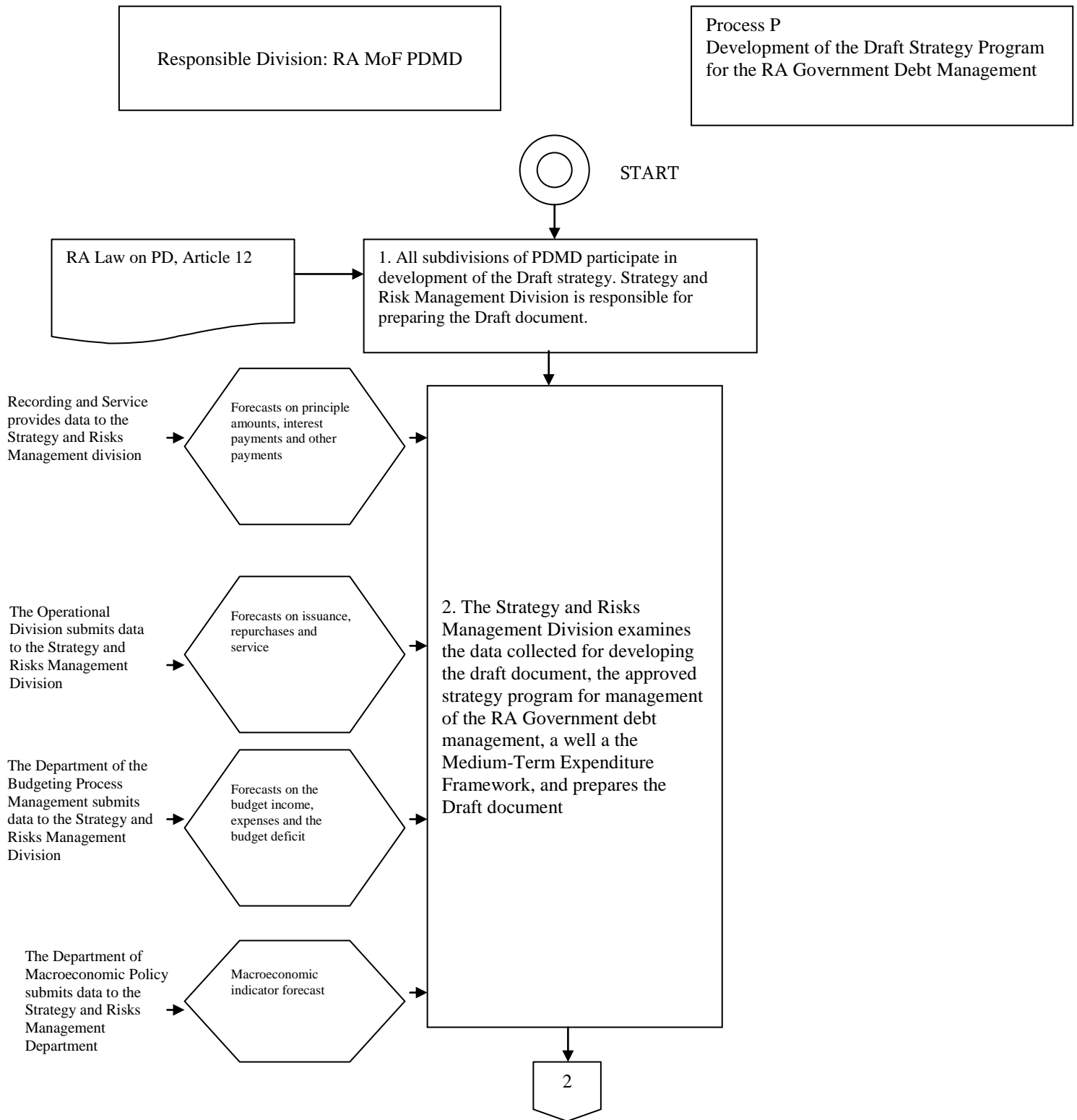
programs. The Operational Division is responsible for provision of data on issuance, repurchases and service forecasts for the current year and the next three years and for forecasting cash inflows and outflows as a result.

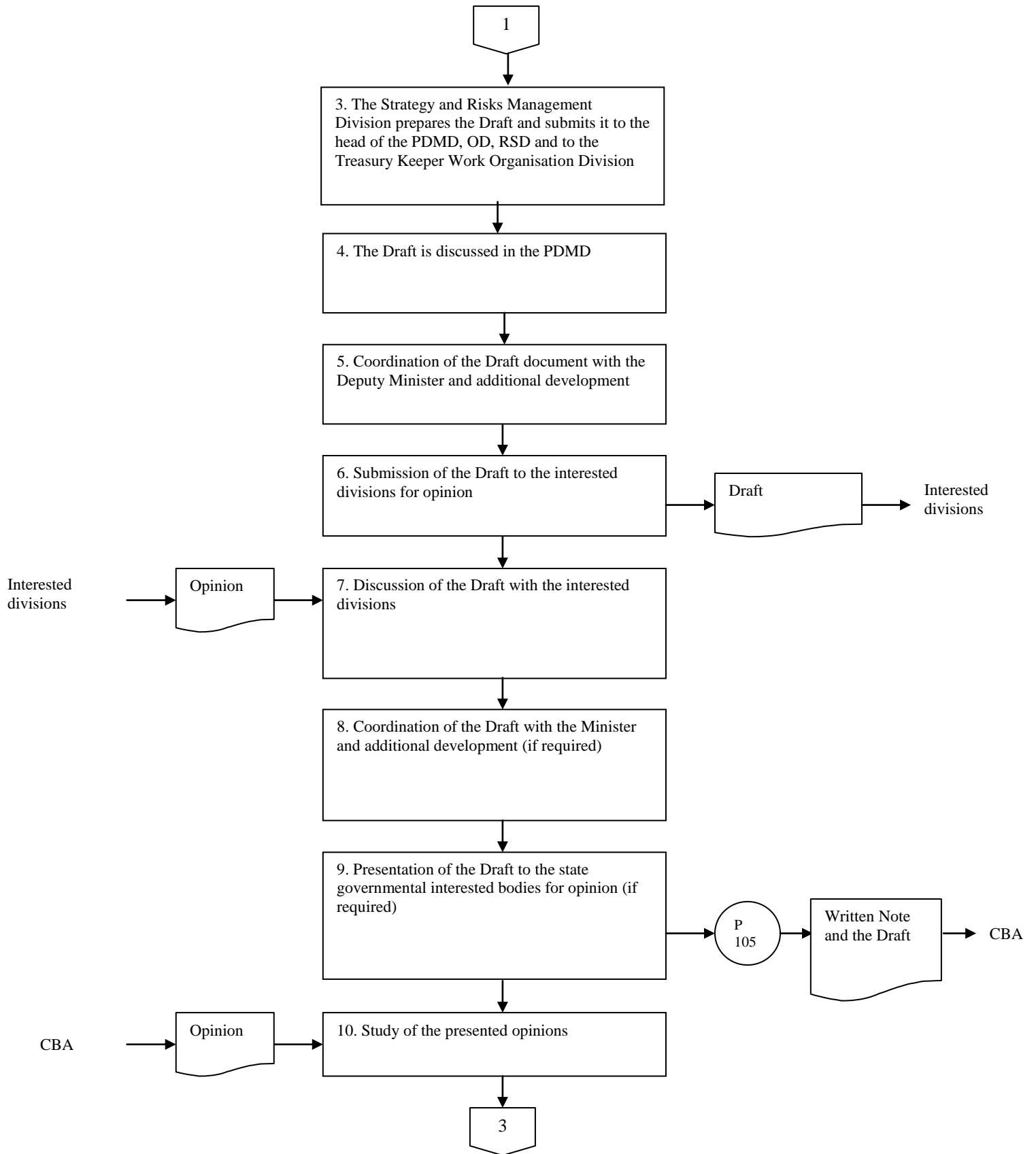
13. Recording and Service Division provides data on forecasted volumes of principal, interest and other payments for the next three years and provides other necessary information to the Strategy and Risk Management Division during the entire development period of the Draft, if required.
14. The Operational Division provides forecasts of issuance, repurchase and servicing forecasts for the given year and for the next three years, as well as provides cash inflows and outflows as a result of these forecasts to the Strategy and Risk Management Division. In addition, provides other necessary information during the entire development period of the Draft, if required.
15. The Strategy and Risk Management Division ensures the receipt of the data on the forecast budget revenue, expenditure, deficit and other required information for the given projected year and the forecast for the next three years from the RA MoF Department of the Budgeting Process Management. The Budgeting Process Management Department is responsible for timely provision of data.
16. The Strategy and Risk Management Division ensures the receipt of macroeconomic indicators and other necessary data for the given projected year and the forecast for the next three years from the RA MoF Department of Macroeconomic Policy. The Department of Macroeconomic Policy is responsible for timely provision of data.
17. The Strategy and Risk Management Division reviews the data collected for development of the Draft, the approved Government Debt Management Strategic Plan and the Medium-Term Expenditure Framework and draws up the Draft that shall include:
 - Objective of the public debt management for the next three years, taking into account the expected budgetary, macroeconomic and financial market developments and potential risks;
 - Lending principles, that is, what are the principles that should be guided by the Department of the Public Debt Management in attracting external loans (privileges, term, lenders, etc.), as well as in attracting internal loans (new lending terms, the portion of short-term liabilities, auction frequency and other data). The Operational Division actively supports the Strategy and Risk Management Division in developing the principles mentioned above;
 - Differentiation of loans per internal and external sources, per currency and justifications thereof. The Operational Division actively supports the Strategy and Risk Management Division in this function;
 - Differentiation of loans per fixed and floating interest rates, per instruments and justifications thereof. The Operational Division actively supports the Strategy and Risk Management Division in this function;
 - Currency structure of future loans and the level of acceptable interest rates, per currencies;
 - Definition of potential lenders. The Operational Division actively supports the Strategy and Risk Management Division in this function;
 - Debt repayment schedule as of the year end;
 - The Draft should define whether the Public Debt Management Department should implement an active or passive management of the debt. Active debt management means that the Operational Division must conduct financial transactions in the financial market within the

