



HM Treasury

# **Debt and reserves management report 2014-15**

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March 2014





HM Treasury

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# 1

## Introduction

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**1.1** The *Debt and reserves management report* (DRMR) is published in accordance with the Charter for Budget Responsibility. The Charter requires the Treasury to “report through its Debt Management Report – published as part of the Budget Report – on its plans for borrowing in each financial year” and to set remits for its agents. In particular, the Charter requires the report to include:

- the overall size of the debt financing programme for each financial year
- the planned maturity structure of gilt issuance and the proportion of conventional and index-linked gilt issuance
- a forecast of net financing through National Savings and Investments (NS&I)

**1.2** The Debt Management Office (DMO) publishes detailed information on developments in debt management and the gilt market over the previous year in its *Annual Review*.

**1.3** Chapters 2 and 3 along with Annexes A and B contain information on the government’s wholesale debt management activities. Information about financing from NS&I is set out in Annex C. The DMO’s cash management remit is contained in Annex D.

**1.4** Detail on the management of the UK’s Official Reserves can be found on the GOV.UK website.<sup>1</sup>

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<sup>1</sup> [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/236352/management\\_of\\_the\\_official\\_reserves\\_2013\\_14.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/236352/management_of_the_official_reserves_2013_14.pdf)



# 2

## Debt management policy

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**2.1** This chapter provides an overview of the government's debt management framework. It also sets out medium-term considerations for debt management policy during the current period of fiscal consolidation. The debt management framework is part of the overall macroeconomic framework which includes the fiscal and monetary policy frameworks. These are outlined in the Budget 2014 document.<sup>1</sup>

### Debt management framework

**2.2** The debt management framework includes:

- the debt management objective
- the principles that underpin the debt management policy framework
- the roles of the DMO and HM Treasury
- the full funding rule

### Debt management objective

**2.3** The debt management objective was established in 1995 following the *Debt Management Review*. The objective, which is explicitly long-term, is:

*"to minimise, over the long term, the costs of meeting the Government's financing needs, taking into account risk, while ensuring that debt management policy is consistent with the aims of monetary policy."*

**2.4** While decisions on debt management policy must be taken with a long-term perspective, specific decisions on funding the government's gross financing requirement are taken annually. Those decisions are announced in the Budget for the forthcoming year and can be updated during the year consistent with the government's forecast for the net financing requirement. The components of the objective are examined in Box 2.A.

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<sup>1</sup> Available at <https://www.gov.uk/government/publications>

### Box 2.A: Components of the debt management objective

The cost of meeting the government's financing needs in the long term arises directly from interest payable on debt (coupons and the difference between issuance proceeds and redemption payments) and the costs associated with issuance.

'Over the long term' means that the government expects to borrow in the future over the long term i.e. beyond the forecast period for fiscal policy. This expectation is reflected in the government's choice of debt management strategies. For example, the government promotes secondary market liquidity because it is a 'repeat borrower'. In addition, the government may dismiss strategies offering short-term 'opportunistic' benefits if those strategies would adversely affect investors' attitudes over the long term.

There is no single definition of risk in debt management. Rather, a number of risks are taken into account when selecting possible debt management strategies. Five particularly important risks are:

- **interest rate risk** – the risk associated with new issuance each year as interest rate exposure arises at the time that new debt is issued
- **refinancing risk** – the risk associated with the roll-over of maturing debt. An interest rate exposure arises at the time that debt is rolled over and the debt may need to be rolled over at a time when the future CGNCR may also be high, and against a market background that cannot be forecast. In addition, refinancing risk is greater if redemptions are concentrated in particular years
- **inflation risk** – the exposure to inflation arising from the indexation of coupons and principal of index-linked gilts
- **liquidity risk** – the risk that the government may not be able to borrow from a particular part of the market in the required size at a particular point in time because that part of the market is insufficiently liquid for it to do so
- **execution risk** – the risk that the government may not be able to sell the offered amount of debt at a particular point in time, either in full, or at a particularly deep discount to the market price, that would not yield value for money for the Exchequer

This list of risks is not exhaustive. However, these are the major risks that have been taken into account in recent years in the determination of the debt management remit and are expected to be taken into account in future years. The weight placed on each risk can change over time. An explanation of how risk is taken into account in determining the DMO's financing remit for 2014-15 is set out in Annex B.

### Debt management policy principles

2.5 The debt management objective is achieved by:

- meeting the principles of openness, transparency and predictability
- developing a liquid and efficient gilt market
- issuing gilts that achieve a benchmark premium
- adjusting the maturity and nature of the government's debt portfolio, primarily by means of the maturity and composition of debt issuance and potentially by other market operations including switch auctions, conversion offers and buy-backs

- offering cost-effective savings instruments to the retail sector through NS&I

**2.6** The framework is underpinned by the institutional arrangements for debt management policy established in 1998, in particular the creation of the DMO with responsibility for the implementation and operation of debt management policy.

### **Roles of HM Treasury and the DMO**

**2.7** The respective roles of HM Treasury and the DMO are set out in the DMO's *Executive Agency Framework Document*.<sup>2</sup>

**2.8** The government's approach to debt management is based on the principles of openness, predictability and transparency, which is recognised internationally as the most effective way to minimise the long-term costs of debt management. In support of this:

- the DMO will continue to conduct its operations in accordance with the principles of openness, predictability and transparency
- HM Treasury and the DMO will explain the basis for their decisions on debt issuance as fully as possible to the market to allow market participants to understand better the rationale behind the decisions
- the DMO will continue to have a responsibility to advise on, and promote the liquidity and efficiency of, the gilt and Treasury bill markets

**2.9** HM Treasury sets the annual financing remit using the projected financing requirement prepared on the basis of the Office for Budget Responsibility's (OBR) forecasts for the fiscal policy aggregates. The DMO has responsibility for pre-announcing the details of its debt issuance plans to the market, including an auction calendar setting out the dates and gilt type for the year ahead, and details on planned average auction sizes.

### **The full funding rule**

**2.10** An overarching requirement of debt management policy is that the government fully finances its projected financing requirement each year through the sale of debt. This is known as the 'full funding rule'. The government therefore issues sufficient wholesale and retail debt instruments to enable it to meet its projected financing requirement.<sup>3</sup>

**2.11** The rationale for the full funding rule is:

- that the government believes that the principles of transparency and predictability are best met by full funding of its financing requirement
- to avoid the perception that financial transactions of the public sector could affect monetary conditions, consistent with the institutional separation between monetary policy and debt management policy<sup>4</sup>

**2.12** However, the total amount of financing raised in a financial year will at the margin differ in practice from the projected financing requirement. This divergence normally occurs towards the end of the financial year and can be explained by a number of different factors. These include: the difference between the projected CGNCR and its outturn; auction proceeds (including via the

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<sup>2</sup> Available at <http://www.dmo.gov.uk/documentview.aspx?docname=publications/corpgovernance/fwork040405.pdf&page=>.

<sup>3</sup> Wholesale refers to gilts and Treasury bills; retail refers to NS&I products.

<sup>4</sup> With the exception of a small and stable balance on the Debt Management Account held at the Bank of England and the Ways and Means Advance (a government account at the Bank of England), the short-term net cash position of the Exchequer will normally be held with market counterparts. This means that, in practice, financial transactions of the public sector would not affect monetary conditions.

Post Auction Option Facility (PAOF)) in the period following the Autumn Statement that are different from those required to meet relevant financing targets;<sup>5</sup> the sale of Treasury bills, including the DMO's operational flexibility to vary the end-year stock; and the implementation of the syndication programme at year-end.<sup>6</sup>

**2.13** The difference will be reflected in an increase/decrease in the DMO's cash balance at the end of the financial year. To meet the full funding rule year by year, the government aims to return the DMO's net cash balance to its original level by adjusting the projected net financing requirement in the following financial year.

### Medium-term projections for annual financing requirements

**2.14** The government publishes projections for the financing requirement in each year of the fiscal policy forecast period, consistent with the path for fiscal consolidation. The financing requirement includes the projected path for borrowing, the gilt redemption profile and financing for the Official Reserves. Table 2.A sets out the financing requirement projections from 2015-16 to 2018-19. The projected financing requirements are a broad indication of future gilt sales on the neutral assumption that the Treasury bill stock is unchanged and NS&I makes a zero net contribution to financing. Although a zero net contribution from NS&I is considered neutral, measures announced in Budget 2014 are likely to have implications for NS&I inflows in 2015-16.

**Table 2.A: Financing requirement projections, 2015-16 to 2018-19**

|  | 2015-16 | 2016-17 | 2017-18 | 2018-19 |
|--|---------|---------|---------|---------|
| £ billion                              |         |         |         |         |
| CGNCR ex. NRAM and B&B                 | 81      | 67      | 38      | 10      |
| Redemptions                            | 70      | 69      | 79      | 67      |
| Financing for the Official Reserves    | 0       | 0       | 0       | 0       |
| Indicative gross financing requirement | 151     | 135     | 118     | 77      |

*Source: OBR, HM Treasury and DMO*

**2.15** Debt management considerations during the period of fiscal consolidation are set out in Box 2.B.

<sup>5</sup> To meet the financing requirement, which is determined in cash terms, the DMO sizes auctions in nominal terms and takes into account prevailing market prices. Movements in market prices between the announcement of auction sizes and gilt auctions taking place mean that it is not possible to meet these targets precisely.

<sup>6</sup> Outlined further in Annex B.

### Box 2.B: Debt management considerations during the period of fiscal consolidation

Decisions on debt management policy are taken annually, in advance, to achieve the debt management objective:

*“to minimise, over the long term, the costs of meeting the Government’s financing needs, taking into account risk, while ensuring that debt management policy is consistent with the aims of monetary policy.”*

Each year, the government assesses the costs and risks associated with different possible patterns of debt issuance taking into account the most up-to-date evidence and information about market conditions and demand for debt instruments.

