

Debt and reserves management report 2004-05

March 2004



HM TREASURY



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**Debt and reserves
management report
2004-05**

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FOREWORD BY THE FINANCIAL SECRETARY TO THE TREASURY

This is the eleventh report outlining the Government's debt management activities. It also includes detail of the management of the Official Reserves by the Bank of England.

Gross gilts issuance in 2003-04 is forecast to be some £49.8 billion, the highest level in a decade. It is to the considerable credit of the UK Debt Management Office (DMO) that it has met the operational demands of this programme, requiring the greatest number of auctions since it was created, so successfully. The programme was notable not only for its size but also because 4½% Treasury Stock 2007 was the first ultra-short gilt auctioned by the DMO. Another notable event was the issue of a foreign currency bond in order to finance the Official Reserves. This was the UK's first US dollar denominated bond in seven years and its first foreign currency bond issue since 2000.

In the retail sector, National Savings & Investments continues to perform strongly with forecast product sales of £13.8 billion and an expected net contribution to financing of £3.7 billion. This was a positive start to their five-year strategic plan, Direction 2007, and represents a significant step towards meeting its commitment to deliver £15 billion net financing over the period to 2007-08.

Net issuance in 2004-05 is projected to be £33.3 billion. The structure of issuance and planned auction calendar reflect the Government's ongoing commitment to a well-functioning and liquid gilts market, as well as its aim of being responsive to the needs of the market whilst balancing the cost and risks associated with the gilts portfolio.



17 March 2004

RUTH KELLY
Financial Secretary to the Treasury

INTRODUCTION

This is the eleventh report outlining the Government's debt management activities.

The *Debt and Reserves Management Report* is published in compliance with the Code for Fiscal Stability¹ that requires that a debt management report be published every financial year covering the following areas:

- the overall size of the gilts issuance programme for the coming financial year;
- the planned debt maturity structure and proportion of index-linked and conventional gilts;
- the gilt auction calendar; and
- a forecast of net financing through National Savings & Investments.

This report is designed to review developments in debt management over the past financial year and to set out the details of the Government's borrowing programme for the forthcoming financial year.

This report complements the Debt Management Office's (DMO's) regular publications and covers the following areas:

- the size and structure of the UK Government's debt portfolio;
- UK debt and cash management policy;
- a review of the Government's financing programme in 2003-04;
- developments in National Savings & Investments in 2003-04;
- developments in the management of the Official Reserves by the Bank of England;
- the Government's financing programme for 2004-05; and
- the remits for 2004-05 set by HM Treasury for the DMO, Bank of England and National Savings & Investments.

¹The Code for Fiscal Stability can be found on HM Treasury's website at:
http://www.hm-treasury.gov.uk/documents/uk_economy/fiscal_policy/ukecon_fisc_code98.cfm

SIZE AND STRUCTURE OF UK GOVERNMENT'S DEBT IN 2003-04

Debt stock

The total nominal outstanding stock of United Kingdom central government marketable sterling debt (including official holdings by central government) was £335.3 billion at end-December 2003. This comprised £232.3 billion of conventional gilt-edged stock, £79.0 billion of index-linked gilts (including accrued inflation uplift) and £24.0 billion of Treasury bills (see Table 1). In addition, there was £66.3 billion invested in National Savings & Investments instruments.

Table 1: Composition of UK central government sterling debt

	End-Mar 2003	End-Dec 2003
<i>(£billion, nominal value, including official holdings)</i>		
Conventional gilts¹	206.1	232.3
Index-linked gilts²	76.0	79.0
Treasury bills³	15.0	24.0
Total	297.1	335.3
National Savings & Investments	63.1	66.3

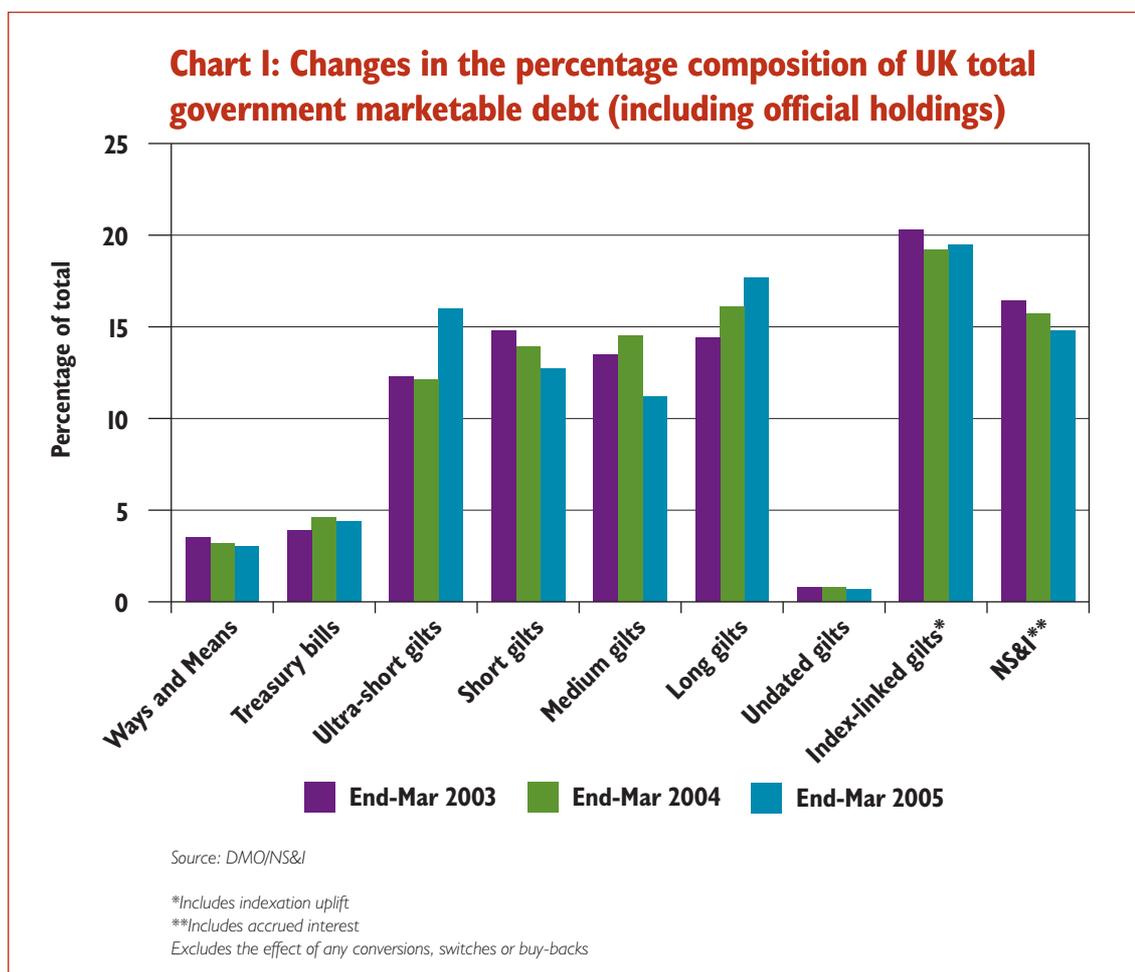
1 includes undated stocks
2 includes accrued inflation uplift
3 Treasury bill stock in market hands

Source: DMO/NS&I

Maturity and duration

The average maturity of the stock of all dated gilts rose from 11.22 years to 11.78 years between end-March 2003 and end-December 2003. Over the same period, the modified duration of the conventional portfolio of marketable gilts rose from 6.89 years to 7.40 years. The maturity and duration of the Government's marketable domestic debt continues to be amongst the longest compared to other European countries.

Chart 1 shows a comparison of the Government's debt portfolio at end-March 2003 through to the proposed composition at end-March 2005. It assumes that new debt is issued in accordance with the financing remit. It should be noted that within short maturity issuance, it is assumed that equal amounts of 1-3 and 3-7 year gilts are issued – this might not necessarily be the case. It also takes into account the ageing of existing debt. It does not, however, make assumptions about possible conversion offers, switch and reverse auctions or buy-backs.



Distribution of gilt holdings

Table 2 shows the distribution of gilt holdings by sector at end-March 2003 and end-September 2003. Insurance companies and pension funds continue to be major investors in gilts, owning the majority of gilts in issue, whilst holdings by banks and building societies remain the smallest.

Table 2: Distribution of gilt holdings (market values)

	End-Mar 2003		End-Sept 2003	
	£ billion	%	£ billion	%
Insurance companies and pension funds	201.8	63.8	211.5	64.5
Banks and building societies	2.2	0.7	0.3	0.1
Other financial institutions	31.4	9.9	33.3	10.2
Households	20.8	6.6	21.2	6.5
Other public sector¹	3.4	1.1	3.3	1.0
Overseas	56.9	18.0	58.4	17.8
Total	316.5	100	328.0	100

¹ Other public sector = local authorities and public corporations

Note: Numbers may not sum due to rounding

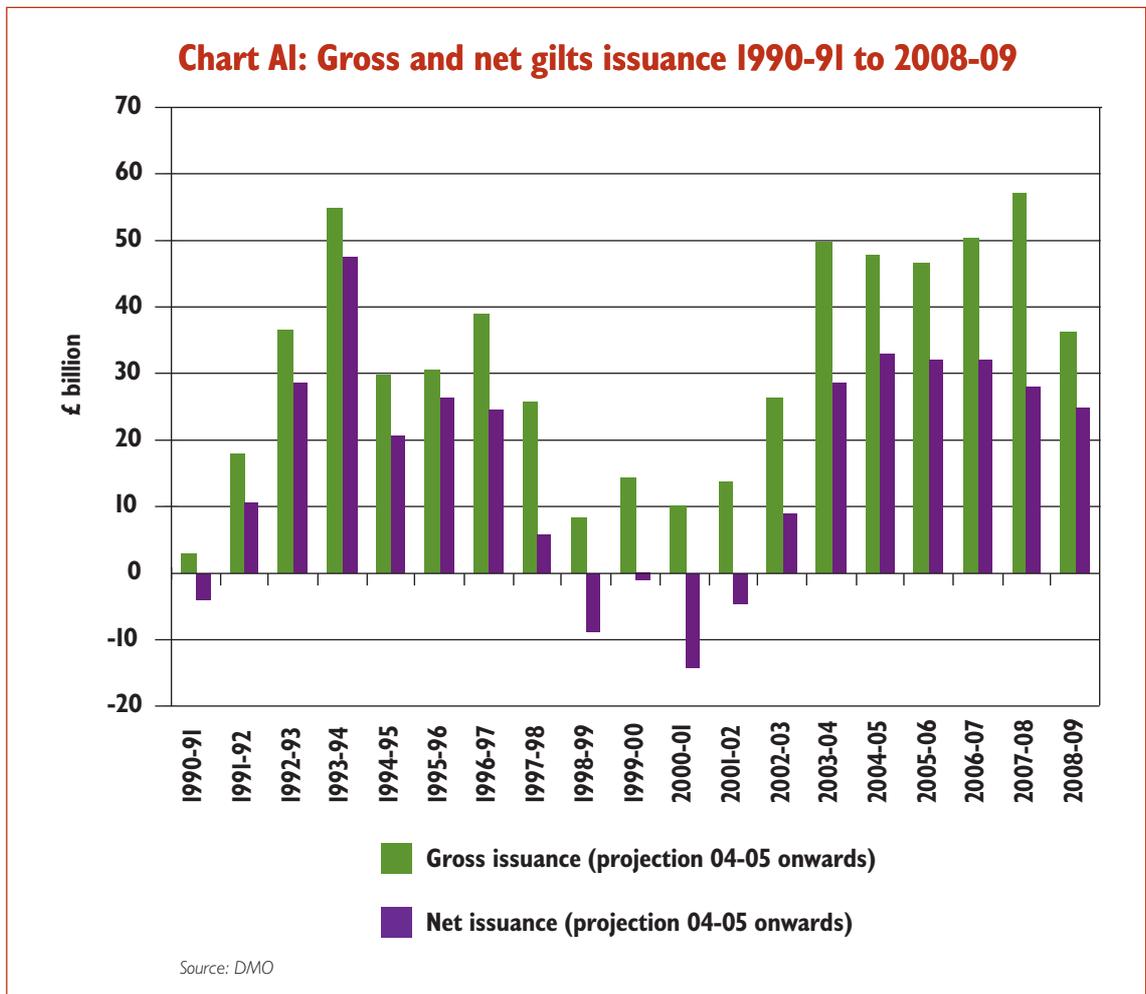
Source: ONS

Interest Payments

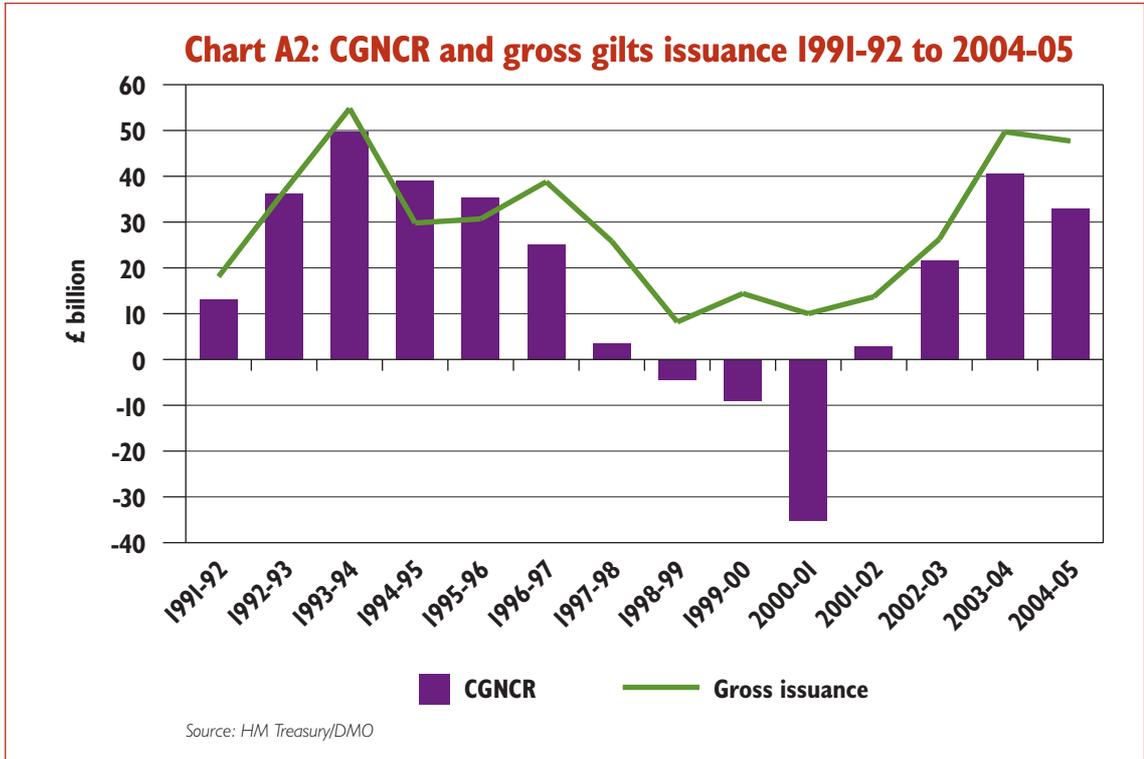
Gross central government debt interest payments in 2003-04 were £22.2 billion, equivalent to 4.8% of total managed expenditure (TME). In 2004-05, they are forecast to be £23.9 billion (4.9% of TME) and in 2005-06, £25.4 billion (4.9% of TME).

