



HM Treasury

# **Debt and reserves management report 2015-16**

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March 2015





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 for each financial year" and to set remits for its agents. 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 index-linked and conventional 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 Exchequer cash management remit for 2015-16 is contained in Annex D.

**1.4** Details on the management of the UK's Official Reserves can be found on [www.gov.uk](http://www.gov.uk).<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 2015 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, established in 1995 following the 'Debt Management Review', 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.

### Components of the debt management objective

**2.5** The **costs of meeting the government's financing needs** arise 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 beyond the forecast period for fiscal policy. This expectation is reflected in the government's choice of debt management strategies.

**2.6** A number of **risks** are taken into account when selecting possible debt management strategies. Five particularly important risks are:

- **interest rate risk** – interest rate exposure arising when new debt is issued
- **refinancing risk** – interest rate exposure arising when debt is rolled over, with an increase in refinancing risk if redemptions are concentrated in particular years
- **inflation risk** – exposure to inflation from the indexation of coupons and principal of index-linked gilts
- **liquidity risk** – the risk of insufficient liquidity for the government to borrow from a particular part of the market in the required size at a particular time

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

- **execution risk** – the risk the government is not able to sell the offered amount of debt at a particular time, or must sell it at a large discount to the market price

**2.7** These are the major risks the government has taken into account in recent years and expects to take 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 2015-16 is set out in Annex B.

### **Debt management policy principles**

**2.8** 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

**2.9** 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**

**2.10** The respective roles of HM Treasury and the DMO are set out in the DMO’s ‘Executive Agency Framework Document’.<sup>2</sup> In particular:

- 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 allow market participants to understand 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

**2.11** 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 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**

**2.12** 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>

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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.

**2.13** 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>

**2.14** 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 central government net cash requirement (CGNCR) and its outturn
- auction proceeds 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
- the implementation of the syndication programme at year-end<sup>6</sup>

**2.15** The difference will be reflected in a change 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 position to its original level by adjusting the projected net financing requirement in the following financial year.

### Medium-term projections for annual financing requirements

**2.16** The government publishes projections for financing requirements in the fiscal policy forecast period. The financing requirements include the forecast path for the CGNCR (excluding NRAM plc, Bradford and Bingley and Network Rail) (ex NRAM, B&B and NR), the gilt redemption profile and planned financing for the Official Reserves.<sup>7</sup> Table 2.A sets out the financing requirement projections from 2016-17 to 2019-20. 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.

**Table 2.A: Financing requirement projections, 2016-17 to 2019-20**

	2016-17	2017-18	2018-19	2019-20
<b>£ billion</b>				
CGNCR (ex NRAM, B&B and NR)	72	38	17	17
Redemptions	70	79	67	93
Financing for the Official Reserves	6	6	6	6
Illustrative gross financing requirement	148	124	90	116
<i>Source: OBR, HM Treasury and DMO</i>				

<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 be held with market counterparts. This means that, in practice, financial transactions of the public sector would not affect monetary conditions.

<sup>5</sup> To meet the financing requirement, which is determined in cash terms, the DMO sizes auctions in nominal terms, taking 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.

<sup>7</sup> This excludes Network Rail's cash requirement but includes HM Treasury's requirement for financing lending to Network Rail.

## **Debt management considerations during the period of fiscal consolidation**

**2.17** Decisions on debt management policy are taken in advance to achieve the debt management objective. 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 information on market conditions and demand for debt instruments.

**2.18** 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 that 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 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

**2.19** 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 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

## **Bond issuance by devolved administrations**

**2.20** The government announced in February 2014 that the Scottish government would be given the power to issue bonds when its new borrowing powers come into force on 1 April 2015. The Scotland Act 2012 initially provided for the Scottish government to be able to borrow up to a total of £2.2 billion for capital investment via the National Loans Fund and commercial loans from 2015-16. The sources of borrowing within this overall limit are now being extended to include bond issuance.

**2.21** On 27 February 2015, the government announced that the Welsh government's means of borrowing for capital investment from April 2018 would also be extended to include bond issuance. The level of borrowing for capital investment will remain up to £125 million per year within an overall cap of £500 million. The devolution of bond issuance powers will broaden the sources of financing available to the devolved administrations for capital investment such as major transport projects, hospitals, schools and flood defences when their borrowing powers are implemented.

**2.22** The Scottish and Welsh governments will be solely responsible for meeting their liabilities and the UK government will provide no guarantee on any bonds issued by the Scottish and Welsh governments. The UK government will review the extent to which bond issuance powers apply in the event of any subsequent increase in borrowing limits. In addition, the Scottish and Welsh governments would need further approval from HM Treasury to issue in any currency other than sterling.

## **Borrowing by local authorities**

**2.23** Under the prudential code, local authorities are fully responsible for meeting their own liabilities, including those they incur by entering into any guarantee commitments. The UK government provides no guarantee on local authority debt.

**2.24** Local authorities undertake the bulk of their borrowing via the Public Works Loan Board (PWLB). The government took a power in the Infrastructure Act 2015 to abolish the PWLB via the Public Bodies Act 2011 and intends to consult on succession arrangements later in the year. This change is about governance only: local authorities will continue to be able to access borrowing from central government.



# The Debt Management Office's financing remit for 2015-16

## 3

### Introduction

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

### Financing arithmetic

**3.2** The OBR's forecast for the central government net cash requirement (excluding NRAM plc, Bradford and Bingley and Network Rail) (CGNCR (ex NRAM, B&B and NR)) in 2015-16 is £78.9 billion. The CGNCR (ex NRAM, B&B and NR), which is the fiscal aggregate that determines gross debt sales, is derived from public sector net borrowing (PSNB). The relationship between PSNB and the CGNCR (ex NRAM, B&B and NR) is set out in the OBR's March 2015 'Economic and fiscal outlook'.

**3.3** The financing arithmetic is adjusted in 2015-16 to reflect UKAR's deconsolidated liabilities that will transfer to the buyer of the Granite securitisation vehicle, if such a sale should go ahead. As a result of the sale of Granite, public sector net debt will fall by £10.9 billion, reflecting the assets at closing net of the cash earnings that would have accrued to the Exchequer should a sale not have taken place. The OBR's forecast for the CGNCR (ex NRAM, B&B and NR) assumes the full value of this sale would accrue to the Exchequer. However, the government's cash requirement will only fall by £4.2 billion due to the transfer of the £6.7 billion funding for the securitisation vehicle to the buyer.

