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Debt Office Commentary

More efficient management of Swedish government agencies' international payments

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In recent years, the Debt Office has been able to reduce Swedish government agencies' overall costs for currency conversions through better prices in the central government framework agreements for cross-border payments and the introduction of a multi-currency cash pool model for improved coordination of the agencies' payments in foreign currencies. A liquidity management structure as equally well-functioning and efficient as that used for Swedish kronor is now in place for agencies' payments in other currencies using a multi-currency cash pool solution (MCCP).

The central government payment model

The Swedish National Debt Office is responsible for the central government payment model: a collective term for the regulations, account structures, payment services and technical systems for handling government payments. The payment model is to ensure that the Debt Office meets the Swedish state's requirements for efficiency, security, information and freedom of choice.

In the model, payments are centralised in a cash pool structure whereby the liquidity is gathered in top accounts belonging to the Debt Office at each framework agreement bank. Every day, the Debt Office manages the liquidity in the form of a surplus or deficit from the agencies within the framework of central government debt management. The agencies' payments and payment activities ultimately affect Sweden's central government debt. By providing centralised liquidity management for the government and good cash management, the government's interest costs can be minimised over the long-term.

To achieve the objective of efficient liquidity management for payments by government agencies, the Debt Office procures framework agreements with commercial banks, and it is mandatory for government agencies to use these agreements. In addition to infrastructure in the form of bank accounts, cash pool structures and back-reporting, the framework agreements contain payment processing services that the agencies need in their various payment operations.

Most of the central government payments are made in Swedish kronor, such as tax payments, disbursements of internal transfers, and agencies' management costs. The gross value of payments made by government agencies amounts to about SEK 7,400 billion annually, with the total number of payments amounting to about 172 million.[1] These payments have a long history of being managed efficiently and with overall low transaction costs thanks to the exposure to competition provided by public procurement.

Payments made by government agencies in foreign currencies have been significantly less extensive than those in Swedish kronor. For the years 2018 and 2019, currency conversions with an annual value of about SEK 60 billion were made. The size of the agencies' currency conversions has increased, and it amounted to around SEK 78 billion in 2020[2]. As the size of currency conversions made by the agencies increases, so does the potential for savings that the central government can achieve using a multi-currency cash pool solution (MCCP).

There are a few agencies that account for the majority of payments in foreign currencies, and most payments of this kind are made in EUR and USD. For example, the Swedish Pensions Agency needs currency payments in its fund trading and the Swedish International Development Cooperation Agency (Sida) also makes large payments abroad.

The smaller scope of payments in foreign currencies compared with payments in Swedish kronor has meant that there have not been the same economies of scale and that it has been more difficult to reduce the costs of central government payments in foreign currencies. This has been particularly visible in the form of unfavourable exchange rates for the agencies' currency payments in previous framework agreements. The Debt Office has therefore worked to improve the payment services in foreign currencies in current framework agreements. This has been done both by opening the margin for conversion rates to competition, which has resulted in more favourable conversion rates for the agencies, and by procuring and implementing a multi-currency cash pool solution for the government that involves the government's currency flows being netted, thereby reducing the amounts that need to be converted at the framework agreement banks. There is a cash pool for each of the currencies most frequently used by the agencies.

This Debt Office Commentary describes, among other things, how the agencies can make currency conversions, how the costs of currency conversions have been reduced and how the Debt Office acts to manage currency risks in the agencies' currency payments.

[1] The Debt Office's statistics used in its Annual Report for 2020.

[2] The agencies' reported currency conversions include currencies that account for the largest share of total conversions: EUR, USD, GBP, CHF, JPY, NOK, DKK

The agencies undertake conversions with the currency bank or the Debt Office

Agencies that perform currency conversions outside the MCCP obtain a conversion rate directly from the bank, provided in accordance with the terms of the new framework agreement. The rate is based on fixing rates in Bloomberg at specified times each day. The bank may then charge a fixed conversion margin determined by the framework agreement, which corresponds to between 5 and 25 basis points depending on the currency involved.[3] This means that it is both clear to the agency what conversion rate is used and what cost is associated with the conversion. In the previous framework agreement, the agencies received a real-time rate and the bank's margin was concealed in the conversion rate. The framework banks that managed currency payments then made annual repayments of what was referred to as a currency conversion discount. This arrangement made it difficult for the agencies to estimate the actual costs.