At present, annual debt management decisions are also made in the context of an elevated level of debt relative to gross domestic product (GDP), high but falling government borrowing and fiscal consolidation. Consistent with the long-term focus of the debt management objective, the government takes annual decisions which enhance fiscal resilience by:

- mitigating refinancing risk, that is, the need to roll-over continuously high levels of debt and to avoid concentrating redemptions in particular years, by taking issuance decisions which spread out gilt issuance along the maturity spectrum
- promoting the liquidity and efficiency of the gilt market
- maintaining a diversity of exposure, both real and nominal, across the maturity spectrum, reflecting its preference for a balanced portfolio

As a result, subject to cost-effective financing, the government will:

- maintain a relatively high proportion of long fixed-rate exposure and a relatively long average maturity in the debt portfolio in order to limit exposure to interest rate volatility
- maintain a significant proportion of real exposure by issuing index-linked gilts
- continue to issue conventional and index-linked gilts over a range of maturities, taking account of structural demand
- maintain the Treasury bill stock at a level that will support market liquidity

## Sovereign Sukuk

**2.16** The government announced in October 2013 that it plans to issue around £200 million of sovereign Sukuk, the Islamic-law compliant equivalent of government bonds, in 2014-15. Issuance of sovereign Sukuk will not be part of the government’s normal debt management policy but is designed to deliver wider benefits, including reinforcing London’s status as the leading centre for Islamic finance outside of the Muslim world and promoting greater trade and investment into the United Kingdom. An ongoing programme is not envisaged at this stage.

**2.17** Unlike gilt issuance, it is expected that the issuance of sovereign Sukuk will serve to directly reduce the central government net cash requirement. Therefore, the forecast for the central government net cash requirement (CGNCR) in 2014-15 is £200 million lower than would otherwise be the case. However, the ONS will classify Sukuk in due course and this will determine whether in outturn the proceeds from Sukuk issuance act to reduce the CGNCR, or act to finance the CGNCR in the same way as gilts.



# 3

## The Debt Management Office's financing remit for 2014-15

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### Introduction

**3.1** The financing arithmetic sets out the components of the government's net financing requirement and the contributions from the various sources of financing. The DMO's financing remit sets out how the DMO, acting as the government's agent, will fund the projected net financing requirement.

### Financing arithmetic

**3.2** The OBR's forecast for the central government net financing requirement excluding Bradford and Bingley plc and Northern Rock (Asset Management) (CGNCR ex. B&B and NRAM) in 2014-15 is £100.7 billion. The CGNCR ex. B&B and NRAM, which is the fiscal aggregate that ultimately determines gross debt sales, is derived from public sector net borrowing (PSNB). The relationship between PSNB and the CGNCR ex. B&B and NRAM is set out in the OBR's March 2014 *Economic and fiscal outlook*.

**3.3** The forecast net financing requirement (NFR) in 2014-15 of £144.9 billion also reflects projected gilt redemptions of £62.2 billion and additional sterling financing for the Official Reserves of £6.0 billion.

**3.4** In addition, NS&I is expected to make a £13.0 billion net contribution to financing in 2014-15, following a net contribution of £3.4 billion in 2013-14. This projection assumes gross inflows of £24.7 billion in 2014-15.

**3.5** Gilt issuance is the Government's primary means of meeting the net financing requirement. Treasury bills and other cash management instruments may be used at the margin.

**3.6** The NFR will be met by:

- gross gilt issuance of £128.4 billion
- £16.5 billion net issuance of Treasury bills, implying an end-March 2015 stock of £73.0 billion

**Table 3.A: Financing arithmetic in 2013-14 and 2014-15**

|   | 2013-14      | 2014-15      |
|---|--------------|--------------|
| £ billion   |              |              |
| <b>Central government net cash requirement excluding B&amp;B and NRAM<sup>1</sup></b> | <b>87.5</b>  | <b>100.7</b> |
| Gilt redemptions  | 51.5         | 62.2         |
| Financing for the Official Reserves   | 6.0          | 6.0          |
| Buy-backs <sup>2</sup>  | 0.0          | 0.0          |
| Planned short-term financing adjustment <sup>3</sup>                                  | 5.8          | -11.1        |
| <b>Gross financing requirement</b>  | <b>150.8</b> | <b>157.9</b> |
| Less  |              |              |
| National Savings and Investments  | 3.4          | 13.0         |
| <b>Net financing requirement</b>  | <b>147.4</b> | <b>144.9</b> |
| Financed by:  |              |              |
| <b>1. Debt issuance by the Debt Management Office (DMO)</b>                           |              |              |
| <b>a. Treasury bills<sup>4</sup></b>  | <b>5.0</b>   | <b>16.5</b>  |
| <b>b. Gilts</b>   | <b>153.4</b> | <b>128.4</b> |
| of which:   |              |              |
| Conventional:   |              |              |
| Short   | 42.6         | 32.4         |
| Medium  | 32.5         | 26.9         |
| Long  | 34.3         | 33.1         |
| Index-linked  | 38.4         | 31.0         |
| Mini-tenders  | 5.6          | 5.0          |
| <b>2. Other planned changes in net short-term debt<sup>5</sup></b>                    |              |              |
| Change in the Ways and Means Advance  | 0.0          | 0.0          |
| <b>3. Change in net short-term cash position<sup>6</sup></b>                          | <b>11.1</b>  | <b>0.0</b>   |
| <b>Total financing</b>  | <b>158.4</b> | <b>144.9</b> |
| <b>Short-term debt levels at end of financial year</b>                                |              |              |
| Treasury bill stock via tenders <sup>7</sup>  | 56.5         | 73.0         |
| Ways and Means Advance  | 0.4          | 0.4          |
| DMO net cash position   | 11.6         | 0.5          |

Figures may not sum due to rounding.

<sup>1</sup> Reflects an expected £200 million contribution from sovereign Sukuk issuance in 2014-15.

<sup>2</sup> Purchases of 'rump' gilts, with a small nominal outstanding, in which Gilt-edged Market Makers (GEMMs) are not required to make two-way markets. The government will not sell further amounts of such gilts to the market but the DMO is prepared, when asked by a GEMM, to make a price to purchase such gilts.

<sup>3</sup> To accommodate changes to the stated year's financing requirement resulting from: (i) revision to the previous year's CGNCR outturn; (ii) an increase in the DMO's net cash position; and/or (iii) carryover of unanticipated changes to the net cash position from the previous year.

<sup>4</sup> The £5.0 billion shown is the difference between the Treasury bill stock issued via tenders only at end-March 2013 (£51.5 billion) and the planned Treasury bill stock issued via tenders only at end-March 2014 (£56.5 billion). The equivalent numbers published at AS 2013 included Treasury bill sales directly to counterparties that spanned the end of the financial year. Hence, at AS 2013, planned Treasury bill sales in 2013-14 were -£0.7 billion, which was the difference between a Treasury bill stock at end-March 2013 of £57.2 billion and a planned end-March 2014 stock of £56.5 billion.

<sup>5</sup> Total planned changes to short-term debt are the sum of: (i) the planned short-term financing adjustment; (ii) net Treasury bill sales; and (iii) changes to the level of the Ways and Means Advance.

<sup>6</sup> The change in the net short-term cash position for 2014-15 (and the level of the net short-term cash position at the end of the financial year) reflects changes to the public finance forecasts and any changes to financing from NS&I and Treasury bills. It will also reflect any variances between the gilt sales outturn and plans. In addition, the change will include any impact on financing arising from other activities carried out within the government (e.g. issuance of tax instruments, transfers between central government and other sectors, and foreign exchange transactions). The zero change for the net short-term cash position in 2014-15 assumes that the DMO's planning assumption for the end-year Treasury bill stock via tenders is met. A negative (positive) number here indicates an increase in (reduction in) the financing requirement for the following financial year.

<sup>7</sup> From 2014-15, the Treasury bill stock outstanding at year-end can be increased or decreased by a maximum of £5 billion relative to the planning assumption, to offset any anticipated net Exchequer cash surplus or deficit towards year-end.

Source: DMO, HM Treasury and OBR

## Financing for the Official Reserves<sup>1</sup>

**3.7** The financing arithmetic provides for £6.0 billion of sterling financing for the Official Reserves in 2014-15. This additional financing, announced at Budget 2011, is intended to meet potential calls on the Official Reserves that may arise and ensure that the level of foreign currency reserves held is sufficient.

**3.8** For the purposes of the financing arithmetic in Table 3.A, it is assumed that sterling will remain the main form of financing for the Official Reserves (as has been the case in recent years) and no new foreign currency debt will be issued in 2014-15. However, if the government judges that there is a case for doing so, taking into account cost, risk, market conditions and consistency with debt management objectives, consideration would be given to issuing foreign currency securities to finance part of the increase in the Official Reserves in 2014-15. If the government were to decide to issue a foreign currency bond later in the year, this would be taken into account in subsequent updates to the DMO's financing remit. The Bank of England will act as HM Treasury's agent in issuing and managing any foreign currency liabilities associated with the Official Reserves.

## Other short-term debt

**3.9** The projected level of the Ways and Means Advance at the Bank of England at March 2014 is £0.4 billion. No changes to the level of the Ways and Means Advance are planned in 2014-15.

**3.10** The projected level of the DMO's net cash balance at 31 March 2013 is £11.6 billion, £11.1 billion above the level projected at Autumn Statement 2013. The level will be reduced to £0.5 billion during 2014-15, as shown by the planned short-term financing adjustment, and this will in turn reduce the net financing requirement in 2014-15.

## Quantity of gilt sales

**3.11** The DMO, on behalf of the government, will deliver gilt sales of £128.4 billion (cash) in 2014-15.

<sup>1</sup> The government's official holdings of international reserves, with the exception of the Special Drawing Right (SDR) assets, are held in the Exchange Equalisation Account (EEA).

## Gilt issuance methods

**3.12** Auctions will remain the government's primary method of gilt issuance. In addition, the government has decided to continue the use of supplementary methods of gilt issuance, which will comprise syndications and mini-tenders.

**3.13** The use of supplementary methods adds flexibility to the gilt issuance programme. This additional flexibility is designed to facilitate the effective delivery of the gilt issuance programme while remaining consistent with the debt management principles of openness, predictability and transparency.

**3.14** It is anticipated that:

- £106.4 billion (82.9% of total issuance) will be issued by auction
- £17.0 billion (13.2% of total issuance) will be issued by syndication
- £5.0 billion (3.9% of total issuance) will be issued by mini-tender

## The maturity structure of debt issuance

**3.15** The amount of issuance via auctions and syndicated offerings in 2014-15 is planned to total £123.4 billion (or 96.1% of total issuance) and will be split by maturity and type as follows:<sup>2</sup>

- £32.4 billion of short conventional gilts (25.2% of total issuance)
- £26.9 billion of medium conventional gilts (21.0% of total issuance)
- £33.1 billion of long conventional gilts (25.8% of total issuance)
- £31.0 billion of index-linked gilts (24.1% of total issuance)

**3.16** In addition, the DMO plans to deliver sales via mini-tender of £5.0 billion (3.9% of total issuance), which can be used for issuance of conventional and index-linked gilts across the curve, following consultation with the market. The mini-tender programme will continue to be used to support the syndication programme by providing flexibility to accommodate any variations in proceeds from syndicated offerings.

