Debt and reserves management report 2008-09

March 2008

HM TREASURY

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Foreword by the Exchequer Secretary to the Treasury

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

Gross gilt issuance in 2007-08 is projected to be £58.5 billion, a level broadly similar to that in the previous year. Net gilt issuance is projected to be £29.3 billion. A total of 34 auctions are planned in 2007-08. The structure of issuance and the gilt auction calendar reflect the Government's commitment to the principles of transparency and predictability, to delivering its debt management objective and a well-functioning gilt market as well as its aim to be responsive to investor demand and the market environment. It is a testimony to the efficiency of the UK Debt Management Office (DMO), the Gilt-edged Market Makers (GEMMs) and the gilt market in general that the gilt sales programme has been managed so effectively to date in challenging market circumstances.

A notable development in 2007-08 has been the change in the shape of the nominal yield curve. At the beginning of the year, the slope of the yield curve was negative as it had been for most of the decade. However, throughout 2007-08 the slope of the yield curve changed. The yield curve is currently 'hump shaped', that is, it is positively sloped between short and medium maturities and negatively sloped between medium and long maturities. By contrast, the slope of the real yield curve remains distinctly negatively sloped. The change in the slope of the yield curve during the year reflects a number of factors but is largely a reflection of developments at the short end of the curve in which yields on short-maturity gilts have fallen significantly. By contrast, yields on long-maturity gilts have fallen less dramatically.

Against this backdrop, there has been a clear skew towards long-dated conventional and index-linked gilts. Together, long-dated conventional and index-linked gilts are expected to account for 66 per cent of all gilt issuance in 2007-08.

Net gilt issuance in 2008-09 is projected to be £62.7 billion and gross gilt issuance is projected to be £80.0 billion. This includes the impact of the refinancing of the Bank of England's loan to Northern Rock by a loan from HM Treasury to Northern Rock. The net amount outstanding of that loan as at 31 March 2009 is projected to be £14 billion. It also includes the impact of the partial repayment in 2007-08 of £6 billion of the Ways and Means Advance from the Bank of England. The remit also takes into account further repayments of up to £7 billion of the remaining balance of the Ways and Means Advance during 2008-09. The structure of issuance and the planned gilt auction calendar reflect the Government's commitment to a well-functioning gilt market as well as its aim to be responsive to investor demand and the market environment.

Our annual consultation held in December 2007 with GEMMs and end-investors showed clear support for skewing gilt issuance toward short-maturity and long-maturity nominal gilts and continued high issuance of index-linked gilts. Underlying conditions in the gilt market support these preferences. The gilt issuance plans for 2008-09 announced today are underpinned by the medium-term approach to gilt issuance announced in Budget 2007 but are tempered by the changed market environment and the change in the shape of the nominal yield curve since Budget 2007. Issuance of long-maturity gilts will remain at the historically high levels of recent years, responding to ongoing strong structural demand at that end of the curve. We have also responded to greatly increased demand at the short end of the curve by increasing planned issuance of short-maturity gilts.

In the retail sector, National Savings & Investments (NS&I) is estimated to sell more than £16.7 billion of retail products, bringing its net financing contribution for 2007-08 to an estimated £5.6 billion. 2007-08 was the first year of NS&I's five year strategy "Adding Value" which aims to deliver sustainable long-term value to stakeholders by simplifying, modernising and diversifying the business. NS&I's overall cost of financing was estimated at £353 million lower than that of comparable gilts, taking into account management costs and imputed tax foregone. Gross sales (including reinvestments and gross accrued interest) of NS&I products are assumed to be around £15.3 billion in 2008-09. After meeting expected maturities and withdrawals, NS&I is expected to make a net contribution to Government financing of £4.0 billion in 2008-09.

ANGELA EAGLE

Exchequer Secretary

1 INTRODUCTION

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

1.2 The Debt and reserves management report (DRMR) is published in compliance with the *Code for Fiscal Stability*[1] which requires that a debt management report be published every year covering the following areas:

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

1.3 The Debt Management Office (DMO) publishes detailed information in its Annual Reviews on developments in debt management and the gilt market over the previous year. To avoid duplication, only a summary of developments in the gilt market during 2007-08 (up to January 2008) is set out in Annex A of this report.

[1] The 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

2 Size and structure of UK Government debt in 2007-08

Debt stock

2.1 The total nominal outstanding stock of United Kingdom central government marketable sterling debt (including official holdings by central government) was £575.7 billion at end-December 2007. This debt comprised £337.9 billion of conventional gilts, £136.0 billion of index-linked gilts (including accrued inflation uplift) and £18.0 billion of Treasury bills (see Table 2.1). In addition, there was £83.8 billion invested in NS&I's (non-marketable) instruments.

Table 2.1: Composition of UK Central Government marketable sterling debt

	End-March 2007	End-December 2007
(£ billion, nominal value including official holdings)		
Conventional gilts[1]	322.2	337.9
Index-linked gilts[2]	120.7	136.0
Treasury bills[3]	15.6	18.0
Total gilts and Treasury bills	**458.5**	**491.9**
National Savings & Investments	78.9	83.8
Total central government sterling debt	**537.4**	**575.7**

1. Includes undated gilts

2. Includes accrued inflation uplift

3. Treasury bill stock in market hands

Source: Debt Management Office/National Savings & Investments

Maturity and duration

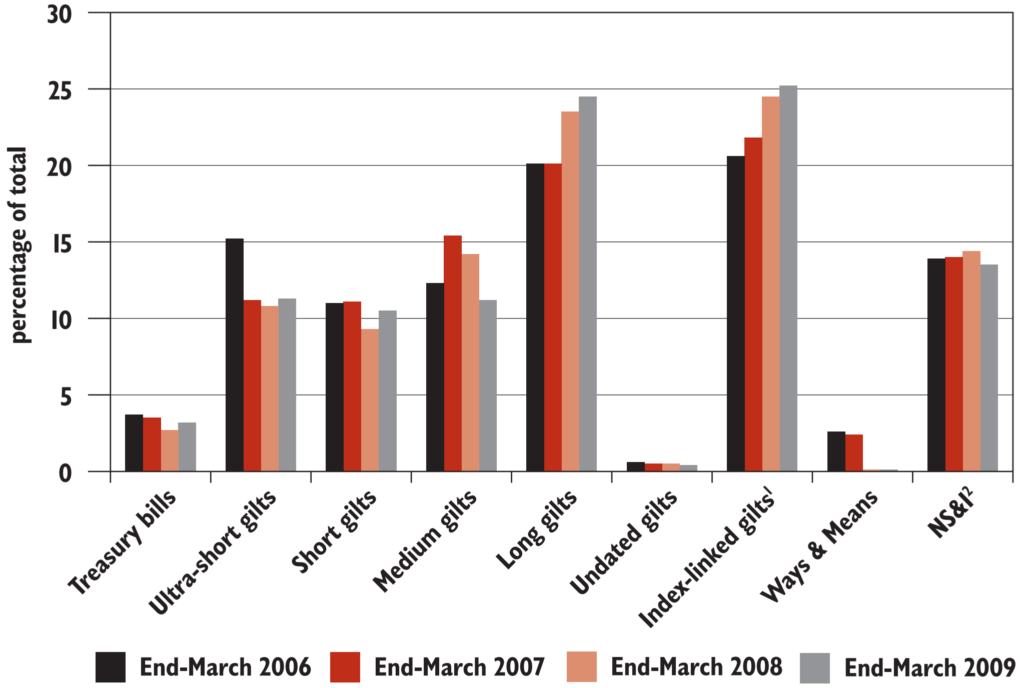
2.2 The average maturity of the stock of all dated marketable gilts increased from 14.2 years to 14.5 years between end-March 2007 and end-December 2007. Over the same period, the modified duration[2] of the conventional portfolio of marketable gilts increased from 8.5 years to 8.8 years. The maturity and duration of the UK Government's marketable domestic debt continues to be amongst the longest in the OECD[3].

