DEBT MANAGEMENT DIRECTORATE

Introduction

The Debt Management Directorate (DMO) was established within the Treasury in December 2006 with responsibilities for the operational dimensions of debt and cash management for the central government and for providing specified funding requirements as authorised by Parliament.

The principal objective of the Directorate in its debt and cash management activities is to raise funds as well as carry out other financial transactions in such a way as to ensure that:

- The central government borrowing programme (short and long term) is financed prudently and cost effectively consistent with an acceptable level of risk;
- The annual debt servicing costs are met at the lowest possible cost;
- The development of the domestic financial markets is given the necessary support; and
- The liquidity of government funds is adequate to meet government's payment obligations as and when they fall due.

I. Organisation and resources

The DMO is organized along functional lines under three main areas: a Front, Middle and Back Office to ensure a clear division of responsibilities.

The **Front** office executes government debt policy regarding the issuance of government securities, the **Middle** office undertakes market research and analysis, whilst the **Back** office is responsible for recording, servicing and settlements of central government debt.

II. Legal framework for borrowing

The statutory basis for central government borrowing is set out under the following primary and subsidiary legislation:

- Malta Treasury Bills Act, Cap.133 *(relating to the issue of short-term borrowing up to 12 months maximum maturity*. The maximum amount of outstanding Treasury bills is established by Parliamentary Resolution. In 2002, the maximum amount was set at €698.80 million;
- Malta Treasury Bills (Dematerialisation) Regulations, 2007;
- Local Loans (Registered Stock and Securities) Ordinance, Cap.161 *(relating to terms and conditions applicable to loans authorised to be raised locally by the issue of stock in Malta);*
- Local Loans (Registered Stock) Regulations, S.L.161.01;
- Development Loan Act, Cap.229 *(in respect of bilateral loans raised outside Malta);*
- Government Borrowing and Granting of Loans to the Hellenic Republic Act, 2010 (Act III of 2010);
- Government Borrowing and Granting of Loans to Air Malta PLC Act, Cap.506;
- An annual budget law that authorises the Minister of Finance to raise loans on behalf of the government for an established amount during the financial year by the issuing of securities and provides also the main purposes for which government can apply such borrowing.

Financing Instruments and Operations used in Debt and Cash management

Until now, in order to meet its financing needs, the Government's policy has been that of relying, almost exclusively, on issuing euro-denominated financing instruments in the domestic market rather than raising funds on the international markets.

During 2011, as in previous years, the main financing instruments offered to cover the central government funding requirements were Treasury bills (***T-bills***), being of maturity of 12 months or less, and Malta Government Stock ***(MGS)*** – with a maturity ranging between 3-year to over 20 year bucket.

The Treasury carried out its **cash management operations** by conducting public auctions of Treasury bills on a weekly basis. While T-bills are primarily issued to cover the temporary revenue shortfalls incurred by the Government, at the same time, such issuances maintain liquidity in the domestic Treasury bills market. T-bills issued to investors through such auctions are listed and traded on the Malta Stock Exchange.

The **conventional Fixed Rate MGS** remains the Treasury's primary financial instrument by which it funded the long term borrowing programme for 2011. The Fixed Rate MGS issues were offered in the maturity structure between 6-year and 20-year buckets. As in the past two years, alongside the Fixed Rate MGSs, Treasury continued to offer Floating Rate MGS linked to the six month Euribor through the auction system primarily intended for the institutional investors. The MGSs are listed and traded on the Malta Stock Exchange.

In November 2011 the Treasury introduced a ***Malta Government Stock Switch Auctions Programme*** – to be conducted over a three (3) year period – as part of its issuance strategy for lengthening and smoothening the interest and redemption profile of the existing MGSs debt portfolio and also, to some extent, to provide an opportunity for institutional investors to diversify the maturity of their bond portfolios.

Prior to the launching of this Switch/Conversion Offer – on a voluntary basis – the Treasury held a consultation exercise with the main market players and stakeholders to discuss and consider their views.

Malta Government Stock Financing Operations in 2011

During 2011 the Debt Management Office managed to achieve its funding programme announced at the beginning of the year even though market volatility was high for most of the year especially towards the second part of the year.

In terms of '*The Budget Measures Implementation Act'* (Act No IV of 2011) the total amount of MGS financing for 2011 was set not to exceed €570 million.

The funding programme was mainly applied for the purpose of:

- redeeming MGS issues of €128 million;
- financing the deficit estimated at €196 million;
- financing of four (4) loan tranches to Hellenic Republic totalling €34 million (Actual €30.8 m)
- financing a loan of €52 million to the national airline to support its restructuring programme; and
- effecting changes in Central Government's debt portfolio in line with Government's debt management policies by reducing the outstanding amount of T-Bills by €120 million (Actual).

I. Issuance Strategy

In view of the uncertainty prevailing in the international markets at the time, the Directorate adopted a front-loaded issuance programme with the result that by end of May 2011 it successfully financed 70% of the Treasury borrowing programme.