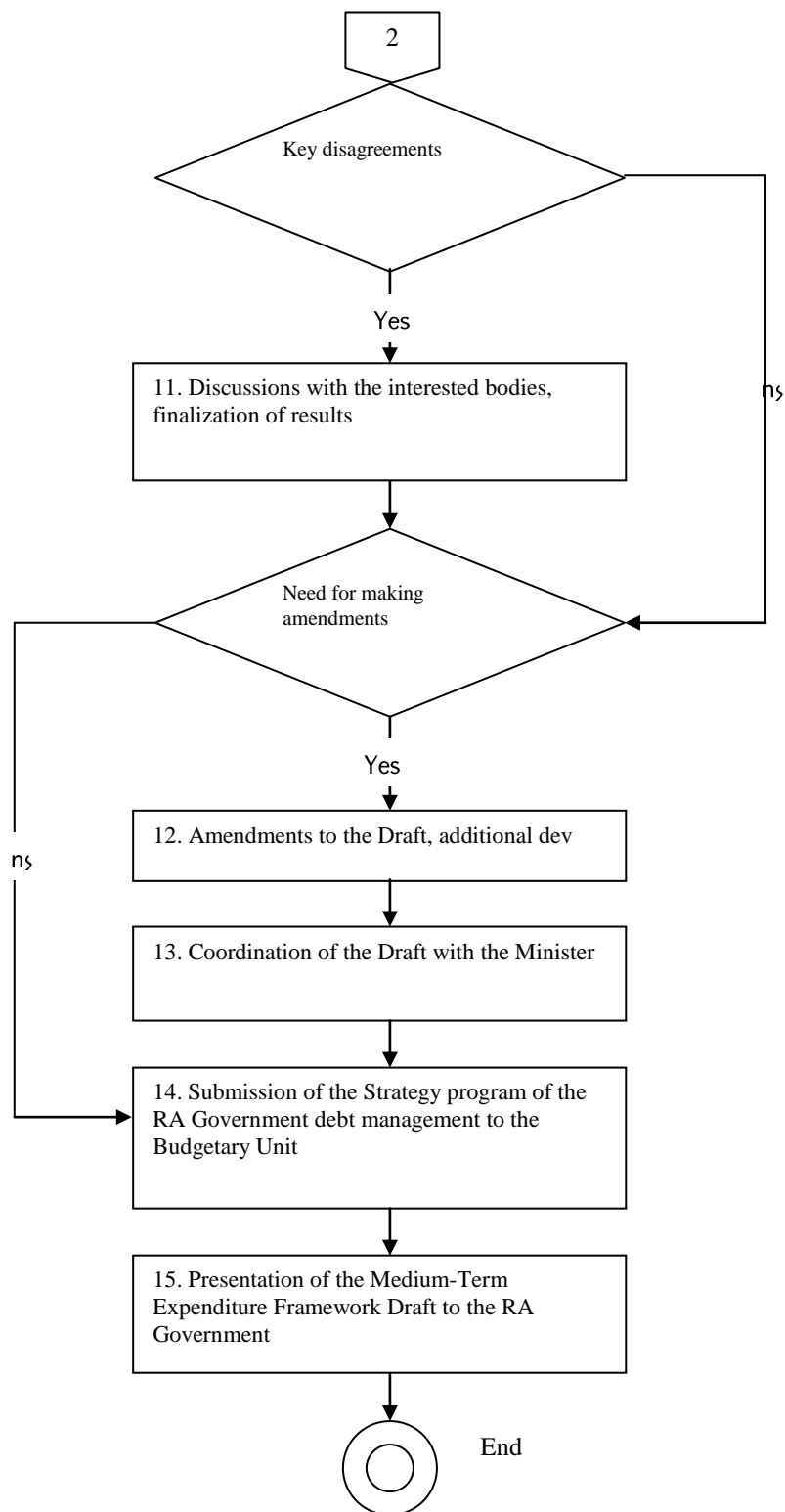
limits and types of transactions (direct sale, repo, swap, etc.) set by the Strategy and Debt Management Division. Passive debt management means that the Operational Division organizes auction placements and repurchase auctions;

- Measures that the Public Debt Management Department should implement to reduce operational risk. This section should cover issues that the Public Debt Management Department has had in the past, and future measures that may relate to organizational structure, staff qualification of the Public Debt Management Department, data security, business processes, data flows, etc;
 - Risks (interest rate, foreign currency rate, refinancing and other risks);
 - The amount of debt outstanding at the end of each period and its components: foreign currency debt, fixed and floating interest rate debt, investor structure, repayment schedule, etc;
 - Other necessary data and analysis.
18. The Strategy and Debt Management Division prepares the Draft and submits it to the head of the Department of the Public Debt Management, the Operational Division, the Recording and Service Division and the Treasury Keeper Work Organization Division.
 19. Head of the PDMD holds discussion with participation of all aforementioned divisions for finalizing the Draft. Representatives of the departments present their suggestions at the discussion.
 20. The SRMD makes certain edition (review) of the Draft and through the head of the Public Debt Management Department submits it to the Deputy Minister and other interested divisions.
 21. The Deputy Minister, if required, organizes a discussion on the Draft, as a result of which, in case of corresponding recommendations, delegates the Public Debt Management Department to edit the Draft.
 22. The PDMD reviews the Draft and submits to the RA Ministry of Finance and to the interested parties of the Ministry for opinion.
 23. If required, the Minister organizes discussions with participation of all interested subdivisions and, in case of corresponding recommendations, delegates the Public Debt Management Department to edit the Draft.
 24. The PDMD reviews the Draft and submits to the RA CB for the opinion.
 25. The PDMD examines the comments and recommendations received from the Central Bank and observes whether there are fundamental disagreements and arguments in the views expressed.
 26. If required, meetings are organized with participation of all stakeholders to discuss comments and recommendations received. All results are summarized at the end of discussions.
 27. On the basis of the comments and recommendations presented and/or discussions, the need to amend and to revise the draft is determined. If necessary, appropriate amendments are made to the Draft and the revised Draft is provided to the budgeting unit to incorporate into the MTEF.
 28. According to the established procedure, the MTEF that also includes the strategic plan of the Government of the Republic of Armenia, is submitted to the Government of the Republic of Armenia for approval.