2.3 Chart 2.1 shows a comparison of the Government's debt portfolio at end-March 2006 through to a projected composition at end-March 2009. It assumes that new debt is issued in accordance with the DMO's and NS&I's financing remits. It also takes into account the ageing of existing debt.

[2] Modified duration is defined in Box 11.1.

[3] According to the OECD Yearbook 2007, comparable portfolio maturities were: France 7.1 years, Italy 6.6 years, Germany 6.3 years, Japan 5.1 years and USA 4.6 years.

Chart 2.1: The composition of UK central government sterling debt



Source: Debt Management Office/National Savings & Investments

[1] Includes inflation uplift
[2] Includes accrued interest

Interest payments

2.4 Gross central government debt interest payments in 2006-07 were £27.6 billion, equivalent to 5.0 per cent of total managed expenditure (TME). In 2007-08 and 2008-09, they are forecast to be £29.9 billion (5.1 per cent of TME) and £30.3 billion (4.9 per cent of TME) respectively.

Gilt issuance and the gilt market

2.5 The DMO was established as part of the Government's reforms to the macroeconomic framework announced in 1997. The DMO took over responsibility for the issuance of gilts from the Bank of England in April 1998. Gross gilt issuance in 2007-08 is expected to be £58.5 billion, around £4 billion less than in 2006-07[4].

2.6 The central government net cash requirement (CGNCR) measures the cash amount that central government needs to borrow for the financial year and is the key fiscal measure from which the volume of gilt issuance is derived. The CGNCR for each of the years in which the DMO has been responsible for gilt issuance and the volume of gilt sales in each of those years is shown in Table 2.2.

[4] Figures are in cash terms unless otherwise stated.

Table 2.2: Central government net cash requirement and gross gilt sales 1998-99 to 2007-08

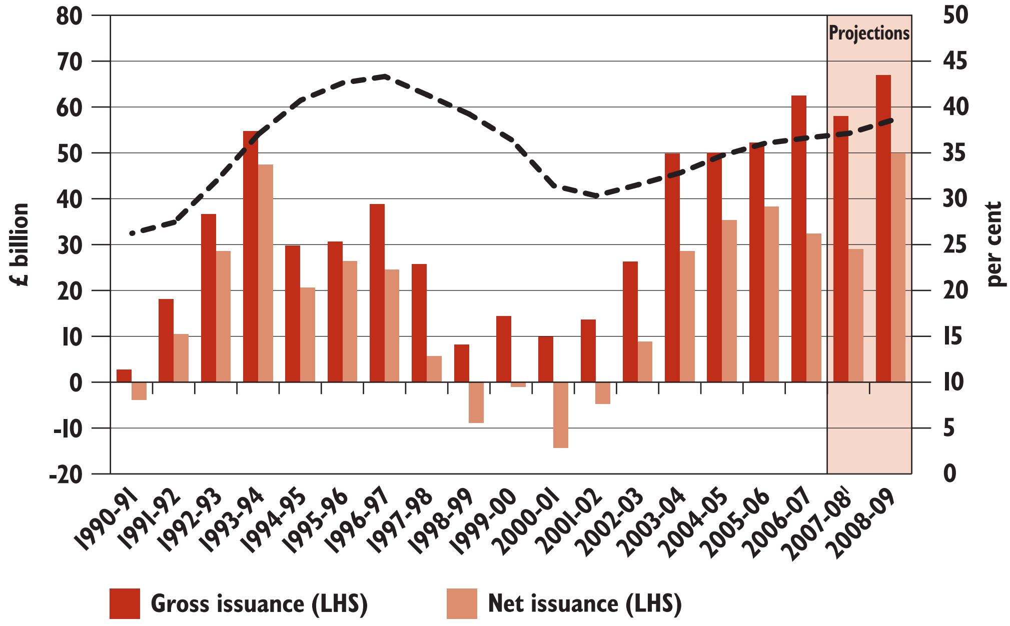
Financial year	CGNCR (£ billion)	Gross gilt sales (£ billion)
1998-99	–4.5	8.2
1999-00	–9.1	14.4
2000-01[1]	–35.6	10.0
2001-02	2.8	13.7
2002-03	21.8	26.3
2003-04	39.4	49.9
2004-05	38.5	50.1
2005-06	40.8	52.3
2006-07	37.1	62.5
2007-08[2]	37.7	58.5

1. Reflecting the proceeds from the 3G Spectrum auction
2. CGNCR forecast at Budget 2008

Source: HM Treasury/Debt Management Office

2.7 In the first years of the DMO's operations, the size of the gilt market shrank as net issuance was negative (i.e. gross issuance was exceeded by gilt redemptions). However, net issuance turned positive in 2002-03 as the financing requirement began to rise. Net issuance is expected to be £29.3 billion in 2007-08 and £62.7 billion in 2008-09. Chart 2.2 shows the trend in gross and net issuance since 1990-91 with projections to 2008-09.

Chart 2.2: Gross and net gilt issuance 1990-91 to 2008-09

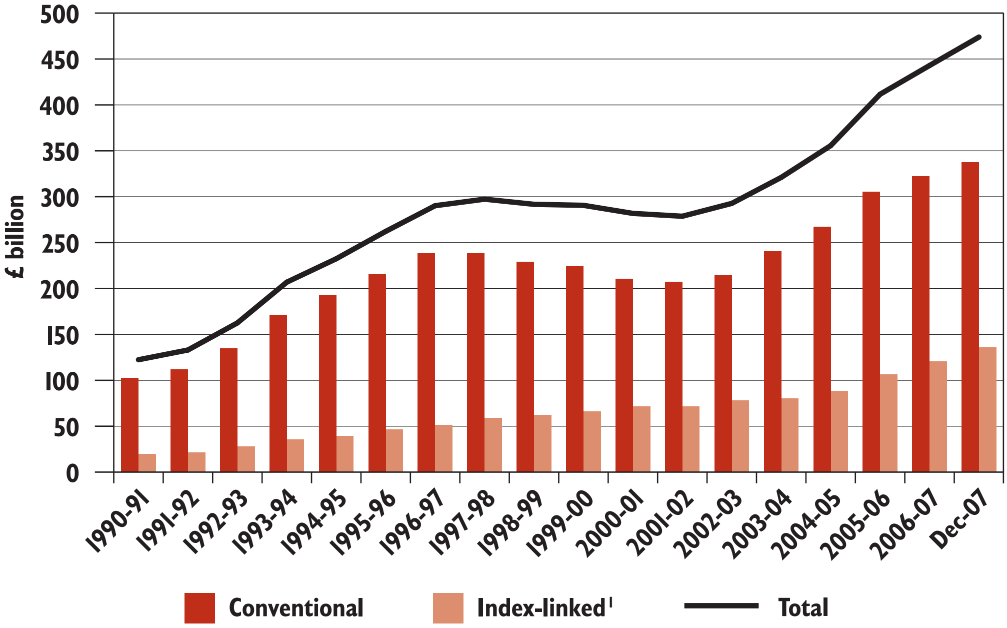


Source: HM Treasury/Debt Management Office

[1] Gross and net gilt issuance are outturns up to and including 2006-07
[2] Net debt/GDP ratio is an estimate

2.8 The size of the gilt market reflects these trends: in March 2002 the nominal value of the gilt market (including accrued inflation uplift) was £278.8 billion but by end-December 2007 it had reached £473.9 billion (nominal) – an increase of 70 per cent. Chart 2.3 shows the change in the size of the gilt market since 1990-91.