The total sum raised in 2011 through the issuance programme of three MGS, held during the months of February, May, and November, reached €569.6 million as illustrated in Table 1.

In line with the Indicative Issuance Calendar issued in January 2011, the issuance strategy focused mainly on the fixed-rate Euro denominated stocks with a maturity horizon biased towards the medium and long term. Two new MGSs were launched: a 6-year maturity bucket, maturing in 2017 mainly to cater for the banking sector, and a 20-year MGS maturing in 2031, with the aim of satisfying the growing demand for long-term paper by the insurance sector and fund managers.

In conjunction with the fixed-rate stock, the Directorate continued on its policy to promote diversification in the domestic financial market by issuing a number of floating-rate stocks, linked to the 6-month Euribor. The ratio of floating rate stock to the total portfolio of MGS increased from 1.9% in 2010 to 3.5% in 2011.

Table 1 – MGS Issuances in 2011

	Issuance Strategy *(€ million)*				
Issuance month	6-Year	20-Year	3-Year FRN	**TOTAL**	**Bid-to-Cover**
February	115.06	84.72	-	199.78	2.72
May	89.92	59.91	52.00	201.83	1.98
November	19.07	124.92	24.00	167.99	2.74
TOTAL	**224.05**	**269.55**	**76.00**	**569.60**	**2.44**

Source: Debt Management Directorate (DMO) internal records

Demand for the government paper by institutional investors and members of the public was strong for each of the three MGS issues held during 2011. Altogether, the average bid-to-cover ratio for 2011 was 2.44 compared with a ratio of 2.10 for 2010.

In line with Government's allocation policy, subscriptions by members of the public (offered at a pre-offer price) were given preference over bids tendered at the auction by institutional investors. To a certain extent this has crowded out allocation for institutional investors with the result that the demand for MGS by institutional investors could not be met in full.

In addition to the above issuances, two MGSs amounting to a total of €3.32 million were issued in June 2011 in partial settlement of ex-Church property transfer.

Table 2 illustrates the ratio allotted by auction to total applications accepted and the ratio of bids accepted against bids received.

Table 2 – Demand vs Allotment of Bids by institutional investors					
Issuance	Security Issued	Total Allotment € millions	Allotted by Auction € millions	% of Total Allotment	% of bids accepted/all bids received
Feb	4.25% MGS 2017	115.1	62.5	54%	33%
	5.25% MGS 2030	84.7	29.5	35%	97%
	Total	199.8	92.0	46%	42%
May	4.25% MGS 2017	89.9	56.0	62%	71%
	5.25% MGS 2030	59.9	26.0	43%	51%
	FRN MGS 2013	52.0	52.0	100%	51%
	Total	201.8	134.0	66%	58%
Nov	4.25% MGS 2017	19.1	3.0	16%	3%
	5.25% MGS 2030	124.9	6.9	6%	10%
	FRN MGS 2014	24.0	24.0	100%	54%
	Total	168.0	33.9	20%	16%

Source: DMO internal records

II. Bond Switch Operation

In the early 2000s the Government adopted a strategy of issuing a series of fungible MGS issues to reduce the fragmentation of its debt portfolio. Also, it was intended to establish a number of benchmark bonds to increase depth and liquidity in the market and at the same time to create the minimum critical mass necessary for a possible international issuance in the future. Following the onset of the international financial crisis of 2008-09, the idea of an international issuance was postponed indefinitely. Such issuance strategy has resulted in the accumulation of MGSs due for redemption during the period 2012 -2014.

In order to address this issue, during the third quarter of 2011, the Treasury held a consultation exercise with the main market players and stakeholders to discuss and consider their views on the introduction of a 3-Year Bond Switch Auction Programme – on a voluntary basis - with a view to lengthen and smoothen the interest and redemption profile of the existing MGSs debt portfolio. At the same time, this issuance strategy, to some extent, provides an opportunity for institutional investors to diversify the maturity of their bond portfolios.

In November 2011 the Treasury conducted the bond switch operation and as a result, the level of MGS maturing in 2012 was reduced from €509.6 million to €349.7 million, in which €160 million in the 5.7% MGS 2012 (II) (source stock) were exchanged for €158 million in the 4.3% MGS 2016 (IV) (destination stock) by auction on a bid price basis. The exchange had a neutral effect on the Debt /GDP ratio and also avoided any negative effect on the budget deficit.