**3.4** The forecast NFR in 2015-16 of £140.4 billion also reflects gilt redemptions of £70.2 billion, including £382 million for redemption of the 4 remaining undated gilts, a planned short-term downward financing adjustment of £11.3 billion resulting from unanticipated overfunding in 2014-15, and additional sterling financing for the Official Reserves of £6.0 billion.

**3.5** In addition, NS&I is expected to make a £10.0 billion net contribution to financing in 2015-16, following a forecast net contribution of £18.3 billion in 2014-15. This projection assumes gross inflows of £25.5 billion in 2015-16.

**3.6** Gilt issuance is the government's primary means of meeting the NFR. Treasury bills and other cash management instruments may be used at the margin.

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

- gross gilt issuance of £133.4 billion
- £7.0 billion net issuance of Treasury bills sold via tenders, implying an end-March 2016 stock of £72.0 billion

**3.8** Table 3.A sets out details of the financing arithmetic for 2014-15 and 2015-16.

**Table 3.A: Financing arithmetic in 2014-15 and 2015-16**

<b>£ billion</b>	<b>2014-15</b>	<b>2015-16</b>
CGNCR (ex NRAM, B&B and NR) <sup>1</sup>	96.2	78.9
UKAR adjustment	0.0	6.7
Gilt redemptions	64.5	70.2
Planned financing for the reserves	12.0	6.0
Gilt secondary market purchases	0.0	0.0
Financing adjustment carried forward from previous financial years	-30.2	-11.3
<b>Gross financing requirement</b>	<b>142.4</b>	<b>150.6</b>
<i>less:</i>		
Net contribution from National Savings and Investments	18.3	10.0
UK sovereign Sukuk	0.2	0.0
Renminbi denominated bond	0.3	0.0
Other financing <sup>2</sup>	0.3	0.2
<b>Net financing requirement (NFR) for Debt Management Office (DMO)</b>	<b>123.3</b>	<b>140.4</b>
Financed by:		
<b>Debt issuance by DMO</b>		
a) Treasury bills (planned change in stock issued via tenders)	8.5	7.0
b) Gilt sales	126.1	133.4
<i>of which:</i>		
Short conventional	31.9	33.9
Medium conventional	27.9	26.7
Long conventional	34.1	37.4
Index-linked	32.3	31.4
Unallocated supplementary sales	-	4.0
<b>Planned change in the level of Ways and Means</b>	<b>0.0</b>	<b>0.0</b>
<b>Total financing</b>	<b>134.6</b>	<b>140.4</b>
<b>Short-term debt/cash levels at end-financial year</b>		
End-year Treasury bill stock via tenders (in market hands) <sup>3</sup>	65.0	72.0
Ways and Means	0.4	0.4
DMO net cash position	11.8	0.5
<i>Figures may not sum due to rounding.</i>		
1. This excludes Network Rail's cash requirement, but includes HM Treasury's requirement for financing lending to Network Rail. This was presented as a separate item in the financing arithmetic at April 2014.		
2. From Autumn Statement 2014 onwards, the financing arithmetic has included provision for small sources of additional financing. This includes non-governmental deposits, coinage and certificates of tax deposit. Prior to publication of the end-year outturn in April each year, this financing item will only comprise estimated revenue from coinage.		
3. The DMO has operational flexibility to vary the end-financial year stock by a maximum of £5 billion relative to the planning assumption, to offset any anticipated net Exchequer cash surplus or deficit towards year-end.		
<i>Source: DMO, HM Treasury and OBR</i>		



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

**3.9** The financing arithmetic provides for £6.0 billion of sterling financing for the Official Reserves in 2015-16. This additional financing, announced at Autumn Statement 2014, is intended to meet potential calls on the Official Reserves that may arise and ensure the level of foreign currency reserves is sufficient so that the UK remains resilient to possible future shocks.

**3.10** 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 and no new foreign currency debt will be issued in 2015-16. However, if the government judges 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 2015-16.

**3.11** If the government were to decide to issue a foreign currency bond, 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 reserves.

### Other short-term debt

**3.12** The projected level of the Ways and Means Advance at the Bank of England at March 2015 is £0.4 billion. No changes to the level of the Ways and Means Advance are planned in 2015-16.

**3.13** The projected level of the DMO's net cash balance at 31 March 2015 is £11.8 billion, £11.3 billion above the level projected at Autumn Statement 2014. The level will be reduced to £0.5 billion during 2015-16, as shown by the planned short-term downward financing adjustment, and this will in turn reduce the NFR in 2015-16.

### Gilt issuance by method, type and maturity

**3.14** The DMO will deliver gilt sales of £133.4 billion (cash) in 2015-16.

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

**3.16** 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 principles of openness, predictability and transparency.

**3.17** The amount of allocated issuance via auction and syndication in 2015-16 is planned at £129.4 billion (or 97.0% of total issuance) and will be split by maturity and type as follows:<sup>2</sup>

- £33.9 billion of short conventional gilts (25.4% of total issuance)
- £26.7 billion of medium conventional gilts (20.0% of total issuance)
- £37.4 billion of long conventional gilts (28.0% of total issuance)
- £31.4 billion of index-linked gilts (23.5% of total issuance)

**3.18** The DMO will deliver supplementary gilt sales of £28.2 billion (or 21.1% of total issuance), via a combination of syndication and, subject to demand, mini-tender. This will comprise a

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<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).

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

minimum of £24.2 billion via syndication. Any additional sales via syndication can only be of long conventional or index-linked gilts but mini-tenders can be used for issuance of conventional and index-linked gilts across the curve.

**3.19** To maintain the operational viability of syndicated offerings at the end of each programme, the overall size of the syndication programmes (conventional and/or 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, at the time of the final operations for either or both types of gilt, the unallocated supplementary issuance amount had been exhausted, whether as a consequence of re-allocation decisions at previous syndications or as part of the sizing decision at the final operation.

**3.20** The government aims at regular gilt issuance across the maturity spectrum throughout the financial year, building up benchmarks at key maturities in conventional and index-linked gilts.

**3.21** The planning assumption for gilt issuance in 2015-16 by method of issue, type and maturity is shown in Table 3.B.