Gilts issuance and the gilts market

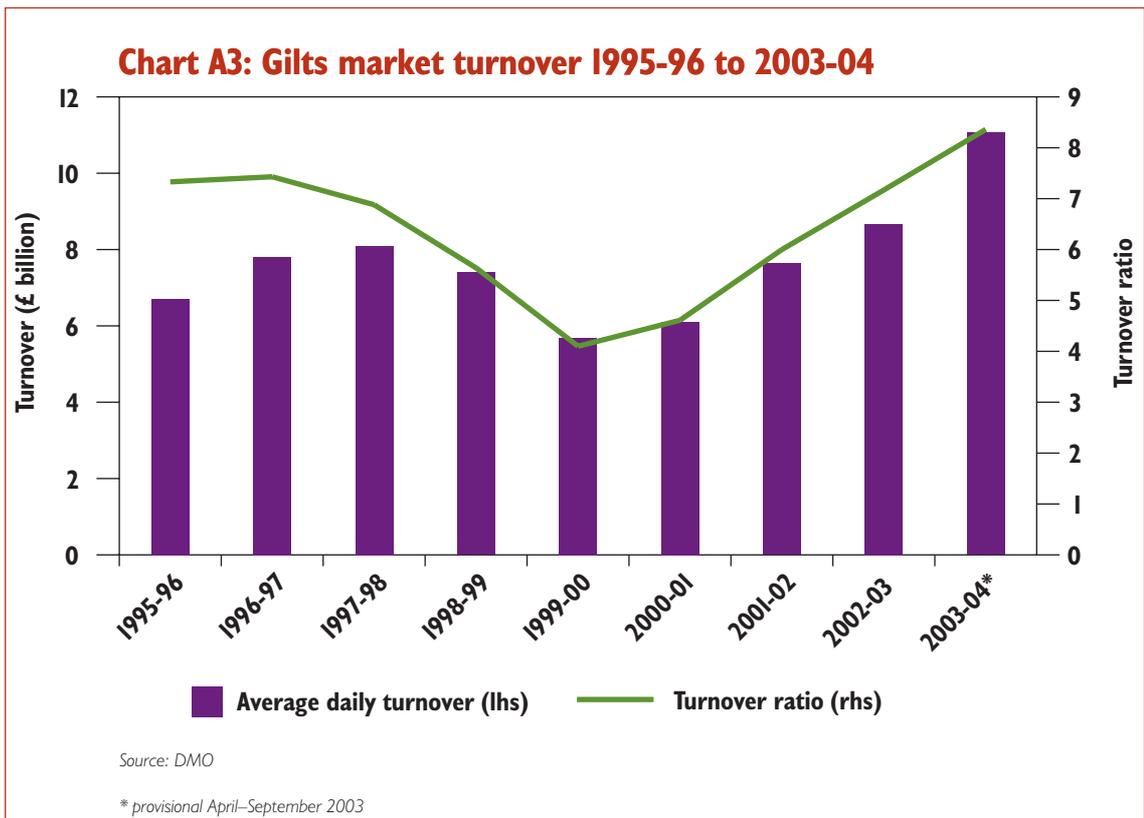
The DMO was established as part of the Government's reforms to the macroeconomic framework announced in 1997. The DMO took over issuance of gilts from the Bank of England in 1998 and held its first auction in May 1998. Since then, gilts issuance has increased significantly (see Chart A1) with expected gross issuance of £49.8 billion in 2003-04 compared with just £8.2 billion in 1998-99.



Net issuance of gilts was positive in 2002-03 for the first time since 1997-98, a trend that is expected to continue over the medium-term, reflecting the Government's on-going investment programme in the public services. The central government net cash requirement (CGNCR) measures the cash amount that central government needs to borrow for the fiscal year and is the key fiscal measure from which the volume of gilts issuance is derived. In the period that the DMO has been the Government's issuing agent, the CGNCR has increased from -£4.6 billion in 1998-99 to a forecast of £35.6 billion for 2004-05 (see Chart A2).



Turnover in the gilts market has continually increased since 1999-2000 (see Chart A3). Annual turnover has increased by 53% between 1999-2000 and 2002-03, with average daily turnover increasing from £5.7 billion to £8.7 billion over the same period. This trend accelerated in the first half of 2003-04 with average daily turnover rising by 27% to £11.0 billion compared with 2002-03. Trading intensity, as measured by the turnover ratio has increased by 102% to 8.3 between 1999-2000 and the first half of 2003-04.



UK GOVERNMENT'S DEBT AND CASH MANAGEMENT POLICY

Objectives of debt management

The Government's debt management policy objective remains:

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

The debt management policy objective is achieved by:

- pursuing an issuance policy that is open, transparent and predictable;
- issuing gilts that achieve a benchmark premium;
- adjusting the maturity and nature of the Government's debt portfolio, by means of the maturity and composition of debt issuance and other market operations including switch auctions, conversion offers and buy-backs;
- developing a liquid and efficient gilts market; and
- offering cost-effective savings instruments to the retail sector through National Savings & Investments.

Maturity and composition of debt issuance

In order to determine the maturity and composition of debt issuance, the Government needs to take account of a number of factors including:

- investors' demand for gilts;
- the Government's own appetite for risk, both nominal and real;
- the shape of both the nominal and real yield curves and the expected effect of issuance policy; and
- changes to the stock of Treasury bills and other short-term instruments.

Stock – flow dynamics

Since 1997-98, the *Debt and Reserves Management Report* has included a simple Stock-Flow Dynamics model, which looks at the impact of adopting different issuance strategies over the long-term and the resultant portfolios generated.

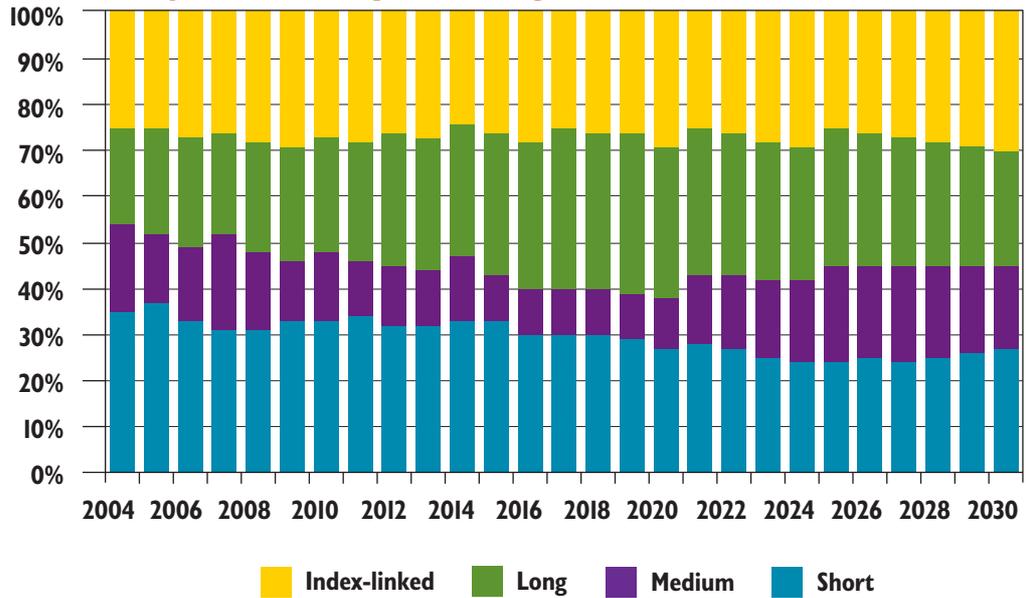
Table A below compares the results from this model based on two different issuance strategies and two different projected paths for the government's financing requirements in the future. The first issuance strategy is a fairly evenly balanced strategy based on that pursued in financial year 1997-98, while the second uses the issuance strategy followed during financial year 2000-01, when only long conventional gilts and index-linked gilts were issued. Both projected paths for the government's financing requirement use the Treasury forecasts for the next five financial years. For subsequent years, the high financing scenario assumes a constant gross financing requirement of £50 billion, while the low financing scenario is based on a constant gross financing requirement of £15 billion (the average actual gilt sales over the last five financial years).

Table A: Illustrative issuance strategies and the resultant debt portfolio

Strategy	Issuance and financing assumption				Resulting Debt Portfolios (End-March 2030)				
	Issuance Split (%)				Portfolio Split (%)				
	Index-linked	Conventional			Index-linked	Conventional			Average Maturity (years)
	Short (0-7 yrs)	Medium (7-15 yrs)	Long (15 yrs+)		Short (0-7 yrs)	Medium (7-15 yrs)	Long (15 yrs+)		
1997-98, high financing requirement	20	28	24	28	30	27	18	25	11.5
2000-01, high financing requirement	35	0	0	65	33	10	20	37	14.5
1997-98, low financing requirement	20	28	24	28	31	33	18	18	9.7
2000-01, low financing requirement	35	0	0	65	31	22	22	25	11.6

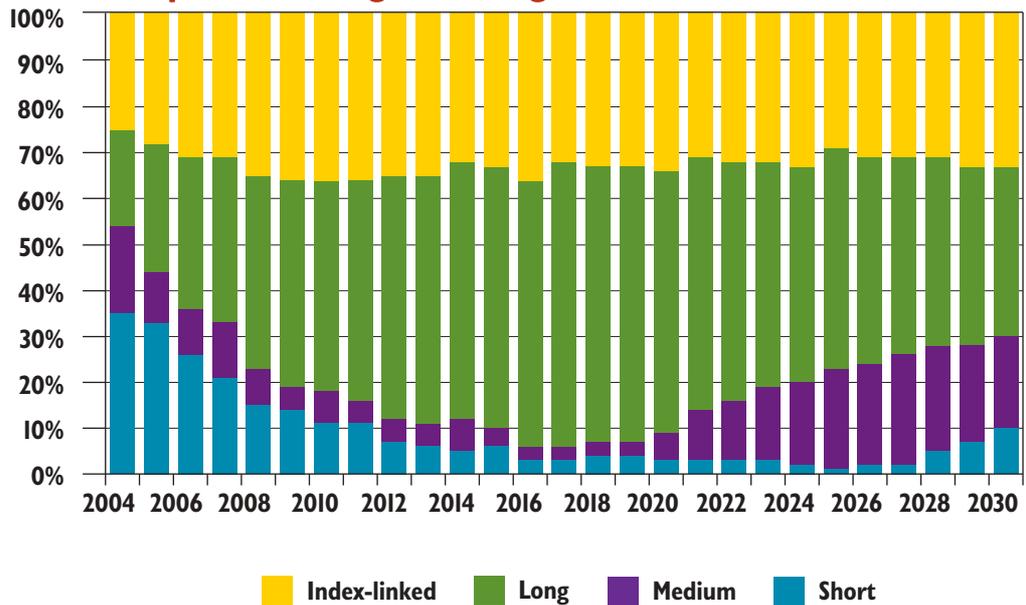
This simple study is intended to convey the impact that different issuance strategies and levels of financing can have on the composition of the government's debt portfolio. It is based on a number of strong assumptions and should not be taken as an indication of future policy.

Chart B1: Portfolio composition if 1997-98 financing pattern is repeated in a high financing environment



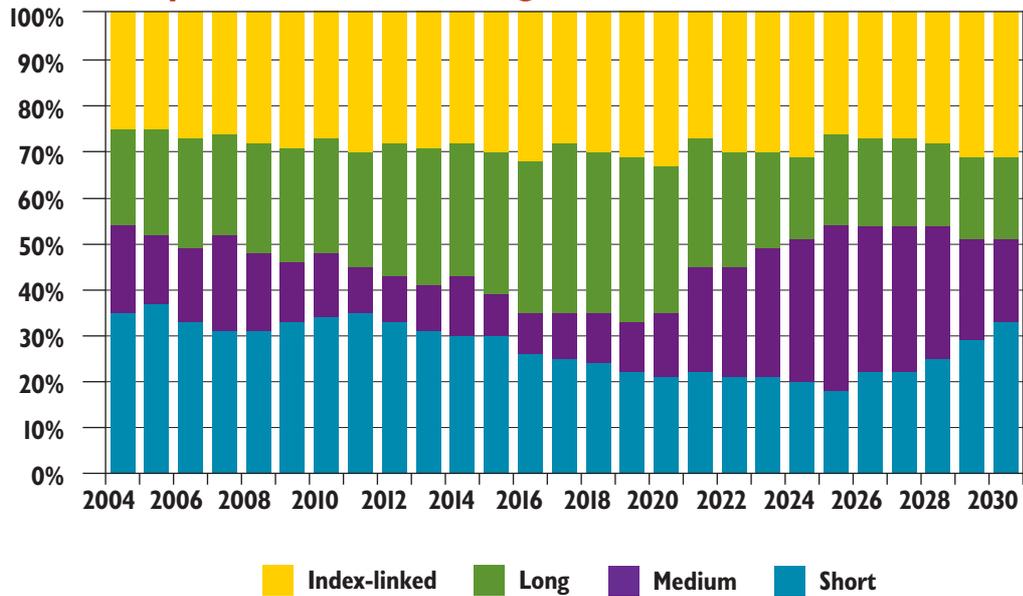
Source: DMO

Chart B2: Portfolio composition if 2000-01 financing pattern is repeated in a high financing environment



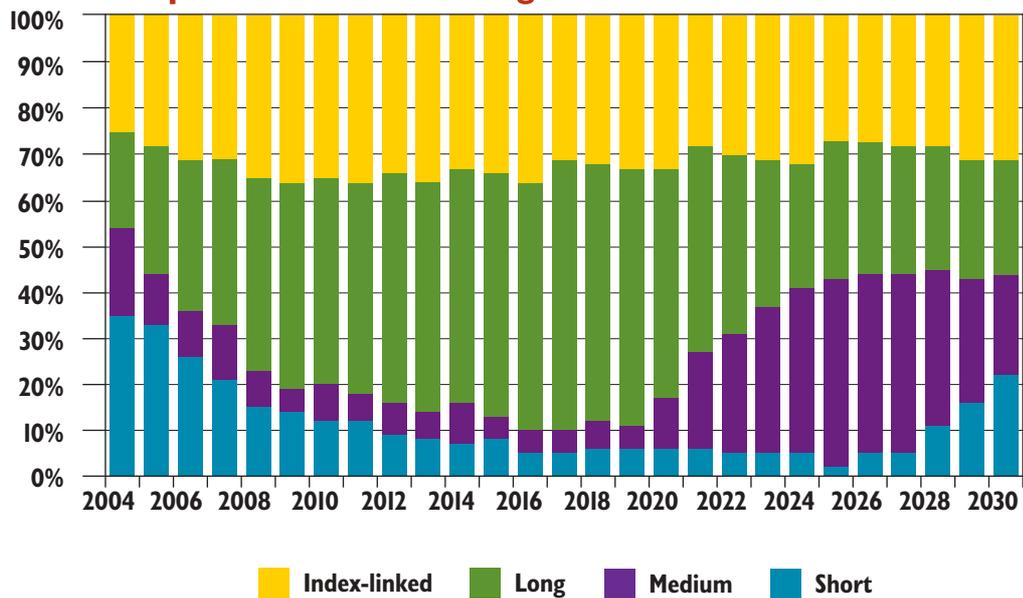
Source: DMO

Chart B3: Portfolio composition if 1997-98 financing pattern is repeated in a low financing environment



Source: DMO

Chart B4: Portfolio composition if 2000-01 financing pattern is repeated in a low financing environment



Source: DMO

Central Government Asset and Liability Risk Monitor

In last year's *Debt and Reserves Management Report*, the Government published the central government asset and liability risk monitor which gave an indication of the financial assets and liabilities that central government held as at 31 December 2002. The monitor is produced to aid quantification of the risks faced by central government on its balance sheet and forms part of an ongoing HM Treasury work programme.