Chart 2.3: Size of the gilt market since 1990-91

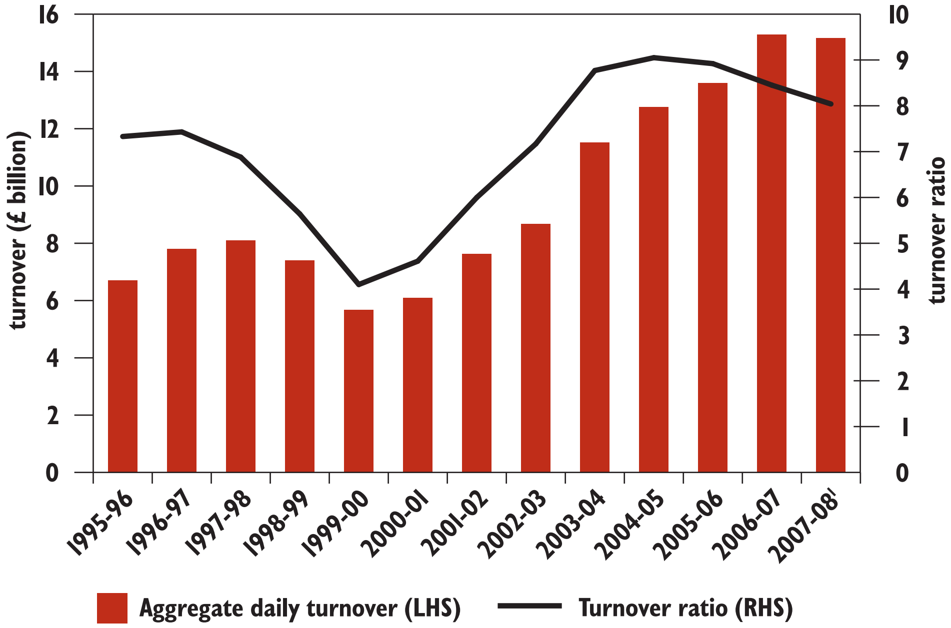


Source: Debt Management Office
[1] Includes indexation uplift

2.9 Turnover[5] in the gilt market rose steadily from 1999-00 to 2006-07. Average daily turnover increased by 168 per cent between 1999-00 and 2006-07 (from £5.7 billion to £15.3 billion). In 2007-08 to date[6] this trend has abated somewhat, with aggregate daily turnover falling marginally to £15.2 billion, perhaps reflecting the ongoing disruption in the financial markets since summer 2007. Trading intensity, as measured by the turnover ratio, increased sharply from 4.1 in 1999-00 to 9.0 in 2004-05. It has fallen back slightly so far in 2007-08 (to 8.0) largely as a result of the marked increase in the size of the underlying portfolio. Chart 2.4 shows these trends.

[5] Turnover is a measure of the level of trading activity in the secondary market. The turnover ratio is aggregate turnover relative to the market value of the portfolio at the start of the year.
[6] Data to end-January 2008.

Chart 2.4: Gilt market turnover



Source: Debt Management Office

[1] *Financial year to end-January 2008*

3 UK Government's debt management policy

Objectives of debt management

3.1 The Government's debt management objective is:

"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".

3.2 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, 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;
- developing a liquid and efficient gilt market; and
- offering cost-effective savings instruments to the retail sector through National Savings & Investments.

3.3 HM Treasury has overall responsibility for meeting the debt management policy objective but has delegated operational responsibility for debt management to its agents: the DMO undertakes borrowing in sterling through issuance of government bonds and short-term debt instruments in the wholesale market; NS&I undertakes retail borrowing through sales of retail savings products; and the Bank of England undertakes borrowing in foreign currencies through issuance of foreign currency denominated government bonds.

The role of the Debt Management Office

3.4 HM Treasury has two overarching requirements for the DMO in the conduct of its delegated responsibility for wholesale debt financing operations, namely, that it:

- raises the quantum of financing set out in its annual financing remit. This means that the DMO is expected to achieve the sale of inflation-linked ("index-linked") and nominal ("conventional") gilts and Treasury bills within the operational tolerances specified in the financing and Exchequer cash management remits respectively (see Chapters 4, 5 and 6); and
- conducts its operations in accordance with the principles of openness, predictability and transparency, which underpin the Government's approach to debt management policy more generally. The Government judges that by conducting its operations in accordance with these principles, the DMO will effectively contribute to achieving long-term cost minimisation subject to risk.

3.5 In practice, this means that HM Treasury expects the DMO to:

- *adopt a predictable approach to debt issuance*, which includes publishing an annual gilt auction calendar before the beginning of each financial year and holding auctions in accordance with its remit;
- *pre-announce the details of its debt issuance plans* to the market to ensure transparency about its activities; and
- *act in a manner consistent with its remit* and explain the basis for its decisions about gilt issuance as fully as possible to the market in order to allow market participants better to understand the rationale behind the DMO's decisions.

3.6 In addition, HM Treasury expects the DMO to:

- *provide advice* in its capacity as the Government's official presence in the gilt market on: (i) the appropriate structure and contents for the financing remit in preparation for publication of the remit each year alongside the Budget; and (ii) how to accommodate revisions to the remit during the course of the year;
- *report during the financial year on progress against the remit*, in particular, progress of gilt sales against the remit targets;
- *monitor developments in the gilt market and the wider economy* and report in a timely manner on changing conditions that might require the terms of the remit to be revisited;
- *maintain open channels of communication with market participants* both formally and informally to solicit their views on gilt issuance and other issues affecting the remit and, as far as possible, to explain the rationale for decisions;
- *advise on any operation to manage the maturity and nature of the Government's debt portfolio and conduct any such operation if so directed by HM Treasury*, through gilt issuance decisions and through use of other market management techniques;
- *develop a liquid and efficient gilt market* primarily through regular issuance of benchmark gilts;
- *provide advice on the introduction of any new financing instrument or debt management technique* as deemed appropriate to fulfil the Government's debt management objective; and
- *ensure the continuing and efficient functioning of the gilt market* by undertaking market management operations as necessary.

3.7 This approach to debt management policy, based on principles of openness, predictability and transparency, is recognised internationally as the most effective way to minimise the long-term costs of debt management, although there is no recognised way to measure quantitatively whether long-term costs are minimised through this approach[7]. In order to demonstrate that the DMO is taking decisions aimed at fulfilling the objective of long-term cost minimisation subject to risk, HM Treasury expects the DMO to explain publicly, in its Annual Review, the key factors that motivated its decisions on implementation of the remit during the course of the previous financial year. Quantitative reporting of aspects of the DMO's performance is also undertaken against a range of measures and indicators wherever that is possible. A number of these measures are set out in the DMO's annual published Business Plan[8].

Maturity and composition of debt issuance

3.8 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.

Medium-term approach to debt issuance

3.9 In the medium term, consistent with the debt management policy objective of minimising long-term costs taking into account risk, the Government's annual decisions about gilt issuance will continue to be informed by a number of factors including: the size of the annual financing requirement; supply-side considerations including the Government's risk preferences; investors' demand for gilts; the shape of the yield curve; and other financial market conditions. It is likely that strong demand for long-dated conventional and index-linked gilts will persist in the medium term and continue to influence the shape of the yield curve. Should that be the case, the Government's policy of skewing issuance towards long maturities would continue.

3.10 In conjunction with sound judgement, formal modelling continues to play a key role in providing analytical support for the formulation of the medium-term debt management strategy. The Strategic Debt Analysis model is a debt strategy simulation model used by the DMO to illustrate the debt service cost and risk of different debt issuance strategies, given assumptions about the shape of both the nominal and real yield curves. The model is not used to determine a single optimal debt issuance strategy but to illustrate the cost and risk trade-off of different issuance strategies. Simulations using this model are set out in Annex B.