Within the MCCP, the bank makes the currency payments on behalf of the agencies and the sum of the payments is consolidated in top accounts, one for each currency, belonging to the Debt Office. To the extent that cash flows can be matched against one another, the need for currency conversions decreases. Once a day, the balance of each of the top accounts is regulated by the Debt Office making a transaction to each bank, either depositing or withdrawing the corresponding amount in each currency.[4] Thus, there is never any conversion between the currency bank and the Debt Office.

The Debt Office also takes a margin against the agency, but this is based on the Debt Office's actual cost of conversion. The Debt Office is not allowed to make a profit but must ensure that full cost recovery is obtained. Therefore, the margin used by the Debt Office is slightly lower than the margin that the bank takes in the conversions done outside the MCCP.

The fact that the margin is lower means that the agency normally benefits from exchanging with the Debt Office within the MCCP rather than with the bank. However, since the Debt Office updates the conversion rates once a day and the bank does so more frequently, in practice it may be that the agency could still have achieved a better rate for certain transactions directly from the bank. Over time, however, it is more advantageous for the agency to be a member of the MCCP. For the agency, whether or not it is a member of the MCCP makes no difference in the practical implementation of the conversion.

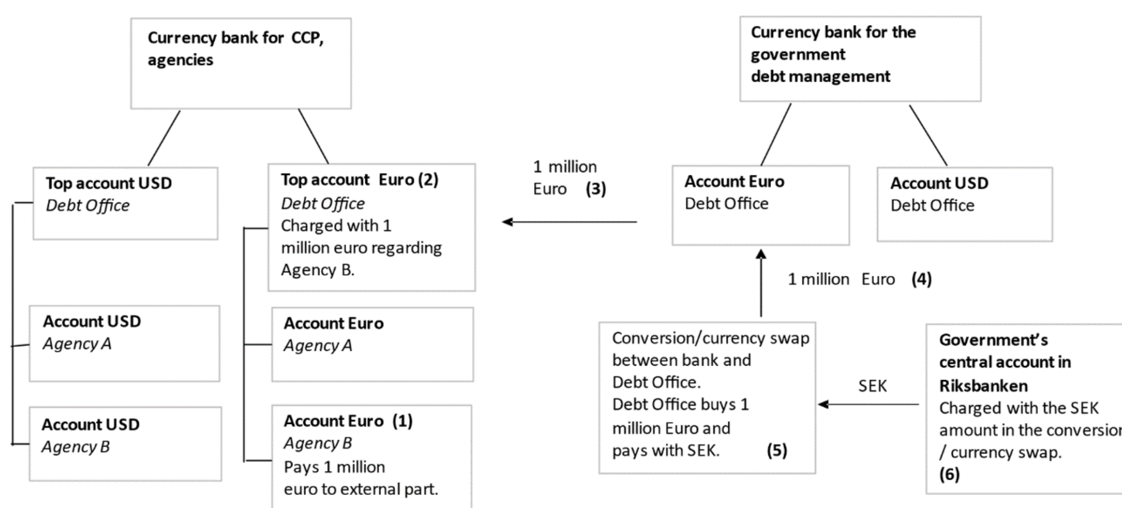
[3] A basis point is expressed as 1/10,000 or one hundredth of one per cent.

[4] The Debt Office uses a mid-rate from Reuters.

Example of a transaction in the MCCP

Suppose Agency B orders a payment of EUR 1 million to an external beneficiary (1). The agency's currency bank carries out the payment according to the order. The Debt Office then needs to cover the top account with EUR 1 million (2). This is done by the Debt Office transferring the amount in EUR from its currency bank (3). In turn, the Debt Office needs to cover the amount again in its currency bank (4). This is normally done with a so-called currency swap (5).[5] The amount is settled in SEK against the government's central account in the Riksbank, which is managed by the Debt Office (6).