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

£ billion	Auction	Syndication	Syndication or mini-tender	Total
Short	33.9	-	-	33.9 (25.4%)
Medium	26.7	-	-	26.7 (20.0%)
Long	28.1	9.3	-	37.4 (28.0%)
Index-linked	16.5	14.9	-	31.4 (23.5%)
Total	105.2 (78.9%)	24.2 (18.1%)	4.0 (3.0%)	133.4

Figures may not sum due to rounding.

**3.22** There are currently no plans to introduce new gilt issuance methods in 2015-16. Before introducing any such methods, the DMO would consult market participants and seek HM Treasury's approval.

### Gilt auction calendar

**3.23** The DMO is publishing a gilt auction calendar consistent with the remit alongside the DRMR. The calendar sets out the planned dates of gilt auctions by type of gilt.

### Post-Auction Option Facility

**3.24** In 2015-16, the DMO will continue to offer 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 are available in the DMO's operational notice.<sup>3</sup>

**3.25** Any additional amounts sold via this facility in 2015-16 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

<sup>3</sup> [http://www.dmo.gov.uk/documentview.aspx?docname=publications/operationalrules/Opnot20140331.pdf&page=operational\\_rules/Document](http://www.dmo.gov.uk/documentview.aspx?docname=publications/operationalrules/Opnot20140331.pdf&page=operational_rules/Document)

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 at Autumn Statement 2015.

### **Taps and reverse taps**

**3.26** The programme of gilt sales by auction, syndication 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**

**3.27** 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 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**

**3.28** The DMO has no current plans for a programme of reverse or switch auctions or conversion offers in 2015-16.

### **Coupons**

**3.29** 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**

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

### **Treasury bill sales**

**3.31** The outstanding stock of Treasury bills sold via weekly tenders at end-March 2016 is expected to be £72.0 billion, an increase of £7.0 billion from the planned stock sold via tenders at end-March 2015. The DMO will have operational 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 towards year-end. The 2014-15 outturn for the Treasury bill stock sold via weekly tenders will be reported alongside the CGNCR outturn in April 2015.

**3.32** 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>

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<sup>4</sup> Taps (reverse taps) are sales (purchases) of gilts undertaken directly with the Gilt-edged Market Makers 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.

<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>

## **New gilt instruments**

**3.33** There are no current plans to introduce new types of gilt instruments in 2015-16. Before introducing any new instruments, the DMO will consult market participants and seek HM Treasury's approval.

## **Revisions to the remit**

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

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

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

# A Debt portfolio

## Debt stock

**A.1** The total nominal outstanding stock of central government sterling debt excluding official holdings by central government at end-December 2014 was £1,482.4 billion. The components of this stock are set out in Table A.1.

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

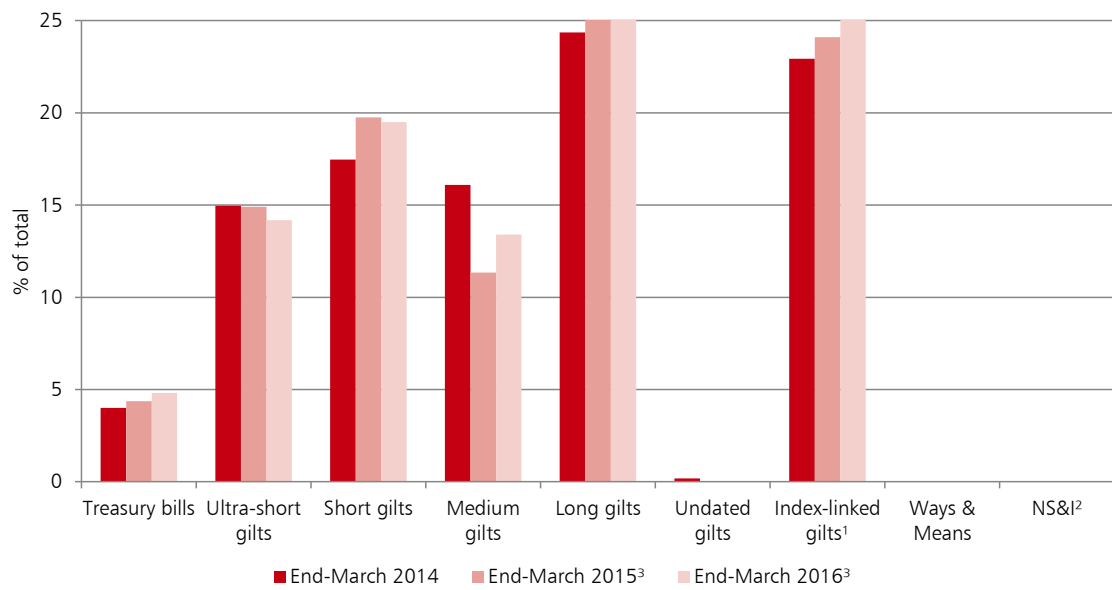
<b>£ billion nominal value, excluding official holdings</b>	<b>End-December 2013</b>	<b>End-December 2014</b>
Conventional gilts <sup>1</sup>	938.8	964.6
Index-linked gilts <sup>2</sup>	304.5	342.7
Treasury bills	37.4	63.0
<b>Total gilts and Treasury bills</b>	<b>1,280.8</b>	<b>1,370.4</b>
NS&I	105.2	111.6
Balance on Ways and Means Advance	0.4	0.4
<b>Total central government sterling debt</b>	<b>1,386.3</b>	<b>1,482.4</b>

<sup>1</sup> Includes undated 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 2014 through to the projected composition at end-March 2016. 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: Composition of central government sterling debt**