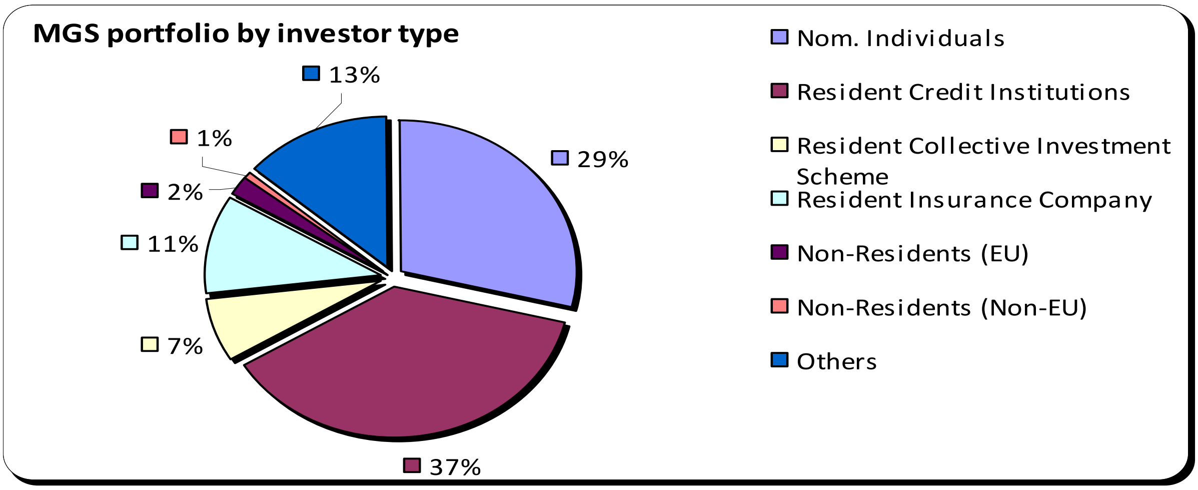
The second and third stage of this exercise will be conducted in 2012 and 2013 with a view to reducing the roll-over levels for the years 2013-2014 by a maximum of €200 million in each year.

III. Distribution by investor type

Chart 1 below illustrates the sectoral distribution of outstanding MGS as at end of December 2011. Out of the outstanding total, 37% is held by resident commercial banks, 29% is held by domestic retail investors while resident Insurance Companies held 11%. Holdings by non-residents accounted for only 2% of outstanding MGS. The fact that the vast majority of Malta Government debt is held domestically acts as a cushion against external market volatility.

During 2011 it was observed that there was a growing interest by the resident insurance sector as by end of November 2011 it was the third largest holder of Malta Government Stocks (MGS) after the resident credit institutions and resident individuals. In particular, the insurance sector has shown interest in the long term MGSs to obtain a better maturing matching between their long term liabilities and assets.

Chart 1 – MGS Holder Distribution as at 31st December 2011



Source: DMO internal records

IV. Borrowing for on-lending purposes

a. Loan Facility Agreement (Hellenic Republic)

After raising €30 million in 2010, under the '*Government Borrowing and Granting of Loans to the Hellenic Republic, Act 2010*, the Treasury issued a second tranche of €24 million in November 2011, via a Floating Rate MGS maturing in 2014, linked to the 6-month Euribor plus a spread of 45 basis points (bps). The issuance of this security was intended for financial institutions and was fully subscribed.

During 2011, four tranches amounting to €30.8 million were disbursed to the Hellenic Republic under the Loan Facility Agreement entered into in May 2010

b. Loan Facility Agreement (Air Malta Plc)

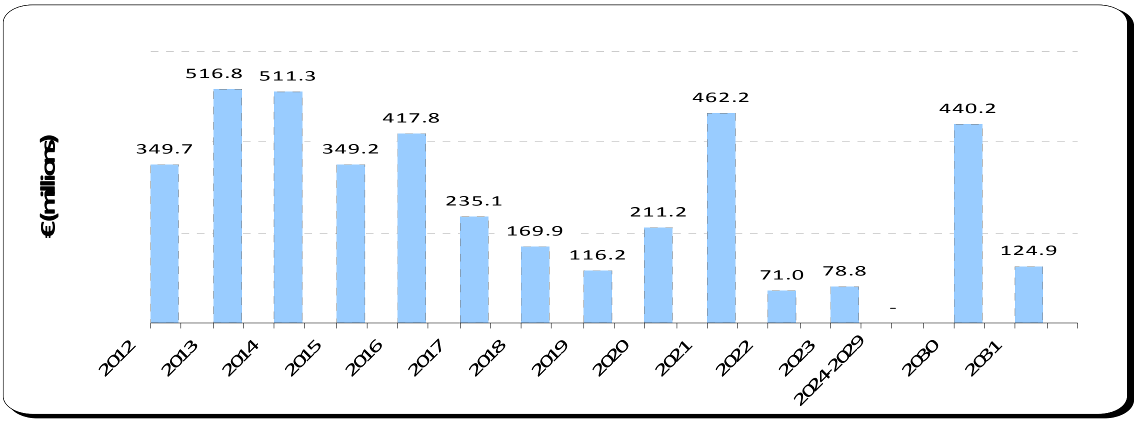
Following the enactment of Act XVIII of 2010, which authorises the raising of loans for the purposes of entering into re-lending agreement between the Malta Government and AirMalta Plc, the Treasury issued a floating rate note linked to Euribor (plus 45bps) maturing in 2013. Under this issuance the Treasury raised a nominal value of €52 million which was loaned to Air Malta in four tranches spread throughout late 2010 and 2011.

V. Maturity Profile

The outstanding nominal value of MGS as at 31st December 2011 reached € 4,054.2 million.
Chart 2 illustrates that the distribution of the MGSs maturity profile lies skewed to the left, with 42.6% of total outstanding MGS maturing during the period 2012-2015.