**3.17** To maintain the operational viability of syndicated offerings at the end of each programme, the overall size of the syndication programmes (conventional and index-linked) may be increased by up to 10% at the time of the final syndicated offering of each type. Scope to up-size the programmes in this way would only be deployed if the capacity to up-size syndications through reallocation of the mini-tender programme had been exhausted.

**3.18** Through its gilt issuance programme the government aims at regular issuance across the maturity spectrum throughout the financial year and at building up benchmarks at key maturities in both conventional and index-linked gilts.

**3.19** The planning assumption for gilt issuance in 2014-15 by method of issue, type and maturity is shown in Table 3.B.

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<sup>2</sup> Short = 1-7 years maturity; medium = 7-15 years maturity; long = > 15 years maturity.

**Table 3.B: Breakdown of planned gilt issuance by type, maturity and issuance method**

| £ billion (%) | Auction          | Syndication     | Mini-tender   | Total           |
|---------------|------------------|-----------------|---------------|-----------------|
| Short         | 32.4             |                 |               | 32.4<br>(25.2%) |
| Medium        | 26.9             |                 |               | 26.9<br>(21.0%) |
| Long          | 24.6             | 8.5             |               | 33.1<br>(25.8%) |
| Index-linked  | 22.5             | 8.5             |               | 31.0<br>(24.1%) |
| Total         | 106.4<br>(82.9%) | 17.0<br>(13.2%) | 5.0<br>(3.9%) | 128.4           |

Figures may not sum due to rounding.

**3.20** There are no current plans to introduce new gilt issuance methods in 2014-15. Before introducing any such methods, the DMO would consult market participants and seek HM Treasury's approval prior to their introduction.

### Gilt auction calendar

**3.21** On the same day as the publication of the DRMR, the DMO will publish a gilt auction calendar consistent with the remit which sets out the planned dates of gilt auctions (by type of gilt).

### Post-auction option facility

**3.22** In 2014-15, the DMO will continue to offer to successful bidders (both primary dealers and investors) an option to purchase additional stock of up to 10% of the amount allocated to them at auction, at the average accepted price at conventional auctions and the clearing (or strike) price at index-linked auctions. Further details of this facility are available in the DMO's gilt market operational notice.<sup>3</sup>

**3.23** Any additional amounts sold via this facility in 2014-15 will count towards the remit sales targets on an auction by auction basis and will, all else equal, be used progressively to reduce the average sizes for the remaining auctions of the maturity/type of gilt in question, throughout the financial year. Average auction sizes will be restated after each auction. If exercised consistently, the option may allow for the cancellation of future auctions. Any such cancellation would be announced well in advance as part of the regular issuance calendar announcements and/or the Autumn Statement 2014.

### Taps and reverse taps

**3.24** The programme of gilt sales by auction, syndicated offering and mini-tender set out above may be supplemented by sales or purchases of gilts "on tap".<sup>4</sup> Taps of gilts will be used only as a market management mechanism in exceptional circumstances.

### The Standing Repo Facility

**3.25** For the purposes of market management, the DMO may create and repo out gilts in accordance with the provisions of its Standing Repo Facility launched on 1 June 2000 and most

<sup>3</sup> [http://www.dmo.gov.uk/documentview.aspx?docname=publications/operationalrules/Opnot20130125.pdf&page=operational\\_rules/Document](http://www.dmo.gov.uk/documentview.aspx?docname=publications/operationalrules/Opnot20130125.pdf&page=operational_rules/Document)

<sup>4</sup> Taps (reverse taps) are sales (purchases) of gilts undertaken directly with the GEMMs by the DMO as a market management mechanism in circumstances, temporary or otherwise, such that the secondary market has become, or is likely to become, dislocated.

recently revised on 6 August 2009.<sup>5</sup> Any such gilts created will not be sold outright to the market and will be cancelled on return.

## **Other operations**

**3.26** The DMO has no current plans for a programme of reverse or switch auctions or conversion offers in 2014-15.

## **Coupons**

**3.27** As far as possible, the DMO will set coupons on new issues to price the gilt close to par at the time of issue.

## **Buy-ins of short maturity debt**

**3.28** The DMO will have responsibility for buying-in gilts close to maturity to help manage Exchequer cash flows.

## **Treasury bill sales**

**3.29** The outstanding stock of Treasury bills sold via weekly tenders at end-March 2015 is expected to be £73.0 billion, an increase of £16.5 billion from the planned stock sold via tenders at end-March 2014. The DMO will have the flexibility to vary the end-financial year stock of Treasury bills issued via tenders by up to £5.0 billion above or below the published planned level to offset any anticipated net exchequer cash surplus or deficit toward year-end. The 2013-14 outturn for the Treasury bill stock sold via weekly tenders will be reported alongside the CGNCR outturn in April 2014.

**3.30** In addition to the scheduled weekly tenders, the DMO may continue to re-open, on request, existing issues of Treasury bills for sale on a bilateral basis, for cash management purposes. Any such bills will not be included in the end-year stock of Treasury bills as described in Table 3.A.<sup>6</sup>

## **New gilt instruments**

**3.31** There are no current plans to introduce new types of gilt instrument in 2014-15. Before introducing any new instruments, the DMO will consult market participants and seek HM Treasury's approval prior to their introduction.

## **Revisions to the remit**

**3.32** In addition to planned updates to the remit, any aspect of this remit may be revised during the year in the light of exceptional circumstances and/or substantial changes in the following:

- the government's forecast for the net financing requirement
- the level and/or shape of the gilt yield curves
- market expectations of future interest and inflation rates
- market volatility

**3.33** Any such unplanned revisions will be announced transparently to the market.

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<sup>5</sup> [http://www.dmo.gov.uk/documentview.aspx?docname=publications/operationalrules/RepoTC060809B.pdf&page=operational\\_rules/Document](http://www.dmo.gov.uk/documentview.aspx?docname=publications/operationalrules/RepoTC060809B.pdf&page=operational_rules/Document)

<sup>6</sup> Issuance of Treasury bills on a bilateral basis will continue to be reported on the DMO website at: <http://www.dmo.gov.uk/ceLogon.aspx?page=about&rptCode=D2.2G>

# A

## Debt portfolio

### Debt stock

**A.1** The total nominal outstanding stock of central government sterling debt excluding official holdings by central government was £1386.2 billion at end-December 2013. The components of this stock are set out in Table A.1.

**Table A.1: Composition of central government sterling debt**

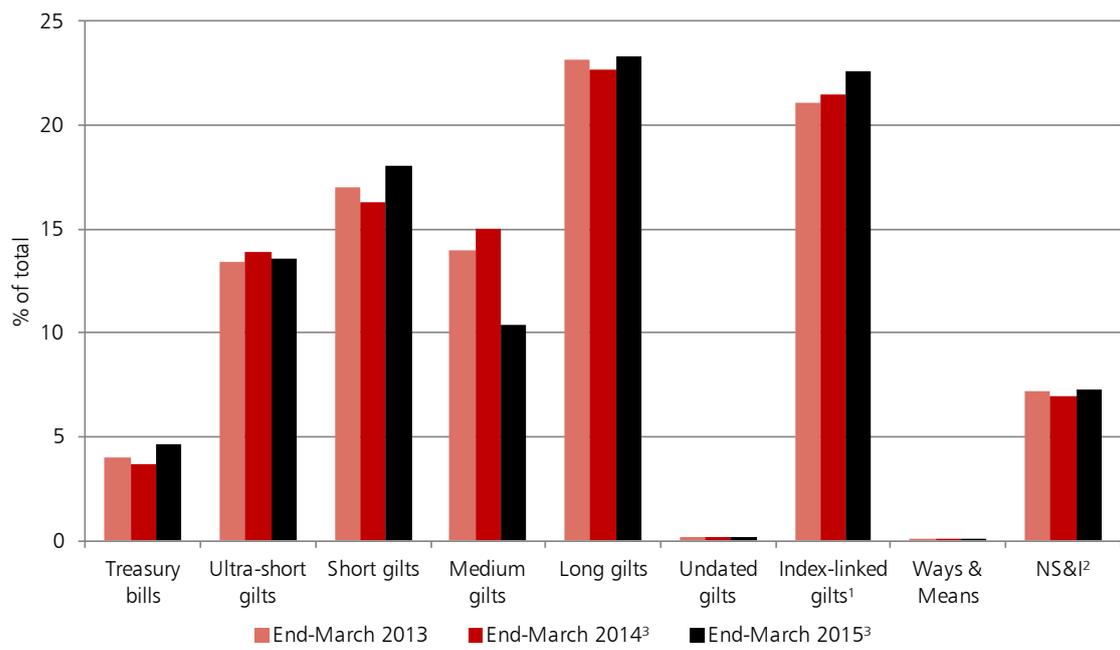
|   | End-December 2012 | End-December 2013 |
|---|-------------------|-------------------|
| £ billion, nominal value, excluding official holdings |                   |                   |
| Conventional gilts <sup>1</sup>                       | 858.1             | 938.8             |
| Index-linked gilts <sup>2</sup>                       | 282.1             | 304.5             |
| Treasury bills  | 52.0              | 37.4              |
| <b>Total gilts and Treasury bills</b>                 | <b>1192.2</b>     | <b>1280.7</b>     |
| NS&I  | 102.1             | 105.1             |
| Balance on Ways and Means Advance                     | 0.4               | 0.4               |
| <b>Total central government sterling debt</b>         | <b>1294.6</b>     | <b>1386.2</b>     |

<sup>1</sup> Includes undated and double-dated gilts  
<sup>2</sup> Includes accrued inflation uplift

Source: DMO and NS&I

**A.2** Chart A.1 shows a comparison of the government's debt portfolio at end-March 2013 through to the projected comparison at end-March 2014. It assumes that new debt is issued in accordance with the DMO's and NS&I's financing remits and also takes account of the ageing of existing debt.