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

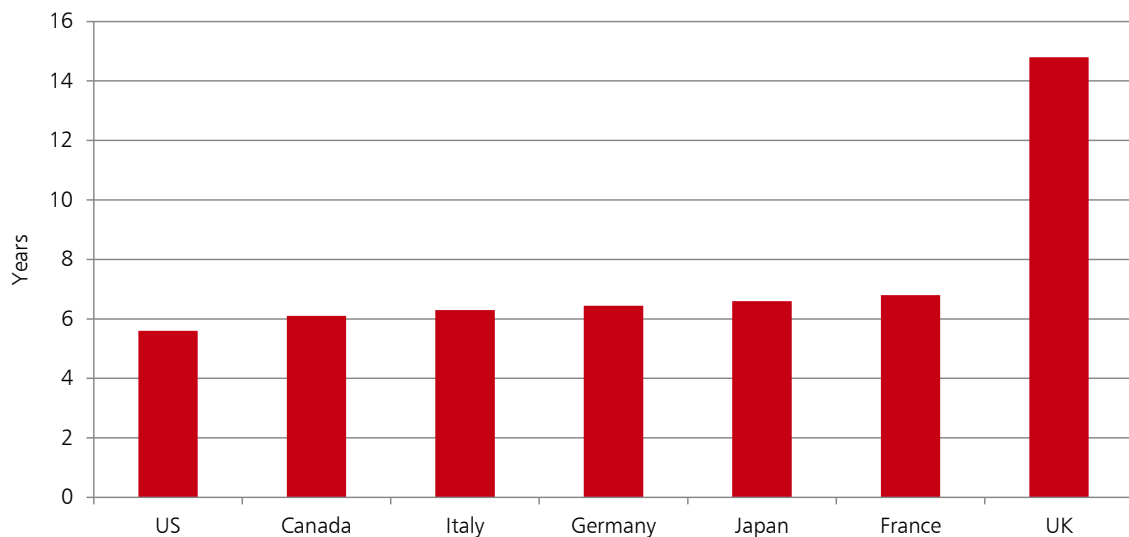
Source: DMO and NS&I

## Maturity and duration of the debt stock

**A.3** By end-March 2015, the average maturity of the stock of all marketable debt is projected to rise to just below 16 years. The average modified duration of the stock of conventional gilts is projected to rise to 10.1 years.<sup>1</sup> The average maturity of the government's wholesale debt is consistently longer than the G7 average, as shown in Chart A.2.

<sup>1</sup> Net figures (excluding government holdings).

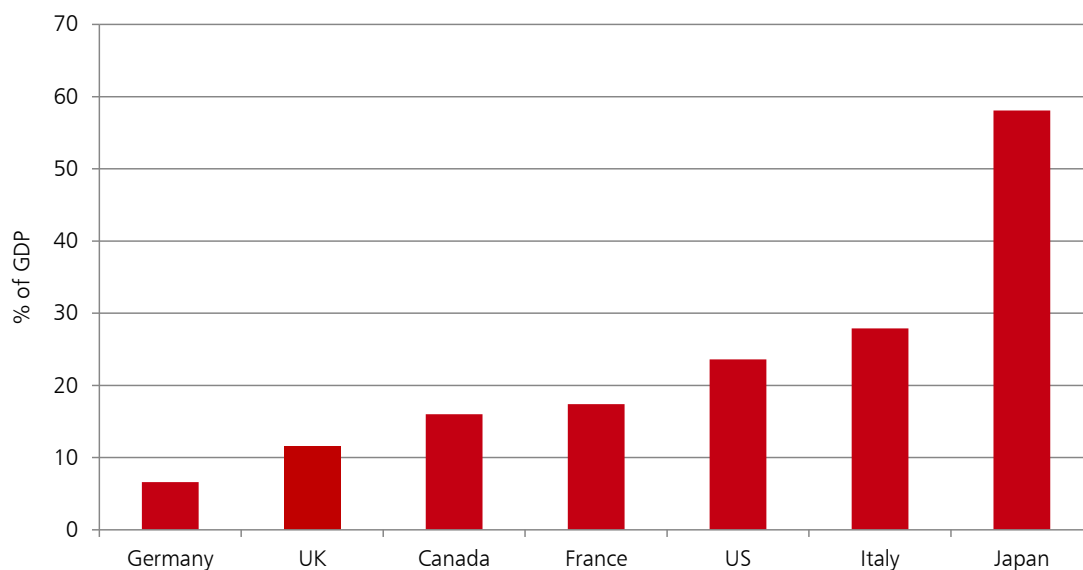
**Chart A.2: Average maturity of the debt stock by country (2014)**



Source: IMF Fiscal Monitor October 2014 and Bloomberg L.P

**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)**



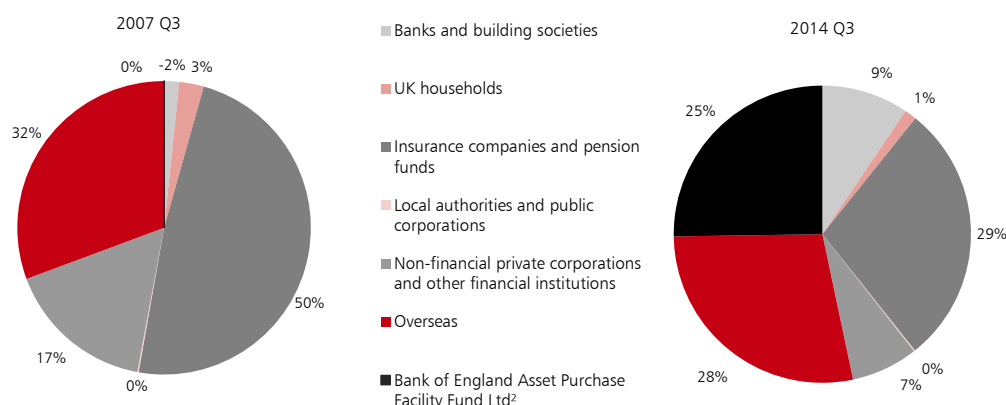
Source: IMF Fiscal Monitor October 2014 and Bloomberg L.P

### 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 3 largest investor groups were insurance companies and pension funds (50%), overseas investors (32%) and non-financial corporations and other financial institutions (17%). Since then there have been significant shifts in the 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 2014, the 3

largest gilt investor groups were insurance companies and pension funds (29%), overseas investors (28%) and the Bank of England Asset Purchase Facility Fund Ltd (25%).

**Chart A.4: Gilt holdings by sector (£ billion, market value)<sup>1</sup>**



<sup>1</sup> Figures may not sum due to rounding.

<sup>2</sup> The Bank of England's holdings of gilts not related to the Asset Purchase Facility are included in the 'Banks and building societies' category.