3.11 It should be noted that the simulation modelling presented in Annex B is intended to convey the impact that the different issuance strategies could have on the debt service cost and risk of the Government's debt portfolio. It is based on a number of strong assumptions, including those for the nominal and real yield curves. The model has not been used to determine a particular debt issuance strategy, but to illustrate the impact of different issuance strategies.

[7] The key ways in which the Debt Management Office seeks to achieve transparency and predictability in its operations are outlined in Box 3.1, Debt and reserves management report 2007-08.

[8] The Business Plan is available on the DMO's website at: http://www.dmo.gov.uk/documentview.aspx?docname=publications/corpgovernance/busplan2007

3.12 The considerations underpinning the 2007-08 remit are set out in Box 3.1.

Box 3.1: Considerations underpinning the 2007-08 financing remit

In 2007-08 the DMO is projected to issue £10.1 billion (17 per cent of total issuance) and £10 billion (17 per cent) of short and medium conventional gilts respectively, along with £23.4 billion (40 per cent) and £15.0 billion (26 per cent) in long-conventional and index-linked gilts respectively in a total planned gilt issuance programme of £58.5 billion.

A key consideration underpinning the 2007-08 remit was the continued inversion of both the nominal and real yield curves at the time that the remit was set. The Government could achieve long-term cost savings by skewing issuance towards long-maturity gilts. HM Treasury and the Debt Management Office had also continued to receive representations from Gilt-edged Market Makers (GEMMs) and end-investors that there was strong underlying demand for both long-maturity conventional and index-linked gilts, particularly demand from pension funds seeking assets to match their liabilities. In the context of a historically large quantum of planned gilt issuance (projected at Budget 2007 to be £58.4 billion), and the need to maintain a well-functioning and liquid gilt market across the maturity spectrum, the Government decided also to continue issuance at key short and medium-maturity benchmark gilts to ensure sufficient liquidity across the whole yield curve.

3.13 Table 3.1 shows gilt issuance by maturity since 2002-03.

Table 3.1: Gilt issuance by maturity 2002-03 to 2007-08[1]

	Financial year					
	2002-03	**2003-04**	**2004-05**	**2005-06**	**2006-07**	**2007-08**
£ billion						
Conventional gilts:						
Short maturity	8.4	18.8	17.6	12.2	10.1	10.1
Medium maturity	5.6	13.1	10.1	11.4	9.9	10.0
Long maturity	7.7	11.4	14.5	17.9	25.2	23.4
Index-linked gilts	4.6	6.5	8.0	10.8	17.2	15.0
Total	**26.3**	**49.8**	**50.2**	**52.3**	**62.5**	**58.5**

1. Totals may not add due to rounding

Source: Debt Management Office

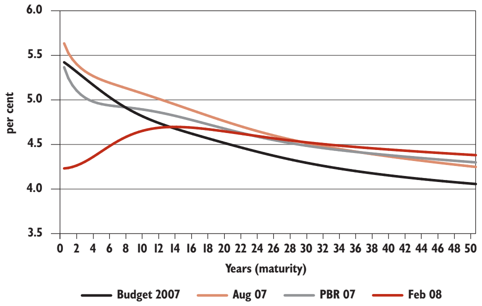
3.14 An assessment of the demand for short and long-maturity gilts in 2007-08 and the possible impact on the yield curve of that demand is set out in Box 3.2.

Box 3.2: Demand at the short and long ends of the nominal yield curve

Developments in the demand for long-conventional and index-linked gilts were assessed in Box 3.2 of the Debt and reserves management report 2007-08. This included the view that a significant determinant of demand for long-conventional and index-linked gilts was demand from defined benefit pension funds seeking assets to match their liabilities. The strength and depth of this demand was assessed as exerting downward pressure at the long maturity sectors of both the nominal and real yield curves. Partly as a result, strong demand from pension funds was assessed as a determinant of the then negative slope of the yield curve. Moreover, the strength of this demand resulted in the yield curve in the UK having a distinctive negative slope when compared to sovereign yield curves in the United States, the Euro-area and Japan where the slope of the yield curve has been predominantly positive or flat.

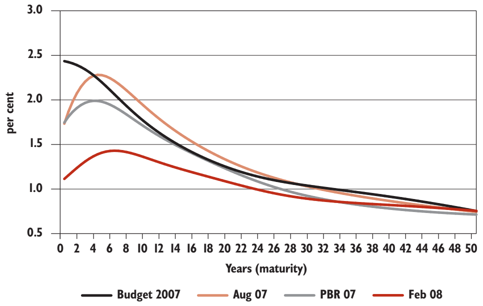
Since Budget 2007, the slope of the nominal yield curve has changed. As shown in Chart A, the nominal yield curve is currently hump shaped, that is, it is positively sloped between short and medium maturities and negatively sloped between medium and long maturities. By contrast, as shown in Chart B, the real yield curve retains its distinct negative slope.

Chart A: Nominal yield curve



Source: Debt Management Office

Chart B: Real yield curve



Source: Debt Management Office

Despite the change in the slope of the yield curve in 2007-08, the Government does not believe that there has been a fundamental change in the demand for long-dated conventional and index-linked gilts which remains strong, sustained and is likely to continue in the medium term. In part, this belief reflects the fact that there does not appear to have been any significant observed changes to pension funds' strategies in 2007 in relation to liability driven investment in these instruments. Despite aggregate pension fund deficits having closed, to an extent (for example, according to three measures in the 2007 Purple Book[1], funding improved between March 2006 and 2007 from +£0.2 billion to +£53.0 billion (S179 basis), –£127 billion to –£86 billion (FRS17 basis) and –£419 billion to –£401 billion (buy out basis)), an aggregate deficit remains on the FRS17 and buy out bases. Gilt market participants have informed the Government of their continued strong demand for long-maturity and index-linked gilts, including at the Annual Consultation meetings held in December 2007. Moreover, long-maturity gilt yields have not moved significantly relative to movements in short-maturity gilt yields since Budget 2007.

At the short end of the yield curve, yields have fallen significantly since Budget 2007; 5-year yields fell 87 basis points from end-March 2007 to end-January 2008. Yields at the short end of the spot yield curve can be expected to be affected by macroeconomic factors such as the position of the economy in its cycle and monetary policy. However, as shown in Chart C, short-term forward yields have also fallen significantly since Budget 2007, indicating that the demand for short-maturity gilts relative to supply of those gilts has shifted significantly and/or interest rate expectations have changed.

[1] The Purple Book, DB Pensions Universe Risk Profile, Pension Protection Fund and The Pensions Regulator, 2007.