The monitor should be regarded as "work in progress" as it records only current financial assets and liabilities of central government (for example, it does not include central government's contingent liabilities) and some of the calculations involve approximating assumptions. Also, the details in the monitor are unaudited. Therefore, it cannot be, and is not designed to be, a central government accounting publication.

The monitor is a precursor to the publication of "Whole of Government Accounts" in 2005-06 and is intended to enhance the transparency and accountability of central government, in accordance with the recommendations published in the International Monetary Fund's "Guidelines on Public Debt Management", 2001².

Table B sets out the monitor at end-December 2003. The nominal value of central government financial assets was £107 billion and the nominal value of financial liabilities was £479 billion. This compares to £128 billion and £442 billion respectively at end-December 2002.

Average maturity in Table B indicates the average length of time before assets and liabilities are due to be redeemed. Average maturity was 10.3 years for assets and 8.7 years for liabilities. This compares to 10.2 years and 8.5 years respectively at end-December 2002. Changes in the average maturity of assets can be brought about by factors such as changes in the average length of loans made by the National Loans Fund. On the liabilities side, changes can be brought about by factors such as the gilts issuance strategy. For example, increased issuance of long maturity gilts will increase the average maturity of liabilities, all other things being equal.

Average modified duration is a measure of interest rate risk. In the context of the monitor, duration offers some indication of how great an impact small interest rate changes might have on the market value of the portfolio of liabilities and assets.

²The latest version of the Guidelines on Public Debt Management can be found on the IMF website at: <http://www.imf.org/external/np/mfd/pdebt/2003/eng/am/index.htm>.

Table B: Central Government's Asset and Liability Risk Monitor at 31 December 2003

ASSETS						
Managing Organisation or HM Treasury Agent	Nominal Value¹ (£ bn)	Market Value (£ bn)	Maturities of less than 1 yr¹ (£ bn)	Modified duration² (yrs)	Average maturity (yrs)	Floating rate composition (£ bn)
Public Works Loan Board (loans to local authorities)	41.9	50.0	2.3	10.2	19.3	2.0
Debt Management Office						
<i>Gilts held by DMO</i>						
Marketable conventionals	7.5	8.4	1.1	5.9	6.8	–
Marketable index-linked	1.5	1.7	0.0	10.2	12.5	–
Total	9.0	10.1	1.1	–	7.8	–
<i>Gilts held in central government funds by the Commissioners for the Reduction of the National Debt (CRND)</i>						
Marketable conventionals	0.0	0.0	0.0	6.0	8.0	–
Non-marketable conventionals	13.8	14.9	3.8	3.4	4.1	–
Non-marketable index-linked	0.8	0.9	0.0	7.0	8.0	–
Total	14.6	15.8	3.8	–	4.3	–
<i>CRND loans to local authorities</i>	0.0	0.0	0.0	0.0	0.0	–
<i>Other short-term bills held by CRND in central government funds</i>	0.0	0.0	0.0	0.0	0.0	–
<i>Other short-term assets</i>						
Reverse repos – outstanding	3.1	3.1	3.1	0.2	0.2	–
Deposits at commercial banks	0.0	0.0	0.0	0.0	0.0	–
Cash deposits at the Bank of England	0.2	0.2	0.2	0.0	0.0	–
Sterling Certificates of Deposit	0.0	0.0	0.0	0.0	0.0	–
Sterling Commercial Paper	0.0	0.0	0.0	0.0	0.0	–
FX Commercial Paper	0.0	0.0	0.0	0.0	0.0	–
Total	3.3	3.3	3.3	0.2	0.2	–
Bank of England						
<i>Sterling assets</i>						
Sterling leg of swaps and FX liabilities ³	10.4	10.4	3.6	0.2	2.0	10.4
<i>Foreign currency assets</i>						
Bonds	15.3	16.2	3.2	2.1	2.0	0.0
Money market instruments	0.2	0.2	0.2	0.1	0.0	–
Short-term assets ⁴	3.3	3.3	3.3	0.1	0.0	–
Gold ⁵	2.3	2.3	–	9.7	–	–
IMF Special Drawing Rights	0.2	0.2	–	0.0	–	0.2
HM Treasury						
<i>Sterling assets</i>						
National Loans Fund Loans ⁶	3.1	3.1	0.1	9.2	16.3	–
<i>Foreign currency assets</i>						
IMF Reserve Tranche Position	3.5	3.5	–	0.0	–	3.5
Total^{7,8}	107.0	118.3	20.8	5.7	10.3	16.0

LIABILITIES						
Managing Organisation or HM Treasury Agent	Nominal Value¹ (£ bn)	Market Value (£ bn)	Maturities of less than 1 yr¹ (£ bn)	Modified duration² (yrs)	Average maturity (yrs)	Floating rate composition (£ bn)
National Savings and Investments	66.3	66.3	10.5	4.6	4.7	43.2
Debt Management Office						
<i>Gross gilts in issue⁹</i>						
Marketable conventionals	232.3	255.3	16.3	7.4	11.2	–
Non-marketable conventionals	20.1	21.6	6.0	3.2	3.9	–
Marketable index-linked	79.0	85.2	0.0	10.8	13.4	–
Non-marketable index-linked	0.8	0.9	0.0	7.0	8.0	–
Total	332.2	362.9	22.4	–	11.3	–
<i>Treasury bills¹⁰</i>						
Treasury bills ¹⁰	34.0	33.8	34.0	0.2	0.2	–
Other short-term bills	11.9	12.0	11.9	0.1	0.1	–
Total	45.9	45.8	45.9	0.2	0.2	–
<i>Other short-term liabilities</i>						
Reverse repos – outstanding	5.9	5.9	5.9	0.0	0.0	–
Deposits made by local authorities and commercial banks	0.2	0.2	0.2	0.0	0.0	–
Total	6.1	6.1	6.1	0.0	0.0	–
Bank of England						
<i>Sterling liabilities</i>						
Ways and Means Advance	13.4	13.4	–	0.0	–	13.4
<i>Foreign currency liabilities</i>						
HMG Bonds	1.7	1.6	0.0	4.5	5.0	–
Loans ¹¹	0.3	0.3	0.0	1.8	3.0	–
Repos	1.9	1.9	1.9	0.1	0.0	–
Swaps & FX Liabilities (excludes £ leg) ¹²	9.7	10.4	3.6	1.4	1.0	9.7
IMF Special Drawing Rights allocation	1.6	1.6	–	0.0	–	1.6
HM Treasury						
<i>Sterling assets</i>						
IMF non-interest bearing securities	0.0	0.0	–	0.0	–	–
Total^{7,8}	479.1	510.2	90.3	4.5	8.7	67.9

1 Nominal value of index-linked gilts includes inflation uplift

2 Modified duration of index-linked gilts is calculated with respect to changes in real yield

3 Modified duration covers swaps only

4 Short term assets = deposits + reverse repos

5 Modified duration gold = 30-day moving average volatility of spot gold prices

6 NLF loans are composed of loans to nationalised industries and public corporations

7 Totals for modified duration are weighted by market value (excluding gold volatility measure and duration for index-linked gilts)

8 Totals for average maturity are weighed by market value

9 Non-marketable gilts are held by the Commissioners for the Reduction of the National Debt (CRND)

10 Includes £10 billion of Treasury bills created for collateral purposes held by the DMO. These bills will mature on 29 March 2004

11 Composed of Canadian and US war debt

12 Modified duration covers only swaps

Cash management operations

The DMO's main strategic objective in carrying out its cash management role is³:

“to offset, through its market operations, the expected cash flow into or out of the National Loans Fund (NLF) on every business day, in a cost-effective manner with due regard for credit risk management”.

The DMO's money market dealers borrow from, or lend to, the market on each business day to balance the position in the NLF. In order to do so the DMO receives (from HM Treasury) forecasts for each business day's significant cash flows into and out of central government. Additionally, the DMO requires up-to-date intra-day monitoring of cash flows as they occur.

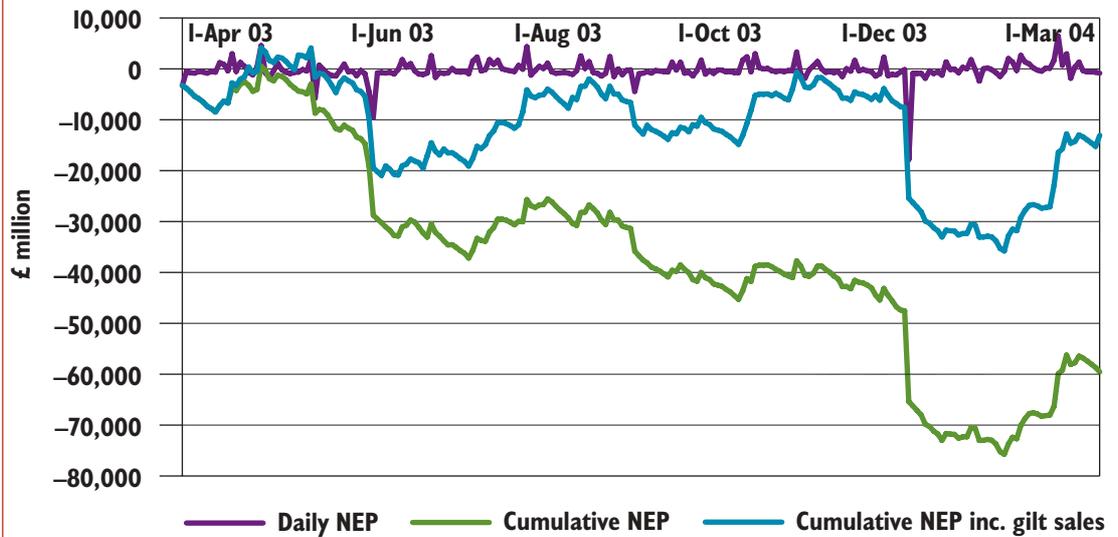
Over the course of a financial year, the Exchequer's cash flow has a fairly regular pattern associated with the tax receipts and expenditure cycles and outflows associated with gilt redemptions and coupon payments.

Chart 2 below shows the scale of daily cash flows in 2003-04. It excludes the effects of Treasury bill issuance, transactions undertaken by the DMO's money market dealers, the run down of the DMO's net cash position and NS&I's overall net contribution to Government financing. However, it highlights the contribution of gilt sales to reducing the intra-year cumulative deficit. The increase in the deficit required a further increase in the stock of outstanding Treasury bills in order to help manage seasonal cash outflows. The stock began the financial year at £15.0 billion, and reached a peak of £27.3 billion in mid-December 2003, ahead of outflows in early January 2004. Over the financial year as a whole, the stock is expected to rise by £4.3 billion to £19.3 billion (see Chart 3). This is an increase of £1.0 billion from the forecast published in the Pre-Budget Report 2003.

In order to aid the efficient execution of the DMO's cash management operations, on 11 December 2003 £10.0 billion of Treasury bills were issued to the DMO for use as collateral. The collateral will only be used, if required, in Delivery-by-Value (DBV) transactions and will not be sold outright to the market. The bills created will mature on 29 March 2004.

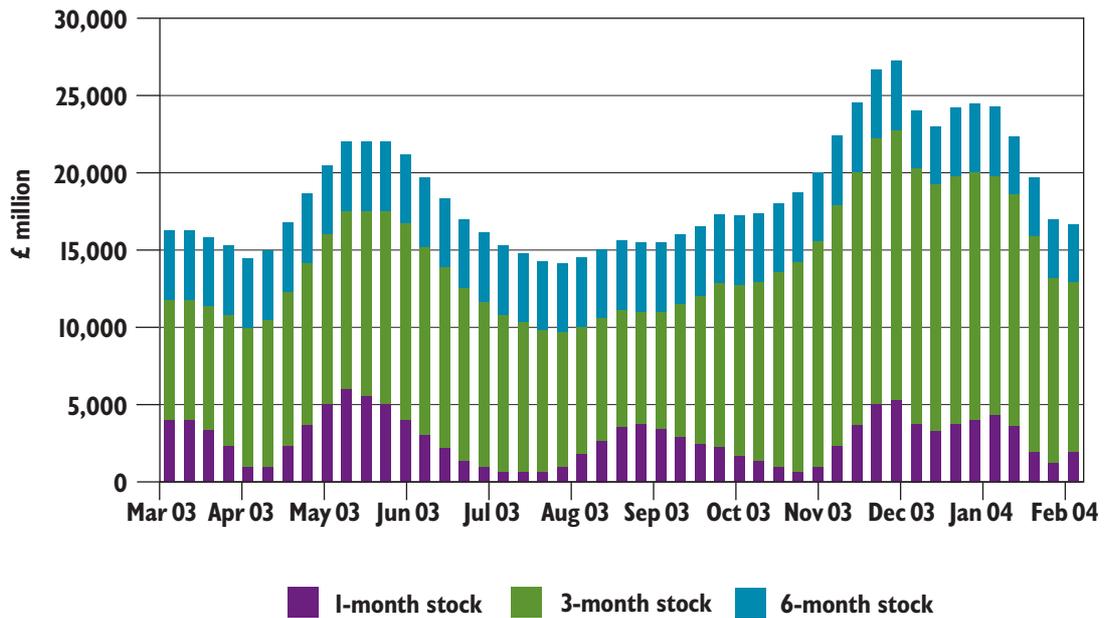
³A full description of the DMO's cash management objectives and operations can be found in “Exchequer Cash Management – Operational Notice and Treasury Bill Information Memorandum” – available on the DMO website at: <http://www.dmo.gov.uk/cash/cashops/110903.pdf>.