Source: ONS and Bank of England

## Gilt issuance

**A.6** The CGNCR, gilt redemptions, and the volume of gilt sales for each of the last 10 years is shown in Table A.2.

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

£ billion	CGNCR <sup>1</sup>	Redemptions	Gross gilt sales <sup>2</sup>
2006-07	37.4	29.9	62.5
2007-08	33.3	29.2	58.5
2008-09	163.8	18.3	146.5
2009-10	198.6	16.6	227.6
2010-11	134.0	38.6	166.4
2011-12	117.7	49.0	179.4
2012-13	95.9	52.9	161.5
2013-14	78.5	51.5	153.4
2014-15 <sup>3</sup>	87.8	64.5	126.1
2015-16 <sup>3</sup>	68.7	70.2	133.4

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

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

<sup>3</sup> Budget 2015 projections

Source: DMO, HM Treasury and OBR



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

## B

### Introduction

**B.1** This annex provides the context for the government's decisions on gilt and Treasury bill issuance in 2015-16, 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 report ongoing demand for conventional and index-linked gilts that is well diversified across the maturity spectrum and by investor type.

**B.6** At the government's annual consultation meetings with gilt market participants in January 2015, both GEMMs and end-investors anticipated continued strong demand for UK government debt from domestic pension funds and insurance companies in 2015-16, with a particular focus on index-linked gilts.<sup>1</sup>

**B.7** In the coming financial year, market expectations are for continued demand for gilts from a range of international investors, including central banks and reserve managers, as well as investors looking to diversify their bond holdings from other sovereign bond markets.

**B.8** Domestic banks and building societies have become significant holders of gilts in recent years for regulatory purposes. No major changes in gilt investment by domestic financial institutions are expected in the coming year.

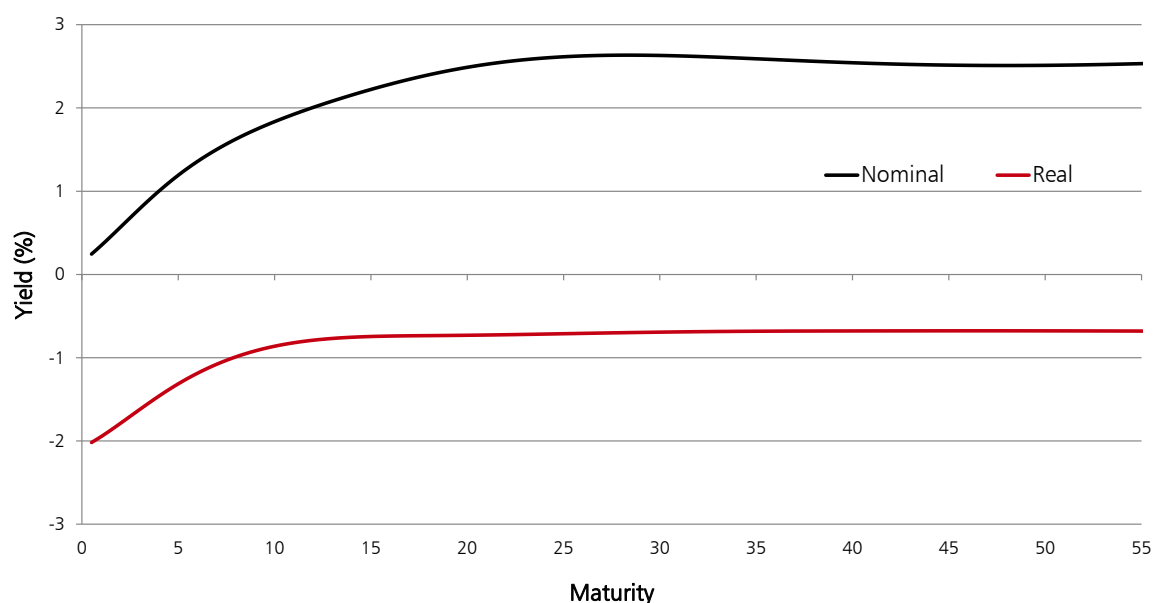
### Cost

**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 17 February 2015.

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<sup>1</sup> Minutes of the meetings are available at: <http://www.dmo.gov.uk/documentview.aspx?docName=/gilts/press/sa210115.pdf>

**Chart B.1: Nominal and real spot yield curves (17 February 2015)**



Source: DMO

**B.10** Modern asset pricing theory suggests the observed yield on a bond can be decomposed into 2 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 compensation investors require for holding riskier (i.e. longer maturity) assets. The variability and trends in risk premia reflect investors' risk preferences over time.

**B.11** Results from the DMO's risk premia analysis in the conventional gilt market indicate the existence of a time-varying risk premium which is usually positive and, on a historical basis, increases with maturity.<sup>3</sup> However, risk premia have fallen significantly in the last year. As at December 2014, the risk premium was estimated at very similar levels at all maturities of conventional gilts, primarily as a result of premia narrowing for longer maturity bonds. Longer maturity bonds have therefore become more cost-effective since last year relative to short and medium conventional gilts.

**B.12** Alongside this analysis of the relative cost-effectiveness of conventional gilts across different maturity sectors, the government undertakes an evaluation of the cost-effectiveness of index-linked gilts, using conventional gilts as a benchmark for comparison, by examining the evolution of breakeven inflation rates.<sup>4</sup>

<sup>2</sup> The risk premium can be considered to have several components, including, but not limited to: (i) a premium which compensates investors for duration risk that 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 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>. The model has not been adjusted to account for 'zero bound effects'.

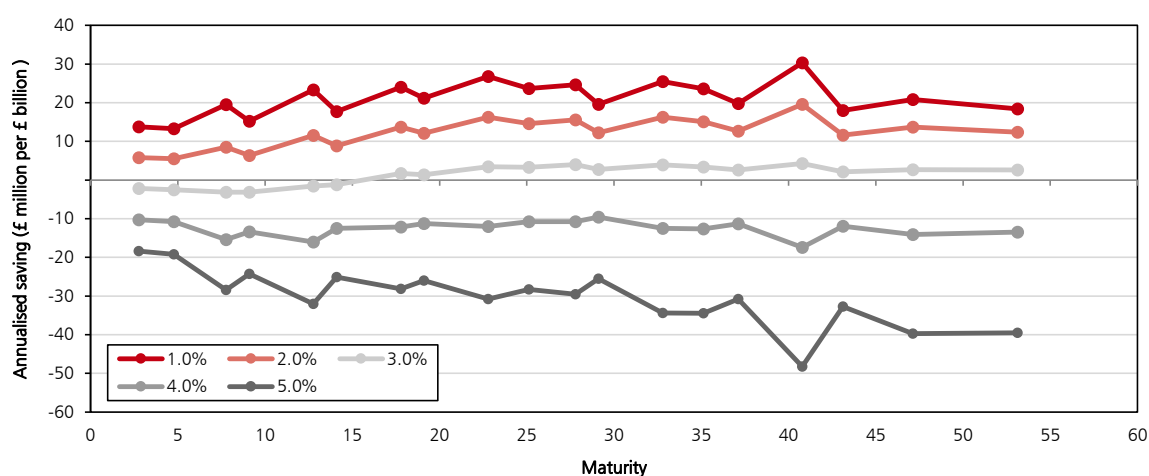
<sup>4</sup> A more detailed explanation of the methodology used in this analysis can be found in the DMO's Annual Review 2011-12: <http://www.dmo.gov.uk/documentview.aspx?docname=publications/annualreviews/gar1112.pdf>.