Box 3.2 Demand at the long- and short-ends of the yield curve *(continued)*

Chart C: Nominal forward curve

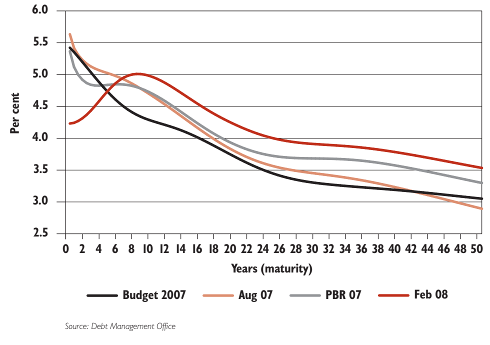
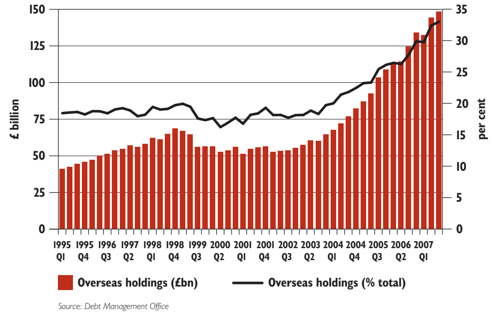


Chart D: Overseas holdings of gilts



The demand for short-maturity gilts is likely to have increased relative to supply as a result of:

- rising purchases of gilts by overseas investors, attributed, in particular, by market participants to purchases of short-dated gilts by central banks, reserve managers, sovereign wealth funds and hedge funds. By end-September 2007 overseas investors held £148 billion, or 33 per cent of outstanding supply, up from £77 billion (22 per cent) at end-September 2004[2]. These trends are shown in Chart D;
- the coincidence of the above with a period of cumulative flat net supply at the short-end of the curve. This reflects a combination of the net impact of gross issuance and redemptions at the short end of the yield curve, as well as the number of longer maturity bonds in issue that are due to mature in the next few years. As a consequence of these factors in 2007-08, the net supply of short-maturity gilts was strongly negative; and
- a 'flight to quality' to short-maturity gilts as demand for high quality collateral increased. The 'flight to quality' has been evidenced by the 'spikes' in premia paid for 'special' short maturity gilts in the repo market and the increased spread between short-maturity gilt yields and swaps of equivalent maturity. The 'flight to quality' is a reflection of a change in risk appetite amongst investors following the ongoing disruption in the financial markets. The impact of this disruption can be seen in the increased spread between LIBOR and general collateral (GC) and 3 month Overnight Index Swap (OIS) rates and the increased 5-year swap spread, as shown in Charts E and F, since August 2007.

Chart E: LIBOR 3-month – OIS 3-month spread

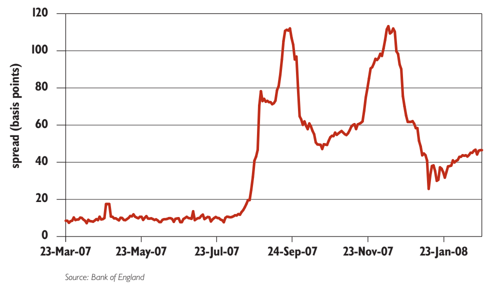


Chart F: 5-year swap spread

It is evident, therefore, that significant demand for gilts exists at both ends of the yield curve. The Government has taken account of this demand in setting the remit for 2008-09.

[2] Source: Office for National Statistics.

4 UK GOVERNMENT'S FINANCING PROGRAMME FOR 2008-09

Financing framework

4.1 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. Auctions remain the preferred means of issuance for all gilts. In addition, the Government may hold conversion offers, switch auctions, reverse auctions of non-benchmark gilts and syndicated offerings of gilts (although there are no current plans to hold such operations in 2008-09).

Financing arithmetic

4.2 The new forecast for the CGNCR in 2008-09 is £59.3 billion, an increase of £21.3 billion from the forecast in the Pre-Budget Report (PBR) 2007. The 2008-09 forecast includes the impact of the refinancing of the Bank of England's loan to Northern Rock by a loan from HM Treasury to Northern Rock. The net amount outstanding of that loan as at 31 March 2009 is projected to be £14 billion but this amount is subject to revision and will be updated at the 2008 PBR.

4.3 The forecast net financing requirement of £78.8 billion reflects expected gilt redemptions of £17.3 billion and the decision to refinance, in sterling, the $US3 billion bond due to mature on 8 July 2008. NS&I's net contribution to financing (including accrued interest) in 2008-09 is forecast to be £4.0 billion. This assumes gross sales (i.e. sales and deposits including accrued interest) of £15.3 billion. This forecast is not a target but an estimate based on experience in previous years, trends in the retail savings product market during 2007-08 and NS&I's own forecasts and objectives.

4.4 In addition, the net financing requirement in 2008-09 includes the impact of the partial repayment in 2007-08 of £6 billion of the Ways and Means Advance from the Bank of England. The Government's decision to repay up to £7 billion of the Ways and Means Advance from the Bank of England is not reflected in the net financing requirement in 2008-09 but is included as a planned change in the short-term debt level (see Box 4.1).

4.5 The financing requirement will be met by gross gilt issuance of £80.0 billion and an increase in the Treasury bill stock of £5.8 billion. The additional sum raised in excess of the net financing requirement is to meet further repayments of the Ways and Means Advance in 2008-09.

4.6 Table 4.1 gives details of the financing arithmetic for 2008-09. It shows the proposed debt instruments that the Government intends to use to meet its financing requirement in 2008-09.

Table 4.1: Financing arithmetic 2008-09

			£ billion
Central Government Net Cash Requirement			**59.3**
Gilt redemptions[1]			17.3
Financing for the Official Reserves[2]			2.0
Buy-backs[3]			0.0
Planned short-term financing adjustment[4]			4.2
Gross financing requirement			**82.8**
less:			
National Savings & Investments			4.0
Net financing requirement			**78.8**
Financed by:			
1. Debt Issuance by the Debt Management Office			
a) Treasury bills			**5.8**
b) Gilt			**80.0**
of which:			
	Conventional	short	25.0
		medium	12.8
		long	24.2
	Index-linked		18.0
2. Other planned changes in short-term debt[5]			
Change in Ways & Means[6]			–7.0
3. Unanticipated changes in net short-term cash position[7]			**0.0**
Total financing			**78.8**
Short-term debt levels at end of financial year			
Treasury bill stock[8]			22.0
Ways & Means			0.4
DMO net cash position			0.5

Figures may not sum due to rounding

1. The total assumes that the 5½% 2008-12 conventional gilt will be redeemed in September 2008.

2. The total includes the sterling refinancing of the US $3 billion 5-year bond issued in July 2003 that matures on 8 July 2008. The total also reflects a small increase in the level of the hedged reserves.

3. Purchases of "rump gilts" which are older, smaller gilts, declared as such by the DMO and in which Gilt-edged Market Makers (GEMMs) are not required to make two-way markets. The Government will not sell further amounts of such gilts to the market but the DMO is prepared, when asked by a GEMM, to make a price to purchase such gilts.

4. To accommodate changes to the current year's financing requirement resulting from: (i) publication of the previous year's outturn CGNCR and/or (ii) carry over of unanticipated changes to the cash position from the previous year. In 2008-09, the planned short-term financing adjustment includes the partial repayment of £6 billion of the Government's Ways and Means Advance at the Bank of England in 2007-08.

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

6. This number reflects the Governments decision to repay up to £7 billion of the remaining balance of the Ways and Means Advance in 2008-09.

7. A negative (positive) number indicates an addition to (reduction in) the financing requirement for the folllowing financial year.

8. The DMO has operational flexibility to vary the end-financial year stock subject to its operational requirements from 2007-08.

Financing for the Official Reserves

4.7 If the Government judges that there is a value-for-money case for doing so, consideration would be given to issuing foreign currency securities to finance the borrowed reserves in 2008-09. Any decisions will be taken on the basis of the least cost comparison set out in chapter 9.

4.8 If foreign currency bonds are issued in place of swapped sterling liabilities to finance the official reserves then the net sterling financing requirement will decline by the sterling value of the bonds issued. Similarly, when the foreign currency bonds mature (assuming that the level of the hedged reserves remains unchanged and new foreign currency bonds are not issued) the net sterling financing requirement will rise by the equivalent amount.