**Chart A.1: The composition of central government debt**



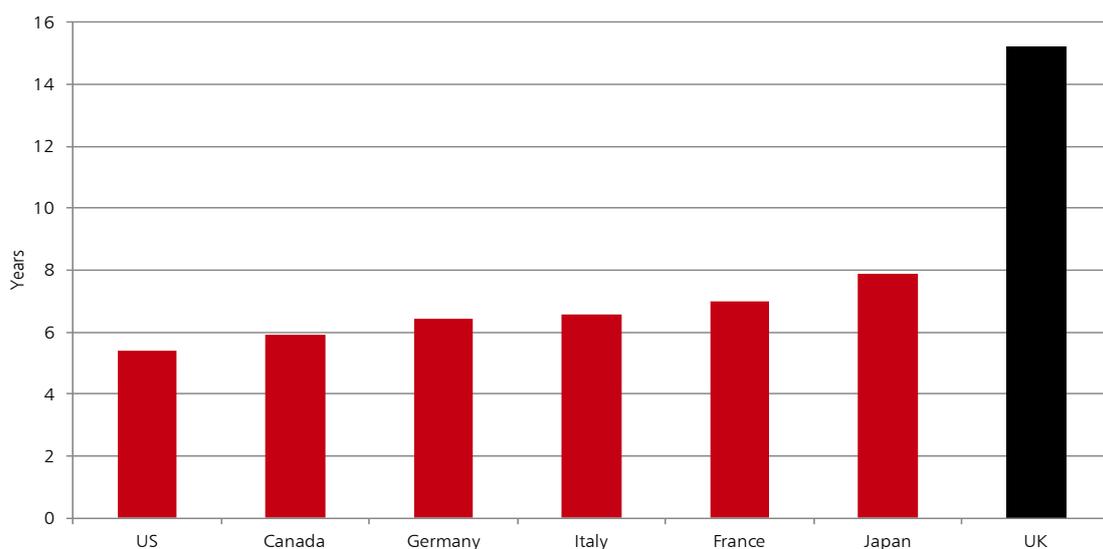
<sup>1</sup> Includes inflation uplift  
<sup>2</sup> Includes accrued interest  
<sup>3</sup> Projections

Source: DMO and NS&I

**Maturity and duration of the debt stock**

**A.3** The average maturity of the stock of all marketable debt is projected to remain just below 15 years by end-March 2014. Over the same period the average modified duration of the stock of conventional gilts is projected to fall from 9.2 years to 8.9 years. The average maturity of the government’s wholesale debt is significantly longer than the G7 average, as shown in Chart A.2.

**Chart A.2: Average maturity of the debt stock by country (2012)<sup>1</sup>**

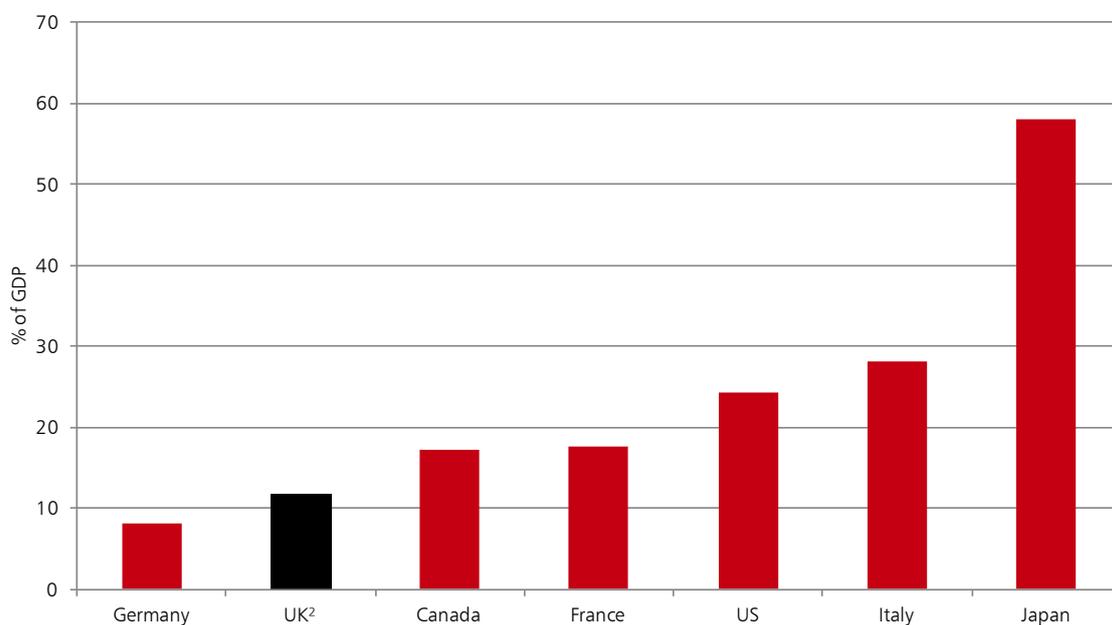


<sup>1</sup> Excludes Treasury bills. Data for Canada is at end-December 2011

Source: DMO and OECD

**A.4** Chart A.3 shows the supportive impact of the long average maturity of the stock of UK wholesale debt on the UK's gross financing requirement, which compares favourably with that of other G7 countries.

**Chart A.3: Gross financing needs as % of GDP (2014)<sup>1</sup>**



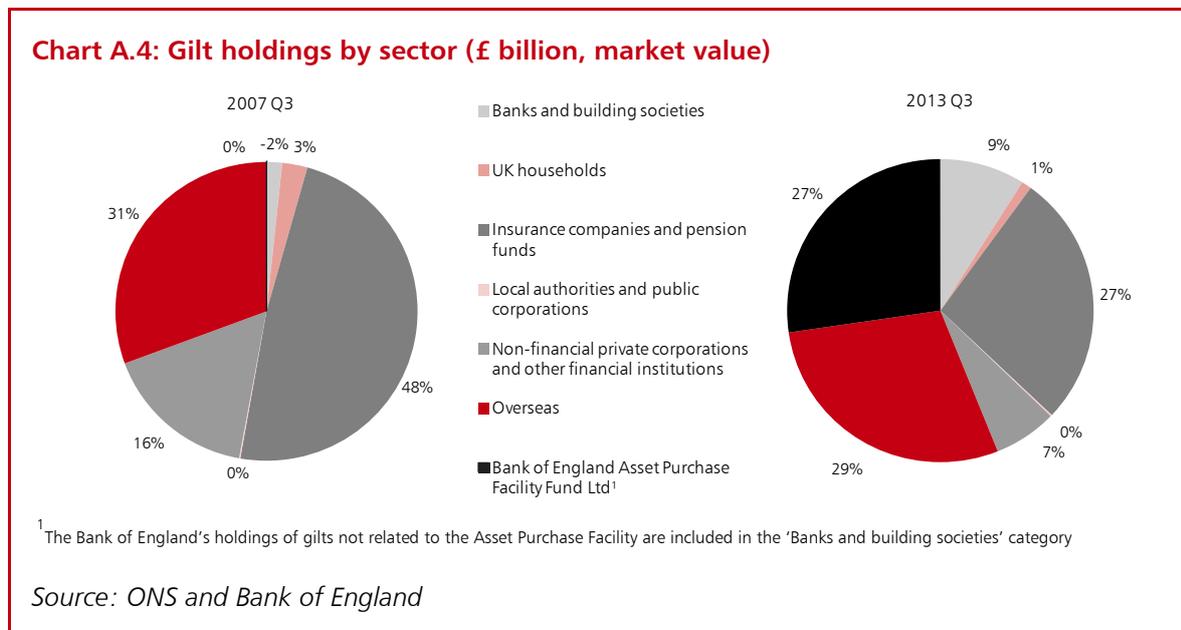
<sup>1</sup> Includes rollover of short-term debt (i.e. stock of Treasury Bills)

<sup>2</sup> For financial year 2014-15.

Source: HM Treasury and IMF Fiscal Monitor October 2013

## Gilt holdings by sector

**A.5** Chart A.4 shows gilt holdings by sector. Data published by the Office for National Statistics (ONS) show that in Q3 2007 the three largest investor groups were: insurance companies and pension funds (48%), overseas investors (31%) and non-financial corporations and other financial institutions (16%). Since then there have been significant shifts in the proportionate holdings of gilts, in part driven by the substantial increase in the size of the debt stock, as well as by the introduction of the quantitative easing programme by the Bank of England. In Q3 2013 the three largest gilt investor groups were: overseas investors (29%), the Bank of England's Asset Purchase Facility (27%) and insurance companies and pension funds (27%).



## Gilt Issuance

**A.6** The CGNCR ex. B&B and NRAM measures the cash amount that the central government needs to borrow for the financial year and is the key fiscal measure from which the volume of gilt issuance is derived. The CGNCR for each of the years in which the DMO has been responsible for gilt issuance, and the volume of gilt sales in each of those years, is shown in Table A.2.

**Table A.2: CGNCR and gross gilt sales**

| <b>£ billion</b>     | <b>CGNCR<sup>1</sup></b> | <b>Gross gilt sales<sup>2</sup></b> |
|----------------------|--------------------------|-------------------------------------|
| 1998-99              | -4.5                     | 8.2                                 |
| 1999-00              | -9.1                     | 14.4                                |
| 2000-01              | -35.6 <sup>3</sup>       | 10.0                                |
| 2001-02              | 2.8                      | 13.7                                |
| 2002-03              | 21.8                     | 26.3                                |
| 2003-04              | 39.4                     | 49.9                                |
| 2004-05              | 38.5                     | 50.1                                |
| 2005-06              | 40.8                     | 52.3                                |
| 2006-07              | 37.1                     | 62.5                                |
| 2007-08              | 32.6                     | 58.5                                |
| 2008-09              | 162.4                    | 146.5                               |
| 2009-10              | 198.8                    | 227.6                               |
| 2010-11              | 139.7                    | 166.4                               |
| 2011-12              | 126.5                    | 179.4                               |
| 2012-13              | 105.0                    | 161.5                               |
| 2013-14 <sup>4</sup> | 83.2                     | 153.4                               |
| 2014-15 <sup>4</sup> | 96.3                     | 128.4                               |

<sup>1</sup> Figures are for the headline CGNCR and therefore not directly comparable with the CGNCR ex. B&B and NRAM in Table 3.A

<sup>2</sup> Figures are in cash terms

<sup>3</sup> Reflecting proceeds from the 3G Spectrum auction

<sup>4</sup> Budget 2014 predictions

Source: DMO, HM Treasury and OBR



# B

# Context for decisions on the Debt Management Office's financing remit

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## Introduction

**B.1** This annex provides the context for the government's decisions on gilt and Treasury bill issuance in 2014-15, setting out the qualitative and quantitative considerations that have influenced the government's decisions.

**B.2** The government's decisions on the structure of the financing remit, which are taken annually, are made in accordance with the debt management objective, the debt management framework and wider policy considerations during the period of fiscal consolidation (see Chapter 2).

**B.3** In determining the overall structure of the financing remit, the government assesses the costs and risks of debt issuance by maturity and type of instrument. The government's decisions on the composition of debt issuance are also informed by an assessment of investor demand for debt instruments by maturity and type as reported by stakeholders, and as manifested in the shape of the nominal and real yield curves, as well as the government's appetite for risk.