**B.13** The breakeven 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 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.14** To the extent that future inflation turns out to be higher or lower than the breakeven 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.15** As such, the government can compare prevailing breakeven inflation rates on index-linked gilts against a range of paths for future inflation (see Chart B.2) to evaluate the relative cost-effectiveness of conventional and index-linked gilt issuance of equivalent maturities. In order to facilitate the comparison of cost-effectiveness by maturity, the data are evaluated on an annualised basis.

**Chart B.2: Annualised cost-effectiveness of index-linked gilts relative to equivalent maturity conventional gilts under a range of RPI inflation assumptions**



Source: DMO

**B.16** The analysis shows that, for future average RPI inflation of up to around 3%, longer-maturity index-linked gilts are marginally more cost-effective than conventional gilts.

**B.17** 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, longer maturity index-linked gilts are generally cost-effective relative to equivalent maturity conventional gilts.<sup>5</sup>

## Risk

**B.18** In the context of the long-term focus of the debt management objective, 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 issuance decisions and assesses the relative importance of each risk in accordance with its risk appetite.

**B.19** The government places a high weight on minimising near-term exposure to refinancing risk. The government can partly manage this exposure by maintaining a high proportion of long-

<sup>5</sup> This conclusion is based on the assumption that the long run wedge between CPI and RPI is within the range of external estimates.

dated debt in its portfolio, which reduces the need to roll over debt frequently. Significant importance is also given to avoiding large concentrations of redemptions in any one year. To achieve this, the government will issue debt across a range of maturities, smoothing the profile of gilt redemptions.

**B.20** Prudent debt management is also served by promoting sustainable market access. The government places significant importance on maintaining a deep, liquid and efficient gilt market and a diverse investor base in order to maintain continuous access to cost-effective financing in all market conditions.

**B.21** The design of the structure of the remit can support sustainable market access by maintaining a deep and liquid gilt market that can readily be understood and engaged with by investors globally, a healthy intermediation model and a well-diversified investor base. Promoting these features of the gilt market will also serve to minimise debt costs to the issuer because investors reward the issuer for providing a continuous and ready market and a globally recognised benchmark product.

## Modelling of cost and interest rate/refinancing risk

**B.22** An additional input to the analysis underpinning the government's decisions on its issuance strategy is an exercise in which debt interest cost and risk simulations are generated to illustrate the cost-risk trade-off associated with different issuance strategies.<sup>6</sup> This allows the government to investigate the medium-term implications of deviations in the future issuance skew from the current annual issuance strategy. This year the exercise has been carried out over a longer 15-year horizon to approximately match the average maturity of the gilt portfolio.<sup>7</sup>

**B.23** Debt interest 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 interest cost or debt interest cost volatility. This can be seen as a measure combining both interest rate risk and refinancing risk.

**B.24** The metrics resulting from this analysis combine the impact from alternative issuance strategies for financing new government debt (to meet the central government net cash requirement (CGNCR) and the refinancing of redemptions) with the existing characteristics of the debt portfolio inherited from previous financial years.<sup>8</sup> 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>9,10</sup> In this way, the PST 'maps' the projected yield curve distribution to a debt interest cost distribution so that simulated cost and risk metrics can be analysed.

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<sup>6</sup> The government does not use this simulation tool to determine a single optimal debt issuance strategy.

<sup>7</sup> Beyond the 5 year horizon, for which CGNCR forecasts are not available, a balanced budget assumption, i.e.  $CGNCR=0$ , has been made. This implies: (i) that in years 5 to 15 the debt interest cost incurred every year is covered by a surplus in the other components of the CGNCR; and (ii) that total financing in those years for the DMO is equal to redemption refinancing, assuming no pay down of debt.

<sup>8</sup> The financing assumptions used in this exercise are in line with Autumn Statement 2014 numbers.

<sup>9</sup> There are differences in the methods used to calculate debt interest cost by the DMO and the Office for Budget Responsibility (OBR), who publish the official debt interest forecast.

