What is a debt-swap scheme?

IN early '03, the finance minister announced a scheme to replace the high cost debt of states with lower cost borrowings, taking advantage of falling interest rates. The scheme envisages states pre-paying that portion of their outstanding debt to the Centre, on which the interest rate is 13% and more, contracted during the mid-1990s when general interest rates were high. Of a total stock of Rs 2,44,000 crore of outstanding Plan loans, Rs 1,00,000 crore worth of loans bear a coupon rate of 13% and above. Servicing these loans is a major burden for states, many of whom are undergoing fiscal stress. These loans from the centre would be prepaid using fresh, lower cost debt that consists of both the small savings lent to the states by the National Small Savings Fund and additional market borrowings. As a result, while the total debt of the states would remain unchanged, the cost of servicing the loans would come down. This is the fiscal benefit to the states.

How does it work ?

All collections from small savings, which include post office deposits, Kisan Vikas Patras, National Savings Certificates and the Public Provident Fund (PPF), flow to the public account. After adjusting for repayments to the depositors of these small savings instruments, the entire net collections are lent to the states. Of the amount apportioned to each state based on the collection in the respective states, 70% is made available as cash transfer, while the remaining 30% is used for repaying the high cost loans of

ET IN THE CLASSROOM

13% and above. Let's say Maharashtra had mobilised Rs 10,000 crore through small savings in the last fiscal. After adjusting for repayment to depositors of, say, Rs 3,000 crore, the net collections would be Rs 7,000 crore. Of this, the Centre will make available Rs 4,900 crore in cash to Maharashtra while, the balance Rs 2,100 will used for substituting the costly loans of 13% and above. This is done by the states issuing securities against 100% of their collections and receiving cash for 70%. The balance 30% will be fully used for retiring the past debt through transfer of small savings collections at 9.5 %. Apart from this, states are also now allowed to use additional market borrowings at an average interest rate of less than 6.5% to retire high cost debt. Therefore, states save considerably on the interest front. Over a three year period ending '04-05, the scheme envisages the entire high cost debt stock of Rs 1,00,000 crore being cleaned from the books. So far, close to Rs 60,000 crore of these high cost loans have been swapped. The balance will be swapped in the next fiscal, when the states will utilise 40% of the net collections for this purpose.

How does the NSSF come into the picture?

The outstanding liabilities of the Centre on account of small savings aggregating Rs 1,76,221 crore prior to April 1, 1999 were transferred to the National Small Savings Fund (NSSF) set up with effect from that date. This was ostensibly done to give a transparent picture of the viability of small savings schemes. Since all small savings are accounted under the NSSF, the debt swap scheme involves a repayment from the states to the Centre and fresh loans from the NSSF (not the Centre) to the states. The Centre used the states' debt repayment under the debt swap scheme to reduce its fiscal deficit in '02-03 but used these capital receipts in '03-04 to reduce its liabilities to the NSSF. The NSSF then invests these funds in special long term securities issued by the Centre.

What is the gain for the states and the Centres ?

The states, as explained, gain in terms of lower interest payments. Of course, there is a corresponding reduction in the state's flexibility to determine how it wishes to use its borrowings and also lower liquidity. From the Centre's point of view, when it gives states Plan loans for a maturity of 25 years, it charges a spread of close to 150 basis points (1.5 percentage points) over the average weighted cost of its own borrowings. This is to take into account the maturity mismatch. In simple language, what this means is that while the small savings deposits except for the PPF have a maturity of five to six years, the repayment of loans given to states against small savings is over a period of 25 years.

If interest rates were to rise over the medium to long term, this could obviously create a problem for the Centre, since the cost of its borrowings would be going up, while the return on its existing loans to the states would remain locked. It is to take care of this risk that the higher spread is needed.