4.9 For the purposes of the financing arithmetic in Table 4.1, it is assumed that swapped sterling will remain the main form of financing of the borrowed reserves (as has been the case in recent years) and no new foreign currency debt will be issued in 2008-09. A redemption of one of the Government's foreign borrowings, the $US3.0 billion bond, will take place in July 2008. However, the official reserves will remain unchanged as the dollar bond will be replaced by equivalent sterling financing. This redemption is projected to increase the financing requirement by around £1.5 billion. There is, in addition, a further small increase in the level of the hedged reserves. If the Government were to decide to issue a foreign currency bond later in the year, this would be taken into account in subsequent revisions to the DMO's financing remit, either in PBR 2008 in the autumn or in Budget 2009, depending on when the bond was issued.

Treasury bill sales

4.10 The financing plans for 2008-09 show that the outstanding stock of Treasury bills is expected to rise by £5.8 billion to £22.0 billion. 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, to raise funds for cash management. Consequently, the DMO will continue to have operational flexibility to vary the end-financial year stock subject to its operational requirements (see Chapter 6 paragraph 6.8). The 2007-08 financial year outturn for the Treasury bill stock will be reported alongside the CGNCR outturn for 2007-08 in April 2008; similarly, the outturn for 2008-09 will be reported in April 2009.

Other short-term debt

4.11 In 2007-08, HM Treasury made a partial payment of its Ways & Means Advance from the Bank of England (see Box 4.1) of £6 billion. The level of the Ways & Means Advance from the Bank of England planned for 31 March 2008 is £7.4 billion. Further repayments of up to £7 billion are planned in 2008-09. Continuing the practice established in 2007-08, repayments in 2008-09 will be announced by the DMO as and when they take place.

4.12 The average level of the DMO's cash balance at the Bank of England is forecast to be £500 million.

4.13 It is anticipated that the level of the DMO's net cash position at end-March 2008 will be –£3.7 billion largely as a result of the repayment of £6 billion of the Ways and Means Advance. This position will be refinanced during 2008-09 to return it to a level of £0.5 billion through a planned increase in short-term financing of £4.2 billion, increasing the net financing requirement in 2008-09.

Box 4.1 The Ways and Means Advance

The Ways and Means Advance is the Government's overdraft facility from the Bank of England. Before the responsibility for Government cash management was transferred to the DMO, in April 2000, the Bank of England managed the daily changes in the Government's net cash position by varying the Ways and Means overdraft. To finance changes in the level of this overdraft, the Bank undertook daily operations in the short-term money markets.

However, once the DMO assumed the role of Government cash manager, it no longer needed to use the Ways and Means Advance for this purpose, as the DMO uses market instruments to manage the Government's cash position. At the time of transition, the outstanding balance of this overdraft was £13.4 billion.

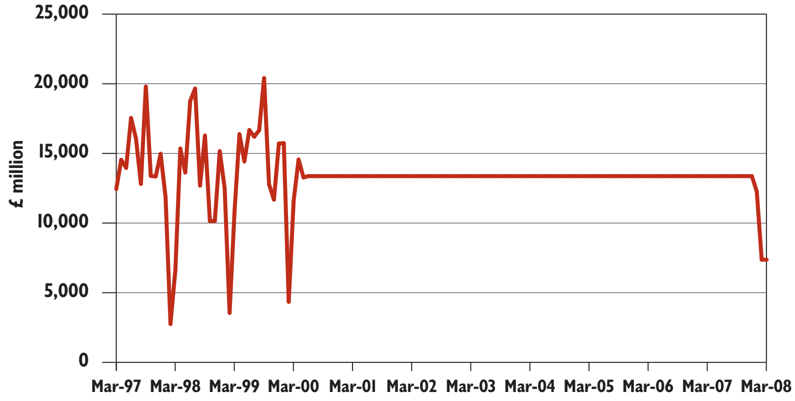
The amount of the Ways and Means Advance was frozen (as announced in 1997[1]) at the time of the transition to the new cash management system. At the same time, the Government also expressed its intention to repay the balance of the Ways and Means Advance. This balance was left effectively unchanged at £13.4 billion until January 2008.

In 2007-08, the Government made a partial repayment of £6 billion of the Ways and Means Advance. The rationale for repaying part of the Advance was to provide the Bank of England with additional flexibility to manage its own balance sheet. From the Bank's perspective, the presence of a large asset that cannot be traded limits its flexibility to manage its balance sheet.

Table: Ways and Means Advance from the Bank of England[2]

Year	Balance
2000 – 2007	£13.4 billion
12 March 2008	£7.4 billion

Chart A: Ways and Means Advance monthly averages



Source: Debt Management Office

[1] HM Treasury document published on 22 December 1997: The Future of UK Government Debt and Cash Management (A response to consultation).

[2] This is the Ways and Means Advance from the Issue Department at the Bank of England.

Quantity of gilt sales

4.14 The DMO will aim to meet the remainder of the financing requirement by selling gilts to the private sector – on a broadly even-flow basis throughout the financial year. On the basis of the forecast for the CGNCR, this means that there will be gross gilt sales of approximately £80.0 billion (cash) in 2008-09.

Benchmark gilts

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

5 The Debt Management Office's financing remit for 2008-09

Objectives

5.1 The 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 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 Ministers on the DMO's performance against its remit, objectives and targets;
- 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 Computershare Investor Services plc 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 lowers costs of debt issuance.

Quantity of gilt sales

5.2 The DMO, on behalf of the Government, will aim to deliver gilt sales of £80.0 billion (cash)[9] in 2008-09.

[9] Figures in Chapter 5 are in cash terms unless otherwise stated.

Amount and maturity of conventional gilt issuance

5.3 The planned amount of issuance and maturity mix of conventional gilts in 41 auctions in 2008-09 is:

- 7 auctions in the short (1-7 years) maturity area, aiming to raise £25.0 billion cash;
- 5 auctions in the medium (7-15 years) maturity area, aiming to raise £12.8 billion cash; and
- 11 auctions in the long (15 years and over) maturity area, aiming to raise £24.2 billion cash.

Amount of index-linked gilt issuance

5.4 In 2008-09, the DMO aims to sell £18.0 billion (cash) in index-linked gilts.

5.5 18 auctions of index-linked gilts are planned in 2008-09. These auctions will include frequent issuance at long maturities.

Size of gilt auctions

5.6 The gilt sales targets in paragraphs 5.3 and 5.4 above are specified in cash terms, but the gilt auctions are sized in nominal terms, typically in £0.25 billion increments for conventional gilts and £0.025 billion increments for index-linked gilts. Therefore all gilt sales targets are expressed in approximate terms.

Method of issuance of gilts

5.7 Auctions will constitute the preferred means of issuance of all gilts (conventional and index-linked). All auctions will be single auctions held on the day indicated.

5.8 Each outright auction of conventional gilts is planned to be between £1.5 billion and £4.0 billion (cash) on a competitive bid-price basis. Each outright auction of index-linked gilts will be between £0.5 billion and £2.0 billion (cash) on a uniform price basis.

5.9 The expected timing of gilt sales is set out in the auction calendar in Table 5.1 below. A more detailed auction calendar for the first quarter of the financial year, including the gilts to be auctioned on each date, will be announced by the DMO at 3.30pm on Monday 31 March 2008. For the rest of 2008-09 the quarterly calendar announcements will be made at 3.30pm on Friday 30 May, Friday 29 August and Friday 28 November[10]. Full details of all auctions will normally be announced at 3.30pm on the Tuesday of the week preceding the auction.

[10] The announcement in November is subject to the date of the Pre-Budget Report.