As a result of strategic measures being undertaken by the Directorate, both the skew of the maturity profile and the weighted average maturity **(WAM)** of MGSs have now improved, notably the WAM which has reached 6.80 years compared to 6.60 years at 2010.

Chart 2 - Outstanding MGS Profile as at 31 December 2011

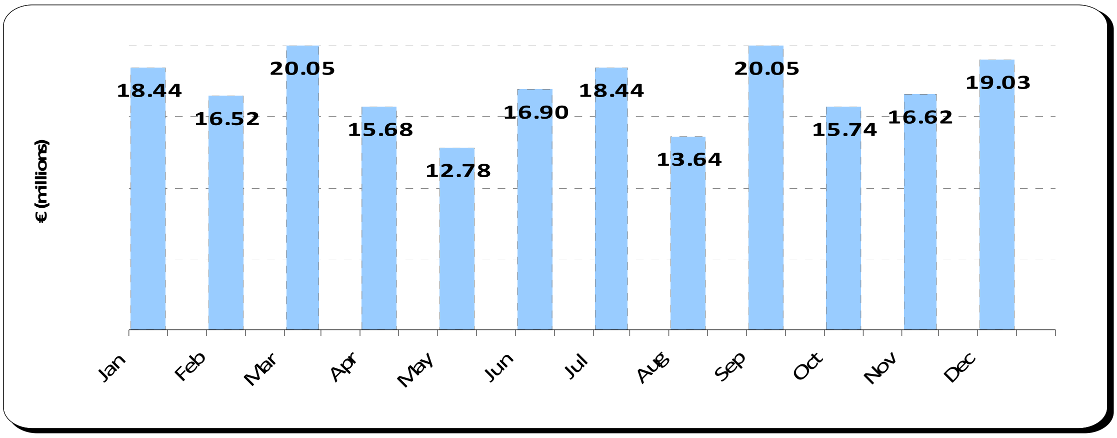


Source: DMO internal records

VI. Cost of Borrowing

During 2011 the total interest payments on MGSs amounted to €203.89 million. Such payments of interest throughout the year were spread as illustrated in Chart 3.

Chart 3 - Distribution of Monthly Interest Payments on MGS



Source: DMO internal records

As interest payments for 2011 have increased by 9.5% year on year while the outstanding MGS balance increased by 12.3%, it resulted that the average amount of interest paid during 2011on outstanding debt has actually decreased. In fact, the weighted average coupon (WAC) in 2011 has dropped to 5.19% from 5.41% a year earlier.

Treasury Bills

In line with Government's debt management policy in effecting changes in its debt portfolio by placing more emphasis on long term loans rather than on short term borrowing, the Treasury managed to reduce the stock of outstanding T-Bills at end of 2011 by €120 million.

I. Issuance Strategy

Total offers of T-bills accepted and redeemed by the Treasury during 2011 in respect to each tenor are presented in Table 3.

It is remarked that such issuance strategy, which focused mainly on the 91-day and the 182-day tenor (equivalent to 56% and 21% of total issuance respectively), is in line with that for the preceding year. The weighted average maturity (WAM) has also remained fairly constant vis-à-vis 2010, with the duration for T-bills issued in 2011 being 132 days, decreasing from 142 days a year earlier.

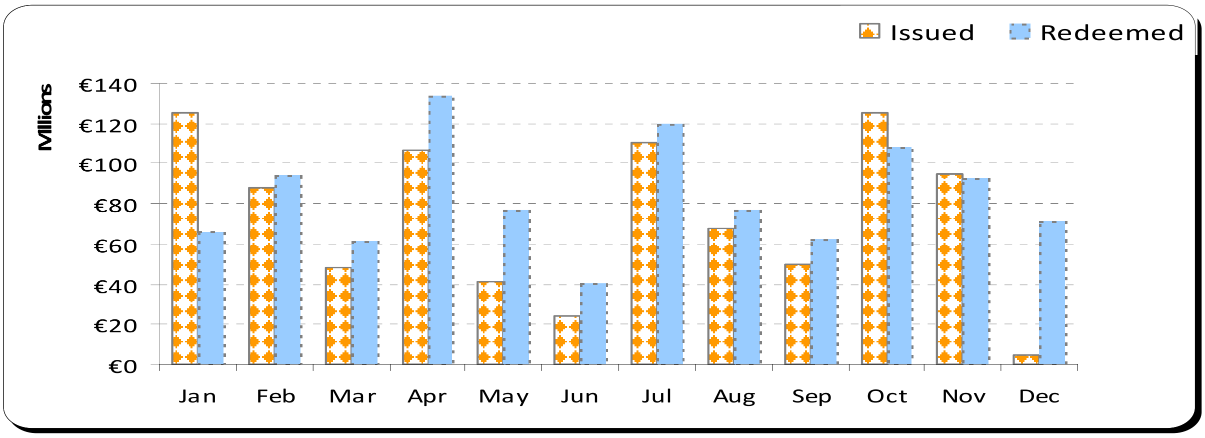
Table 3 - T-Bills issued by tenor in 2011

Tenor	Amount issued*(€ million)*	% of Total	Amount redeemed
28	€72.95	8%	€72.95
91	€491.38	56%	€401.92
182	€187.82	21%	€326.88
273	€132.75	15%	€203.02
364	€0	0%	€0
Total Issuance	€884.91	100%	1,004.78

Source: DMO internal records

Chart 4 shows that on a monthly basis the level of T-bills redemptions - except for three months - was higher than the level of issues, thus leading to a reduction in outstanding stock of treasury bills of €119.86 million year-on-year.