Process of Developing and Approving the RA Government Debt Management Strategy







The following key issues were identified with regard to the RA Government Debt Management Strategy during the audit:

1. Despite the fact that the highest risk of the RA public debt portfolio is the exchange rate risk, the benchmark indicator of the RA Government debt portfolio for that risk is that the share of domestic debt in the total debt remains constant at the 20% level.
2. In the medium-term horizon, there were significant deviations between the projected and actual indicators of the RA Government debt and interest payments. Low quality of forecasts may disrupt the process of finding and negotiating more beneficial sources of debt attraction.

AMD, Billion

	Projected and actual figures for 2017			Projected and actual figures for 2018		
	Forecast per the 2016-2018 Strategy	Forecast per the 2017-2019 Strategy	Actual	Forecast per the 2016-2018 Strategy	Forecast per the 2017-2019 Strategy	Actual
RA Government Debt	2,286	2,649.1	2,988.4	2,399	2,784.7	3,082.9
Interest payment	99	108.2	122.1	103.8	118.2	139

3. In terms of the exchange rate risk reduction and efficient management, the possibility of applying different hedging approaches has been provided for by the Debt Management Strategy of the RA Government, such as currency swaps. However, this opportunity has not actually been realized. There are no procedures for derivative instruments
4. There is no an imperative requirement to submit the Draft to the Central Bank for the opinion. This action is implemented by the MoF as needed. In 2018, it was not submitted to the Central Bank for the opinion.
5. There is no established procedure for reviewing the Strategy sooner (if the indicators underlying the Strategy have undergone a substantial change) than the defined schedule (annually).
6. Constant issuance of government bonds is not sufficient for the development of the domestic public debt market²⁷. The composition of investors in government treasury bonds is not diversified (about 80% of investments belong to the banking system). In this situation when there is a limited composition of domestic investors, opportunities for development of the domestic public debt market in the long-run are uncertain due to suppression of the substantial exchange rate risk. As of 31.12.2018, the specific weight of the RA government bonds acquired by non-residents amounted to 0.6% in the total amount. No any definite strategic measures for non-residents to promote investments in the RA government bonds were planned.
7. The strategy has not sufficiently addressed the structural factors that may affect the debt in the long-run.

²⁷ In compliance with Article 8 of the RA Law on Public Debt, one of the objectives of the public debt attraction is maintenance and development of the domestic public debt market.

8. There was no effective system of managerial internal accountability introduced with regard to the performance of the Strategy, in particular, absence of internal formal accountability procedures with regard to the implementation process of the debt management strategy and annual loan program to the RA Minister of Finance from the public debt management units.

Response of the audited entity

Among the RA Government debt benchmark indicators, the Indicator Domestic Debt Share to the Total Debt was included in the RA Government Debt Management Strategy in 2016, in the RA Government Debt Management Strategy developed for the years 2017-2019, where it was predicted at 17.7% as the 2016 state budget program-based indicator, while 18.2%, 19.1% and 19.6%, respectively, for the years 2017-2019. However, at the end of the year 2016, the Indicator Domestic Debt Share to the Total Debt was actually 20.9%, providing the benchmark level for 2015 exceeding the same indicator by 4.4 percentage points. For the year 2017 it was not changed significantly, however in 2018 it increased and was amounted to 21.8%, which is also a significant achievement, as due to the peculiarities of the structure of the RA Government debt portfolio of Armenia, it is impossible to ensure a high growth rate of the Indicator Domestic Debt Share to the Total Debt.

Deviations between the projected and actual indicators of the RA Government Debt and interest payments that were provided in 2016-2018 through 2017-2019 indicators presented in the RA Government Debt Management Strategies are conditioned by the exchange rate fluctuations and changes in predicted and actual recorded macro-environment during the years from 2015 to 2018.

In terms of the possibility of applying foreign currency swaps as stated by the RA Government Debt Management Strategy, it should be noted that in respect of individual external loan agreements, which provided for the application of swaps, that opportunity has been used and swap was implemented between the floating and fixed interest rates. There is no established procedure for reviewing the Strategy sooner than the defined schedule (annually), since in compliance with the RA Law on Public Debt, it is a part of the Medium-Term Expenditure Framework and that review shall be implemented per the procedure defined by the Medium-Term Expenditure Framework

For the purpose of diversification of the composition of investors in the RA government treasury bonds of the Republic of Armenia, the following measures have been taken to support the objectives of the Government of Armenia Debt Management Strategies:

- In compliance with the new revised version of the RA Government Decree No 381-N, dated 13 April 2017, the following procedures were approved: the procedure for issuance, placement, repurchase, circulation and redemption of the state treasury short-term bonds, medium-term and long-term coupons, the procedure for issuance, placement, repurchase and redemption of savings coupon bonds and the activity procedure for the treasury keeper was approved. Its purpose is to develop the primary market of government treasury bonds, the retail market and to introduce a system of online bond sale.
- For the purpose of developing the retail market and increasing the share of individuals, online system of retail sale of government treasury bonds through Treasury Keeper was introduced that contributed to expand the scope of retail sale investors and increase of investment volumes.
- Through the launch of International Central Securities Depository Clearstream Depository Connection, an opportunity is given to foreign investors to invest in the RA government bonds without opening an account in Central Securities Depository of Armenia.

- On 08 June 2017, state treasury long-term coupon bonds in local currency with 30-year maturity date were successfully placed for the first time. The target is mainly pension, insurance companies and other long-term investors.
- In July 2019 state treasury bonds with 10 year maturity date and with an unprecedented volume equivalent to USD 100 million were issued, that derives from the overall objective of the RA Government Debt Management Strategy, that is, to increase the liquidity of bonds through increase of the volume of bonds in circulation.

Interpretation of the Audit Chamber

A part of the response of the audited entity in relation to the Indicator *Domestic Debt Share to the Total Debt* from the benchmark indicators of the RA Government debt did not refer to the audited period, while with regard to the years 2017-2018, the position of the RA Audit Chamber was re-affirmed - Despite the fact that the actual indicator has increased, the benchmark indicator for the coming three years remains constant at the 20% level.

Accordingly, the Strategy sets easily achievable targets that are even less than current indicators.

The rest of the response of the audited entity, in substance, is an explanation of the facts recorded by the Audit Chamber, hence, the Audit Chamber re-affirms its position

Conclusion

Despite the fact that the highest risk of the RA public debt portfolio is the exchange rate risk, the benchmark indicator of the RA Government debt portfolio for that risk is that the share of domestic debt in total debt remains constant at the 20% level.

Hedging instruments have not been used to fence the foreign exchange risk. Procedures for the use of derivative instruments have not been established. As of 31.12.2018, the specific weight of the RA government bonds acquired by non-residents totaled 0.6%. The quality of medium-term forecasts of the RA Government debt and interest payments was low (for example, in 2018 the actual amount of the debt of the Government of the Republic of Armenia exceeded the predicted 2016-2018 strategy level by 28.5%). There is no an imperative requirement to submit the Draft for the opinion to the Central Bank of Armenia and it has not been submitted for the opinion in 2018. There is no an effective system of managerial internal accountability on performance of the Strategy introduced.

Recommendations

We recommend the following:

- To discuss the possibilities of raising the benchmark indicator of the RA Government debt portfolio (the share of the domestic debt in total debt);
- To discuss possibilities for raising the benchmark indicator (the share of the domestic debt in total debt) of the RA Government debt portfolio;
- To improve the quality of mid-term forecasts of the RA Government's debt size and interest payments;
- To submit the Draft Strategy to the Central Bank of Armenia on annual basis for the opinion;
- To discuss the possibility of introducing hedging instruments and developing procedures for derivative instruments;

- To establish the procedure for reviewing the Strategy sooner than the defined schedule (annually), specifying the cases (thresholds for changes of milestones underlying the Strategy) in occurrence of which there will be a need for reviewing the Strategy;
- To define and publish conceptual approaches for diversification of investors in the RA treasury government bonds, including for attraction of non-resident investors;
- To introduce a regularly set internal managerial reporting system on performance of the Strategy and annual loan program through submission of summary reports.

STATE GUARANTEE MANAGEMENT SYSTEM

Audit Topic: Whether there is a formal budget guarantee policy in place?