Chart 2: Daily cumulative Exchequer cash flows 2003-04



Source: HM Treasury/DMO

Chart 3: Cumulative Treasury bill stock (March 2003–February 2004)

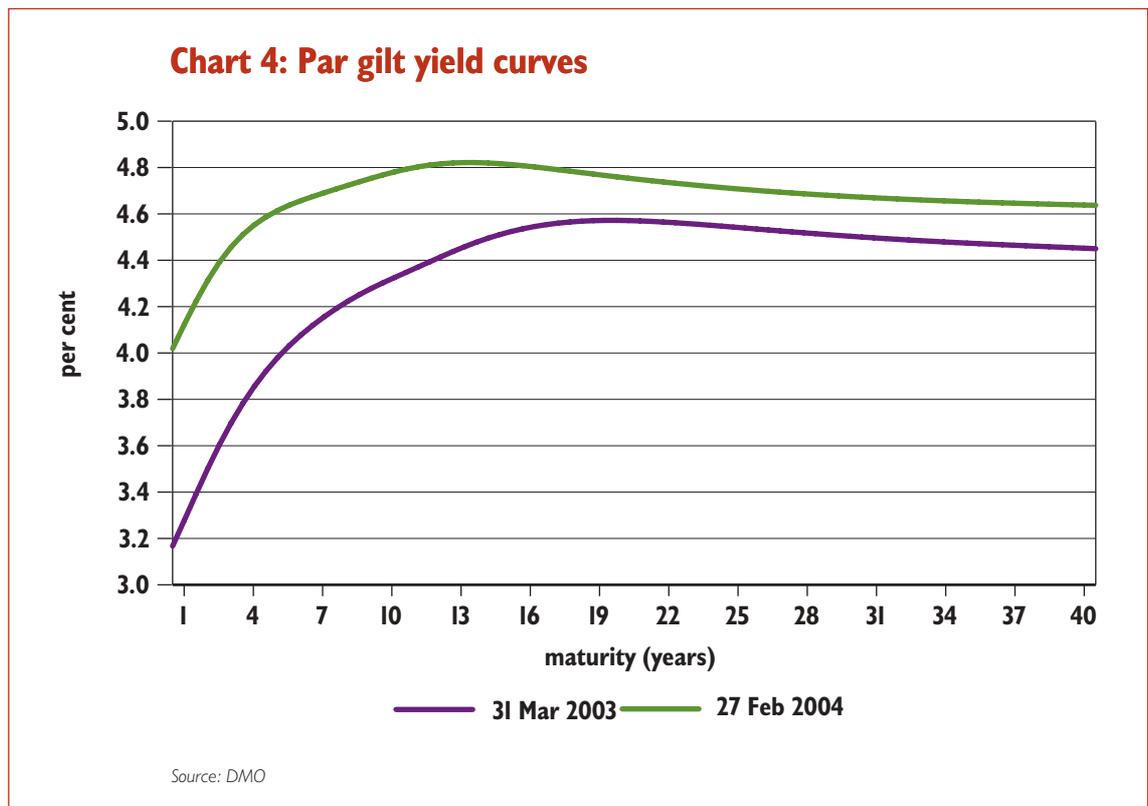


Source: DMO

THE GOVERNMENT'S BORROWING PROGRAMME FOR 2003-04

Gilts market review 2003-04

Between end-March 2003 and end-February 2004, yields on conventional gilts rose along the curve with the long-end of the curve out-performing shorter maturities as the expectation increased for the interest rate tightening cycle to begin over the course of the financial year. Overall, par gilt yields rose by 64 basis points (bps) at the 5-year maturity, by 45 bps at the 10-year maturity and by 17 bps at the 30-year maturity (see Chart 4).



The opening of the financial year coincided with rising geopolitical tension in the Middle East and, reflecting demand for safe assets, gilt yields fell along the curve. Continuing weak economic data and expectations of cuts in key policy rates by central banks on both sides of the Atlantic further encouraged “flight-to-quality” flows into short-maturity government bonds.

Short gilt yields fell to historic lows at the start of June as the Chancellor announced a planned move to a new inflation target measured by the Consumer Price Index (CPI)⁴ and the result of the Treasury’s assessment of the five economic tests for membership of the single currency was published. However, by mid-June assessments of the strength of the global economy began to improve and yields rose accordingly.

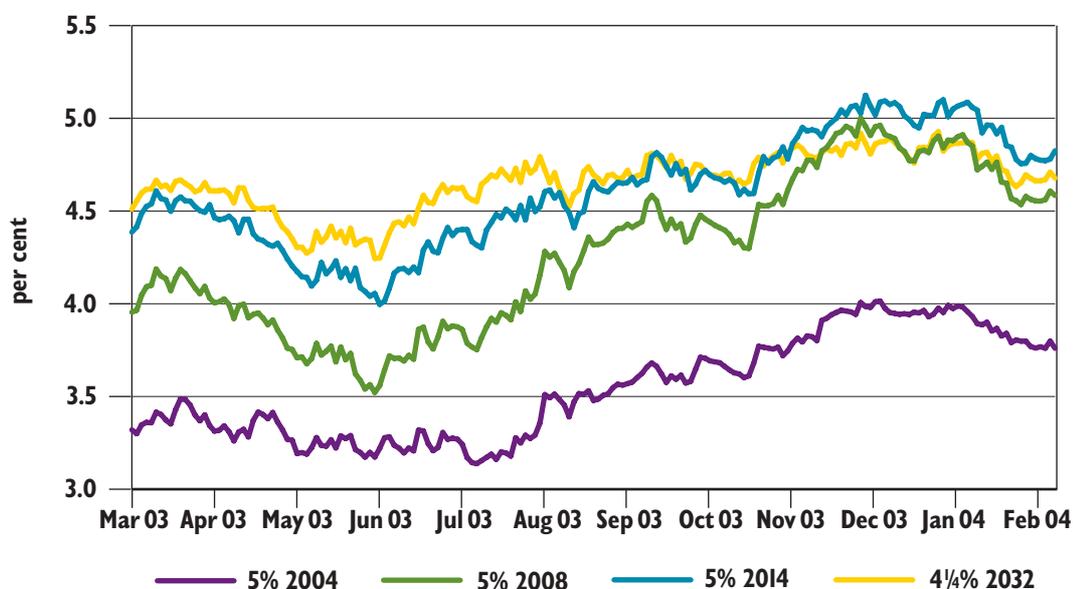
Yields continued to rise during the second quarter of the financial year as stronger economic data from the Eurozone, the United States and the UK, combined with a sharp rally in equity markets increased market expectations that interest rates had reached their trough. Short maturity gilts underperformed relative to other sectors of the curve as investors began switching into longer maturity gilts.

⁴ Subsequently announced to be 2%.

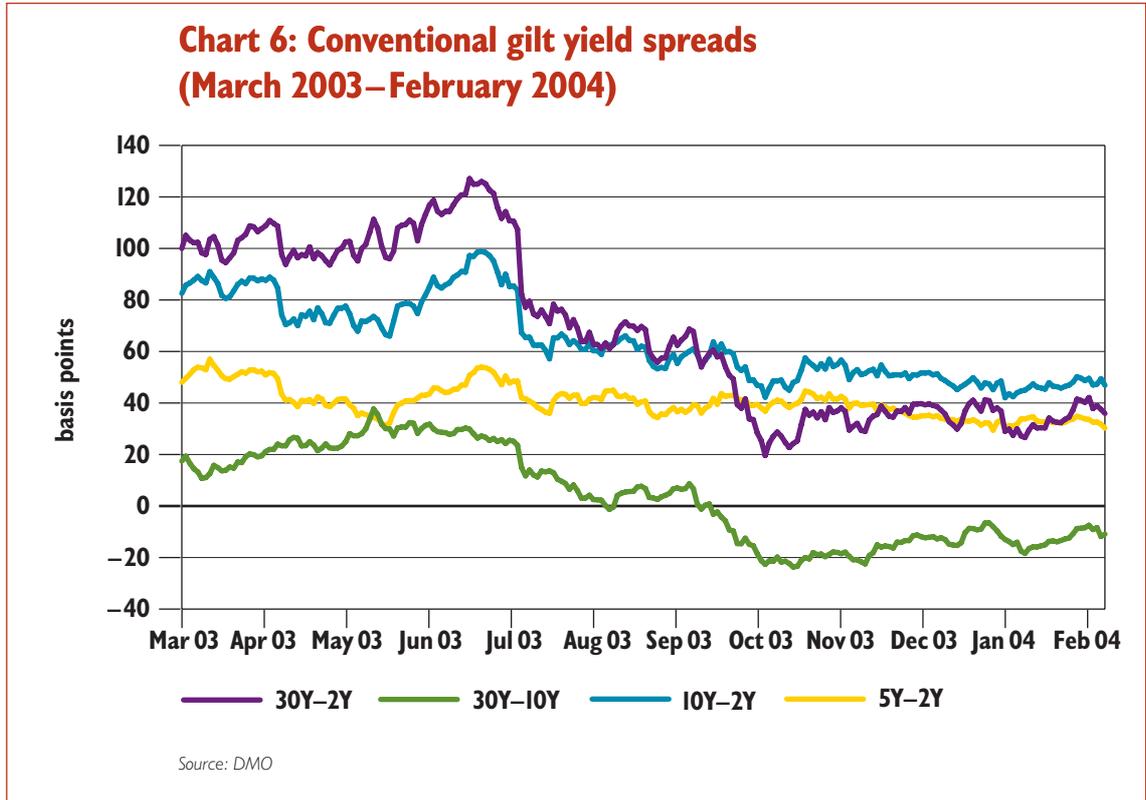
However, despite continued positive economic data, particularly from the US, market perceptions were for only a partial recovery in the global economy. Central banks began talking down expectations of imminent rate rises and mid-September saw a brief rally in global bond markets.

Bond markets turned bearish again at the start of the third quarter as they factored in further indications of economic recovery. The Bank of England responded to continuing signs of strength in the UK economy by raising its repo rate by 25 bps to 3.75% on 6 November. Yields reached 16-month highs in early November with gilt yields in the 5- to 20-year maturities all rising above 5%. However, the terrorist attacks in Istanbul and persistent threats against the US, UK and other countries saw gilt yields drop as, globally, investors again sought the relative safe haven of government bonds. However, continuing robust economic data and business confidence indicators, in particular in the US, prompted prices to retrace earlier gains as we entered the final quarter of the financial year.

**Chart 5: Benchmark conventional gilt yields
(March 2003–February 2004)**



Source: DMO

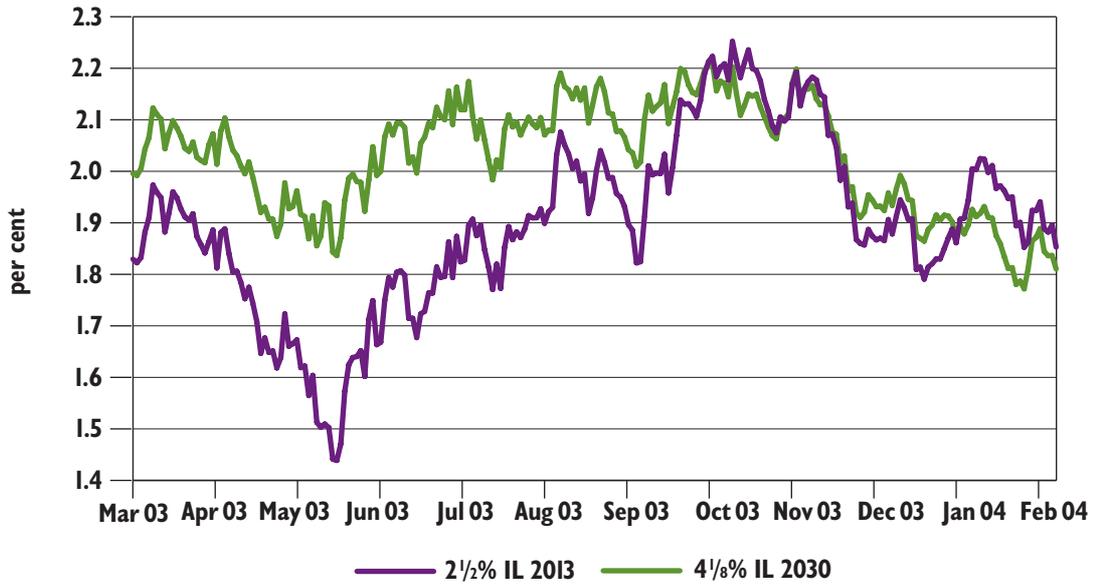


As with conventional gilts, the yields on index-linked gilts initially fell then rose reflecting perceptions of the outlook for the global economy and developments in geo-political risks. The real yield on 2½% Index-linked Treasury 2013 and 4⅞% Index-linked Treasury 2030 hit lows of 1.47% and 1.84% respectively in June 2003 (see Chart 7). However, index-linked gilts have outperformed conventional gilts, with breakeven inflation rates (BEIRs) rising consistently throughout the first half of the year to reach new highs at end-October. They have since (generally) remained above this level (see Chart 8).

In the last quarter of the financial year, sharp falls in real yields occurred following an increase in inflationary pressures (reflecting rises in rail fares, gas and water prices) and some switching into gilts and out of equities. The expectation of the introduction of the regulations outlined in the Financial Services Authority consultation document CP195⁵ prompted demand for long maturity gilts as investors moved away from lower-rated corporate bonds. This led to an inversion of the real yield curve in January. As a consequence, 10-year BEIRs fell by 6 bps and 30-year BEIRs rose by 6 bps. Overall, in the financial year to end-February 2004 BEIRs rose by 45 bps in the 10-year area and 38 bps in the 30-year area of the curve.