Chart 4 - T-Bills issued and redeemed per month in 2011



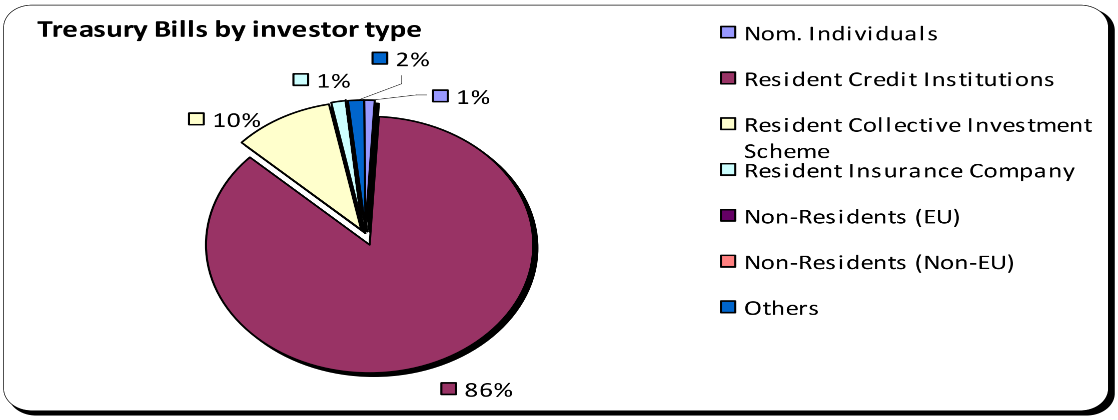
Source: DMO internal records

II. Distribution by investor type

Chart 5 illustrates the distribution of outstanding T-bills categorised by investor type. Auctions are regularly oversubscribed by the various participants

As at 31st December 2011, 86% of outstanding treasury bills were held by resident credit institutions, followed by collective investment schemes (10%).

Chart 5 – Treasury Bills Holder Distribution as at 31st December 2011

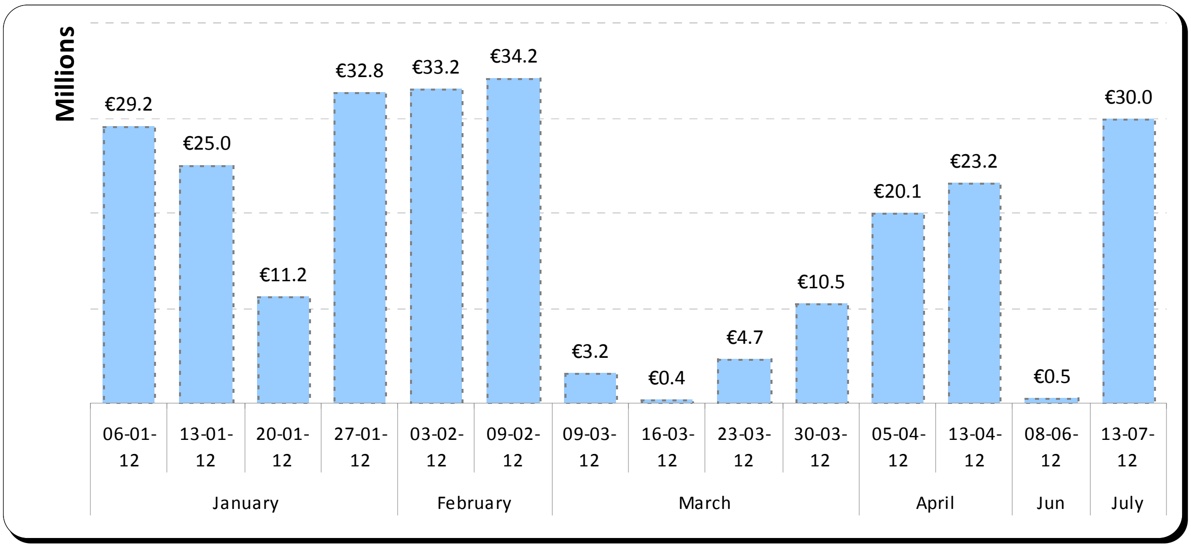


Source: DMO internal records

III. Redemption Profile

At end December 2011, the nominal value of outstanding T-bills stood at €257.90 million and its redemption profile is presented in Chart 6.