Audit criteria and requirements

- Availability of and publicly accessible a formal guarantee policy that will provide information on the sectors of industry or program types, that will be supported by guarantees to reduce the risk of ad hoc decisions or political patronage (WB DEMPA DPI-2)
- Priority of economic sectors receiving budget guarantees is reflected in the Government Debt Management Strategy (the RA Law on Public Debt, Article 23, clause 7)
- Management of the public debt is realized guided by the transparent principle (the RA Law on Public Debt, Article 10)

Audit results

No information has been published on the state's guarantee policy that would have provided the potential bidder of the guarantee with an understanding of the priority industry sectors and would have guaranteed equal conditions for them. The principle of transparency with regard to management of the public debt is stated by the RA Law on the Public Debt (Article 10). In addition, the aforementioned law provides also an effective mechanism for ensuring that transparency for the subject matter, according to which the priority of economic sectors receiving budget guarantees are reflected in the RA Government debt management strategy (Article 23, clause 7). However, in practice, those sectoral priorities have not been addressed by the Government debt management strategies, and under these conditions some entities have been provided with the state (internal and external) guarantees. The lack of a transparent guarantee policy and a failure to comply with the statutory requirement have created unequal opportunities with regard to the government-borrowed funds for those entities that have been provided with the state guarantees against those that operate in the same industry and are in similar financial and economic situation. Hence, in terms of the audit criteria, the process of guarantee provision was ineffective, had an ad hoc nature, and did not provide equal starting conditions for potential bidders.

Response of the audited entity

Taking into consideration that the provision of budget guarantees is not regarded as an application of a financial instrument, as a priority, in the RA Government Economic Development Strategy, the expense items of the RA state budget do not provide for the programs implementation sources of which will be the financial resources attracted under the provision of budget guarantees. Therefore, no relevant development plans have with regard to those guarantees been developed by the RA MoF. It is worth noting that provision of budget guarantees by the Government of the Republic of Armenia is exclusively made when such a toolkit is required to apply under certain circumstances for urgent resolution of certain problems arising during the given year.

The consideration '*did not provide equal starting conditions for potential bidders*' mentioned in the above paragraph is not true, since only one entity was provided with the budget guarantee by the RA Government during the audited period and during that period no any other bidders applied to the Government for such a request, hence, there is no reason for inequality to be violated.

Interpretation of the Audit Chamber

In terms of the audit criteria, as well as per the requirement of the RA legislation, the use of the state guarantee instrument should be preceded by the publication of a guarantee policy so that the provision

of state guarantees does not have an ad hoc nature and the state does not create preferential conditions for some entities. The feedback from the RA MoF confirms that the provision of state guarantees had an ad hoc nature and that, in terms of audit criteria, it is an ineffective approach.

An effective system of the provision of state guarantees implies that prior to the possible use of this instrument, the State, as required by the RA Law on the Public Debt, should publish the sector (s) where guarantees may be provided, after which the entities operating in the given sector (s) will be able to submit a bid for receiving a guarantee, to go through the procedures defined by the RA State Budget Guarantee Procedures, as a result of which the bid may either be approved or rejected. Instead, this process has not been followed. The fact submitted by the MoF that other bidders had not applied to the Government for the request of getting guarantees is a consequence of the failure to comply with the requirement of the RA Law on the Public Debt, and potential bidders could not know that the State could provide a guarantee in their field of business to apply for such a claim. Moreover, the guarantee was provided to entities that did not go through the established common procedures. Accordingly, these entities appear to be on an unequal footing against other entities operating in their field of business.

Conclusion

No information has been published on the state guarantee policy, but individual entities have been provided with internal and external state guarantees, thereby creating unequal conditions for those entities against other entities operating in the same sector and having similar financial and economic standing. The provision of the state guarantees had an ad hoc nature.

Recommendation

If a provision of the state guarantee is envisaged during the year, we recommend the Government's Debt Management Strategy to include those sectors or programs of the industry that may be subject to the state guarantees.

Audit Topic: Whether state guarantees are provided in the pre-defined procedure?

Audit criteria and requirements

- Availability of effective formal procedures for provision of the state guarantees (WB DEMPA DPI-10);
- The RA Government Decree N 380, dated 18.06.98, *On Approving the Procedure for Issuing RA State Budget Guarantees*.

Audit results

The established practice of issuing state guarantees allowed in lieu of complying with the defined common procedural arrangements set forth for provision of guarantees by the RA Government Decree No 380, dated 18.06.98 to bypass those regulations and in each individual case of providing a guarantee, to prepare a draft Government decree and to submit it for approval, by which the guaranty receiver and the guarantee terms have already been defined.

The MoF did not apply the procedure mentioned above to external guarantees, arguing that it applies only to internal budget guarantees, whereas, in reality, the procedures defined by this Decree are also applicable to the process of providing external guarantees

The RA Law on the Budgetary System, Article 11.1 defines legal regulations for issuing budget guarantees to the Deposit Guarantee Fund. In particular, if the stability of the banking system of the Republic of Armenia may be jeopardized at the time of occurrence of a case of reimbursement

(liquidity and / or solvency), then the Deposit Guarantee Fund may be provided with a minimum of three years budget guarantee by the decree of the RA Government, without *collateral*.

There are no formal methodological guidelines to assess the feasibility of a provision of a budget guarantee for the coming years on the above basis.

In addition, in compliance with Article 11.1, clause 3 of the RA Law on the Budgetary System, the procedure defined by the RA Government on provision of budget guarantees shall not be applied to provision of budget guarantees to the Deposit Guarantee Fund. Hence, there are not procedural regulations for provision of such guarantees.

Given that such guarantees will be provided without collateral, this regulation poses a significant risk to the fiscal stability of the Republic of Armenia.

Response of the audited entity

Not available.

Conclusion

Provision of state guarantees had an ad hoc nature, the defined procedures were not followed. Moreover, procedures for provision of the budget guarantee to the Deposit Guarantee Fund are not defined at all.

Recommendation

We recommend the following:

- To refrain from provision of state guarantees for solving issues having ad hoc nature;
- When providing both internal and external guarantees, to be guided by the defined procedural regulations. To defined procedures for providing state guarantees to the Deposit Guarantee Fund.

Audit topic: Whether credit risk assessments are carried out when providing and monitoring state guarantees?

Audit criteria and requirements

- Before making a decision to provide a guarantee or not, the procedure on issuing guarantees should contain the requirement of submitting a credit risk assessment, methodology applied for that assessment (that should include for instance credit risk thresholds), as well as the requirement of implementing monitoring during the period of that guarantee;
- Availability of a financial impact analysis procedure in place when the guarantee is called (WB DEMPA DPI-10).

Audit results

There were no methodological guidelines to make credit risk assessments based on those approaches made, prior to issuing state guarantees.

There were no methodological guidelines to monitor the existing guarantees, to manage risks arising during their implementation, as well as to make financial impact analyses on the state budget when the guarantee is called, in particular, no ongoing credit risk assessment was made with regard to the already issued guarantees, there were no requirements, procedures and methodological guidelines with regard to that assessment.

Pursuant to clause 12 of the RA Government Decree N 380, dated 18.06.98, supervision of the contract on provision of the guarantor letter shall be made by the guarantor that shall have the right, through verifications made at regular intervals specified by the contract, to supervise the implementation of the project by the guaranteed entity, as well as the process of the execution of the contract on issuance of the guarantor letter.

However, actually, no such verifications were made during the period covered by the audit (including, inspections on the intended use of the funding of the loan guaranteed project)

At the same time, the need for such verifications should be justified as a result of the aforementioned (follow-up) monitoring process, the mechanisms of which are missing.

Response of the audited entity

The credit risk assessment during the provision of the budget guarantee, as well as follow-up procedures during the audited period were carried out by the Liabilities Management Department to the State Budget with no specific methodological guidelines.

During the operation of the budget guarantee period no verification was made on its execution, due to the lack of the issues.

The borrower's conduct was regularly discussed with the bank providing the credit under the guarantee and there was no need for verification.

It should be noted that the guarantee provided has already expired and no breaches of the terms have been reported.

Interpretation of the Audit Chamber

Conducting credit risk assessments without methodological guidelines does not meet audit criteria.