Table 5.1: Gilt auction calendar 2008-09[1]

Date	Type
2008	
3 April	Conventional
8 April	Index-linked
17 April	Conventional
24 April	Index-linked
15 May	Conventional
22 May	Index-linked
3 June	Conventional
10 June	Index-linked
12 June	Conventional
24 June	Index-linked
2 July	Conventional
8 July	Index-linked
17 July	Conventional
24 July	Index-linked
29 July	Conventional
5 August	Conventional
14 August	Index-linked
2 September	Conventional
10 September	Conventional
23 September	Index-linked
25 September	Conventional
1 October	Conventional
7 October	Index-linked
16 October	Conventional
28 October	Index-linked
4 November	Conventional
20 November	Conventional
25 November	Index-linked
2 December	Conventional
9 December	Index-linked
11 December	Conventional
2009	
13 January	Conventional
15 January	Index-linked
27 January	Index-linked
3 February	Conventional
12 February	Index-linked
24 February	Index-linked
26 February	Conventional
3 March	Conventional
10 March	Conventional
26 March	Index-linked

1. Auctions in Q3 and Q4 are subject to confirmation of the dates of the Pre-Budget Report and the Budget.

5.10 The above programme of conventional and index-linked gilt auctions and any others that may be added during the year may be supplemented between auctions by official sales of gilts by the DMO "on tap". Taps of gilts will be used only as a market management instrument in exceptional circumstances.

5.11 The DMO has no plans to issue gilts by syndicated offering in 2008-09.

5.12 After an auction the DMO will generally refrain from issuing gilts of a similar type or maturity to the auctioned gilt for a reasonable period, unless already pre-announced, or if there is a clear market management case for doing so.

5.13 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 as revised in the DMO's announcement of 21 December 2007[11].

Reverse auctions

5.14 The DMO has no current plans for a programme of reverse auctions in 2008-09.

Conversions and switch auctions

5.15 The DMO has no current plans for a programme of conversion or switch auctions in 2008-09.

Coupons

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

Buy-ins of short-maturity debt

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

Revisions to the remit

5.18 Any aspect of this remit may be revised during the year, in the light of exceptional circumstances and/or substantial changes in the following:

- the Government's forecast 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.

5.19 Any revisions to the remit will be announced.

[11] The announcement of 21 December 2007 is available on the DMO website at: http://www.dmo.gov.uk/documentview.aspx?docname=giltspress/pr211207

6 The Debt Management Office's Exchequer cash management remit for 2008-09

Exchequer cash management objective

6.1 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.

6.2 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.

6.3 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.

6.4 The Government's preferences in relation to the different types of risk taking inherent in cash management are defined by a set of explicit limits covering four types of risks, which taken together represent the Government's overall risk appetite[12]. 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

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

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

Instruments and operations used in Exchequer cash management

6.6 The range of instruments and operations that the DMO may use for cash management purposes is set out in its Operational Notice[13]. The arrangements for the issuance of Treasury bills, and the management of the Treasury bill stock in market hands, will be set out in, and operated according to, the DMO's Operational Notice.

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

[13] 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/opnot110903.pdf

6.7 One component of the debt sales planned to meet the Government's annual financing requirement is the year-on-year change in the outstanding stock of Treasury bills (excluding bills issued solely for collateral purposes). In addition to the bills issued at scheduled weekly tenders, the DMO is able to reopen, on request from its counterparties, existing issues of Treasury bills on a bilateral basis to raise funds for cash management. This change was announced as part of the financing remit given by HM Treasury to the DMO last year[14].

6.8 During the financial year, the DMO will manage the level of the Treasury bill stock and may increase or reduce the stock vis-à-vis the end year target level, in order to support the implementation of Government cash management. The DMO will announce the dates of Treasury bill tenders on the last Friday of a quarter[15]. The precise details of the maturity and the amount of the Treasury bills on offer at specific tenders will be announced one week in advance.

6.9 As a contingency measure, the DMO may issue Treasury bills to the market 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 a request from the Bank, 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.

DMO Collateral Pool

6.10 To assist the DMO in the efficient execution of its cash management operations, a combination of Treasury bills and gilts, which shall be chosen to have a negligible effect on relevant indices, may be issued to the DMO on the third Wednesday of April, July and October 2008 and January 2009. Any such issues to the DMO will only be used as collateral in the DMO's cash management operations and will not be available for outright sale. The precise details of any such issues to the DMO will be announced in advance. If no issue is to take place in a particular quarter, the DMO will announce that this is the case in advance.

Active cash management

6.11 The combination of HM Treasury's cash flow forecasts and the DMO's market operations characterises the active approach to Exchequer cash management. In 2006-07, a new 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 was introduced. These include quantifying the excess returns to active management by measuring the net cost of cash management after deducting an interest charge equivalent to the Government's marginal cost of funds.

[14] See Chapter 4 (paragraph 4.8) of the Debt and reserves management report 2007-08.

[15] Or the immediately preceding working day if the last Friday is a public holiday.

6.12 The original performance measure had compared the net interest costs of implementing the chosen active cash management strategy against the net interest cost of a notional benchmark, intended to represent an alternative, passive default strategy. One of the reasons for adopting this approach was to ensure that it would be resilient to the volatility then observed in money market rates. This approach was reviewed internally following the reforms to the sterling money markets introduced in May 2006 after which the performance methodology was simplified. Under the new approach, performance is no longer evaluated against a notional strategy; rather, it can be evaluated directly against the cash management objective of minimising the costs of offsetting the Government's cash flows.

6.13 Formal reporting of the performance of active cash management is intended for publication to take place in 2008-09. HM Treasury and the DMO recognise that measuring the net costs of active management alone would provide a narrow view of performance. As a consequence, active cash management performance is evaluated against a series of key qualitative and quantitative performance indicators that together reflect the ethos and objectives of the Government.

6.14 Quantitative performance is one such measure. Other indicators and controls that are used to monitor and assess performance in meeting the Government's cash management objectives are listed at Annex C.

7 National Savings & Investments' activities in 2007-08

Introduction

7.1 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 is an integral part of the Government'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.

7.2 2007-08 was the first year of NS&I's five year strategy "Adding Value" which aims to deliver sustainable long-term value to stakeholders by simplifying, modernising and diversifying the business. In 2007-08, NS&I's overall cost of financing was an estimated £353 million lower than that of comparable gilts, taking into account management costs and imputed tax foregone. NS&I announced nine packages of interest rate changes during 2007-08. For new issues of fixed rate products, these reflected changes in gilt yields and for variable rate products these reflected changes in the Bank of England's base rate as announced by the Bank's Monetary Policy Committee. For both fixed and variable rate products, the cost of providing the product to the customer was also taken into account in the setting of interest rates and tax foregone where relevant.

7.3 The net contribution to financing in 2007-08 is estimated to be £5.6 billion with gross sales (including reinvestments and gross accrued interest) of approximately £16.7 billion. Table 7.1 below outlines changes in NS&I's product stock during 2007-08.

Table 7.1: Changes in National Savings & Investments' product stock in 2007-08

	End-March 2007 £ billion	End-March 2008[1] £ billion
Variable rate	52.4	56.1
Fixed rate	15.5	15.0
Index-linked	11.1	13.4
Total[2]	**78.9**	**84.5**

1. Estimates

2. Total may not sum due to rounding

Source: National Savings & Investments

7.4 The Government intends to legislate in the Finance Bill 2008 to permit the Commissioners for the Reduction of the National Debt to transfer funds relating to certain NS&I legacy products to the National Loans Fund. This will reduce administration costs by standardising the accounting arrangements for all NS&I products.

NS&I's net financing target

7.5 The target for NS&I's net contribution to financing the Government's gross financing requirement published at Budget 2007 was £2.8 billion. The forecast for NS&I's contribution was revised upwards at the 2007 Pre-Budget Report to £4.2 billion. This was a result of prevailing market conditions and changes to interest rates and inflation beyond those originally forecast. However, despite the revised forecast, the official target remains unchanged. The estimated outturn of £5.6 billion reflects a continued trend since the Pre-Budget Report of higher than expected deposits and lower repayments.