Chart 6 - Outstanding Treasury Bills as at end 2011



Source: DMO internal records

IV. Yields & cost of borrowing

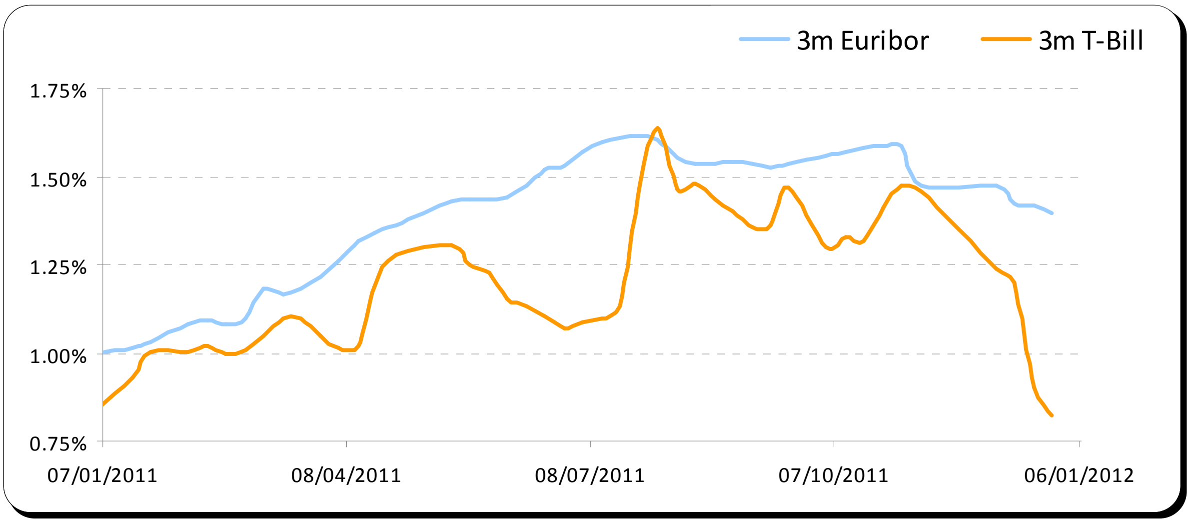
Throughout the year the weighted average rate of the accepted bids in respect of the 91 & 182-day, was lower than the prevailing average Euribor rate on auction date, except for one occasion. However, as a result of higher money market rates, the weighted average yield for the accepted bids at all maturities throughout the year was 1.335%, being an increase of 0.925%over 2010.

The primary market yields for the 91-day T-bill fluctuated between a maximum of 1.637% (on 2nd August 2011) and a minimum of 0.824% (on 27th December 2011). The primary market yield of the 182-day T-bill peaked at 1.799% (on 9th August 2011) and was lowest at 1.041% (on 14th January 2011).

The servicing cost accrued on new T-bills issued in 2011 reached €4.32 million compared to €4.51 million for 2010 (-€0.19 million), whereas the cost incurred on maturing T-bills during 2011 was €4.63 million compared to €6.03 million (-€1.42 million for 2010).

Chart 7 shows that during 2011 the 91-day T-bill yield outperformed the 3-month Euribor rates.

Chart 7 - 3m Euribor vs. 3 month T-bill rates



Source: DMO internal records; European Banking Federation (www.euribor-ebf.eu)

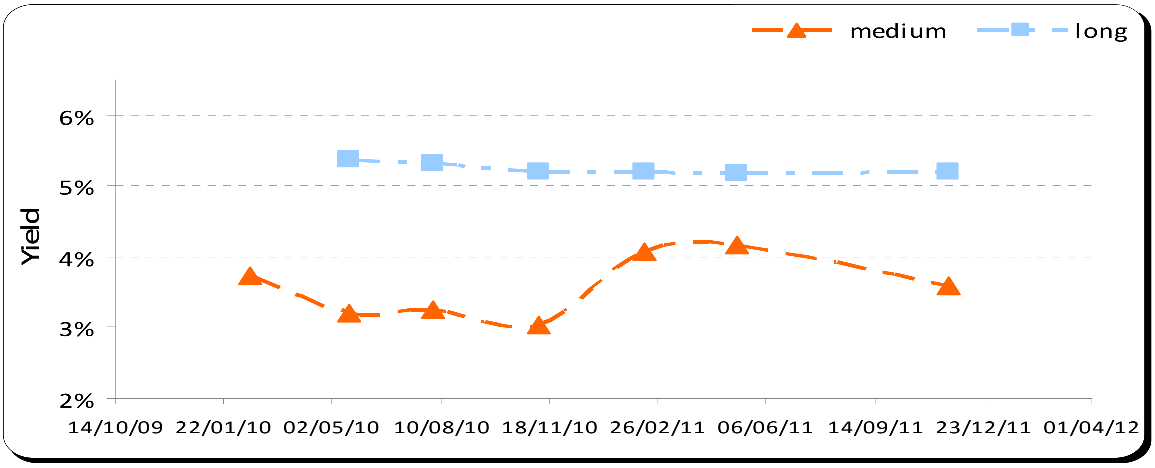
Developments in the MGS Primary & Secondary Markets during 2011

The year 2011 was again characterised by a high volatile market conditions in many sovereign debt markets especially in the Eurozone. While the borrowing cost for peripheral countries in the Eurozone surged on sustainability concerns, the borrowing cost for the Malta Government Stocks was stable throughout 2011 both in the 6-year (medium) and the 20-year (long) maturity buckets.