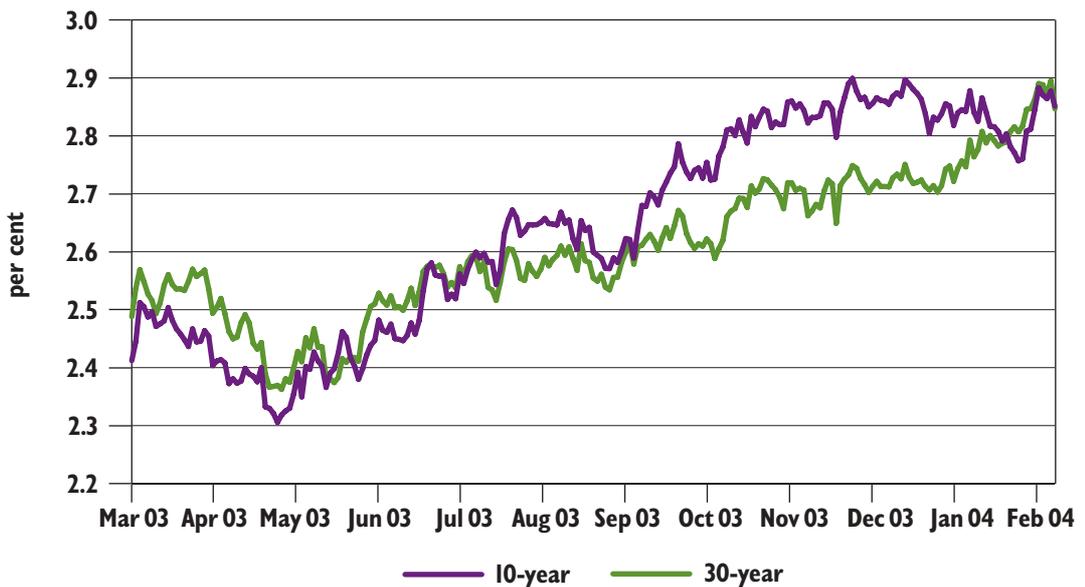
⁵ CP195 addresses the capital requirements of life insurance companies and can be found on the FSA's website at: <http://www.fsa.gov.uk/pubs/cp/cp195.pdf>.

Chart 7: Real yields on 10- and 30-year index-linked gilts (March 2003–February 2004)



Source: DMO

Chart 8: Breakeven inflation rates (March 2003–February 2004)



Source: DMO

Gilt sales and contingencies

This section sets out how the central government net cash requirement (CGNCR) for 2003-04 has evolved since the publication of the *Debt & Reserves Management Report 2003-04* on 9 April 2003⁶. Subsequent changes to the financing arithmetic for 2003-04 are outlined in Table 3.

Budget 2003

The DMO remit for 2003-04, was published on 9 April 2003 in the *Debt and Reserves Management Report 2003-04*. On the basis of the updated Treasury fiscal forecasts, the forecast for the CGNCR for 2003-04 was increased by £5.1 billion to £35.3 billion compared to the PBR 2002 projection used in the provisional remit in March 2003⁷.

Consequently, the contingencies outlined in the provisional remit were exercised. Planned gross gilt sales were increased by £7.4 billion to a forecast level of £47.4 billion – the highest level of gross issuance for 10 years. The increase in conventional sales was as follows:

- short conventional sales rose by £3.0 billion to £16.4 billion;
- medium conventional sales rose by £2.4 billion to £13.2 billion; and
- long conventional sales rose by £2.0 billion to £11.3 billion.

Index-linked gilt sales remained unchanged at £6.5 billion.

A further auction date (14 August) was added to those previously announced in the provisional remit to accommodate the increase in conventional sales – this took the total number of planned auctions to 23 (five each of short, medium and long conventionals and eight of index-linked).

Other elements contributing to financing announced in the remit of 9 April 2003 were an increase in the planned Treasury bill stock in 2003-04 of £3.2 billion (taking it to £18.2 billion) and a run-down in the level of the DMO short-term cash position of £4.2 billion – completing the planned run down of the assets acquired as a result of the spectrum auctions in 2000 (see the box on page 27 which describes this in further detail).

The remit included contingencies that might be triggered in the event that the financing requirement subsequently changed. These were:

In the event of a falling financing requirement:

- a reduction in planned Treasury bill sales by up to £2.0 billion;
- a reduction in planned conventional gilt sales broadly in proportion to the maturity split in the remit.

In the event of a rising financing requirement:

- an increase in planned Treasury bill sales by up to £2.0 billion;
- an increase in planned conventional gilt sales broadly in proportion to the maturity split in the remit (including an ultra-short (1-3 year) maturity gilt).

⁶ The Debt & Reserves Management Report 2003-04 can be found on the HM Treasury website at: www.hm-treasury.gov.uk/media/70A0A/debtmanagerpt03to04.pdf.

⁷ The Code for Fiscal Stability requires HM Treasury to publish a debt management report within each financial year.

The outturn CGNCR for 2002-03 was published on 23 April 2003. At £21.5 billion, it was £0.1 billion higher than the Budget forecast. The higher financing requirement was accommodated by an increase of £0.1 billion in planned Treasury bill sales in 2003-04 taking the expected level at end-March 2004 to £18.3 billion.

Pre-Budget Report 2003

The Pre-Budget Report 2003 (PBR 2003) was published on 10 December 2003 and included an update of HM Treasury's fiscal forecast. The forecast for the CGNCR in 2003-04 was increased by £5.2 billion from the Budget 2003 forecast, taking it to £40.5 billion. However, planned gilt sales rose by only £2.3 billion, to £49.7 billion. The increase in the CGNCR was offset by the release of £1.6 billion back to the National Loans Fund (NLF) as the net result of arrangements made for the financing of the Official Reserves (see pages 33-36) and an increase of £1.5 billion in the forecast of National Savings & Investments' net contribution to financing.

The additional planned gilt sales were accommodated in increased short conventional sales, taking them to £18.8 billion. An additional gilt auction was scheduled for 12 February 2004.

Budget 2004

Budget 2004 includes an update of HM Treasury's fiscal forecasts. The CGNCR for 2003-04 is now forecast to be £42.3 billion, an increase of £1.8 billion from the PBR 2003 forecast. Other changes to the financing arithmetic include a revision to the net financing for the Official Reserves and a £0.7 billion increase in NS&I's forecast net contribution to £3.7 billion. Overall, the net financing requirement for 2003-04 is now forecast to be £58.0 billion, an increase of £0.9 billion from PBR 2003. The forecast increase in net financing requirement will be met by a £4.3 billion increase in the planned stock of outstanding Treasury bills in market hands at end-March 2004, leaving an end-March 2004 planned stock of £19.3 billion.

The development of the financing requirement over 2003-04 is shown in Table 3.

Table 3: Financing requirement 2003-04 (£ billion)

	Provisional Remit	Budget 2003* April 2003	PBR 2003 10 December 2003	Budget 2004 17 March 2004
CGNCR	30.2	35.3	40.5	42.3
Gilt redemptions	21.1	21.1	21.1	21.1
Financing for the Official Reserves	0.0	0.0	-1.6	-1.8
Buy-backs	0.0	0.0	0.2	0.2
Gross Financing Requirement	51.3	56.4	60.2	61.8
<i>less</i>				
National Savings and Investments	1.5	1.5	3.0	3.7
DMO cash deposit at Bank of England	0.0	0.1	0.1	0.1
Net Financing Requirement	49.8	54.8	57.1	58.0
Financed by:				
1. Planned gilts sales	40.0	47.4	49.7	49.8
<i>of which:</i>				
Short conventional	13.4	16.4	18.8	18.8
Medium conventional	10.8	13.2	13.1	13.1
Long conventional	9.3	11.3	11.3	11.4
Index-linked	6.5	6.5	6.5	6.5
2. Planned net short-term debt sales	9.8	7.4	7.4	8.2
<i>of which:</i>				
Change in Ways & Means	0.0	0.0	0.0	0.0
Change in Treasury bill stock	3.2	3.3	3.3	4.3
Change in DMO net cash position**	6.6	4.1	4.1	3.9
Short-term debt levels				
Ways & Means at end of financial year	13.4	13.4	13.4	13.4
Treasury bill stock at end of financial year	18.2	18.3	18.3	19.3
DMO net cash position***	0.2	0.2	0.2	0.4

* as revised on publication of outturn of 2002-03 CGNCR on 23 April 2003

** excluding changes in the DMO's cash deposit at the Bank of England

*** including the DMO's cash deposit at the Bank of England

Source: HM Treasury

DMO Operations

The DMO issued three new gilts in 2003-04; 4% Treasury Stock 2009 on 27 June 2003, 4¾% Treasury Stock 2015 on 26 September 2003 and 4½% Treasury Stock 2007 on 13 February 2004. The latter had the distinction of being the first ultra-short gilt issued by the DMO and the first issued by HM Treasury in over 25 years.

Table 4 shows the results of the outright gilt auctions in 2003-04 to date. No conversion offers or switch auctions were held in the financial year.

Table 4: Results of DMO Market Operations 2003-04

Date	Stock Auctioned	Amount (£ mm)	Cover	Average Accepted Price (AAP)	Yield at AAP (%)	Tail (bp)*
16 April 2003	2½% IL 2009	£425	2.22	£234.27	1.74	na
24 April 2003	5% 2014	£2,500	2.60	£104.22	4.52	0
13 May 2003	4% 2009	£3,500	2.85	£99.82	4.04	0
28 May 2003	4¼% 2036	£2,250	1.51	£98.27	4.35	2
12 June 2003	5% 2014	£2,500	2.48	£107.98	4.11	1
24 June 2003	2½% IL 2024	£350	2.15	£200.00	1.95	na
26 June 2003	4% 2009	£3,250	1.76	£100.44	3.91	1
2 July 2003	4¼% 2036	£2,250	1.51	£93.86	4.62	2
16 July 2003	2½% IL 2013	£425	2.00	£213.25	1.77	na
29 July 2003	5% 2014	£2,500	2.67	£103.68	4.57	0
14 August 2003	4% 2009	£3,250	2.03	£98.12	4.38	0
10 September 2003	4¼% 2036	£2,500	2.05	£91.39	4.77	1
23 September 2003	2% IL 2035	£650	2.73	£100.70	2.09	na
25 September 2003	4¾% 2015	£2,750	2.22	£100.66	4.68	0
15 October 2003	4% 2009	£3,250	2.16	£96.42	4.76	0
23 October 2003	2½% IL 2011	£400	1.83	£247.50	2.10	na
29 October 2003	4¾% 2015	£2,500	1.64	£97.70	5.01	1
25 November 2003	4¼% 2036	£2,500	1.33	£89.93	4.88	2
2 December 2003	2% IL 2035	£675	2.45	£101.00	2.10	na
13 January 2004	2½% IL 2016	£400	3.31	£235.26	1.89	na
28 January 2004	5% 2025	£2,500	1.49	£102.99	4.77	1
12 February 2004	4½% 2007	£3,000	1.81	£100.05	4.48	1
24 February 2004	2% IL 2035	£600	2.35	£107.43	1.85	na
24 March 2004	4½% 2007					

* index-linked gilts are issued on a uniform price basis

Source: DMO

Cash Market Review

Developments in the sterling money markets

The financial year began with money markets still anticipating a further downward movement in official interest rates – reflecting continuing weak economic data and the uncertainties caused by conflict in the Middle East. In the UK, 3-month LIBOR⁸ was on average 11 bps below the Bank of England repo rate for the first quarter of the financial year. The European Central Bank (ECB) was the first of the major central banks to cut its rates – by 50 bps to 2.0% on 6 June 2003, the Federal Reserve followed with a 25 bps cut to 1.0% on 25 June and the Bank of England's Monetary Policy Committee (MPC) voted to cut its repo rate by 25 bps to 3.5% on 10 July. These were to be the final reductions in the interest rate cutting cycle that had begun in November 2002⁹. The path of official rates is outlined in Chart 9 below.

By the second quarter of the financial year, official economic data began to indicate that the global economic recovery was growing in both strength and pace. Therefore, the market's expectations of both the scale and speed of future interest rate rises began to increase. This was particularly true in the UK. By mid-August 2003, 3-month LIBOR rose above the Bank of England repo rate and by mid-September, was 20 bps above it, thus indicating that the market expected the MPC to raise rates. In the face of increasingly robust economic data, 3-month LIBOR had reached 49 bps above the repo rate by the time the MPC raised rates by 25 bps to 3.75% on 6 November 2003, the first of the major central banks to do so. Official UK rates were increased by a further 25 bps to 4% on 5 February 2004.

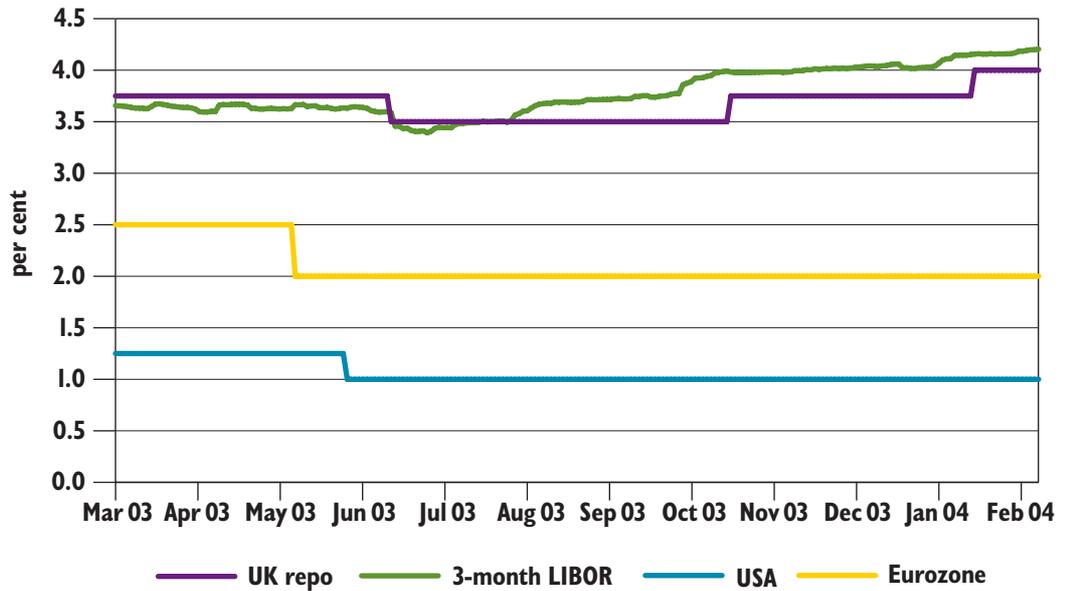
In the United States, increasingly robust economic data and survey results were not reflected in the labour market – in particular in the closely watched monthly payrolls data, the Federal Reserve's preferred measure of labour market performance. The Federal Reserve maintained a policy stance that was widely interpreted to indicate that rate rises were unlikely until there was solid evidence of a sustained recovery in the labour market. The key phrase in the Federal Reserve's statements "for a considerable period of time" was dropped in January 2004 and, at the time of writing, expectations are for a rate rise in the second half of 2004.