**B.4** Alongside these considerations the government takes into account the practical implications of issuance (for example the scheduling of operations during the course of the year and the appropriate use of different issuance methods).

## Demand

**B.5** The Gilt-edged Market Makers (GEMMs) and end-investors continue to report well diversified demand for conventional and index-linked gilts across the maturity spectrum. These views were most recently expressed at the government's annual consultation meetings with gilt market participants in January 2014.<sup>1</sup>

**B.6** Continued demand for long-dated conventional and index-linked gilts from domestic pension funds and insurance companies is anticipated in 2014-15. Any improvements in pension fund solvency in the coming year may accelerate the pace of de-risking by funds undertaking liability driven investment strategies.

**B.7** In recent years, international investors have been an important source of demand for gilts. In 2014-15, market expectations are for continued demand from international investors, including central banks and reserve managers looking to diversify growing reserves. However, cross-market flows into, and out of, gilts in 2014-15 may be affected by market expectations around the path of global economic growth.

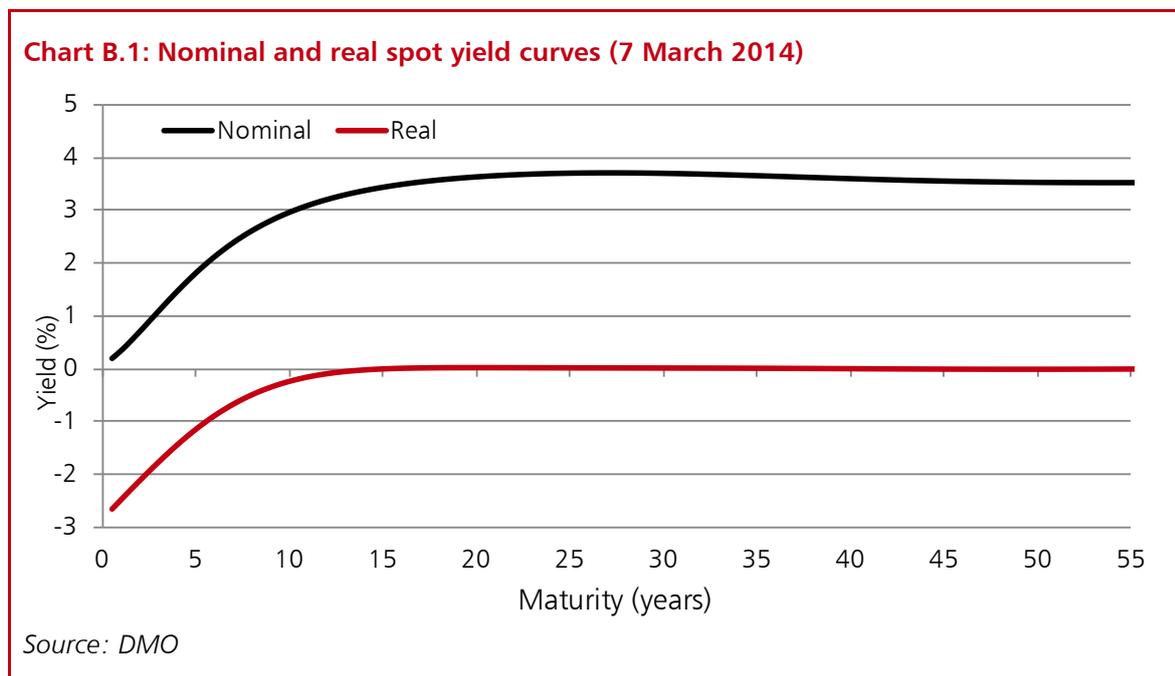
**B.8** In recent years, there have been significant inflows into gilts from domestic banks and building societies, to meet forthcoming regulatory requirements relating to the maintenance of buffers of high quality liquid assets. Given the volume of purchases made to date, and current regulatory requirements, no major changes in gilt investment by domestic financial institutions are expected in the coming year.

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<sup>1</sup> Minutes of the meetings are available at: <http://www.dmo.gov.uk/documentview.aspx?docName=/gilts/press/sa130114.pdf>

## Cost

**B.9** In assessing the cost of different types of debt issuance by maturity and type the Government undertakes an analysis of the nominal and real yield curves. Chart B.1 shows the shape of the nominal and real spot curves at 7 March 2014.



**B.10** As part of this analysis, the government seeks to estimate risk premia in the yield curve in order to identify maturity segments where gilt issuance could be more cost-effective.

**B.11** Modern asset pricing theory suggests that the observed yield on a bond can be decomposed into two components: a 'risk neutral' yield and a risk premium. The risk neutral yield is the interest rate under 'pure expectations'. In practice, forward yields follow a different path, as investors impose a charge on the issuer in the form of higher yields in order to protect investments against a variety of risks.<sup>2</sup> This gives rise to the *risk premium*. Theory suggests that the risk premium should be positive and increase with maturity, reflecting the fact that investors require compensation for holding riskier (i.e. longer maturity) assets. The variability and trends in risk premia reflect investors risk preferences over time.

**B.12** Results from the DMO's risk premia analysis indicate the existence of a time-varying risk premium in the conventional gilt market which is usually positive and, as a general rule, increases with maturity.<sup>3</sup> Premia increased at all maturities during the second half of 2008, but the magnitude of this rise varied with maturity and it was followed by a significant and prolonged fall after April 2011.<sup>4</sup> Over the past year, premia have risen at all maturities and by December 2013 were back at levels close to their historical averages.

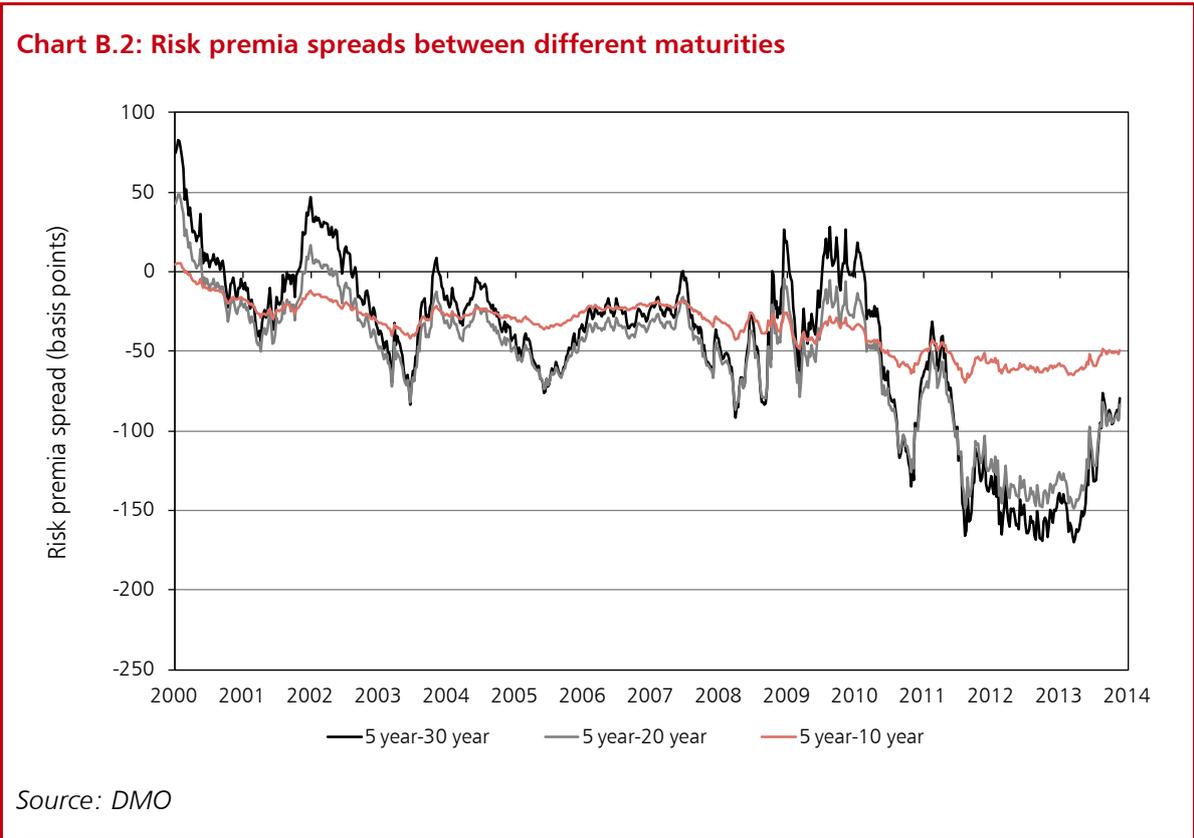
<sup>2</sup> The risk premium can be considered to have several components, including, but not limited to: (i) a term premium, which compensates investors for the fact that uncertainty increases for longer maturity investments; (ii) a credit and default risk premium; (iii) a liquidity premium due to the lower level of liquidity in some bonds or maturities, which restricts investors ability to hedge; and (iv) an inflation risk premium to compensate investors in nominal bonds for uncertainty due to inflation. In general, the premium is the extra return investors expect to obtain from holding long-term bonds as opposed to holding and rolling over a sequence of short-term securities over the same period. The risk premium estimated by the DMO's model also includes a 'convexity premium' component – this increases with maturity and yield volatility and it offsets to some degree the other risk premium components as it represents a charge that the investor pays the issuer.

<sup>3</sup> This analysis is based on recent academic research by Christensen, Diebold and Rudebusch. Further details can be found in the DMO's Annual Review 2011-12: <http://www.dmo.gov.uk/documentview.aspx?docname=publications/annualreviews/gar1112.pdf>.

<sup>4</sup> The model has not been adjusted to account for 'zero bound effects' and if this had been done it would have tended to increase the premia estimates of short and medium gilts in the period since 2009.

**B.13** For the period examined, the risk premium at the 5-year maturity has generally been lower than at other maturities, indicating that short gilts have been the most cost-effective maturity of conventional gilts to issue.<sup>5</sup> Chart B.2 plots the spread between the risk premium at the 5-year maturity and at other key maturities. It shows that spreads have generally been negative due to the premium at the short end usually being lower than at other (longer) maturities. These spreads widened significantly at the onset of the financial crisis, although the spread between medium maturity (10-year) gilts and 5-year gilts has been relatively stable. By contrast, in the last year the relative spread versus longer maturity bonds has halved, reducing the cost-effectiveness of 5-year gilts compared with longer maturity conventional gilts.