I. Primary Market

Chart 8 illustrates the comparative accepted ISMA yields in each primary market issue during 2010 and 2011. In 2011, average medium term yields were higher than the equivalent 2010 yields. On the other hand, the average 20-year yield was lower in 2011 compared to 2010. Yet the average 6-year yield accepted in the last issuance of 2011 declined remarkably when compared to previous issuances of similar maturity in 2011.

Chart 8 - Medium & Long Term Yields on the Primary Market 2010-2011



Source: DMO internal records

As can be seen from Table 4**,** the spreads attained during the first half of 2011 were narrower than those attained in the first half of 2010. The positive trend was reversed in the last auction of 2011 (held in November) where the spread against the German Bund widened in comparison to issuances that took places in the first six months of the year.

Table 4 – Spread Over Bund in Primary Market					
Year	**Issuance**	**Medium term**		**Long term**	
		Retail	**Auction**	**Retail**	**Auction**
2010	Feb	+125bps	+98bps	-	
	May	+123bps	+148bps	+169bps	+199bps
	Aug	+135bps	+133bps	+192bps	+185bps
	Nov	+134bps	-	+220bps	-
2011	Feb	+119bps	+96bps	+134bps	+126bps
	May	+118bps	+119bps	+140bps	+143bps
	Nov	+249bps	+211bps	+269bps	+229bps

Source: DMO internal records; Deutsche Bundesbank (www.bundesbank.de)

This illustrates the contrast between a fairly calm first half of the year during which market analysts perceived to be in line with what had been seen in 2010, and an extremely volatile second half of 2011 which led many market participants to switch to a risk-off attitude which, among other things, led to the appreciation in the price of the Bund.

II. Secondary Market

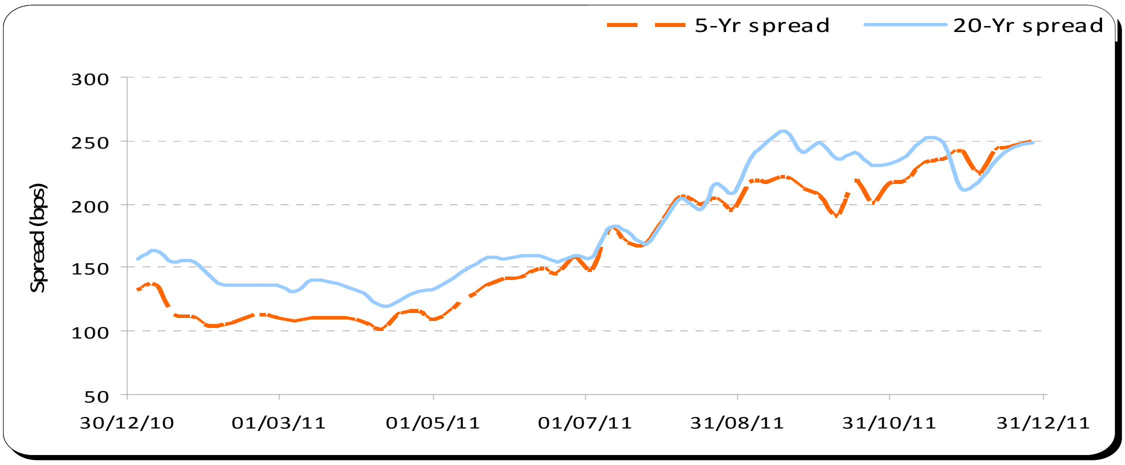
Table 5 illustrates how the benchmark MGS yields moved throughout 2011 on the secondary market. Figures refer to yields sampled at regular intervals throughout the year representing closing bid prices at which the Central Bank of Malta broker actually traded or would have been prepared to buy on the dealing date.

Table 5 - MGS Yields in secondary market			
Term	Lowest	Highest	Average
2-Yr	1.97%	2.86%	2.43%
5-Yr	3.11%	3.81%	3.48%
10-Yr	4.05%	4.74%	4.44%
20-Yr	4.97%	5.23%	5.10%

Source: Central Bank of Malta (www.centralbankmalta.org)

Chart 9 displays the evolution of sampled MGS and German Bund yields for the 5- and 20-year tenors during 2011. The general pattern is similar for both tenors, with spreads widening consistently as from mid-April onwards as bund yields plunged due to heightened uncertainty caused by the eurozone sovereign debt crisis. The overall 'flight to quality' led Bund yields to reach record lows during 2011, as investors rushed to buy the safest government bonds in the euro zone.

Chart 9 – Spreads MGS vs. Bund (5yr & 20yr)



Source: DMO internal records; Financial Times; Bloomberg

In some instances the two curves intersect, suggesting that apprehension by market participants in the shorter term was higher than in the long term as pressure on the 5-year Bund yield increased the spread whereas the 20-year would move at a slower pace.