In general, economic data in the Eurozone was less bullish than in the UK or US and pressures on the ECB to begin its tightening cycle were correspondingly weaker. In particular, continuing weak domestic demand and the overall weakness of private consumption was cited as a factor in contributing to slowing economic recovery on the continent.

⁸ London Interbank Offer Rate – the rate at which AA-rated banks lend to each other. LIBOR is a key market reference rate.

⁹ Up to end-February 2004.

Chart 9: Official central bank interest rates and LIBOR (March 2003 – February 2004)



Source: DMO

Managing the proceeds of the 3G Spectrum auctions

The 3G spectrum auction in 2000 had a major impact on the public finances and left the DMO a short-term cash position to manage over three financial years. The *Debt and Reserves Management Report 2002-03* explained the background to the net cash position. Additionally, in 2003 the Treasury Select Sub-committee asked the DMO and HM Treasury to report on the management of the cash position in the next Debt and Reserves Management Report.

On 12 June 2000, HM Treasury announced that cash receipts from the spectrum auctions were £19.5 billion more than had been forecast in Budget 2000. Part of the immediate response to the cash surplus was to reduce planned gilt sales in 2000-01 (from £12.2 billion to £10.0 billion) and to begin a planned £5.0 billion programme of debt buy-backs. The residual surplus of £10.7 billion was earmarked to reduce net short-term debt, but decisions on the composition of the reduction were left for the Pre-Budget Report (PBR).

In the PBR published on 8 November 2000, HM Treasury announced further details of planned reductions in net short-term debt:

- a repayment of £1.6 billion in the level of the Government's Ways and Means Advance at the Bank of England;
- a reduction of £4.5 billion in the planned stock of Treasury bills at end-March 2001;
- a residual balance of £6.3 billion to be maintained as a short-term cash position (i.e. invested in financial assets) to be managed by the DMO and run down over the following three financial years (i.e. to end-March 2004); and
- any subsequent variation in the CGNCR in 2000-01 was to be reflected in the level of the net short-term cash position¹⁰. In the event, given further increases in the size of the CGNCR surplus in 2000-01 the DMO's net short-term cash position ended that financial year at £11.7 billion.

The table below shows the level of the DMO net short-term cash position at the end of each financial year. (The figures do not include a balance of £200 million that the DMO targets as a daily closing cash balance at the Bank of England to help with cash management operations).

End financial year	Size of DMO Net Cash Position (£ billion)
2000-01	11.7
2001-02	11.0
2002-03	4.2
2003-04*	0.2

*This balance reflects unanticipated cash flows that have occurred since PBR 2003

¹⁰ In practice this has also been the case in subsequent years.

Management of the cash position

Following the PBR in November 2000, part of the short-term net cash position (SCP) on the Debt Management Account (DMA) was set aside as a fund and managed against a benchmark. The intention was that the fund should be run along similar lines to a private sector AAA-rated institutional money market fund (MMF). To receive the highest AAA credit rating MMFs must satisfy the rating agencies that they meet the relevant standards including the minimum credit quality of holdings, diversification of credit exposures and style of investment.

The investment parameters (covering for example credit quality, liquidity and interest rate risk limits) were modelled along these lines but were probably more conservative than a typical MMF – partly reflecting the requirement to maintain a high level of liquidity given that the fund was managed as an extension to the Government's cash management operations¹¹. For example, at least 50% of the fund had to be invested in reverse repo, collateralised with government bonds and typically no more than 40% would be invested in bank or corporate commercial paper (CP) and certificates of deposit (CDs). This overall approach was agreed with Treasury Ministers.

The basic fund structure was intended to be a series of investments into 3-month, high credit quality instruments with an average maturity of about 1½ months. The benchmark was designed to reflect this basic structure and the return that would be achieved on a simple, replicable portfolio with low management and infrastructure requirements. The preferred benchmark was therefore the return on a simple, liquid and safe asset such as gilt reverse repo. The DMO used 3-month LIBOR less 25 basis points (bps) to represent the level at which the funds could have been invested in gilt reverse repo.

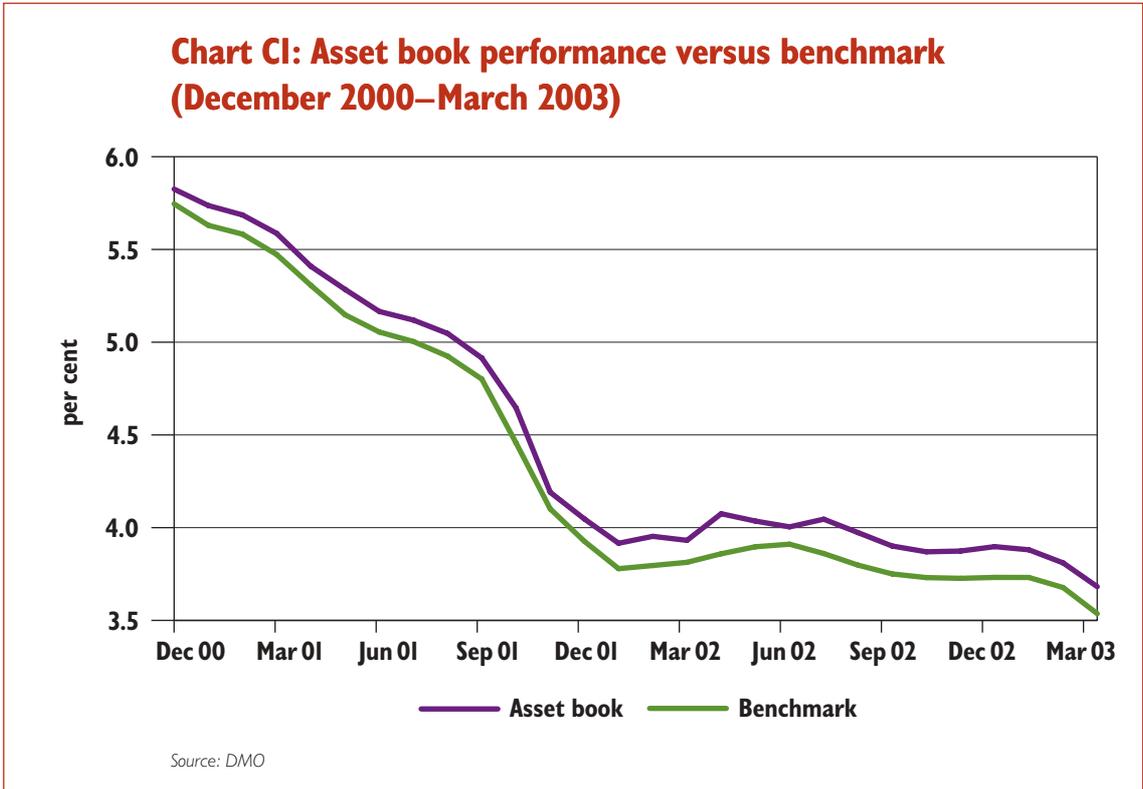
Performance against the benchmark

The gross return on the fund was measured against the benchmark, while the net return (allowing for management costs) was +10bps. Performance relative to the benchmark over the life of the fund was +14bps. The higher return over the benchmark came principally from:

- investing a proportion of the fund (typically up to 40%) in bank or corporate paper; and
- choosing, according to best value, to collateralise reverse repos using gilts or selected European government bonds.

The chart below tracks the relative gross rates of return.

¹¹ For a typical MMF client liquidity requirements are partly met by a diversification of clients: the DMO fund had only one client.



National Savings & Investments

National Savings & Investments (NS&I) is both a Government Department and an Executive Agency of the Chancellor of the Exchequer. It is one of the largest savings institutions in the UK, and as such, is an integral part of the UK's debt management strategy. NS&I contributes to reducing the cost of Government borrowing by raising cost-effective financing from the retail sector. NS&I meets this primary objective by offering customers secure savings and investment products that are both attractive and competitive.

The outstanding balance of liabilities of NS&I instruments at end-December 2003 was £66.3 billion. During 2003-04, NS&I was initially expected to make a net contribution of £1.5 billion, in line with its strategic plan to grow the business and raise £10 billion of net financing over the next 5 years. However, given the relatively low nominal interest rates and diminished confidence in the equity market, there has been overall strong demand for safer investments including NS&I products, in particular for Premium Bonds. The net contribution to financing in 2003-04 is now estimated to be £3.7 billion with gross sales (including accrued interest) of £13.8 billion. Table 5 below outlines the changes over 2003-04.

Direction 2007: National Savings & Investments' Strategic Plan

In March 2003, NS&I agreed with Treasury Ministers a detailed 5-year strategic plan that, against a backdrop of a positive contribution to Government financing needs, builds on the consolidation of the business and the development of customer-focussed, product delivery channels. The overriding objective is to produce strong and consistent business growth, and to develop a greater understanding of customer needs.

This plan envisaged increasing total net financing by £10 billion over the next five years through the continued modernisation of the Agency's product range and sales channels.

Successful products in 2003-04 were:

- **Premium Bonds:** 23 million people hold Premium Bonds, and May 2003 saw sales of over £1.1 billion following the increase in the maximum holding from £20,000 to £30,000. Currently, there are 100,000 people with the maximum holding.
- **Guaranteed Equity Bonds (GEB):** were introduced in March 2002 and were the first product issued under the "National Savings & Investments" brand name and the Agency's first product sold where the return is linked to the equity market. Since its launch, over £500 million has been sold, with over £250 million in 2003-04.

Another key development for NS&I in 2003-04 was the launch of the new Easy Access Savings Account (EASA) in January. This reflected a major move in the modernisation of its product range that is at the core of its new corporate strategy. It was introduced as a replacement of the Ordinary Account, set up in 1861 as a basic savings account, and is accessible through an extended range of delivery channels, including the Post Office, ATMs and telephone, as well as offering savers a more attractive rate of return.

In order to maintain their position as one of the leading savings institutions in the UK, NS&I aims to develop modern, innovative products that meet changing customer needs. The EASA and GEB are recent examples of how NS&I is modernising and broadening its existing product range and extending choice for customers, while still delivering cost-effective financing for the Government. Given the positive start to its Direction 2007 plan, NS&I and Treasury Ministers have agreed to increase NS&I's net financing target to £15 billion delivered over the five years to 2007-08, with a corresponding increase in the value-added.

Table 5: Change in NS&I product stock

	End-Mar 2003		End-Mar 2004 ¹	
	£ billion	%	£ billion	%
Variable rate	38.2	60.6	42.4	63.4
Fixed rate	16.8	26.6	16.3	24.4
Index-linked	8.1	12.8	8.1	12.1
Total	63.1	100	66.8	100

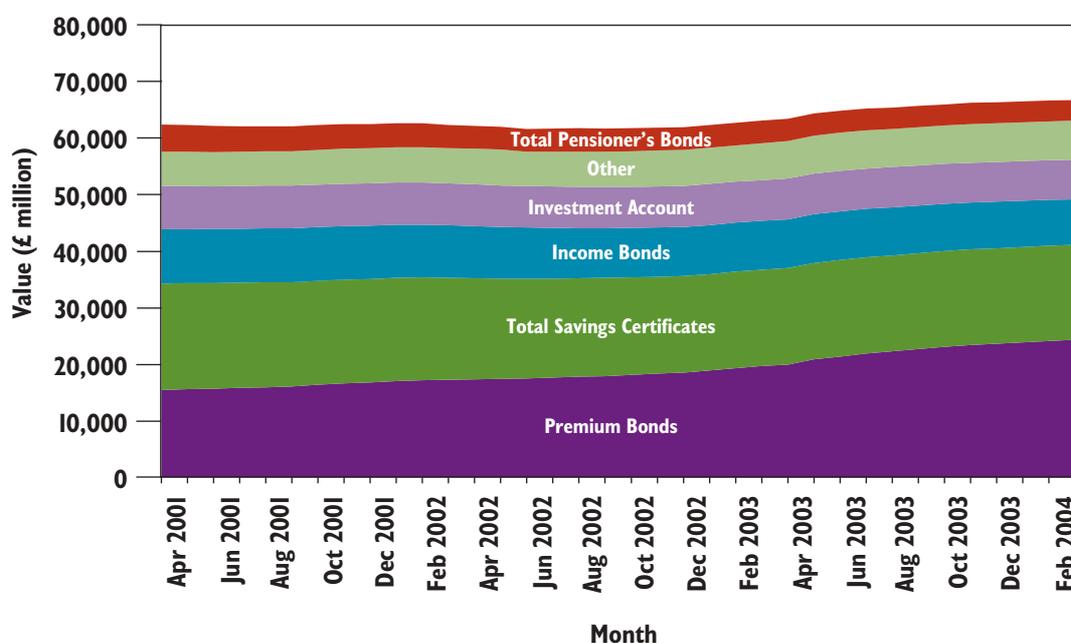
¹ estimates

Note: figures may not sum due to rounding

Source: NS&I

Throughout the year, NS&I's overall cost of financing remained lower than that of comparable gilts, taking into account management costs and imputed tax foregone. NS&I announced seven packages of rate changes during 2003-04. For new issues of fixed rate products, these reflected changes in gilt yields. For variable rate products, these reflected the changes in the repo rate as announced by the Bank of England's Monetary Policy Committee.

Chart 10: NS&I liability portfolio by product 2001 to 2004



Source: NS&I

THE MANAGEMENT OF THE OFFICIAL RESERVES IN 2003-04

Introduction

The United Kingdom's official holdings of international reserves comprise of gold, foreign currency and International Monetary Fund (IMF) Special Drawing Rights (SDRs). These reserves, with the exception of the SDR assets that constitute the UK's reserve tranche position (RTP) at the IMF, are held in the Exchange Equalisation Account (EEA). The EEA is under the control of HM Treasury, which has appointed the Bank of England as its agent to carry out the day-to-day dealing in foreign currencies and the investment of the reserves. The parameters of this agreement are contained in an annual Remit agreed between the Bank and HM Treasury, which sets out the parameters under which the Bank will manage the reserves. A summary of the Remit appears on pages 49-51.

Origin and purpose

The EEA was established in 1932 to provide a fund that could be used for "checking undue fluctuations in the exchange value of sterling". Subsequent legislation has extended the possible use of the fund to include making payments abroad on behalf of the Government and for transactions associated with the UK's membership of the IMF. The Exchange Equalisation Act 1979 permits the EEA to invest in assets denominated in the currency of any country, the purchase of gold or in the acquisition of SDRs.

The Act does not however permit the EEA to issue debt and therefore the National Loans Fund (NLF) conducts all such borrowing on the EEA's behalf. The Bank of England manages any NLF foreign currency exposures alongside those of the EEA.