**B.14** The results from the DMO’s premia analysis have been tested for consistency against an analysis of the forward curve<sup>6</sup> and alternative scenarios for interest rates based on macroeconomic assumptions.<sup>7</sup>



**B.15** Alongside this analysis of the relative cost-effectiveness of conventional gilts across different maturity sectors, the government undertakes an evaluation of index-linked gilt cost-effectiveness, using conventional gilts as a benchmark for comparison, by examining the evolution of break-even inflation rates.<sup>8</sup>

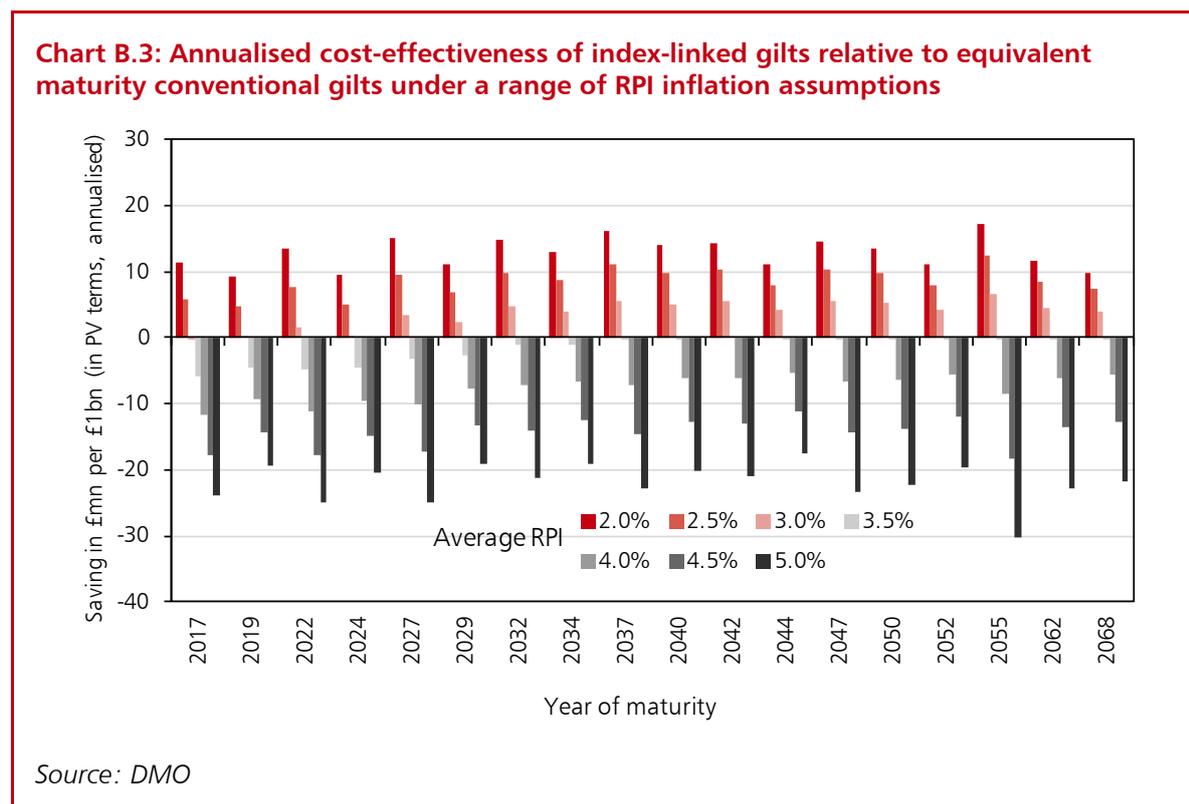
**B.16** The break-even inflation rate is the rate of inflation that equalises the return on an index-linked gilt with that of a conventional gilt of the same maturity. It can be seen as the average

<sup>5</sup> Data: January 2000 to December 2013.  
<sup>6</sup> Historical analysis of the forward curve provides a useful indication of the existence of historical risk premia.  
<sup>7</sup> Risk premia estimation requires an estimate of the future short rate. Alternative scenarios for the future short rate were developed from historical regression analysis based on a set of inflation, output gap and Bank of England Rate data.  
<sup>8</sup> A more detailed explanation of the methodology used in this analysis can be found in Knight, J. (2013). *Assessing the Cost Effectiveness of Index-linked Bond Issuance: A Methodological Approach, Illustrated Using UK Examples. OECD Working Papers on Sovereign Borrowing and Public Debt Management, No. 7.*

rate of inflation, over the life of an index-linked gilt issue, which will make the government indifferent on cost grounds between issuing either a conventional or an index-linked gilt.

**B.17** To the extent that future inflation turns out to be higher or lower than the break-even inflation rate prevailing at the time an index-linked gilt is issued, it will have been more cost-effective for the government to have issued a conventional or an index-linked gilt respectively.

**B.18** As such, the government can compare prevailing break-even inflation rates on index-linked gilts against a range of paths for future inflation (see Chart B.3) to evaluate, at a point in time, the relative cost-effectiveness of conventional and index-linked gilt issuance of equivalent maturities. In order to enable the comparison of cost-effectiveness by maturity, the data are evaluated on an annualised basis.



**B.19** The analysis shows that, for future average RPI inflation of up to around 3.5%, index-linked gilts are, at the margin, more cost-effective than conventional gilts (of equivalent maturity). This cost-effectiveness is slightly more pronounced for longer-dated index-linked gilt issuance.

**B.20** On the assumption that inflation is in line with the Bank of England’s target rate in the medium term, and based on a neutral assumption that inflation remains at target thereafter, an assessment of the path of long-term inflation relative to that priced in by the market indicates that, at the margin, index-linked gilts are generally cost-effective relative to equivalent maturity conventional gilts.<sup>9</sup>

## Risk

**B.21** The other key determinant in the government’s decisions on debt issuance by maturity and type of instrument is its assessment of risk. In reaching a decision on the overall structure of the remit, the government considers the risks to which the Exchequer is exposed through its debt

<sup>9</sup> This conclusion is based on the assumption that the long-run wedge between CPI and RPI is within the range of external estimates.

issuance decisions, and balances its assessment of risk against its assessment of cost in order to reach a judgement about the skew of issuance.

**B.22** Different maturities and types of issuance give rise to different risk exposures. The government assesses the relative importance of each risk in accordance with its risk appetite. These risks are also considered in the context of supporting fiscal resilience in the medium term while remaining consistent with the long-term focus of the debt management objective.

**B.23** The government currently places a relatively high weight on reducing near-term exposure to refinancing risk. One of the ways in which the government can manage this exposure is by maintaining a high proportion of long-dated debt in its portfolio, which can reduce the need to roll over debt frequently. The government also places significant importance on avoiding large concentrations of redemptions in any one year. To achieve this, it will issue debt across a range of maturities, smoothing the profile of gilt redemptions.

## Modelling of cost and interest rate/refinancing risk

**B.24** An additional input to the analysis underpinning the government's decisions on its issuance strategy is an exercise in which cost and risk simulations are generated to illustrate the cost-risk trade-off associated with different issuance strategies.<sup>10</sup> This allows the government to investigate the near-term implications of different annual issuance strategies.

**B.25** This exercise provides estimates of the evolution, over a 10-year horizon, of cost and risk metrics of the gilt portfolio.<sup>11</sup> Debt service cost is defined as the cost of the coupon payments and redemptions associated with government debt, measured in terms of the relevant yield. Risk is defined as the standard deviation of debt service cost or debt service cost volatility. This can be seen as a measure combining both interest rate risk and refinancing risk.<sup>12</sup>

**B.26** The metrics resulting from this analysis combine the impact from alternative issuance strategies for financing new government debt (to meet the CGNCR and the refinancing of redemptions) with the existing characteristics of the debt portfolio inherited from previous financial years. The DMO's Portfolio Simulation Tool (PST), which calculates debt interest cost, is used in conjunction with a macroeconomic-based Vector Autoregressive (VAR) model, which provides a distribution of projections of the yield curve, to depict risk in cost terms.<sup>13,14</sup> In this way, the PST 'maps' the projected yield curve distribution to a debt service cost distribution so that simulated cost and risk metrics can be analysed.

**B.27** Table B.1 illustrates three issuance strategies. Strategies 1 and 3 represent two extreme issuance programmes with 100% allocation of conventional gilts to short and long issuance respectively. Strategy 2 represents a split of issuance based on the actual 2013-14 issuance split followed by the DMO, which is well diversified across maturity buckets. All strategies have the same issuance split between conventional and index-linked gilts, 74% and 26% respectively.

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<sup>10</sup> The government does not use this simulation tool to determine a single optimal debt issuance strategy.

<sup>11</sup> From years 5 to 10, a balanced budget assumption, i.e. CGNCR=0, has been made. This implies: (i) that in years 5 to 10 the debt interest cost incurred every year is covered by a surplus in the other components of the CGNCR; and (ii) that total financing for the DMO is equal to redemption refinancing, assuming no pay down of debt.

<sup>12</sup> Interest rate risk is the risk associated with new issuance while refinancing risk is the risk associated with the roll-over of maturing debt.

<sup>13</sup> There are differences in the methods used to calculate debt interest cost by the DMO and the Office for Budget Responsibility (OBR) (the latter publishes the official debt interest forecast).

<sup>14</sup> The variables in the VAR model are: GDP, CPI and the Bank Rate as macroeconomic variables and three 'latent factors' taken from the work of Diebold and Li (2006) that describe the yield curve, using 10 benchmark maturity points. The VAR is estimated using data from October 1991 to September 2013 with restrictions on the long-term mean of the output gap (zero) and CPI (2%), as well as the restriction that the nominal yields forecast should be positive. The VAR model is then used for forecasting. For each year of the 10-year horizon, a yield curve forecast is produced. In order to generate a distribution of yield curve forecasts, simulations around the central forecast are made by drawing from a normally distributed series of errors, one thousand times. This implies that the volatility of the yield curve forecasts varies every year, i.e. there is more uncertainty the longer is the forecast horizon. The VAR currently only forecasts nominal yields; the break-even inflation rate from the Variable Roughness Penalty (VRP) yield curve model (originally developed by the Bank of England) is used to derive the real yield curve.

**Table B.1: Gilt issuance strategy composition (%)<sup>15</sup>**

|                            | <b>Short conventional</b><br>(0 – 7 years) | <b>Medium conventional</b><br>(7 – 15 years) | <b>Long conventional</b><br>(over 15 years) | <b>Index-linked</b> |
|----------------------------|--|--|---|---------------------|
| Strategy 1                 | 74   | 0  | 0   | 26                  |
| Strategy 2<br>2013-14 skew | 29   | 23   | 22  | 26                  |
| Strategy 3                 | 0  | 0  | 74  | 26                  |

**B.28** The probability distribution of debt service cost if issuance were to follow Strategy 2 for the next 10 years is shown in Chart B.4. The central line represents the average debt interest cost after 1,000 simulations using the PST model (each simulation using an alternative yield curve) for each financial year. The shaded red areas (from darker to lighter red respectively) around the central debt interest cost projection represent one, two and three standard deviations of volatility in debt interest cost.<sup>16</sup> Forecast uncertainty increases further into the future and therefore the ‘fan’ widens over the horizon. Overall, at the 10-year horizon, the model implies with 99% certainty that debt interest cost will fall in a range of £60 billion to £86 billion, with an average value of £73 billion.