Actually, credit risk assessments can be both made and not made. In the absence of an effective monitoring system over guarantees, the need for making verifications cannot be properly justified.

Conclusion

There is no methodology for credit risk assessment, based on which before the guarantee was issued and after the guarantee was issued assessments should have been made. Therefore, the system of issuing and managing state guarantees is ineffective as it does not have effective institutional mechanisms to control the likelihood of materialization.

Recommendation

We recommend the following:

- To Conduct a risk assessment based on the credit risk assessment methodology for each of the guarantees provided (internal and external); and
- To reassess credit risk at least quarterly, determining the likelihood of materialization of guarantees.

Audit topic: Whether guarantee payments were charged to cover the credit risk?

Audit criteria and requirements

There should be a requirement for guarantee fee calculation and charging thereof (if it does not cover, then the government actually subsidizes the beneficiary) (WB DEMPA DPI-10).

Audit results

In compliance with the RA Law on the Public Debt, guarantee payments to be charged from legal entities are fixed amount, at 1% of the guarantee fee. There is no requirement to analyze whether the guarantee fee covers the credit risk.

There are no payment requirements for guarantee payments, in case the guarantees are issued to local self-governing bodies, as well as in case of external guarantees with regard to the CB.

Response of the audited entity

The amount of the guarantee fee charged for the issue of the budget guarantee is not defined by the RA Law on the Public Debt, Article 23, clause 7, according to which '*Resident legal entities of the Republic of Armenia, for which budget guarantees have been provided, will have to pay a commission fee to the state budget at the end of the guarantee program, at the rate of 1% of the guarantee amount*'. The commission fee does not in any way relate to the credit risk guarantee payment and is not intended to eliminate such risk.

Interpretation of the Audit Chamber

MoF response reaffirms the absence of the credit risk guarantee payment system.

Conclusion

The current guarantee payment charging system is not linked to the credit risk.

Recommendation

We recommend the following:

- To introduce a risk-based differentiated guarantee payment system, as well as to develop methodology for calculation of guarantee payments
- To define guarantee payment requirements with respect to external guarantees provided to local governments and to the Central Bank.

Audit topic: Whether there are proper systems and procedures for recording guarantee related data?

Audit criteria and requirements

Internal procedures should specify data input and recording rules to the guarantee-related database. As a rule, data on guarantees are recorded in a unified system of the public debt registration and management. (WB DEMPA DPI-10)

Audit results

The Budget Guarantees Database is an Excel file, despite the fact that DMFAS 6 program was installed in the MoF and is planned for recording of guarantees. Actually, the State Guarantees Database is incomplete as it contains only information on internal guarantees. This information is submitted to the Department of the Public Debt Management by the Department of Liabilities Management to the State Budget for reporting purposes on monthly basis. There are no procedural arrangements effective for recording guarantees and entering data thereof into databases.

Response of the audited entity

Due to the lack of a DMFAS 6 service administrator, the program either fails to operate or operates with malfunctions.

Interpretation of the Audit Chamber

Failure to have an administrator for four years is not a sufficient justification for not running the program and not having a complete database.

Conclusion

State guarantee database is incomplete, guarantees are not registered in DMFAS 6 system, data entry procedures are missing.

Recommendation

We recommend the following:

- To record all state guarantee data in the DMFAS 6 system;
- To develop guarantee-related data recording procedures.

MANAGEMENT OF SUB-LOANS AND BUDGETARY LOANS

Audit topic: Whether sub-loans and budgetary loans have been provided based on certain predetermined selection procedures of borrowers?

Audit criteria and requirements

- Availability of procedures established by the RA Government for provision of sub-loans and budgetary loans that should regulate decision-making process of lending (WB DEMPA DPI-10);
- RA Law on Budget System, Article 10, clause 3, in compliance with this Law, the legislative body delegates the Government with the authority to define the issue procedure of the budgetary loans;
- RA Government Decree N 168, dated 09.03.98, On Approval of the Issue Procedure of Loans from the RA State Budget.

Audit results

To comply with the requirement of the RA Law on the Budget System, based on the Decree N 168, dated 09.03.98, the RA Government defined the procedure for issuing budgetary loans, however, the established practice of issuing budgetary loans has allowed instead of complying with common procedural arrangements set forth by the aforementioned Decree, to bypass these arrangements and, in each individual case, to form a draft Government decree and to submit it for approval by which the borrower, the amount of the loan and terms of lending have already been specified.

Procedural arrangements to the issuance of sub-loans process (as opposed to guarantees and budgetary loans) are not established at all.

Response of the audited entity

Not available

Conclusion

The budgetary lending process had an ad hoc nature, bypassing the set of commonly defined procedural arrangements, moreover, no any procedural arrangements have been defined for issuance of sub-loans.

Recommendations

We recommend the following:

- To develop common procedural amendments for sub-lending purposes;
- To be guided exclusively by commonly specified procedures when issuing budget loans and sub-loans, refraining from making decisions that circumvent these procedures in each individual case.

Audit topic: Whether there is a publicly available policy for issuance of sub-loans and budgetary loans by the state?

Audit criteria and requirements

- Availability of the policy defined by the Government for issuing sub-loans and budgetary loans (WB DEMPA DPI-10);

- RA Government Decree N 168, dated 09.03.98, On Approval of the Issue Procedure of Loans from the RA State Budget.

Audit results

No information has been published on the state sub-lending and budgetary lending policy, which would provide the potential borrower with an idea of the priority sectors for obtaining loans and guarantee equal conditions for potential borrowers.

Response of the audited entity

Taking into consideration that issuance of budgetary loans is not considered a priority as a financial instrument in the Economic Development Strategy of the Government, the expense items of the RA state budget do not specify programs, the implementation source of which would have been provision of budgetary loans, therefore, no relevant development plans are developed thereon by the RA MoF. It is worth noting that provision of budgetary loans by the RA Government is conducted only in cases when such a toolkit is necessary for urgent regulation of certain problems of ad hoc nature arising during the given year.

Interpretation of the Audit Chamber

As at the end of 2018, the portfolio of sub-loans was amounted to AMD 427.0 billion (USD 882.7 million), or 14.9% of the Government debt. Notwithstanding that this instrument was actively used, no information has been released on the state's sub-loan policy.

In compliance with the requirement of clause 9 of the RA Government Decree N 168, dated 09.03.98, budgetary loans are provided to legal entities included in the target program of the state significance approved by the RA Law or the RA Government to provide financial support for implementation of the program objectives, while in compliance with the requirement of clause 11 of the same Law, the bids that will not correspond to the requirements of the Procedure shall be subject to refusal. The response of the RA MoF reaffirms that such programs have not been developed and published, however, as at the end of 2018, the amount equal to AMD 6.3 billion were provided as budgetary loans that, in terms of audit criteria, is ineffective approach.

Conclusion

No any policy on sub-loans and budgetary loans has been published, although sub-loans and budgetary loans were provided.

Recommendation

We recommend the following:

- To establish a legislative requirement to publish a policy on sub-loans and budgetary loans in the Government's Debt Management Strategic Plans (similar to the requirement with regard to the state guarantees set forth in the RA Law on the Public Debt);
- To develop and publish policy on sub-loans and budgetary loans.

Audit topic. Whether credit risk assessments are carried out when providing and monitoring of sub-loans and budgetary loans?

Audit criteria and requirements

The established procedures shall contain:

- methodological guidelines to credit risk assessment (guidelines) and, prior to making a sub-lending and budgetary lending, to require a credit risk assessment guided by those guidelines;
- credit risk monitoring requirement (borrower's ability to meet its credit obligations, periodic risk assessments for unintended expenses, detailed analysis of documentation of big loans and collateral, small loan sample analysis, etc);
- requirement for calculation of margin interest rate covering the credit risk (calculation should be based on a proper credit risk assessment, otherwise, it would be treated as a subsidization by the Government to the borrower).
- Requirement for making financial impact analysis in case the loan requirements of the sub-borrower are not complied with (WB DEMPA DPI-10);
- The fact that donor organizations carry out a comprehensive preliminary review of programs implemented by public sector entities does not relieve the Government of its sovereign responsibility for conducting such a review (UNCTAD, Principle 12);

Audit result

There is no requirement for credit risk assessment before the the sub-loan and budgetary loan is provided.

