



## Romania: Providing Advisory Services to Use Derivatives as a Hedging Tool in Public Debt Management

Romania's Ministry of Public Finance wanted to use derivatives to delink its funding activity from the debt portfolio's foreign currency and interest rate exposure. To be able to undertake derivatives transactions, the country needed to develop a legal and operational framework.

The Romanian government partnered with the World Bank Treasury to provide them with a multi-component advisory solution: setting up the governance structure, building capacity on the operational framework and training the staff for using derivatives as a hedging tool.

### Background

Romania's Ministry of Public Finance (MoPF) has been making significant progress in bringing its debt and cash management practices in line with those of other European Union countries. As the MoPF continues to modernize its debt management process, one of its objectives is to more actively explore funding opportunities in different markets and currencies. This provides an opening to diversify the investor base, issue very long-term tenors, and take advantage of arbitrage opportunities to reduce funding costs.

Romania has been tapping the USD Eurobond market since issuing its debut USD-denominated Eurobond in 2012. Considering the Romanian Lei's high correlation with the Euro (EUR), the MoPF has considered hedging its USD exposure into EUR as a more relevant funding currency. The authorities' medium-term debt management strategy for 2017–19 carries with it the need for hedging instruments. The practice will be critical for the country to opportunistically tap into the USD segment of the international capital markets to extend the average maturity of its debt portfolio and diversify its investor base. The MoPF has decided to use derivatives to delink its funding activity from the debt portfolio's foreign currency and interest rate exposure. By using cross-currency swaps, for example, the MoPF can continue tapping into USD investor demand in the international capital markets at maturities up to 30 years while keeping its currency exposure primarily in EUR.

Before undertaking derivatives transactions, however, the country needed to put in place a sound derivatives framework, which would contain detailed information about all the relevant aspects of the planned derivatives operations.

### Objective

The objective of the World Bank advisory engagement was to help the MoPF develop a legal and operational framework (policies, procedures, and norms) for using interest rate and cross-currency swaps and provide MoPF staff with the necessary training.

### Solution

A Six-Component Advisory engagement was delivered by the World Bank over a 21-month period.

**Legal:** Prepare Romania to negotiate derivatives documentation with commercial financial counterparties, and in developing a general internal framework for the negotiations.

**Pricing and Valuation:** Build capacity to price “plain vanilla” derivatives with emphasis on the valuation of interest rate and currency swaps. MoPF staff were to ultimately be comfortable using the financial math of valuing interest rate and currency swaps and be familiar with the pricing sources and market practices related to quotations.

**Risk Management:** Advance MoPF’s capability to assess and manage the risks related to derivatives, especially counterparty credit risk.

**Execution:** Develop high-level operational procedures and train the MoPF staff that would implement them during the pre-trade processes related to interest rate and cross-currency swaps.

**Post-Trade Processes:** Increase MoPF staff’s competency to better understand the need for legal documentation, electronic affirmation, confirmation of derivatives transactions, and post-trade execution processes, including the significant roles to be performed by staff in mitigating associated risks. Also, build capacity of MoPF staff to assess the pros and cons of outsourcing post-trade functions and collateral management to a third party, and manage the collateral in-house, if they decided to do so, as well as the relationship with a third party.

**Training:** Deliver hands-on training, technical workshops, and extensive written material to MoPF staff to accomplish the required level of expertise.

## World Bank’s Role

The World Bank Treasury put together a team, consisting of expert practitioners from several units of the Bank, including Treasury, Accounting, Credit, Legal and outside subject matter experts. The experts, with extensive day-to-day market-facing experience, provided the necessary training to prepare the Romanian MoPF to set up the necessary legal and operational framework. More specifically, the team:

- Identified the MoPF’s objectives.
- Defined the scope of the project, internal and external resources needed, time-frame, deliverables, project flow, and cost.
- Assessed current Romanian legal and operational framework.
- Advised on policy frameworks and guidelines for (i) developing a general legal framework and internal procedures; (ii) managing credit risk with the counterparties on OTC derivatives; (iii) sound practices.
- Assessed internal organization, overall staffing, IT capabilities, and post-trade execution management requirements.
- Provided specific formal and ad hoc assistance as well as extensive training on (i) setting up the legal framework; (ii) pricing and valuation of derivatives; (iii) risk management; (iv) execution and post-trade processes of interest rate and cross-currency swaps.
- Assessed pros and cons, including cost implications, of using a third party for post-trade processes related to interest rate and cross-currency swaps, and provided guidance for selecting and managing the relationship with external third parties.
- Ensured timely and cost-efficient implementation of the project.

## Outcome

Since June 30, 2018, the conclusion of the advisory engagement, the MoPF has taken several steps to implement the project’s recommendations. For example, it proceeded to make amendments to the primary and secondary legislation.

On August 31, 2018, new legislation was approved which amends and supplements earlier legislation on public debt, and includes new definitions related to the close-out netting provision and the use of collateral. This supplements legislation provisions which explicitly grant authority to the Ministry of Public Finance to undertake derivatives transactions.

The Ministry of Public Finance is also in the process of amending the Methodological Norms in order to apply the provisions of existing legislation on public debt concerning the use of financial derivatives and introducing new concepts specific to financial derivatives that reflect good international practice in the field of derivatives and a clear, predictable and coherent legislative framework.

In addition, the 2019 State Budget law, which was adopted in March 2019, includes provisions authorizing the Ministry of Public Finance to start the procurement process for selecting outside legal counsel in order to negotiate and conclude an ISDA Master Agreement and related documentation with commercial banks.

Providing advisory services on derivatives is one of many ways World Bank Treasury, drawing on Bank-wide and outside resources, can help member countries become more resilient to economic shocks. IBRD's AAA credit rating, market presence, and convening power enable the World Bank Treasury's Banking Products team to develop innovative new products that help clients maximize financing and mitigate risk..



## ADVISORY SERVICES

The World Bank Treasury partners with other units across the World Bank to provide technical assistance to countries on:

- IDA to IBRD transition
- Access market-based disaster risk transfer instruments
- Issuance of thematic bonds such as Green Bonds, Blue Bonds, Social Bonds, Sustainable Bonds, Social Impact Bonds, etc.
- Derivatives for hedging purposes



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