**B.29** This exercise is carried out for alternative issuance strategies. Of the three strategies considered, particularly in the first half of the 10-year horizon, Strategy 1 results in the lowest cost, whereas Strategy 3 results in the highest cost, with Strategy 2 somewhere in the middle. These results mainly reflect the upward sloping shape of the yield curve, i.e. short-term issuance is comparatively more cost-effective than long-term issuance in the near term.

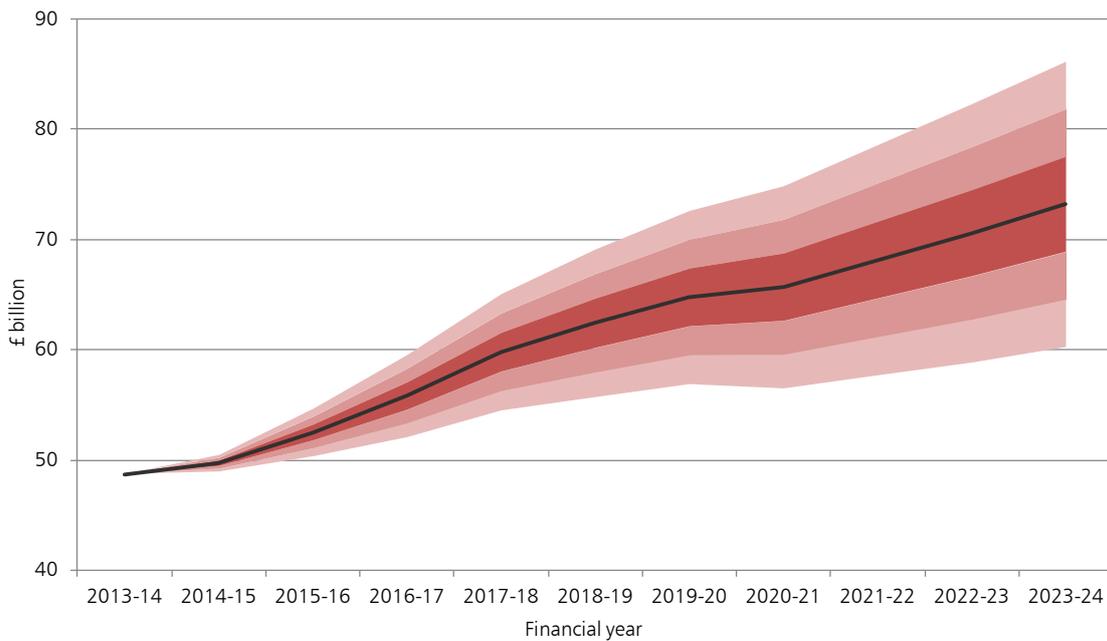
**B.30** However, the standard deviation of debt service cost, or debt service cost volatility compared to Strategy 2, is larger for Strategy 1 and smaller for Strategy 3, as would be expected given that short-term yields are typically much more volatile than long-term yields. This would mean that Strategy 1 would show a wider set of probable debt interest values, with the opposite being true for Strategy 3.

**B.31** Nonetheless, well-diversified issuance strategies which represent small deviations around Strategy 2 all depict very similar debt interest cost distributions.

<sup>15</sup> Numbers may not sum to 100 due to rounding.

<sup>16</sup> Assuming a normal distribution, the range of one standard deviation has a 68.2% probability of occurring (34.1% on each side). This means that debt interest costs have a 68.2% probability of falling within this range. Similarly, the range of two standard deviations has a probability of occurring of 95% (47.5% on each side). Finally, the range of three standard deviations has a 99% probability of occurring.

**Chart B.4: Probability distribution of debt service cost (2013-14 issuance skew)**



Source: DMO

**B.32** It is worth noting that in the simulation it takes several years before the different issuance strategies start to diverge significantly in terms of their cost and risk characteristics.<sup>17</sup> This is due to the large existing debt stock relative to the flow of new issuance, as well as the long average maturity of the UK's debt portfolio, which induces 'inertia' in the debt portfolio. Consequently, any impact on its structure as a result of new issuance is slow to take effect. Following Strategy 2 for example would mean that even after 10 years, only about half of the entire debt interest cost bill would have been 're-fixed' at new yield levels.

**B.33** Given the long-term nature of the government's debt management objective, further analysis is carried out to illustrate the impact on the profile of gilt redemptions and coupon payment obligations from projecting forward the current issuance strategy over a longer horizon.<sup>18</sup>

**B.34** Overall, the results of the cost and risk simulations support the government's approach to issuance across maturities, which balances the estimated lower cost of shorter maturity issuance (with its higher exposure to near-term refinancing risk) against the higher cost (and reduced near-term exposure to refinancing risk) associated with longer maturity issuance. The results also provide a useful indication of the implications for the debt stock over a longer-term horizon of rolling forward a particular issuance strategy over successive years.

## Liquidity, market management and portfolio diversification

**B.35** The government places significant importance on maintaining a deep and liquid gilt market and a diverse investor base in order to maintain continuous access to cost-effective financing in all market conditions. To do so, the government will continue to issue both conventional and index-linked gilts at key maturities in sufficient size, seeking to achieve a benchmark premium for issuance.

<sup>17</sup> In order to depict completely the cost and risk characteristics of each issuance strategy, a longer horizon that covers all cash flows up to the maturity of the longest bond should be considered. This is, however, beyond the scope of this analysis.

<sup>18</sup> In practice, however, issuance strategies are determined on an annual basis.

## Gilt distribution

**B.36** The gilt issuance programme in 2014-15 will be somewhat smaller than in the previous financial year although still large by historical standards. To raise this amount of financing in 2014-15, the government will issue conventional and index-linked gilts across a range of maturities, with auctions remaining the primary method of issuance.

**B.37** The government has reviewed the performance of the syndication programme in 2013-14 and has decided that it should continue to be used in the coming financial year in the same way as it was in 2013-14: (i) to launch new gilts and/or for the re-opening of high duration conventional and index-linked gilts; and (ii) for the size of transactions to be determined in response to market demand for the gilt being sold.

**B.38** The government anticipates that there will be around four syndicated transactions in 2014-15.

**B.39** There will also be a planned mini-tender programme. The main purpose of this will be to accommodate variations in proceeds from syndicated offerings, with the size of the mini-tender programme adjusted accordingly. Mini-tenders may be used for the issuance of conventional and index-linked gilts across maturities. The DMO will determine the maturity and type of gilts sold at mini-tenders in consultation with the market during the year.

**B.40** To maintain the operational viability of the final syndicated offerings (by type) at the end of the financial year, the overall size of the long conventional and index-linked programmes may be increased by up to 10% (in cash terms) at the time of the relevant transactions. Scope to up-size the programmes in this way would only be deployed if the capacity to up-size syndications through reallocation of the mini-tender quantum had been exhausted.

## Gilt issuance by maturity and type in 2014-15

**B.41** The relatively high weight that the government places on managing its near-term exposure to refinancing risk has continued to influence its decision on the amount of short-dated conventional gilt issuance. Risk management considerations were weighed against an assessment that short conventional issuance in the coming financial year is likely to be relatively cost-effective in comparison with medium and long conventional gilt issuance, although less so than in 2013-14. On this basis, short conventional gilts will constitute a broadly similar proportion of gilt sales as in 2013-14.

**B.42** The government recognises the important role that medium conventional gilts (particularly in the 10-year maturity area) play in facilitating the hedging of a wide range of gilt market exposures through the futures market, which in turn underpins the overall cost-effectiveness of the government's financing programme. In addition, given a large financing programme, the liquidity of the sector means that issuance of medium conventional gilts enables the government to raise financing in an efficient manner. Taking into account these factors, in the context of wider cost and risk considerations, as well as the shape of the redemption profile, the government intends to issue a broadly similar proportion of medium conventional gilts in 2014-15 as in 2013-14.

**B.43** The analysis set out above suggests that long conventional gilts are less cost-effective to issue than shorter-dated instruments although the cost differential has narrowed over the last year. However, the government has also weighed the contribution that long conventional issuance can make to mitigating its near-term exposure to refinancing risk. Overall, the government has chosen to increase marginally the proportionate allocation of issuance to long conventional gilts in 2014-15 relative to 2013-14.

**B.44** The government judges that index-linked gilts remain a cost-effective means of financing, especially at longer maturities. The government has also noted the anticipated demand for index-linked gilts in 2014-15 from domestic pension funds and insurance companies. As a result, the government has chosen to maintain a similar proportion of issuance of index-linked gilts in the coming financial year.

### **Treasury bill issuance in 2014-15**

**B.45** The government has also assessed the contribution to financing made by Treasury bill issuance and has concluded that Treasury bills continue to offer value in terms of cost-effectiveness as well as contributing to effective risk management. For example, changes to the Treasury bill stock offer an efficient way to accommodate in-year changes to the financing requirement (particularly towards the end of the financial year) and maintaining a larger stock is a means to increase investor diversification.<sup>19</sup>

**B.46** Accordingly, the government has determined that the planned end-March 2015 Treasury bill stock should be increased by £16.5 billion to £73.0 billion, relative to end-March 2014.

### **Interaction with NS&I**

**B.47** In determining the contribution to financing of both Treasury bills and short conventional gilts, the government has also weighed the risk exposure that arises from the increased contribution to financing from NS&I in 2014-15. Inflows from NS&I are likely to be in the form of relatively short-dated deposits.

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<sup>19</sup> In 2012-13 and 2013-14, the planned stock-build in Treasury bills announced at Budgets 2012 and 2013 respectively facilitated a smooth handling of a significant reduction in the financing requirement announced at the following Autumn Statement, protecting the gilt sales programme from a significant in-year change.





# National Savings and Investments' financing remit for 2014-15

**C.1** This annex sets out information on the activities of National Savings and Investments (NS&I) in 2013-14 and 2014-15. NS&I is both a government department and an executive agency of the Chancellor of the Exchequer. Its activities are conducted in accordance with its remit, which is to provide cost-effective finance now and in the future for the government. It does this by raising deposits and investments from retail customers. This will remain the case in 2014-15.