When providing sub-loans and budgetary loans, no credit risk assessments were made based on the predetermined methodology.

There were no analyzes of financial impact on the state budget implemented by the entity that was provided with sub-loans and budgetary loans and failed to comply with its loan obligations, nor there were methodological guidelines for implementing such analyses.

No monitoring was made on credit risks in the predetermined methodologies with regard to the budgetary loans and sub-loans.

No inspections were made on the intended use of the provided budget loans. In compliance with clause 20 of the RA Government Decree N 168, dated 09.03.98, control over the intended use of the loan is exercised by the RA MoF that should be entitled to carry out inspections on the intended use of the loan in the period specified by the loan agreement, at the defined periodicity, while in compliance with clause 17, in case of unintended use of the loan resources by the borrower, the outstanding amount of the loan and the interest accrued before the defined maturity date of the loan agreement, shall be subject to early repayment.

When providing sub-loans and budgetary loans, no margin interest rate was applied, moreover, there are no any methodological guidelines to calculate it. As at 31.12.2018, from the provided 58 budgetary loans and sub-loans, 25 was provided without collateral.

Response of the audited entity

During the reporting period, credit risk assessment when providing sub-loans and budget loans, as well as further monitoring (follow-up) thereof was carried out by the Liabilities Management Department to the State Budget without any methodological guidelines.

No inspections were carried out in relation to sub-loans and budgetary loans during the audited period due to the lack of issues in the conduct of borrowers while complying with loan obligations. The interest rate on budgetary loans is set by the relevant decree of the Government of the Republic of Armenia, while the interest rate on sub-loans is set at the rate of the loan agreement.

In all cases when the loan agreement has allowed for sub-loans to set a margin interest rate (excess margin), 1% margin rate has been added to the interest rate specified by the loan agreement.

In some cases, the lack of collateral for budget loans and sub-loans is stipulated either by the Government Decree or they are in the pledging progress (in the case of sub-loans, new or reconstructed infrastructures are pledged along with the implementation of the project, the process of which can be implemented over a long period).

Interpretation of the Audit Chamber

Without the predetermined credit risk assessment and monitoring methodology, assessments and monitoring can not be considered effective from the standpoint of accounting criteria. Implementation of assessments was made discretionary.

In fact, in the audited period both cases of non-compliance with credit liabilities, as well as changes in lending terms stipulated by the RA Government decree were recorded.

The RA Government decree on provision of budgetary loans is preceded by preparing the draft decree, in case of loan agreement, negotiation thereof, during which consideration of the possibility of setting a margin interest rate exceeding the calculated rate and determined by the by the defined methodology. The MoF approach of increasing the constant 1 percent margin is ineffective, as it is not differentiated depending on the credit risk. As at 31.12.2018, among the 58 budget loans and sub-loans granted, margin rate was applied only to one loan²⁸.

The lack of procedures, as well as their bypassing, have led to the failure of appropriate application of effective credit risk mitigation mechanisms, such as the collateral.

Failure to properly assess and monitor credit risk, on the one hand, and failure to provide collateral for covering possible losses resulting from materialization of that credit risk on the other, creates a portfolio that can be highly vulnerable to unfavorable stages of periodic economic development.

Conclusion

There is no methodology for assessing credit risk, and no any other assessments were made based on that methodology, prior to and after the provision of budget loans and sub-loans. No margin interest rate in relation to the credit risk was applied. In 43% cases, lending was made without collateral.

Recommendation

We recommend the following:

- For each budgetary loan and sub-loan provided, to make a risk assessment guided by the credit risk assessment methodology, as well as, at least quarterly, to reassess the credit risk
- To introduce the system of applying margin interest rates based on risks, and calculation methodology thereof.

Audit topic: Whether there are proper systems and procedures for registering sub-loans and budgetary loans?

Audit criteria and requirements

²⁸ Source: As at 31.12.2018, Database of budgetary loans and sub-loans provided from the state budget of the Republic of Armenia, at the expenses of the loan resources attracted by international organizations and foreign countries.

Internal procedures should establish rules for data entry and accounting of sub-loans and budgetary loans. As a rule, data on guarantees are recorded in the unified system of the public debt registration and management (WB DEMPA DPI-10).

Audit results

The database of the budgetary loans and sub-loans is an Excel file, despite the fact that DMFAS 6 program was installed in the MoF for recording thereof. There are no procedural arrangements for registering guarantees and entering data thereof into databases.

Response of the audited entity

Due to the lack of a DMFAS 6 service administrator, the program is either not functioning or is being interrupted due to which it is impossible to service the loan portfolio through the mentioned program

Due to the lack of a DMFAS 6 service administrator, the program either fails to operate or operates with malfunctions. As a result, it is impossible to service the loan portfolio through this program.

Interpretation of the Audit Chamber

Failure to have an administrator for four years is not a sound justification for not running the program and not having a unified database.

Conclusion

Sub-loans and budgetary loans were not recorded in the DMFAS 6 system, data entry procedures were missing.

Recommendation

We recommend the following:

- To record data on sub-loans and budgetary loans in the DMFAS 6 system;
- To develop procedures for recording their data.

PUBLIC DEBT MANAGEMENT REPORTING

Audit topic: Whether sufficient reporting on the public debt was ensured?

Audit criteria and requirements

- A stand-alone report on the public debt and public debt management activities should be presented and published annually to the Parliament that should include: a) result assessment of the public debt management performance against the objectives set forth by the public debt management; b) compliance with the public debt management performance with the public debt management strategy (WB DEMPA DPI – 6, DPI -1);
- Debt statistical bulletin should be published at least semiannually (that should include key risk indicators of the debt portfolio), the data of which at the time of publication must be at least two months old (WB DEMPA DPI-6);
- Management of the RA public debt, among other principles, should also be carried out per the reporting principle (RA Law on the Public Debt, Article 10).

Audit results

The following reports were published by the RA MoF on the public debt:

- *Annual reports on the public debt* containing data and analyses on the involvement, repayment and servicing of the RA Government debt and CBA external debt during the budget year, as well as cash flow and government debt risk assessments²⁹. However, there are no formal legislative requirements on submission of that report to the National Assembly and for discussion thereof in the sessions held in the National Assembly. This report is not subject to discussion in the NA, as well as in the sessions of the commission. In addition, this report does not explicitly and measurably address the performance level of all public debt management objectives established by the law during the reporting period.
- *Monthly public debt statistical bulletins*. As a rule, at the end of each reporting period, information is published at the end of each reporting month within 10 business days after the end of the reporting month. The bulletins contain operational (preliminary) information on debt and operations thereon that is adjusted, as necessary, in subsequent publications. It covers the entire public debt, including the CBA debt. The statistical bulletin contains information on debt stock (structure by residency, toolkit, currency, interest rate, issue / attraction) and residual maturity, by lenders / and flows / interest payments on external loans and principal repayments /. The Bulletin also contains information on guarantees, including information on payments made by the Government of the Republic of Armenia for guarantee services / conditioned by the principal's failure to fulfill its payment obligations /. The Bulletin also presents a number of risk indicators, such as specific weight of the debt with fixed interest rate, weighted average remaining term before re-fixing of the interest rate, weighted average remaining term before the remaining maturity, specific weight of the foreign currency debt in the debt, etc. The Bulletin also contains information on deficit financing, treasury and foreign currency bonds³⁰.
- Information on the public debt is also published in the quarterly and annual reports on the state budget execution of the Republic of Armenia³¹.

²⁹ http://www.minfin.am/hy/page/tarekan_hashvetvutyunner/

³⁰ http://www.minfin.am/hy/page/amsakan_vichakagrakan_teghekagrer/

³¹ http://www.minfin.am/hy/page/petakan_byujei_hashvetvutyun/

- Other information related to the Government debt is also published in the “Public Debt” section of the RA MoF website³²:

The primary legislation of the Republic of Armenia did not provide for a requirement to submit a separate report on the public debt to the National Assembly, instead it provides for a requirement to submit information on the public debt and current liabilities in the annual report on the state budget execution³³.

