SWEDISH NATIONAL AUDIT OFFICE

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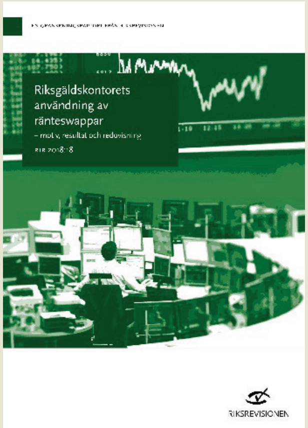


RiR 2018:18

# The Swedish National Debt Office's use of interest rate swaps

– motives, results and reporting

## Summary, conclusion and recommendations

One of the main tasks of the Swedish National Debt Office, according to instructions from the Government, is to *borrow money on behalf of central government and to manage central government debt.* The objective is to minimise the long-term cost of the debt while taking account of risk.

Every year, to achieve a desired balance between cost and risk, the Government decides, as part of a guideline decision, upon the structure of the national debt as well as the average maturity for the respective parts of the national debt. The Swedish National Debt Office in turn manages the maturity of the national debt by choosing the debt's distribution between floating and fixed interest rates. Since 2003, the Swedish National Debt Office has used interest rate swaps, amongst other things, to achieve an appropriate distribution and hence maturity. An interest rate swap means that two parties exchange interest rates with each other, usually a fixed interest rate is swapped for a floating interest rate and vice versa.

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The use of interest rate swaps has become more extensive, and between 2003 and 2017 the Swedish National Debt Office has entered into interest rate swap agreements for state bonds amounting to nearly SEK 300 billion. The reasons presented by the Swedish National Debt Office for the use of interest rate swaps have varied over time, as has the model of reporting financial results from such use.

In light of the extensive use of interest rate swaps, as well as the change in the motives for using and reporting of interest rate swaps, the Swedish National Audit Office has audited how the use of interest rate swaps meets the overall objective for the national debt and whether the reporting of the profits is satisfactory.

The report attempts to answer two audit questions:

1. Has the use of interest rate swaps been effective?
2. Is the reporting of interest rate swaps satisfactory?

# Background

## Changes in motives and reporting

In 2003, the Swedish National Debt Office began to use interest rate swaps to lower the cost of the national debt. The Swedish National Debt Office can borrow under more favourable conditions than other actors in the market. This competitive advantage is normally greater the longer the loan term is. The Swedish National Debt Office's original motive for using interest rate swaps was to exploit this competitive advantage by taking loans with longer loan terms at fixed interest rates, after which they would use the interest rate swaps to obtain a floating rate. The market data for the years preceding the 2003 decision showed that this would lead to cost savings, compared to borrowing money by issuing treasury bills.

Initially, the Swedish National Debt Office reported that the use of interest rate swaps resulted in lower costs for the state. However, during the financial crisis, issues of trust in the financial markets upset previous market conditions. Between 2008 and 2012, the difference in costs for three-month loans between the market (which the Swedish National Debt Office pays when it uses interest rate swaps) and the state (the alternative borrowing method being treasury bills) tripled, compared to the year prior to the financial crisis. As a result, the use of interest rate swaps was no longer the most cost-effective alternative for borrowing with floating interest rates which in comparable terms led to losses, according to the reporting model at the time.

In parallel with the losses, the Swedish National Debt Office changed both its motives for using interest rate swaps and the reporting model of the financial result. The new motives were that the use of interest rate swaps: resulted in a reduction of costs through the shortening of the average maturity of the national debt, improved liquidity in the bond market, reduced refinancing risk and was the only viable option since the alternative to finance the national debt by issuing treasury bills was judged infeasible due to a limited demand.

The new reporting model was based on a comparison of the fixed long-term interest rate with the floating rate of the interest rate swap agreement, i.e. the net payment of the agreement. Hence since 2010, the Swedish National Debt Office has chosen to compare the cost of long-term loans (normally 7-10 years) with the cost of short-term loans (three months), instead of comparing the costs of different short-term loan options.

As long-term borrowing is normally more expensive than short-term borrowing, the modified reporting model once again showed profits tied to the use of interest rate swaps. The fact that interest rates have fallen to record lows - rates for three-month loans have been negative since spring 2014 - has also contributed to the major profits shown by the current reporting model, accumulating to SEK 36 billion for the entire 2003-2017 period.

## The conclusions of the audit

### *The financing strategy of the Swedish National Debt Office has been effective*

The Swedish National Audit Office's audit shows that the use of interest rate swaps has reduced the costs of the national debt by SEK 1.1 billion between the period of 2003-2017, compared to the alternative of financing the debt by issuing treasury bills. The calculation is based on the Swedish National Debt Office's original reporting model.