Disclosure of financial data

Since April 2000, the UK has published reserves data in accordance with the IMF/G10's Special Data Dissemination Standard (SDDS). This data, alongside other information, discloses the value and composition of the UK's foreign currency and gold assets, liabilities and derivatives on a marked-to-market basis (that is, using current market valuations). Reserves data from July 1999 onwards are available on the Bank of England's website.

HM Treasury also publishes the financial accounts for the EEA in accordance with the statutory obligations set out in the EEA Act 1979, as amended by the Finance Act 2000. The financial accounts for 2002-03, audited by the National Audit Office, were published on 1 December 2003.

Table 6: UK Official Holdings of International Reserves

Currency breakdown as at 31 December 2003	
Assets	(US\$ million, market value)
US\$	13,254
Euro	16,481
Yen	5,428
Other currencies	2
SDR	6,626
Gold	4,202
Total	45,993
Liabilities	
US\$	-9,304
Euro	-12,528
Yen	-3,449
Other currencies	-1
SDR	-2,809
Gold	—
Total	-28,091

Source: HM Treasury/Bank of England

Size of the UK reserves

The level of the UK's net reserves increased over the year from US\$15.6 billion at end-December 2002 to US\$17.9 billion at end-December 2003. The value of the gross reserves also rose over the year from US\$42.4 billion at end-December 2002 to US\$45.9 billion at end-December 2003. This increase reflected, in part, the temporary effect of the issue of the US\$3 billion 5-year eurobond in June 2003 (which substituted dollar financing for sterling financing that was due to mature in the course of the financial year).

Evaluation of performance in reserves management

In keeping with the Government's commitment to greater openness and transparency in the reserves, a performance measure in relation to the management of the reserves has been published. This Service Delivery Agreement (SDA) target covers a three-year cycle in which HM Treasury undertakes "to minimise the cost of holding the Government's foreign currency reserves, while managing risk within limits agreed between the Bank and the Treasury". Details of this performance target are reported in detail in HM Treasury's annual report on the expenditure plans of the Chancellor of the Exchequer's Departments. The cost associated with holding foreign currency reserves over the three-year period 2000-01 to 2002-03 was £239 million (US\$355 million) largely due to exchange rate fluctuations.

Financing of the reserves

Section 2(1) of the EEA Act 1979 provides for the EEA to be funded by advances from the NLF at “such times and in such manner as the Treasury may direct” and for “such sums as the Treasury may determine”. Sums advanced from the NLF to the EEA can be raised by issuing foreign currency debt or by issuing sterling debt (gilts) and swapping the proceeds into foreign currency. The key determinant of which approach to adopt is cost or value-for-money. This is determined by comparing the cost of issuing bonds of a given maturity and nominal amount in foreign currency with the cost of issuing a similar bond in sterling on an equivalent currency swapped basis.

In recent years, the Reserves have been financed out of swapped sterling, reflecting the relative cost advantage of borrowing via the gilts market. However, in June 2003, the UK made use of foreign currency borrowing as market conditions made this more favourable on an equivalent currency swapped basis. The £3.4 billion sterling swap programme for 2003-04 was reduced accordingly to £1.6 billion. More information on the bond issue and the value-for-money comparison is provided below.

Looking ahead, for 2004-05, the UK will continue to evaluate the relative cost advantages of domestic versus foreign currency borrowing and will retain the option to finance the reserves by issuing foreign currency debt on a value-for-money basis if there are cost advantages.

Intervention

There was no intervention by the UK in the foreign exchange markets in 2003-04.

June 2003 UK Eurobond issuance

In June 2003, the Bank of England acting on behalf of HM Treasury, issued a US\$3 billion five-year Eurobond. Foreign currency debt is only issued in order to finance the official foreign currency and gold reserves. While the DMO is responsible for the management of the Government’s sterling liabilities, the Bank of England retains responsibility for any foreign currency liability management.

A syndicate of banks led by Citigroup, Deutsche Bank, Goldman Sachs and Morgan Stanley announced the bond on 23 June, to take advantage of significant market demand for high-quality fixed-rate dollar exposure. The bond was the first dollar denominated debt issued by the UK in seven years and the first foreign currency debt issued by the Government since 2000.¹² It included collective action clauses consistent with the recommendations of the G10 reflecting the UK’s continuing support for international efforts to encourage the greater use of these clauses in bond documentation.¹³

The 2.25% 2008 bond was initially priced at 2 basis points over the yield on the five-year US Treasury benchmark. Adjusting for the difference in maturities this represented a spread of more than 3 basis points below the US Treasury curve. The value-for-money comparison between the bond and the alternative of gilt financing swapped into foreign currency is set out in the following table:

Cost of issuing UK \$ Bond swapped into floating rate dollars	Cost of issuing a five year gilt swapped into floating rate dollars	Indicative saving (estimated)
US dollar Libor – 33 basis points spread	US dollar Libor – 19 basis points spread	13 basis points

The thirteen basis point saving is only an indicative figure as not all transactions were actually executed in the market. However, on the basis of this estimate the issue delivered a saving to the Government of approximately £11 million in net present value terms over the life of the bond. The bond issue won International Financing Review’s “Eurobond of the Year” and Euroweek’s “Deal of the Year”.

¹² A \$2 billion 5-year dollar denominated Floating Rate Note was issued in 1996 and a €2.2 billion 3-year euro denominated note was issued in 2000.

¹³ Full details of the clauses can be found on the Bank of England’s website at <http://www.bankofengland.co.uk/cac/index.html>.

THE GOVERNMENT'S FINANCING PROGRAMME FOR 2004-05

Financing Framework

The Government intends to continue to finance the central government net cash requirement (CGNCR) using the framework that was established in the 1995 *Debt Management Review*. The Government aims to finance its net cash requirement plus maturing debt and any financing required for additional net foreign currency reserves through the issuance of debt. All such debt issuance will take place within a set maturity structure. In addition, the Government may hold conversion offers, switch auctions and reverse auctions of non-benchmark stocks.

Financing Arithmetic

Table 7 gives details of the financing arithmetic for 2004-05. It outlines the proposed structure and composition of debt instruments that the Government intends to use to meet its financing requirement in 2004-05.

The new forecast for the CGNCR in 2004-05 is £35.6 billion, an increase of £2.3 billion from the PBR 2003 forecast. Gilt redemptions, excluding official holdings, are expected to be £14.7 billion (see Table 8).

National Savings and Investments

NS&I's net contribution to financing (including accrued interest) in 2004-05 is forecast to be £2.0 billion. This assumes gross sales (i.e. sales and deposits including accrued interest) of around £12 billion. This forecast is not a target but an estimate based on experience in previous years, trends in the retail savings product market over 2003-04 and NS&I's own forecasts and objectives.

Financing for the Official Reserves

If the Government judges that there is a value-for-money case for doing so, consideration would be given to issuance of a short-maturity foreign currency bond to finance the acquisition of foreign currency reserves.

This would have the effect of releasing sterling from the EEA (the account on which the reserves are managed) to the NLF (the Government's central financing account) thereby reducing the net sterling financing requirement by an equivalent amount.

Table 7: Financing Arithmetic 2004-05

	£ billion
Central government net cash requirement	35.6
Gilt redemptions	14.7
Gross Financing Requirement	50.3
<i>less</i>	
National Savings and Investments	2.0
Change in DMO cash deposit at the Bank of England	0.0
Net Financing Requirement	48.3
<i>Financed by</i>	
Gross Gilt Sales	48.0
Conventional	
short	15.0
medium	10.5
long	14.5
Index-linked	8.0
Changes in net short-term debt	0.3
Change in Treasury bill stock	0.1
Change in DMO net cash position*	0.2
Change in the Ways & Means Advance	0.0
Memo	
<i>End-year short-term debt levels</i>	
Treasury bill stock	19.4
DMO net cash position**	0.2
Ways & Means Advance	13.4

*excluding changes in the DMO deposit at the Bank of England

**including changes in the DMO deposit at the Bank of England

Treasury bill sales

The financing plans for 2004-05 assume that the outstanding stock of Treasury bills is increased by £0.1 billion. The planned stock of outstanding Treasury bills held outside central government is targeted to rise to £19.4 billion by end-March 2005.

Other short-term debt

The level of the Ways and Means Advance from the Bank of England planned for 31 March 2004 is £13.4 billion and is assumed to remain at this level for 2004-05.

The DMO will continue to maintain a working balance of £200 million at the Bank of England.

The DMO's net cash position, excluding its balance at the Bank of England, is expected to be £0.2 billion at end-March 2004, reflecting the revised forecast in the CGNCR, relative to that announced in PBR 2003, net of changes to NS&I's expected contribution and changes in the stock of Treasury Bills. This position will be reversed in 2004-05.

Quantity of gilt sales

The DMO, under instruction from HM Treasury and on behalf of HM Government, will aim to meet the remainder of the financing requirement by selling gilts to the private sector. On the basis of the CGNCR forecast, this means gross gilt sales of £48.0 billion (cash).

Nature of stocks

The Government will continue to have available the full range of financing instruments and market operations, including conversion offers and switch auctions to maintain large, liquid issues across the maturity spectrum.

Maturity structure of issuance

Net gilts issuance in 2004-05 will be £33.3 billion. The financing programme for 2004-05 assumes 15 outright auctions for conventional gilts, 5 for short maturities, 4 for medium maturities and 6 for long maturities. It should be noted that within the amount allocated to overall short maturity gilts issuance, it is expected that there will be a proportion of ultra-short maturity gilts issuance. The precise split will be subject to consultation with the market over the course of the fiscal year.

The Government aims to issue £8.0 billion (cash) of index-linked gilts in 2004-05. This assumes 10 outright auctions and reflects the Government's continued commitment to the index-linked market against a background of sustained low inflation.

There are no plans to issue an index-linked gilt indexed to the Consumer Prices Index. Such a gilt would only be issued if market consultation indicated that there was demand for this type of security.

DMO cash collateral

As described in the DMO's Cash Management Remit (see pages 45-47), over the course of 2004-05, HM Treasury may issue gilts or Treasury bills to the DMO for collateral purposes in order to aid the DMO in the efficient execution of its cash market operations. Any such issuance will be wholly transparent and fully reported to the market. It will be designed in such a way as to minimise the effect on key market indices.

Contingencies

Rising (falling) financing requirements will be met by increasing (reducing) planned gilt sales broadly in proportion to the splits planned in the Remit. Planned sales of Treasury bills may also be revised. Specific decisions will be taken subject to considerations about debt portfolio objectives and evolving market conditions.

Table 8: Stocks maturing in 2004-05

Redemption date	Stock	Nominal amount outstanding (£ million)	Official holdings (end-Feb 2004)	Nominal value of stocks outside central govt. (end-Feb 2004)
18 May 2004	10% Treasury 2004	20	6	14
7 June 2004	5% Treasury 2004	7,504	461	7,043
21 October 2004	4 ³ / ₈ % Index-linked Treasury 2004*	1,338	38	1,369
25 October 2004	9 ¹ / ₂ % Conversion 2004	307	158	149
26 November 2004	6 ³ / ₄ % Treasury 2004	6,597	477	6,120
TOTAL		15,766	1,140	14,695

* Redemption amount includes accrued inflation uplift of £0.1 bn

Note: Numbers may not sum due to rounding

Source: DMO

THE DEBT MANAGEMENT OFFICE REMIT FOR 2004-05

A) GILT REMIT

Objectives

I The UK Debt Management Office (DMO), an Executive Agency of HM Treasury, has been given the following objectives in respect of Government debt management:

- to meet the annual remit set by HM Treasury Ministers for the sale of gilts, with due regard to long-term cost minimisation taking account of risk;
- to advise Ministers on setting the remit to meet the Government's debt management objectives and to report to Ministers on the DMO's performance against its remit, objectives and targets;
- to develop policy on and promote advances in new instruments, issuance techniques and structural changes to the debt markets that will help to lower the cost of debt financing, liaising as appropriate with the Bank of England, Financial Services Authority, London Stock Exchange, and other bodies and to provide policy advice to HM Treasury Ministers and senior officials accordingly;
- to conduct its market operations, liaising as necessary with regulatory and other bodies, with a view to maintaining orderly and efficient markets and promoting a liquid market for gilts;
- to provide, including in liaison with the Bank of England and CRESTCo, a high quality efficient service to investors in government debt, and to deal fairly and professionally with market participants in the gilt and money markets, consistent with achieving low cost issuance;
- to contribute to HM Treasury's work on the development of the medium-term strategy for the debt portfolio; and
- to make information publicly available on the debt markets and DMO policies where that contributes through openness and predictability to efficient markets and lower costs of debt issuance.

Quantity of gilt sales

- 2** The DMO, on behalf of the Government, will aim for gilt sales of £48.0 billion in 2004-05.
- 3** The expected timing of gilt sales is set out in the auction calendar below.

Table 9: Gilt Auction Calendar 2004-05

Date	Type
22 April 2004	Conventional
28 April 2004	Index-linked
20 May 2004	Index-linked
25 May 2004	Conventional
27 May 2004	Conventional
17 June 2004	Conventional
24 June 2004	Index-linked
15 July 2004	Conventional
22 July 2004	Conventional
28 July 2004	Index-linked
12 August 2004	Conventional
16 September 2004	Conventional
28 September 2004	Index-linked
14 October 2004	Conventional
26 October 2004*	Index-linked
28 October 2004*	Conventional
18 November 2004*	Conventional
24 November 2004*	Index-linked
1 December 2004*	Conventional
12 January 2005	Index-linked
27 January 2005	Conventional
2 February 2005	Index-linked
24 February 2005*	Conventional
2 March 2005*	Index-linked
24 March 2005*	Conventional

**Subject to confirmation following the Chancellor's decisions on the Budgetary timetable.*

Amount and maturity mix of index-linked gilts issuance

- 4** Over 2004-05, the DMO aims to sell £8.0 billion (cash) in index-linked stocks.
- 5** 10 auctions of index-linked stocks are planned in 2004-05. Issuance will be directed at stocks dated 2011 and longer.
- 6** To ensure the medium-term viability of the index-linked auction programme, the authorities remain committed to a minimum supply of £2.5 billion (cash) of index-linked stocks for the foreseeable future.

Amount and maturity mix of conventional gilts issuance

7 15 auctions of conventional stocks are planned in 2004-05; 6 in the long (15 years and over) maturity area, 4 in the medium (7-15 years) and 5 in the short (1-7 years) maturity area.

Contingencies

8 Any change in the financing requirements will be met by increasing (reducing) planned gilt sales broadly in proportion to the splits planned in the Remit. Planned sales of Treasury bills may also be revised. Specific decisions will be taken subject to considerations about debt portfolio objectives and evolving market conditions.