The legislative body has set out the goals of attracting and managing public debt and delegating its debt management powers to the executive. Implementing governance, the executive must be reportable for the performance of the objectives set by the legislative body. Annual state budget execution reports did not ensure effective reporting in terms of fulfilling the public debt management objectives. In particular, the annual report of 2018 on the state budget execution just makes reference to the RA Law on the Public Debt by stating: ‘*The Government debt management in 2018 was implemented in accordance with the management goals of the Government debt set forth by the RA Law on the Public Debt*’ (page 143), which does not make it measurably clear how the performance of each of the individual goal set forth by law has been achieved³⁴. Information on the performance of management strategy of the Government debt is limited by presenting only brief information of four benchmark indicators (page 144). In addition, reports on the state budget execution are on performance of flow indicators of the previous year and, inclusion of information on stock indicators in these reports gives rise to a logical contradiction, since reporting on these indicators implies not only the accountability of the previous year's portion of the flow of the stock, but also the stock formed over the entire preceding period (in this case, the public debt formed over decades)

On the other hand, information on the public debt is presented in a non-coordinated manner across the various sections of the report consisting of more than 4.000 page. For the unbiased user, such a non-coordination may not give a complete picture of the public debt management.

Statistical bulletins and other publications of the MoF do not disclose segregated information on sub-loans per borrowers and per lending terms for each borrower.

In 2017-2018 the non-financial (output) indicators characterizing implementation of the RA state budget programs did not provide sufficient coverage of the performance assessment of implementation of functions in relation to the public debt management by the MoF.

Response of the audited entity

Debt management objectives of the Government of the Republic of Armenia mainly outline the sectors that should be taken into account when setting specific measurable targets in formulation of a debt management policy and in development of strategy (e.g. in terms of the goal, "coordination of the public debt management and monetary policy").

The measurable targets arising from these goals are presented both in the reports, as well as in debt management strategies of the Armenian Government.

Since 2019 non-financial (output) indicators characterizing implementation of the RA state budget programs have been fully incorporated in the public debt management functions since 2019, although they were partially envisaged during the audited period.

³² http://www.minfin.am/hy/page/petakan_partq/

³³ RA Law on the Public Debt, Article 13, clause 1.

³⁴ For example, the report does not provide a measurable information on the level of performance of the public debt management and monetary policy coordination objective or the level of performance of the Government's optimal debt structure, the level of performance of the domestic public debt market.

Conclusion

- The primary legislation of the Republic of Armenia did not provide for a requirement to submit a separate report on the public debt to the National Assembly, instead it provides for a requirement to submit information on the public debt and current liabilities in the annual report on the state budget execution.
- Statistical bulletins and other publications of the MoF do not disclose segregated information on sub-loans per borrowers and per lending terms for each borrower.
- In 2017-2018 the non-financial (output) indicators characterizing implementation of the RA state budget programs did not provide sufficient coverage of the performance assessment of implementation of functions in relation to the public debt management by the MoF

Recommendation

We recommend the following to:

- Provide for the requirement for the National Assembly to submit annual independent reports on public debt management that should highlight whether the public debt management has been carried out in accordance with the goals set forth by the legislative body and the strategy set forth by the executive.
- Contain in the report sufficient information to allow the National Assembly to assess in a measurable format the extent to which the public debt management objectives and strategies have been met.
- Publish segregated information on sub-loans per borrowers and per lending terms for each borrower.
- Provide a wide range of non-financial (output) indicators characterizing implementation of the RA state budget programs.

MANAGEMENT OF CASH FLOWS

Audit topic: Whether there has been an effective management of cash flows?

Audit criteria and requirements

- Reliable daily forecasts of cash inflow and outflow are being prepared for the next three months, which are updated weekly;
- The Government manages surplus cash (assets exceeding the target level) by investing them in the market in line with appropriate credit risk limits or in the CBA at market rates;
- The Government conducts one-day cash flow management transactions (WB DEMPA DPI-11).

Audit results

State Revenue Committee does not submit information on the state budget revenues to the MoF, based on which while making forecasts on the state revenues in the process of managing cash flows, the MoF is guided by the indicators of the previous year. Hence, the SRC does not comply with the requirements of the RA Government Decree N 1354-N, dated 19.08.04 on Sharing Information between the RA Certain Executive Bodies and the RA Central Bank with regard to provision of corresponding information to the MoF, that undermines the effectiveness of making quality cash flow forecasts. No cash flow forecasts were made on a daily basis. Weekly forecasts have been implemented for the coming one month.

In 2018, in cases of 43 out of 48 weekly forecasts of inflows to the Treasury Single Account and in cases of 36 out of 48 weekly forecasts of outflows from the Treasury Single Account, the predicted indicators deviated by at least 15% from actual indicators. In 2017, in cases of 22 out of 48 weekly forecasts of inflows to the Treasury Single Account and in cases of again 22 out of 48 weekly forecasts of outflows from the Treasury Single Account, the predicted indicators deviated by at least 15% from actual indicators. No active cash flow management was implemented. The only instrument used is the CBA is depositing. The minimum term of the deposit is 7 days, therefore no one-day cash flow management is implemented. No cash balance thresholds (floor and ceiling) are defined. There was no formal methodology for cash flow management.

Response of the audited entity

Daily cash flow forecasts have been implemented since 2019.

Although the minimum deposit period is 7 days, cash flow management is performed on a daily basis, as the balance movement of the Treasury Single Account is monitored on a daily basis and decisions are made in relation to cash flow management.

Moreover, in case of temporary need of funds, issuance of short-term bonds with maturity up to 13 weeks can be carried out, initiating the given issue only one business day before, which is also a daily management instrument.

Cash balance thresholds are not provided, as in the absence of the opportunity to invest funds within up to 7 days is impossible to maintain the defined thresholds. Therefore, at this time it is not advisable to set cash balance thresholds.

Interpretation of the Audit Chamber

The MoF did not possess a cash flow management instrument for one-day transactions / enabling one-day funds to be invested /. The latter has not allowed to minimize cash balances and receive income from their investment

Conclusion

The quality of cash flow forecasts was poor, stipulated also by the failure of providing the forecasts on the revenues of the state budget by the SRC to the MoF.

No active cash flow management through one-day transactions was made.

No formal cash flow management methodology was developed, including thresholds of cash balances (floor and ceiling).

Recommendations

We recommend the following to:

- Develop a cash flow management methodology, as well as to set thresholds of cash balances;
- Perform active cash flow management using one day instruments (e.g., deposit auctions);
- Develop a conceptual approach for improving the quality of cash flow forecasts;
- To the SRC, provide MoF with information on the state budget revenue forecasts at regular intervals.

PUBLIC DEBT MANAGEMENT IT INFRASTRUCTURE IN ARMENIA

Audit topic: Whether there is a unified public debt database?

Audit criteria and requirements

- A public debt management information system should use a single database for achieving the best accuracy and efficiency.
- The information system used by the central government should include complete and timely recorded data on government debt, guarantees and related transactions.

Audit results

There is no unified database in terms of the public debt management information system in the RA MoF. There are 3 debt management information systems used by the RA Government for debt management purposes:

- DMFAS 6 (Debt Management and Financial Analysis System);
- Databases kept in EXCEL files;
- DEPEND (Unified System of Securities Registration and Settlement of Central Depository of Armenia).

DMFAS is a specialized debt management and financial analysis software package developed by UNCTAD and first launched in 1983.

It enables the debt management body to set up a debt database containing detailed and aggregated data on the public debt, short-term and long-term debt (external and internal) secured by the state, general agreements, bonds and grants, private sector unsecured external debt, budgetary loans, sub-loans, debt restructuring, and actual and future transactions (deductions and debt servicing). As the system can process large amounts of data, it becomes possible to devote more time to analytical and management tasks. The DMFAS structure enables to be easily tailored to the needs and preferences of the user organization. It is constantly being improved in line with the best practices of public debt management. For the purpose of improving the overall public financial management system, DMFAS easily integrates with other financial management systems. DMFAS software package contains a number of pre-developed reporting forms, but also allows users to generate their own reports. Flexibility of the reporting module (generation of reports) facilitates the preparation of debt statistics in line with international standards. The possible number of user-generated reports is unlimited and can be easily exported.