The Swedish National Debt Office maintained its strategy of entering into interest rate swaps agreements between the years 2008 and 2012 even though the results of the interest rate swaps, according to the original reporting model, revealed losses (the result is not final but shows the current accumulative financial result of several long-term contracts). This proved to be a prudent position to take, and the Swedish National Debt Office's original reporting model has revealed annual profits from 2013 and onwards. However, it was not until 2015 that the accumulated results of the entire portfolio of swap contracts showed a net profit.

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The conclusion of the Swedish National Audit Office is that the Swedish National Debt Office's strategic decision to use interest rate swaps has lowered the cost of the national debt over the entire period. In parallel, the Swedish National Debt Office has achieved two other desirable effects: improved liquidity in the bond market and reduced refinancing risk. As a result, both cost and risk have progressed in accordance with the objective for the management of the national debt. In light of this, the Swedish National Audit Office's assessment is that the use of interest rate swaps by the Swedish National Debt Office has been effective, within guidelines set by the Government.

## *The Swedish National Debt Office's reporting of interest rate swaps is unsatisfactory.*

In parallel with the losses tied to the use of interest rate swaps during the financial crisis, the Swedish National Debt Office changed its model of reporting. Since 2010, the Swedish National Debt Office has reported the financial result of the use of interest rate swaps as the profit of the interest rate swap agreement, i.e. the difference between the revenue from the fixed interest swap rate and the payment of the floating Stibor rate. This equates to the difference in interest rate costs between 1) issuing a state bond while simultaneously entering into an interest rate agreement and 2) issuing a state bond. The method of reporting implies that the Swedish National Debt Office is comparing the cost of financing the National debt between loans with different loan term conditions. One complication of this reporting model is that the benchmark. i.e. financing the debt with long term fixed interest rate state bonds, is not in accordance with the guidelines set by the Government. From this perspective, the comparison is not reasonable. There is no comparison between alternative means of financing the debt, that fulfils the decision by the Government regarding the maturity of the debt. Therefore, the Swedish National Debt Office's contribution to the overall objective to minimise costs in the long-term, within the guidelines of the Government's is not reported.

The audit shows that the "savings" of SEK 36 billion, that the Swedish National Debt Office has reported as resulting from the use of interest rate swaps between 2003 and 2017, largely (97 per cent) consists of an expected premium due to the reduction of the average maturity of the debt and an unpredicted (and hence unexpected) but advantageous market movements during this period. Both these effects are connected to the Government's guideline decision regarding the maturity of the debt and would have arisen had the loan been financed through treasury bills as well. This fact is not apparent in the report from the Swedish National Debt Office, which only reports the net profits from the interest rate swap agreements.

The Swedish National Audit Office considers that the Swedish National Debt Office's reporting of profits tied to the use of interest rate swaps is unsatisfactory and can easily be misinterpreted. It is the opinion of the Swedish National Audit Office that a report should separate the effects of decisions made by the Swedish National Debt Office's (i.e. the use of interest rate swaps instead of treasury bills) from those made by the Government (i.e. the guideline decision of the average maturity of the debt that have resulted in an expected savings premium due to a shortened maturity of the debt and an unpredicted savings due to favourable market conditions). An analysis of the relationship between the maturity, costs and risks of the national debt is also desirable. Such a report would contribute to a fruitful discussion prior to guideline decisions made by the Government.

The current interest rate situation also indicates the importance of a more complete reporting of financial results. It is less likely that interest rates will be much lower than expected compared to the opposite (that is much higher) in the future. Therefore, there is a risk that profits from the use of interest rate swaps, as they are currently reported by the Swedish National Debt Office, will be significantly weaker than previous years. Losses cannot be ruled out. The current reporting model could result in a negative outcome being interpreted as the Swedish National Debt Office needing to discontinue its use of interest rate swaps. This would be a misinterpretation, according to the Swedish National Audit Office.

## Recommendations

The Swedish National Audit Office considers that the current reporting by the Swedish National Debt Office on the outcome of using interest rate swaps is unsatisfactory and risks resulting in the misinterpretation of their effects. The Swedish National Audit Office recommends that the Swedish National Debt Office, when reporting the outcome of interest rate swaps,

- clarifies the specific effects resulting from the agency's own decisions within the guidelines of the Government's regarding the nominal krona debt.
- considers whether the current definition of the calculated profit from the use of interest rate swaps should be reported henceforth, and if so:
  - divide the outcome into separate components: swap profit, maturity premium and unpredicted market movements.
  - clarify the relationship between debt maturity, cost and risk.