Figure 1. Schematic for liquidity management in a MCCP



Lower currency conversion costs

The Debt Office's calculations show that there are significant cost savings linked to currency conversions under the existing framework agreement for the current currency bank. Part of the savings result from the margin that the bank may charge under the new agreement being clearly regulated and significantly lower than in the old agreement. This actual cost saving is only linked to currency conversions made in the currency bank, i.e. the currency conversions made by agencies that are not connected to the MCCP.

[5] The Debt Office makes a spot conversion, buying euro against kronor, and at the same time a forward in which euro is sold for kronor.

In addition to lower currency conversion costs in the currency bank, the Debt Office's MCCP solution has led to significant cost savings for the central government as a whole. During 2020, the government was able to save at least SEK 6 million in the form of reduced costs for the agencies' currency conversions. The savings potential for the government generated by the MCCP is explained partly by lower margins in currency conversion but mainly by the netting effects enabled by the cash pool structure. As the size of the agencies' currency conversions grows and several agencies join the MCCP, the savings potential that the government can achieve through effective liquidity management in currency also increases.

Netting effects occur when an agency connected to the MCCP makes a payment in a particular currency on the same day that another agency receives an incoming payment, in the same currency. Netting effects also occur when currency flows that the Debt Office has within central government debt management can be used to net flows against agencies' MCCP flows for a particular period. This means that netting can take place in different ways, either between agencies within the MCCP, or between agencies and the Debt Office.

The Debt Office must manage the currency risk taken over as a result of agencies' conversions within the MCCP. The currency risk can be managed in different ways. Whether or not there will ultimately be a saving depends on how the risk is managed and how the exchange rates change up until the time when the Debt Office has carried out the conversion itself. Below is a description of how the Debt Office manages the currency risk.

The Debt Office's management of the central government's currency risk in the MCCP

The Debt Office regulates the daily balance in the MCCP bank by moving over the corresponding amount in each currency from the currency bank used by the Debt Office for central government debt management (see the example on page 3). This means that the Debt Office assumes the currency risk.

One of the purposes of the MCCP is to centralise the central government's currency conversions to the Debt Office, and the Debt Office has therefore chosen not to separate the agencies' conversions. The main reason is to be able to benefit from the savings potential of netting currency flows against each other as described in the previous section. The conversions from the agencies are therefore done within the same framework that is used for conversions made for central government debt management.

The guidelines for debt management specify the Debt Office's level of currency exposure. To achieve the specified level of currency exposure, an internal regulatory framework called the conversion mandate is used. In simple terms, this means that a particular amount is exchanged between the Swedish kronor and the euro evenly distributed over a longer time period in order to strive for the desired currency exposure. This is so that conversion rates are not affected by short-term fluctuations in exchange rates. It is also because the Debt Office is a major player in the foreign exchange market in Swedish kronor and therefore wants to act transparently and predictably. This principle means that the currency risk that the Debt Office assumes in conversions with the agencies

will be settled evenly over a longer time period. Not all currency flows are known in advance, especially those from the agencies, so the pace of the conversions is regularly adjusted. The agencies in the MCCP report forecasts of their currency payments, which makes it easier for the Debt Office in the short term. But the agencies usually do not have any information about their currency payments in the longer term.

The central government can take advantage of the savings potential of reduced transaction costs by netting currency payments from the agencies against currency payments in the debt management. However, the expected reduced cost must be weighed against the increased currency risk that the Debt Office assumes. Over time, the Debt Office estimates that overall, the government benefits from the agencies' currency payments being handled in the same way as the currency payments that take place within the framework of central government debt management.

Improved conditions in framework agreements with more favourable conversion rates result in lower costs for the agencies’ currency payments. Like the central liquidity management for Swedish kronor, the MCCP model has meant that effective liquidity management can now also be used for the agencies’ currency payments. This contributes to a good cash level for the central government and is a further step in achieving the Debt Office’s objective of enabling safe and efficient government payments.

The Swedish National Debt Office is the central government financial manager and the national resolution and deposit insurance authority. The Debt Office thus plays an important role in the Swedish economy as well as in the financial market.

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