The DMFAS 6 information system is used by the Department of the Public Debt Management of the RA Ministry of Finance. The system was installed in 2011, the operating language is English, the access rights are complete (that is, all capacities of the system are available).

Armenia is among the 15 countries with higher than average income that use the DMFAS information system; in general, the system is used by 57 countries.

The Department of the Public Debt Management of the RA Ministry of Finance does not use all capacities of the system. Data on sub-loans, internal and external guarantees, as well as 21 out of 189 external loans are not input to the system, i.e. the database of DMFAS information system is incomplete.

Response of the audited entity

Not available.

Conclusion

In terms of the public debt management information system, there is no unified database in the RA MoF. The DMFAS 6 information system has been installed in the RA MoF since 2011, but does not contain data on sub-loans, internal and external guarantees, as well as 21 out of 189 external loans. Data bases on the public debt are mainly kept in Excel files

Recommendation

We recommend the following:

Within the scope of DMFAS information system, in order to have a unified database of the Government debt and to ensure data integrity, to record all external and internal debt obligations, as well as guarantees, budgetary loans and sub-loans in the DMFAS Information System and to maintain recording of transactions in the DMFAS information system.

Audit topic: Whether users are sufficiently prepared to work effectively with the system?

Audit criteria and requirements

Users of public debt management information system should be sufficiently prepared to carry out their work with the system as effectively as possible.

Audit results

15 staff members of the RA MoF had access to DMFAS, six of which have not passed qualification trainings on operation with the system. Therefore, not all users of the information system were sufficiently prepared to use the system effectively

In total, 16 staff members were trained, 7 of which currently do not have access to the DMFAS information system, including 2 staff members selected by the IT department for training as database administrators. Accordingly, proper institutional memory was not provided.

Response of the audited entity

Not available.

Conclusion

Six of those with access to the DMFAS information system did not pass qualification trainings, and 7 of those who participated in trainings, including those who received trainings as technical administrators, did not have access to the system.

Recommendation

We recommend the following:

In order to raise the level of preparedness of users and administrators of the DMFAS information system, ensure their participation in training programs.

Audit topic: Whether the maintenance system of the DMFAS Public Debt Management Information System operates in compliance with the principles of economy and effectiveness?

Audit criteria and requirement

There should be reliable maintenance of the debt management information system that should be ensured based on the principle of economy.

Audit results

In compliance with clause 2 (2) of the *Procedure On Fulfillment of the Debt Management and Financial Analysis System Maintenance and Administrator Responsibilities*, maintenance of the DMFAS information system is carried out by three entities:

- DMFAS Program back office;
- Department of Introduction and Development of IT Infrastructures;
- Department of the Public Debt Management.

In compliance with clause 2 (3(c)) of the *Procedure On Fulfillment of the Debt Management and Financial Analysis System Maintenance and Administrator Responsibilities*, responsibility for installing software updates received from the DMFAS Program back office falls on the Department of Introduction and Development of IT Infrastructures.

However, since the DMFAS information system has not had an administrator for the last 4 years, the Network Administrator of the Department of Introduction and Development of IT Infrastructures has failed to fulfill its obligations set forth under clause 2 (3) of the Procedure within the period from 2017 to 2018.

During the entire period mentioned, the Department of the Public Debt Management, in the absence of a network administrator, was not able to fully fulfill its obligations under clause 2 (4) of the Procedure.

Relations between DMFAS Program back office and the RA MoF are regulated by *Maintenance Agreement DMFAS 6* signed on 03 May, 2011 that was executed within the scope of PDM-C-2.4 Agreement as at 26.04.2011. In compliance with this Agreement, then maintenance fee for DFAS information system was amounted USD 15,000 that should have to be paid starting from the next year. Up to 31.12.2018, the MoF paid USD 89,329.98 for the maintenance service. The following services are provided within the scope of the Maintenance Agreement:

- Adaptive maintenance;
- Perfective maintenance;
- Corrective maintenance.

Response of the audited entity

Complying with the *Procedure On Fulfillment of the Debt Management and Financial Analysis System Maintenance and Administrator Responsibilities* approved by Order No 444-A of the RA MoF Minister as at 29 August 2017 is possible exclusively after passing appropriate trainings by DMFAS Program. These training are planned to be organized in the framework of ADB technical maintenance and is currently in the organizational phase by ADB and DMFAS Program

Only after receiving the appropriate trainings, computer and functional administrators will perform the duties set forth by the Procedure mentioned above.

At present, the network administrator of IT Department only provides access to the DMFAS system in the corporate network of the Ministry of Finance.

Interpretation of the Audit Chamber

In substance, an explanation is provided on the revealed issue.

Conclusion

In fact, in the years 2017 and 2018, the public debt management system DMFAS was deprived of technical maintenance due to the absence of a technical administrator.

The scope of capacities of the technical maintenance to be provided by DMFAS Program back office was limited.

Recommendation

We recommend the following:

In order to provide reliable technical maintenance of the debt management information system, to involve a relevant specialist in the DMFAS system maintenance process at the local level.

POSITIVE DEVELOPMENTS RECORDED IN THE PUBLIC DEBT MANAGEMENT

The following actions were carried out by the RA MoF for correction of the deficiencies recorded within the scope of performance assessment of the debt management executed by the World Bank for the Republic of Armenia:

- ❖ *Procedure for Assessing and Selecting Behavior of Participants of Primary Market of the RA Government Treasury Bonds* was developed and approved by Order No 348-N of the Minister of the RA MoF, dated 13.07.2017. It contributes to increasing the responsiveness of primary market participants of treasury bonds, ensuring an equal competitive environment, publicity of evaluation of behavior and selection, and activating the secondary bond market;
- ❖ *Procedure on Fulfillment of the Debt Management and Financial Analysis System Maintenance and Administrator Responsibilities* was developed and approved by Order No 444-A of the Minister of the RA MoF, dated 29.08.2017;
- ❖ *Procedure for Issuing Public Foreign Currency Bonds, Procedure on the RA Government External Debt Servicing and Procedure for Recording and Servicing of the RA State Treasury Bonds* were developed and approved by Order No 445-A of the Minister of the RA MoF, dated 29.08.2017;
- ❖ *Scope of Operational Risks Management of the Department of the Public Debt Management of the Ra MoF and Continuity Plan of Business Processes of the Department of the Public Debt Management of the Ra MoF* were developed and approved by Order No 445-A of the Minister of the RA MoF, dated 17.11.2018 to manage the operational risks that may jeopardize or impair the performance of the RA Government debt management operations;
- ❖ In order to strengthen the transparency and predictability of the government bonds market, the basic principles of government bonds issuance and the annual program of issuances thereof have been clarified and posted on the website of the Ministry of Finance;
- ❖ The benchmark standards for bonds were re-established. If previously, the benchmarking of government bonds was defined by the order on issuance and, in case of the new issuance of government bonds of the same period, the former was no longer considered a benchmark, at present, the benchmark for the issuer may be considered government bonds having AMD 10 billion circulation;
- ❖ 10 working days prior to each quarter, the Ministry of Finance releases the list of government bonds to be considered as benchmarks for the forthcoming quarter;
- ❖ New revised version of the procedure for issuance, placement, repurchase, circulation and redemption of the state treasury short-term bonds, medium-term and long-term coupons, the procedure for issuance, placement, repurchase and redemption of savings coupon bonds and the activity procedure for the treasury keeper was developed and approved by the RA Government Decree No 381-N, dated 13.04.2017. Its objective is to develop the primary market for treasury bonds, the retail market, and to apply an online bond trading system.
- ❖ In 2017 the treasury bond auction system transferred from the Central Bank of Armenia to NASDAC OMX Armenia OJSC (at present, the stock exchange of Armenia) enabling the primary placement of treasury bonds to be made through a trading platform equipped with up-to-dated software solutions and capacities to undertake operations by using debt management instruments;

- ❖ Starting from 2017 transactions with government bonds are implemented per (T+n) principle by distinguishing the day of the transaction from the day of the auction that enables the primary market participants of government bonds to more effectively manage their cash and reduce operating expenses;
- ❖ In 2017 the online retail system of the government treasury bonds was introduced through the Treasury Keeper (gp.minfin.am) aimed at improving both the investment process, as well as expanding the range of retailers and increasing investment volumes.