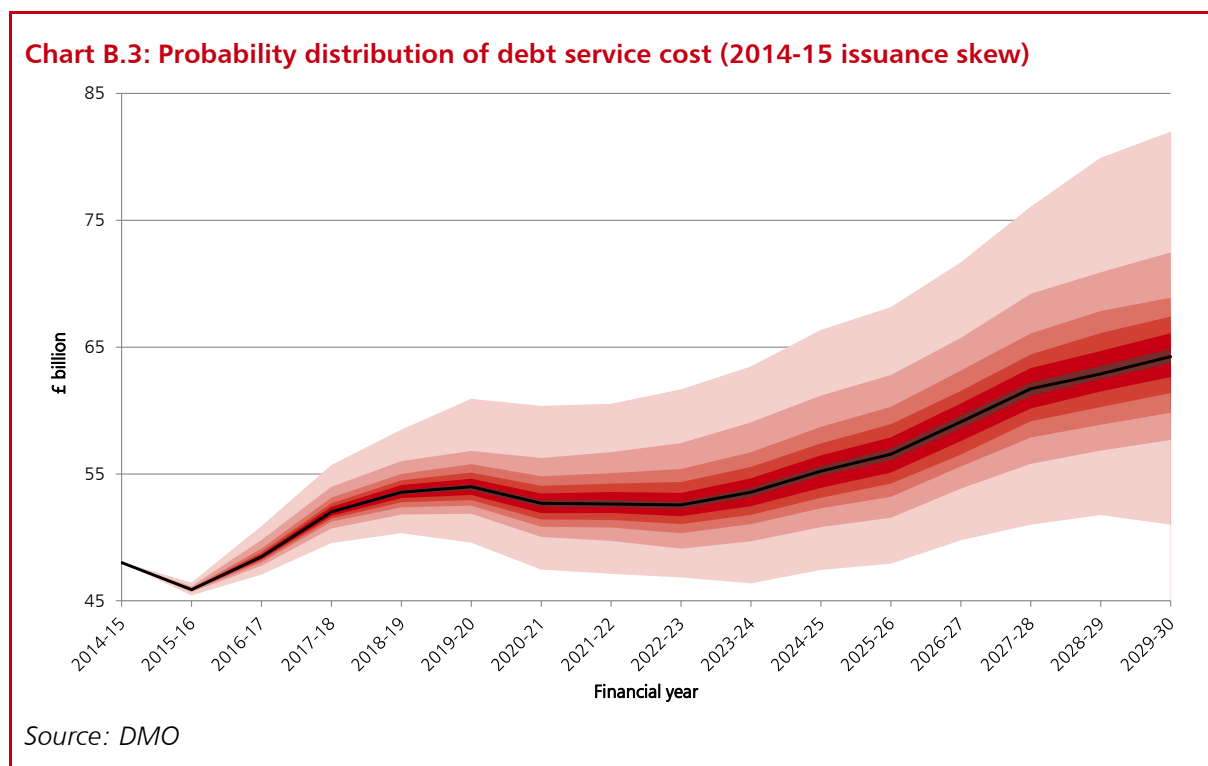
<sup>10</sup> The variables in the VAR model are: GDP, CPI and the Bank Rate as macroeconomic variables and 3 'latent factors' taken from the work of Diebold and Li (2006) that describe the yield curve, using 10 benchmark maturity points. The VAR is estimated using data from October 1992 to January 2015, making use of the official OBR December 2014 forecasts for the macroeconomic variables. For each year of the 15-year horizon, a yield curve forecast is produced. In order to generate a distribution of yield curve forecasts for each year, simulations around the central forecast are made by drawing from a distribution of errors, 1,000 times (thus the volatility of the yield curve forecasts varies over time, with uncertainty increasing over the forecast horizon). Two alternative yield curve distributions are analysed, normal and bootstrapped distributions. A restriction is applied that the nominal yields forecast should be positive. The VAR currently only forecasts nominal yields; the breakeven 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.

**B.25** As an example, Table B.1 illustrates the issuance skew as at December 2014 followed by the DMO in 2014-15, which is well-diversified across maturity buckets.

**Table B.1: Gilt issuance strategy composition (%)<sup>11</sup>**

	<b>Short conventional</b> (0 – 7 years)	<b>Medium conventional</b> (7 – 15 years)	<b>Long conventional</b> (over 15 years)	<b>Index-linked</b>
Issuance skew 2014-15	26	22	27	25

**B.26** The resulting probability distribution of debt interest cost if issuance continued to follow the 2014-15 issuance maturity skew as set out in Table B.1 for the next 15 years is shown in Chart B.3.<sup>12</sup> In this example, rather than assuming that future yields follow a normal distribution, a bootstrapping technique has been used for the simulation of yields.<sup>13</sup>



**B.27** The central line of the fan chart represents the median 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 median debt interest cost projection represent the percentiles of the probability distribution, with each colour range representing an additional 10% probability.<sup>14</sup> The debt interest values in the lightest shades of red at the top and at the bottom of the fan chart represent the ‘tails’ of the distribution, with only 5% probability associated with them. For example, debt interest values on the upper tail of the distribution would not be expected to be reached with a 95% probability.

<sup>11</sup> Numbers may not sum to 100 due to rounding.

<sup>12</sup> Debt interest from APF holdings is not netted out here while it is in the OBR’s official debt interest forecast, in line with changes brought about by ESA10 statistical guidelines.

<sup>13</sup> Bootstrapping is an econometric technique that does not make an assumption about the parametric form of the distribution of errors from estimation, such as the normal distribution. Instead, resampling techniques are applied to actual estimation errors in order to deduce the underlying distribution of the data sample.

<sup>14</sup> A percentile is a statistical measure indicating the value below which a given percentage of observations in a group of observations fall. For example, the 20th percentile is the value below which 20% of the observations may be found.

Forecast uncertainty increases further into the future and, therefore, the 'fan' widens over the horizon. Overall, at the 15-year horizon, it can be said with 90% certainty (i.e. excluding the top and bottom 'tails' of the distribution) that debt interest cost will be between £58 billion and £72 billion, with a median value of £64 billion.<sup>15</sup>

**B.28** It is important to note when looking at Chart B.3 that debt interest simulations reflect the combination of simulated future yields and projected debt issuance together with the unfolding of existing portfolio dynamics. In this way, for example, it can be seen that debt interest seems to pick up in the later part of the horizon. Amongst other factors, this reflects the redemption profile of the debt portfolio, with a higher volume of redemptions that will mature and be refinanced at new rates of financing. Given the long average maturity of the UK's debt portfolio, which induces 'inertia' in the debt portfolio, any impact on its structure as a result of debt issuance is slow to take effect. Following the current issuance skew example, after 15 years only about half of the entire debt interest cost bill would have been refinanced at new yield levels.

**B.29** Overall, the results of the cost and risk simulations support the government's approach to issuance across maturities, which balances the simulated lower cost of shorter maturity issuance (with its higher exposure to near-term refinancing risk) against the simulated 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.

## Gilt distribution

**B.30** The gilt issuance programme in 2015-16 will be slightly larger than in the previous financial year, and remains large by historical standards. To raise this amount of financing in 2015-16, the government will issue conventional and index-linked gilts across a range of maturities, with auctions remaining the primary method of issuance.

**B.31** There will be an additional planned supplementary issuance programme, which will comprise sales via syndication and, subject to demand, sales via gilt mini-tender. The government has reviewed the performance of the syndication programme in 2014-15 and has decided it should continue to be used in 2015-16 in the same way as in 2014-15: (i) to launch new gilts and/or to re-open 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. The government anticipates that there will be around 6 syndicated transactions in 2015-16.