**C.2** NS&I's contribution to financing is agreed with HM Treasury each year, and is based on the government's gross financing requirement, conditions in the retail financial services market and NS&I's ability to raise the funding without distorting the market.

**C.3** At Budget 2014 it has also been announced that NS&I will launch, by the end of January 2015, a choice of fixed-rate market-leading savings bonds for people over 65, subject to tax. This is a Budget measure designed to offer targeted support to a particular group of savers. As such, the costs of raising funding through these bonds, rather than gilts, have been represented in Table 2.1 of the Budget 2014 document.

## Volume of financing in 2013-14

**C.4** NS&I's contribution to financing in 2013-14 is projected to be £3.4 billion with gross inflows (including reinvestments and gross accrued interest) of approximately £17.6 billion. This is in line with the net financing range of zero to +£4.0 billion set for NS&I at Autumn Statement 2013. This target was revised from the range set at Budget 2013 of -£2.0 billion to +£2.0 billion. Table C.1 shows changes in NS&I's product stock during 2013-14.

**Table C.1: Changes in NS&I's product stock in 2013-14**

| £ billion     | End-March 2013 | End-March 2014 <sup>1</sup> |
|---------------|----------------|-----------------------------|
| Variable rate | 64.5           | 69.4                        |
| Fixed rate    | 12.2           | 10.9                        |
| Index-linked  | 25.5           | 25.3                        |
| <b>Total</b>  | <b>102.2</b>   | <b>105.6</b>                |

Figures may not sum due to rounding.  
<sup>1</sup> Projections  
Source: NS&I

**C.5** NS&I calculates the value it creates for the government using the Value Indicator, which compares the cost of funds raised to comparable gilt yields (see Table C.2). These comparator rates have been close to historic lows over the course of the year. On this basis, NS&I projects a Value Indicator return of £350 million in 2013-14. This is in line with the target set by HM Treasury at Budget 2013; for NS&I to deliver positive value, with a lower limit of -£320 million.

**Table C.2: Calculation of Value Indicator**

|               | <b>Comparator cost<sup>1</sup></b>   |
|---------------|--|
| Less          | Capitalised and accrued interest paid on total NS&I stock                            |
| Less          | Management costs of NS&I products (net equivalent of DMO costs & leveraging revenue) |
| Less          | Tax foregone on total stock of 'tax-free' products                                   |
| <b>Equals</b> | <b>Value Indicator</b>   |

<sup>1</sup> This is the cost of raising funds in the wholesale market of an equivalent term. For fixed-rate products it is the term of the product while, for variable rate products, it is the average length of time the product is held by the customer.  
*Source: NS&I*

## **Volume of financing in 2014-15**

**C.6** Gross inflows (including reinvestments and gross accrued interest) of NS&I's products are projected to be around £24.7 billion in 2014-15. After allowing for expected maturities and withdrawals, NS&I is expected to make a £13.0 billion contribution to financing (within a range of £11.0 billion to £15.0 billion) in 2014-15.

**C.7** Based on current market expectations for comparator gilt yields, the cost to government of NS&I's stock is expected to be lower than wholesale funding costs for the year. NS&I's expected Value Indicator outturn for 2014-15 is £800 million.

**C.8** The cost of the fixed-rate market-leading savings bond which NS&I will launch in January 2015 is represented in Table 2.1 of the Budget 2014 document and so will not be reflected in NS&I's Value Indicator calculation.

**C.9** At Budget, it has also been announced that NS&I will raise the Premium Bond investment limit from £30,000 to £40,000, and increase the number of monthly prizes from one to two. The forecast inflows from this change are included in NS&I's 2014-15 net financing target.

**C.10** It has also been announced that the Premium Bond limit will be raised further, to £50,000, in 2015-16. Inflows for this measure will be included in NS&I's 2015-16 financing remit, which will be set at Budget 2015.

**C.11** Further details of NS&I's activities in 2014-15 will be included in its *Annual Report and Accounts*, which is scheduled to be laid in Parliament in 2014 and will be available in print form and at [www.nsandi.com](http://www.nsandi.com).



# The Debt Management Office's Exchequer cash management remit for 2014-15

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## Exchequer cash management objective

**D.1** The government's cash management objective is to ensure that sufficient funds are always available to meet any net daily central government cash shortfall and, on any day when there is a net cash surplus, to ensure this is used to best advantage. HM Treasury and the DMO work together to achieve this.

**D.2** HM Treasury's role in this regard is to make arrangements for a forecast of the daily net flows into or out of the National Loans Fund (NLF); and its objective in so doing is to provide the DMO with timely and accurate forecasts of the expected net cash position over time.

**D.3** The DMO's role is to make arrangements for funding and for placing the net cash positions, primarily by carrying out market transactions in the light of the forecast; and its objective in so doing is to minimise the costs of cash management while operating within the risk appetite approved by Ministers.

**D.4** The government's preferences in relation to the different types of risk taking inherent in cash management are defined by a set of explicit limits covering four types of risk which, taken together, represent the government's overall risk appetite.<sup>1</sup> The risk appetite defines objectively the bounds of appropriate government cash management in accordance with the government's ethos for cash management as a cost minimising, rather than profit maximising, activity and playing no role in the determination of interest rates. The DMO may not exceed this boundary, but, within it, the DMO will have discretion to take the actions it judges will best achieve the cost minimisation objective.

## The DMO's cash management objective

**D.5** The DMO's cash management objective is to minimise the cost of offsetting the government's net cash flows over time, while operating to a risk appetite approved by Ministers. In so doing, the DMO will seek to avoid actions or arrangements that would:

- undermine the efficient functioning of the sterling money markets; or
- conflict with the operational requirements of the Bank of England for monetary policy implementation

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<sup>1</sup> The four types of risk are liquidity risk, interest rate risk, foreign exchange risk and credit risk. An explanation of these risks and the government's cash management operations more generally is set out in Chapter 5 of the DMO's Annual Review 2004-05, which is available on the DMO's website: [http://www.dmo.gov.uk/documentview.aspx?docname=publications/annualreviews/gar0405.pdf&page=Annual\\_Review](http://www.dmo.gov.uk/documentview.aspx?docname=publications/annualreviews/gar0405.pdf&page=Annual_Review)

## Instruments and operations used in Exchequer cash management

**D.6** The range of instruments and operations that the DMO may use for cash management purposes is set out in its Operational Notice.<sup>2</sup> The arrangements for the issuance of Treasury bills, and the management of the Treasury bill stock in market hands, is set out in, and operated according to, the DMO's Operational Notice.

**D.7** One component of the debt sales to meet the government's annual financing requirement is the planned year-on-year change in the outstanding stock of Treasury bills. This excludes bills issued solely for collateral purposes (see D.11) and those issued by bilateral agreement to approved cash counterparties to meet the Exchequer's short-term financing requirements.

**D.8** During the financial year, the DMO has discretion to manage the level of the Treasury bill stock and may increase or reduce the stock in relation to the end-year target level. Doing so can be an effective way of supporting the implementation of government cash management. The DMO will announce the dates of Treasury bill tenders on a quarterly basis. The precise details of the maturity and the amount of the Treasury bills on offer at specific tenders will be announced one week in advance. In addition to the bills issued at weekly and ad hoc tenders, the DMO has discretion to reopen, on request from its counterparties, existing issues of Treasury bills on a bilateral basis to raise funds for cash management.

**D.9** As a contingency measure, the DMO may issue Treasury bills to the market at the request of the Bank of England and, in agreement with HM Treasury, to assist the Bank of England's operations in the sterling money market for the purpose of implementing monetary policy while meeting the liquidity needs of the banking sector as a whole. In response to such a request, the DMO may add a specified amount to the size(s) of the next bill tender(s) and deposit the proceeds with the Bank, remunerated at the weighted average yield(s) of the respective tenders. The amount being offered to accommodate the Bank's request will be identified in the DMO's weekly Treasury bill tender announcement. Treasury bill issues made at the request of the Bank will be identical in all respects to Treasury bills issued in the normal course of DMO business. The DMO may also raise funds to finance advances to the Bank of England and would, in conjunction with HM Treasury, determine the appropriate instruments through which to raise those funds.

### DMO collateral pool

**D.10** To assist the DMO in the efficient execution of its cash management operations an amount of gilts, which shall be chosen to have a negligible effect on relevant indices, may be issued to the DMO and this will normally be on the third Tuesday of April, July and October 2014 and January 2015. Any such issues to the DMO will be used as collateral and will not be available for outright sale. The precise details of any such issues to the DMO will be announced at least two full working days in advance of the creation date. If no issue is planned to take place in a particular quarter, the DMO will announce that this is the case in advance.

**D.11** In the event that the DMO requires collateral to manage short-term requirements, the DMO may create additional Treasury bill collateral. Any such issues to the DMO will only be used as collateral and will not be available for outright sale by the DMO.

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<sup>2</sup> The current edition of Exchequer Cash Management Operational Notice and Treasury Bill Information Memorandum is available on the DMO's website at: [http://www.dmo.gov.uk/documentview.aspx?docname=publications/moneymarkets/cmopnot180210.pdf&page=money\\_markets/publication](http://www.dmo.gov.uk/documentview.aspx?docname=publications/moneymarkets/cmopnot180210.pdf&page=money_markets/publication)

**D.12** The DMO's collateral pool may also be used to support HM Treasury's agreement to provide gilt collateral for the purpose of the Bank of England's Discount Window Facility (DWF).<sup>3</sup> The gilt collateral will be held by the DMO and lent to the Bank of England on an 'as needed' basis; gilts created for this purpose will not be sold or issued outright into the market.

### **Active cash management**

**D.13** The combination of HM Treasury's cash flow forecasts and the DMO's market operations characterises the active approach to Exchequer cash management. Since 2007-08, a performance measurement framework for active cash management – in which discretionary decisions, that are informed by forecast cash flows, are evaluated against a range of indicators – has been in place. These include qualitative measures as well as measures quantifying excess returns to active management, after deducting an interest charge representing the government's cost of funds. Performance against these key indicators is reported in the DMO's Annual Review.<sup>4</sup>

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<sup>3</sup> More information about the Discount Window Facility can be found on the Bank of England's website at: <http://www.bankofengland.co.uk/markets/money/dwf/index.htm>

<sup>4</sup> For the latest report see Annex B of the DMO Annual Review, which can be found on the DMO's website at: [http://www.dmo.gov.uk/index.aspx?page=publications/Annual\\_Reviews](http://www.dmo.gov.uk/index.aspx?page=publications/Annual_Reviews)





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