Buy-backs of debt

9 The DMO has no plans for a programme of reverse auctions in 2004-05.

Method of issuance of gilts

10 Auctions will constitute the primary means of issuance of all gilts (conventional and index-linked). The DMO plans to hold 15 auctions of conventional gilts and 10 auctions of index-linked gilts. All auctions will be single auctions held on the day indicated.

11 Each outright auction of conventional gilts is planned to be for between £1.5 billion and £4.0 billion (cash) of stock on a competitive bid-price basis. Each auction of index-linked gilts will be for between £500 million and £1.25 billion (cash) on a uniform price basis.

12 The programme of conventional and index-linked gilt auctions may be supplemented between auctions by official sales of stock by the DMO "on tap". Taps of stocks will be used only as a market management instrument in conditions of temporary excess demand in a particular stock or sector. The DMO would only contemplate taps of stocks in exceptional circumstances.

13 After an auction, the DMO will generally refrain from issuing stocks of a similar type or maturity to the auctioned stock for a reasonable period. Such stock will only be issued if there is a clear market management case.

14 For the purposes of market management, the DMO may create and repo out stock in accordance with the provisions of its Standing Repo Facility launched on 1 June 2000.

In-year consultation and announcements on auctions

15 Towards the end of each calendar quarter, the DMO will publish, with the agenda for the consultation meetings with gilt market participants, details of progress to date with the gilt issuance programme, including any changes to the Government's financing requirement and any changes to the gilts auction programme. The DMO will then consult Gilt-edged Market-Makers and representatives of major End-Investors on the auction programme for the following quarter and any other issues that may arise. Following that consultation, at the end of the quarter, the DMO will announce plans for the auctions scheduled for the coming quarter. For each auction, this will indicate the stock to be auctioned or, where relevant, the approximate maturity of a new stock.

16 The auction plan for the first quarter of the financial year will be announced at 3:30pm on 31 March 2004.

17 Full details of these, and subsequent auctions, will generally be announced at 3:30p.m. on the Tuesday of the week preceding the auction.

Coupons

18 As far as possible, coupons on new issues of gilts will be set to price the stock close to par at the time of issue.

Buy-ins of short maturity debt

19 The DMO will have responsibility for buying-in stocks close to maturity to manage Exchequer cash flows.

Conversions and switch auctions

20 In order to build up the pool of benchmark stocks further, the DMO may make offers for the conversion of non-strippable stocks into benchmarks of similar maturity during 2004-05. The DMO may consider converting out of stocks with up to £5.5 billion (nominal) in issue. Such offers may be supplemented by switch auctions into benchmark stocks during 2004-05. The DMO may consider using switch auctions to help smooth the redemption profile or to help smooth the market impact of large changes in relevant gilt indices. Details of any future switch auction stocks will be announced at the same time as the end-quarter announcements of forthcoming outright auctions.

Reviews to the remit

21 The remit, and in particular the number of auctions and the allocation between conventional maturity bands and index-linked, may be varied during the year in the light of substantial changes in the following:

- the Government's forecast of the gilt sales requirement;
- the level and shape of the gilt yield curve;
- market expectations of future interest and inflation rates; and
- market volatility.

22 Any revisions to this remit will be announced.

B) EXCHEQUER CASH MANAGEMENT REMIT

Objective

1 The DMO's primary objective in carrying out its Exchequer cash management operations will be:

“to offset, through its market operations, the expected cash flow into or out of the National Loans Funds. It aims to do so in a cost-effective manner, taking account of risk.”

The DMO aims to:

- manage cash flows without influencing the level of short-term interest rates;
- take account of the operational requirements of the Bank of England; and
- take account of its impact on the efficiency of the sterling money market.

2 The DMO will carry out its objective primarily by a combination of:

- weekly Treasury bill tenders;
- bilateral market operations with DMO counterparties; and
- ad hoc tenders of Treasury bills (and repo or reverse repo transactions).

3 The DMO and the Bank of England will work together to avoid clashes in the delivery of their respective objectives in the money markets. The DMO will not take speculative positions on interest rate decisions by the Bank nor hold operations that by their nature or timing in the day could be perceived to clash with the Bank's open market operations.

Treasury bill tenders

4 The DMO will hold Treasury bill tenders on the last business day of each week. When announcing the results, the DMO will also announce the quantity and maturity of Treasury bills on offer in the tender in the following week and may give the maturity and indicative size of any ad hoc tenders in the following week.

5 Following the final tender at the end of each quarter, the DMO will issue a notice outlining the maturities of Treasury bills likely to be available via structured tenders over the following quarter.

Maturities

6 The DMO's Treasury bill tenders in 2004-05 may be of the following maturities:

- one month (approximately 28 days);
- three months (approximately 91 days);
- six months (approximately 182 days); and
- twelve months (approximately 364 days).

Level of stocks

7 The DMO will manage Treasury bill transactions with a view to running down the stock of bills in months of positive cash flows and increasing it in months of higher net expenditure.

Interaction with the Bank of England's money market operations

8 The DMO may also issue Treasury bills to the market to assist the Bank of England in its management of the sterling money markets. In response to a request from the Bank, the DMO will 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 structured bill tender announcement. Treasury bill issues at the request of the Bank will be identical in most respects with the rest of the stock of Treasury bills outstanding.

Ad hoc tenders

9 The DMO may also issue short maturity Treasury bills (up to 28 days) at ad hoc tenders. The objective of such tenders will be to provide additional flexibility for the DMO in smoothing Exchequer cash flows. Treasury bills issued in ad hoc tenders will be identical in every respect with those issued by weekly tenders.

10 In addition to issuing Treasury bills, the DMO may also execute repo or reverse repo transactions at ad hoc tenders. For such transactions, collateral used would either be gilts or Treasury bills.

11 The DMO may also hold ad hoc tenders for buying in gilts (or gilt strips) with a residual maturity of less than six months.

Timing of ad hoc tenders

12 The DMO will usually announce its intention to hold ad hoc tenders in the announcement of the weekly tender result. Such announcements will indicate the day(s) of the following week on which ad hoc tender(s) are expected to be held, together with a guide to the expected maturity and size.

13 The precise details of the maturity and nominal amount on offer will be announced at the opening of the offer on the morning of the tender (usually at either 8:30 a.m. or 10:00 a.m.).

Bilateral operations with the market

14 In pursuit of its cash management objectives, the DMO expects to trade on a daily basis with its counterparties across a range of instruments, including repo, reverse repo and unsecured borrowing and lending. The full range of instruments is set out in the DMO's Exchequer Cash Management Operational Notice.

15 The DMO would give prior notice to the market if it planned to introduce additional instruments for use in its bilateral operations.

16 Other than gilts and Treasury bills, collateral used in the repo and reverse repo transactions may include selected euro-denominated government securities, eligible bank bills and supranational sterling and euro-denominated securities. In carrying out these transactions, the DMO may make use of those of its own holdings of marketable gilts.

DMO cash collateral

17 If required, in exceptional circumstances, gilts or Treasury bills may be issued to the DMO for collateral purposes in order to aid the DMO in the efficient execution of its cash management operations.

BANK OF ENGLAND'S REMIT FOR THE MANAGEMENT OF THE OFFICIAL RESERVES 2004-05

Introduction

1 This remit sets out the objectives and strategy, which the Bank of England (“the Bank”) is to pursue in managing the Exchange Equalisation Account (EEA) as agent for Her Majesty’s Treasury (“HM Treasury”). The EEA is subject to the provisions of the Exchange Equalisation Account Act 1979, which sets out the purposes for which it is to be used. In addition, the Treasury has published a Service Delivery Agreement (SDA) objective under which it undertakes to minimise the cost of holding the Government’s foreign currency reserves, while reducing risk.

Objectives

2 In order to fulfil the functions laid down in the EEA Act 1979 and meet the published SDA objective, HM Treasury and the Bank have agreed that the Bank will:

- carry out in a legal and proper form foreign currency and gold transactions on behalf of HM Treasury and other Government Departments efficiently and cost-effectively;
- manage the official reserves so as to maintain their liquidity and security within limits agreed with HM Treasury and ensure that the published funds entrusted to the Bank in the EEA are properly and well managed and safeguarded;
- subject to the above paragraph, manage the official reserves so as to maximise their return within the agreed risk parameters;
- monitor and report on the level of risk and return on holding the reserves;
- ensure that effective management systems, including financial monitoring and control systems, are in place;
- ensure that proper financial procedures are followed and that accounting records are maintained in a form suited to the requirements of management as well as in the form prescribed for the published accounts;
- provide accurate and timely accounting and statistical information and analysis as requested by HM Treasury;
- advise HM Treasury on foreign exchange market conditions; and
- advise HM Treasury on the financing of the reserves, including as necessary the management of foreign currency borrowing (covering new borrowing, hedging and repayments) and implement agreed strategy in this area.

Composition of the Reserves and discretionary management

3 The reserves will be invested in a specified range of instruments and relative to currency and other benchmarks as agreed with HM Treasury, with limited scope to deviate from these constraints in order to enhance the return on the reserves.

Operational standards

4 In carrying out these tasks, the Bank will, so far as possible, ensure that its internal systems and controls are adequate for the size, nature and complexity of operations on the EEA and compare well with best market practice.

Monitoring and controlling risk

5 The Bank will continue to measure the exposure of the EEA portfolio to market risk in three main ways: using a Value at Risk (VaR) measure to aggregate risk consistently across the components of the portfolio; using sensitivity measures for a more detailed analysis of risk; and using stress tests that quantify the potential loss from plausible worst-case scenarios.

6 The Bank will continue to measure and manage the EEA's exposure to banks, securities houses and issuers using the existing credit system. This system, and the credit limits which it provides, will be kept under review in the light of market or institutional developments affecting the position of counterparties. The Bank will provide HM Treasury with a monthly report of limit excesses or management overrides, and a full statement of credit limits after each six-monthly meeting.

Audit arrangements

7 The Bank agrees to provide regular written reassurance to the EEA Accounting Officer that risks affecting the Bank's management of the EEA and the systems that generate the EEA's annual accounts are properly controlled; and that the Bank has complied with this remit. The Bank's internal audit arrangements will accord with the professional standards set by the Institute of Internal Auditors UK and Ireland and have regard to the objectives, standards and practices set out in HM Treasury's "Government Internal Audit Manual" and the guidance provided in the "Government Information Systems Audit Manual". Bank internal audit follows a risk-based programme of work, agreed with HM Treasury officials.

Accounting and NAO access

8 The Bank will maintain accounts for the EEA based on UK Generally Accepted Accounting Practice UK (GAAP UK) in accordance with the relevant Accounts Direction, and will prepare draft accounts for the EEA for 2003-04 by May 2004 for immediate submission to the National Audit Office.

9 For the purposes of the examination and certification of the EEA accounts, or for any examination pursuant to Section 6(1) of the National Audit Act 1983 concerning the economy, efficiency and effectiveness with which the Bank has managed the EEA, the Comptroller and Auditor General may require access to such documents, Bank buildings, and factual explanations as he considers necessary.

Review of reserves management

10 To enable HM Treasury to monitor the management of the reserves, the Bank will provide HM Treasury with accurate and timely accounting and statistical information. In particular, the following will be provided: a monthly management information report, which will be discussed at a monthly meeting chaired by the Debt and Reserves Management team leader, and a quarterly report on performance which should enable the Accounting Officer to check progress in meeting HM Treasury's SDA target on reserves management.

11 The Accounting Officer for the EEA, or delegated senior officials, will meet the Bank every six months in order to review strategy and to agree on analysis to be commissioned from the Bank.

12 Changes to this remit and meetings to discuss individual issues may be proposed by HM Treasury or by the Bank, and in such cases the Bank will provide relevant information as requested by HM Treasury.

Publications policy

13 Figures on the United Kingdom's net reserves and the Bank's net holdings of foreign currency and gold will be published in a Press Notice at 9:30 am on the third working day of every month. This will disclose the amounts, currencies and dates of any intervention operations undertaken during the period, with explanations as to why the intervention was undertaken. The format of this monthly Press Notice will be in line with the requirements of the IMF's Special Data Dissemination Standard and will be aligned with the conventions of the G10/IMF reserves template published simultaneously on the Bank of England's website.

Cash management

14 Subject to meeting its objectives under this remit, the Bank will as far as possible aim to manage the EEA so as to avoid conflict with the DMO's sterling cash management operations.

Intervention

15 Specific prior authority from Treasury Ministers is required for intervention designed to influence sterling's exchange rate using the EEA, or for EEA participation in concerted intervention in support of any other currency. The Bank will subsequently report on the extent to which any such authority was used, and to what effect, by letter.

NATIONAL SAVINGS AND INVESTMENTS' FINANCING REMIT 2004-05

Introduction

1 National Savings & Investments (NS&I) is an Executive Agency of the Chancellor of the Exchequer. It acts as an integral part of the UK's debt management arrangements, and its aim is to help reduce the cost to the taxpayer of Government borrowing now and in the future. To achieve this NS&I's strategic objective is to:

- provide retail funds for the Government that are cost-effective in relation to funds raised on the wholesale market.

2 Key business objectives for NS&I to deliver its strategic objective are:

- to improve the competitiveness of the overall offer to customers;
- to ensure levels of customer service which meet standards of best practice in the retail financial services sector; and
- to develop a more flexible and responsive business that can deliver a range of net financing requirements to the Treasury.

3 In pursuit of its cost-effectiveness strategy, NS&I will operate fairly, transparently and competitively, engendering customer loyalty and securing new business by offering attractive products on fair terms.

Responsibility for setting product terms

4 HM Treasury is ultimately responsible, under the National Loans Act 1968, for setting the terms of NS&I products.

5 NS&I will normally take the lead in bringing forward proposals to Treasury Ministers on product development (including proposals for new products) or on product terms (including interest rates). If the proposals are consistent with NS&I's objectives and this remit, Treasury Ministers would expect to endorse them.

Volume of financing in 2004-05

6 Sales and deposits (including accrued interest) of NS&I products are assumed to be around £12 billion in 2004-05. After meeting expected maturities and withdrawals, NS&I is expected to make a net contribution to Government financing of £2.0 billion.

Cost of financing

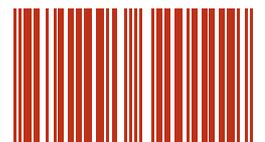
7 The average cost of NS&I products should lie within a reasonable range of the cost of equivalent gilts or other short-term comparators.

8 NS&I or HM Treasury can initiate a review of product terms at any time. NS&I will carry out each review. Any proposed changes will take account of the cost of NS&I's financing, the achievement of this remit and the need for NS&I to retain the capability and market presence to contribute to Government financing over the medium-term.

Review of remit

9 HM Treasury or NS&I may initiate a review of this remit during the course of 2004-05 in the light of any relevant factors.

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