**B.32** The main purpose of the mini-tender programme continues to be to accommodate variations in proceeds from syndicated offerings. In 2015-16, this will be reflected by permitting a small proportion of the remit to be allocated to issuance via either syndication or mini-tender. Mini-tenders may be used for the issuance of conventional and index-linked gilts across maturities.

**B.33** To maintain the operational viability of the final syndicated offerings (by type) of the programme, 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, at the time of the final operations for either or both types of gilt, all the unallocated supplementary issuance amount had been exhausted, whether as a consequence of re-allocation decisions at previous syndications or as part of the sizing decision at the final operation.

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<sup>15</sup> Note that the bootstrapped distribution in this example is asymmetric, so that for the same underlying probability, the area of debt interest values above the median of the distribution is larger than the area of values found below the median.

## Gilt issuance by maturity and type in 2015-16

**B.34** 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 premia analysis suggests short conventional gilts are likely to be as cost-effective as medium and long conventional gilt issuance. Short conventional gilts will constitute a broadly similar proportion of gilt sales relative to 2014-15.

**B.35** 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, the liquidity of the sector means that issuance of medium conventional gilts enables the government to raise finance efficiently. However, the relative cost-effectiveness of medium conventional gilts has fallen since last year. Taking into account these factors, the government intends to issue a slightly smaller proportion of medium conventional gilts in 2015-16.

**B.36** The risk premia analysis suggests long conventional gilts are as cost-effective to issue as short and medium conventional gilts, in contrast to previous years. The government has also considered the role of long conventional issuance in mitigating its near-term exposure to refinancing risk. The government has therefore chosen to increase the allocation of issuance to long conventional gilts in 2015-16 relative to that planned for 2014-15 at Budget 2014.

**B.37** There is a slight reduction in the proportion of index-linked gilt issuance in 2015-16 relative to 2014-15. This reflects the government's judgement about the appropriate balance of cost, risk and demand considerations. In relation to risk, the government is aware the significant volume of index-linked issuance in recent years has consequences for the overall amount of index-linked debt outstanding and is mindful of the need to retain a balance in the debt portfolio as well as in its annual issuance programmes.

**B.38** In reaching its conclusion, government has taken into account its analysis of the relative cost-effectiveness of index-linked gilts, its risk preferences including for the portfolio as well as the issuance programme, and the market feedback it has received, highlighting ongoing strong demand for index-linked gilts. The absolute amount of index-linked issuance is broadly unchanged from that planned at Budget 2014 for 2014-15.

## Treasury bill issuance in 2015-16

**B.39** 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>16</sup>

**B.40** Accordingly, the government has determined that the planned end-March 2016 Treasury bill stock should be increased by £7.0 billion to £72.0 billion, relative to end-March 2015.

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<sup>16</sup> In 2013-14 and 2014-15, the planned stock-build in Treasury bills announced at Budgets 2013 and 2014 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.

## Interaction with NS&I

**B.41** In determining the contribution to financing of both Treasury bills and short conventional gilts, the government has also considered the risk exposure that arises from the large net contribution to financing from NS&I in 2014-15 and 2015-16. Inflows from NS&I are likely to be in the form of relatively short-dated deposits.



# National Savings and Investments' financing remit for 2015-16

C

**C.1** This annex sets out information on the activities of National Savings and Investments (NS&I) in 2014-15 and 2015-16. 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 2015-16.

**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 financing without distorting the market.

**C.3** Budget 2014 announced that NS&I would launch a choice of fixed-rate market-leading savings bonds for people aged 65 and over, subject to tax. A 1-year and 3-year bond with rates of 2.8% and 4.0% respectively were launched in January 2015. Following their huge popularity, the government announced that they would keep the bonds on sale until 15 May 2015, to ensure all pensioners aged 65 and over who want to benefit from these bonds have time to do so.

## Volume of financing in 2014-15

**C.4** NS&I's contribution to financing in 2014-15 is projected to be £18.3 billion with gross inflows (including reinvestments and gross accrued interest) of approximately £34.6 billion. This is above the net financing range of £11 billion to £15 billion set for NS&I at Budget 2014. Demand for NS&I's market-leading fixed-rate bonds for people aged 65 and over ('65+ bonds') was unprecedented and resulted in higher than expected inflows. Table C.1 shows changes in NS&I's product stock during 2014-15.

**Table C.1: Changes in NS&I's product stock in 2014-15**

£ billion	End-March 2014	End-March 2015 <sup>1</sup>
Variable rate	69.4	78.5
Fixed rate	10.9	21.0
Index-linked	25.3	24.4
<b>Total</b>	<b>105.6</b>	<b>123.9</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 at or close to historic lows over the course of the year. On this basis, NS&I projects a Value Indicator return of £299 million in 2014-15. This is in line with the target set by HM Treasury at Budget 2014: for NS&I to deliver positive value excluding 65+ bonds.

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

<b>Comparator cost<sup>1</sup></b>	
<i>Less</i>	Interest and prizes earned by investors
<i>Less</i>	Management costs of NS&I products (net equivalent of DMO costs and leveraging revenue)
<i>Less</i>	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 2015-16**

**C.6** Gross inflows (including reinvestments and gross accrued interest) of NS&I's products are projected to be around £25.5 billion in 2015-16. After allowing for expected maturities and withdrawals, NS&I is expected to make a £10.0 billion contribution to financing in 2015-16.

**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 2015-16 is £130 million.

**C.8** The cost of the initial allocation of the 65+ bonds which NS&I launched in January 2015 was set out at Budget 2014, and the extension to May 2015 is scored in Table 2.1 of the Budget 2015 document. The cost of this in 2015-16 is therefore not reflected in NS&I's Value Indicator calculation.

**C.9** The overall net financing calculations also include the further increase to the Premium Bond holding limit, to £50,000 from 1 June 2015.

**C.10** 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 2015 and will be available in print form and at [www.nsandi.com](http://www.nsandi.com).

# The Exchequer cash management remit for 2015-16

D

## 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 4 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
- conflict with the operational requirements of the Bank of England for monetary policy implementation

## 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,

<sup>1</sup> The 4 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 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)

<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/cmopnot310314.pdf&page=money\\_markets/publication](http://www.dmo.gov.uk/documentview.aspx?docname=publications/moneymarkets/cmopnot310314.pdf&page=money_markets/publication)

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** A 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 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 1 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 2015 and January 2016. 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 2 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.

**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). 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.<sup>3</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>

## 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>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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