Foreign Loans

Bilateral loans with foreign entities are specifically undertaken to finance large capital projects. A total of €13.12 million was repaid throughout 2011 according to the repayment schedule, resulting in an end-of year balance of €74.58 million. Interest costs incurred in servicing these loans amounted to €3.91 million. The majority of Government's bilateral agreements are denominated in Euros as shown in Table 6.

Table 6 - Foreign debt and distribution by currency (in € equivalent)

	Euro	GBP	JPY	USD	CAD	Total
Amount (€ equivalent)	€73,330,228	€54,629	€233,609	€726,134	€236,474	€74,581,073
%	98.32%	0.07%	0.31%	0.97%	0.32%	100.00%

Exchange rates as at 30th December 2011.

Source: DMO internal records; Central Bank of Malta (www.centralbankmalta.org)

Relations with other institutions

I. Credit Rating Agencies

In July 2011 the DMO participated in the annual meeting held at the Ministry of Finance with Standard and Poor's during which debt management matters were discussed.

The Directorate also regularly answers requests for data put forward by other credit rating agencies.

II. EFC sub-committee on EU Sovereign Debt Markets (ESDM)

The DMO attended meetings of the Economic and Financial Committee (EFC) Sub-committee on EU *Government Bills and Bonds* Markets in Brussels. The main objectives of the sub-committee are to promote further the integration and achieve a better functioning of the EU government bond markets.

During the course of 2011, the Debt Management Directorate jointly with officials from CBM participated in five meetings during which issues relevant to the functioning of markets and the potential impact of policy decisions on sovereign debt markets were discussed.

In this context the preparation of the Collective Action Clauses (CACs) took prominent place in the discussions. After the Eurogroup statement of 28th November 2010 followed by the signing of the Treaty Establishing the European Stability Mechanism on 11 July 2011, standardised and identical Collective Action Clauses (CACs) shall be included for all new euro area government securities with maturity above one year with effect from 1st January 2013.

III. National Audit Office

In July 2011, the National Audit Office (NAO) received a questionnaire about the practices of public debt management in Malta from the Swedish National Audit Office.

For this purpose, two representatives from the NAO called at the Directorate to assist them in completing the detailed questionnaire, which was in turn forwarded by the NAO to the Swedish National Audit Office in September 2011.

IV. Other Institutions

The Directorate participated in the meeting with DG ECFIN held at the Ministry of Finance in October 2011 in connection with the Autumn Forecast Mission. Among other things the meeting discussed matters relating to debt management issues.

The DMO participated also in meetings with various foreign financial institutions who had shown interest to meet the DMO and Central Bank of Malta to demonstrate their capabilities in terms of sovereign debt market activities and to update on the ongoing developments in the international capital markets, in particular the euro-area sovereign debt markets.

In its capacity as advisor to Malta Government on financial matters, Central Bank of Malta assisted the Directorate in the pricing process of new issuances of Malta Government Stock.

Draft Legislation

A draft legislation was drawn up to regulate the raising of loans by the Government of Malta, to make provisions, in place of the Local Loans (Registered Stock & Securities) Ordinance, for the creation and issue of stock, to provide for the manner in which Loan Guarantees shall be issued, and to provide for the establishment of a Debt Management Directorate and for other matters related thereto.

In November 2011the draft legislation was forwarded to the other members of the Legal team for their consideration and to solicit any proposals or amendments which they wish to submit for further evaluation by the Ministry of Finance.

Staff Training and Development

The Directorate continued to invest in the training of its human resources, both through in-house programmes and through external courses organised by local and foreign institutions. During 2011 a number of initiatives were undertaken and various opportunities were offered to its staff to attend training courses, seminars and annual conferences organised by institutions both locally and abroad. These included:

- Technical Assistance on Funding Policy & Risk Management, hosted by Dutch State Treasury Agency;

- Professional Assertiveness Workshop, hosted by CDRT;

Support Services

The Directorate continued to offer guidance and provide the necessary service to the heirs of deceased stockholders so that inherited stocks can be transferred in their name by a procedure initiated through the heirs' own legal adviser.

The Directorate received 303 new claims from the heirs' legal advisers requesting the transmission of MGS from deceased stockholders to their clients. Settled claims reached 297, out of which 195 were lodged during 2011 and 102 related to claims which were pending from previous years.

Online Services

In February 2011, the Debt Management section within the Treasury website was revamped to include new information in an effort to better meet the needs of the clients in a faster and more efficient manner. Among other things these include:

- The publication of Treasury bills weekly auction results;
- Weekly bid analysis of Treasury bills;
- Tender forms for Treasury bills;
- Malta Government Stocks auction results;
- Monthly issuance calendar for Treasury bills;
- The yearly indicative issuance calendar of Government Securities;
- Various reports, both of a technical and an informative nature;
- New guidelines intended for the heirs of deceased stockholders in respect of *'causa mortis'* claims was launched.