Diversification of product distribution channels

7.6 NS&I has continued to modernise its product range. It has launched two new products – Guaranteed Growth Bonds and Guaranteed Income Bonds – while also closing three products; Capital Bonds, Pensioners Guaranteed Income Bonds and Fixed Rate Savings Bonds. These changes are designed to standardise and simplify NS&I's product range.

7.7 In November 2007, NS&I began its marketing partnership with WH Smith (direct channel execution only), providing it with an additional retail channel alongside that which it has with the Post Office. NS&I's distribution channel diversification strategy has continued to see an increase in sales through the website and the telephone. In 2007-08, approximately 39 per cent of NS&I's sales were achieved through either the website or the telephone. The forecast for sales through these channels is for continued growth and is set to reach over 50 per cent of total sales by 2011-12.

Marketing activities

7.8 The second marketing campaign to celebrate the 50th anniversary of Premium Bonds, with a special prize draw in June that involved five £1m prizes rather then the usual two, was held in April 2007. NS&I sponsored a garden at the Chelsea Flower Show in May 2007 and continued its sponsorship of the BBC's Proms in the Park. It has actively promoted its Tracing Service to reunite customers with their funds and has, in collaboration with the British Bankers Association (BBA) and British Standards Authority (BSA), launched the joint online tracing portal www.mylostaccount.org.uk. Steps were taken to withdraw the majority of NS&I's planned marketing activity once it became clear that it would exceed its net financing target.

Conclusion

7.9 NS&I had a year of stronger than expected sales. In line with the "Adding Value" strategy it has been taking steps to simplify and modernise its product range to the benefit of customers and continued to develop new and existing distribution channels to help ensure it continues to deliver its targets in the future.

8 National Savings & Investments' financing remit for 2008-09

Introduction

8.1 NS&I's 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.

8.2 The key business objectives for NS&I to deliver its strategic objective are:

- 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 HM Treasury.

8.3 In pursuit of its strategic objectives, 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

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

8.5 NS&I will normally take the lead in bringing forward proposals to HM 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, wider government policy and this remit, Ministers would expect to endorse them.

Volume of financing in 2008-09

8.6 Gross sales (including reinvestments and gross accrued interest) of NS&I products are assumed to be around £15.3 billion in 2008-09. After meeting expected maturities and withdrawals, NS&I is expected to make a net contribution to Government financing of £4 billion.

Cost of financing

8.7 The average cost of NS&I products should lie on average below the cost of equivalent gilts or other short term comparators.

8.8 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

8.9 HM Treasury or NS&I may initiate a review of this remit during the course of 2008-09 in the light of any relevant factors.

9 MANAGEMENT OF THE OFFICIAL RESERVES IN 2007-08

Introduction

9.1 The Government's official holdings of international reserves comprise gold, foreign currency assets and International Monetary Fund (IMF) Special Drawing Rights (SDRs)[16]. With the exception of the SDR assets that constitute the UK's Reserve Tranche Position (RTP) at the IMF, these assets are held in the Exchange Equalisation Account (EEA).

Origin and purpose

9.2 The EEA was established in 1932 to provide a fund that could be used, when necessary, to regulate the exchange value of sterling, and therefore is the mechanism through which any Government exchange rate intervention would be conducted.

9.3 The Government's macroeconomic framework is designed to maintain long-term economic stability. This is achieved by maintaining low inflation, sustainable economic growth and sound public finances. The framework does not entail management of the exchange rate and the Government has not intervened for the purposes of influencing the sterling exchange rate since 1992. Against this background, foreign exchange reserves are held on a precautionary basis – to meet any change in exchange rate policy in the future, if required, or in the event of any unexpected shocks. The reserves are also used to provide foreign currency services for government departments and agencies to provide foreign exchange for making payments abroad and to buy, sell and hold Special Drawing Rights (SDRs) as required by the UK's membership of the IMF. The way the reserve assets are invested, financed and managed is primarily designed to meet these policy objectives.

9.4 The Bank of England may also hold foreign currency reserves on its own balance sheet, including for intervention purposes, in pursuit of the Monetary Policy Committee's monetary policy objective. This is set out in the Chancellor's letter to the Governor of the Bank of England of May 1997[17].

Management of the Exchange Equalisation Account

9.5 The EEA is under the control of HM Treasury, which appoints the Bank of England as its agent to carry out the day-to-day management of the international reserves ('the reserves'). An annual Service Level Agreement (SLA) between HM Treasury and the Bank specifies the parameters under which the reserves are managed. This SLA includes investment benchmarks and limits for controlling credit, market and other risks. The SLA specifies:

- benchmarks[18] for investing the reserves, with limits to the Bank's discretion to take currency or interest rate positions relative to these benchmarks;
- the framework for controlling credit, market, liquidity and other risks;

[16] The SDR is an international reserve asset created by the IMF. Its value is defined in terms of a basket of the US dollar, the euro, the yen and sterling. More information on the SDR can be found at: http://www.imf.org/external/np/exr/facts/sdr.HTM

[17] This letter is available on the HM Treasury website at: http://www.hm-treasury.gov.uk/newsroom_and_speeches/press/1997/press_40_97letter.cfm

[18] The benchmark is the neutral or passive investment strategy for the reserves portfolio. Active management performance is measured against a target return over the benchmark.

- a target return for active management compared to benchmark positions; and
- the programme for financing the reserves, covering the EEA's foreign currency borrowing and currency swaps out of sterling.

9.6 A summary of the current Service Level Agreement (SLA) which excludes market-sensitive risk limits is set out in Chapter 10.

Financing of the reserves

9.7 The reserve assets are partly financed either by issuing securities denominated in foreign currency or, alternatively, sterling financing from issuing gilts is used to acquire foreign currency assets. The Government retains a flexible approach to determining which method to adopt depending upon least cost. Least cost can be determined by comparing, on a swapped basis, the cost of issuing bonds in foreign currency of a given maturity and nominal amount with the cost of issuing in sterling. The Government last issued a US$3.0 billion five year Eurobond in 2003. The remaining part of the reserves are financed by retained earnings, historic sales of sterling for foreign currency and the EEA's net SDR position.

9.8 The reserve assets are divided between those that are currency-hedged and those that are unhedged for currency risk. The currency-hedged reserves are also largely hedged against interest rate risk, through the use of swaps. The unhedged reserves are in effect the net asset position in foreign currency (because the rest of the reserves are hedged with matching foreign currency liabilities): they comprise dollar and euro-denominated bonds, gold, the Reserve Tranche Position (which is part of the National Loans Fund) and yen exposure obtained largely through forward yen purchases. Movements in the value of the reserves largely arise from changes in the value of these assets.

Composition and size of the Reserves

9.9 EEA assets need to be highly liquid so that they can be made available quickly for intervention purposes (or other permitted uses) if necessary. Inevitably, these assets (other than gold) carry some element of credit risk. In order to keep this risk at a low level and to ensure a high level of liquidity, the funds of the EEA are predominantly invested in securities issued or guaranteed by the national governments of the United States, euro-area countries and Japan and in the debt instruments of highly-rated banks.

9.10 Table 9.1 sets out developments in UK official holdings of international reserves. The value of the gross foreign exchange reserves rose over the year, from US$51.7 billion at end-December 2006 to US$57.9 billion at end-December 2007. This was mainly because of valuation effects resulting from the rise in the dollar value of gold and the appreciation of the euro against the US dollar. There was also a slight compositional shift from SDR-denominated assets to foreign currency assets, reflecting repayments from countries that had borrowed from the IMF. The level of the UK's unhedged reserves rose over the year, from US$20.9 billion at end-December 2006 to US$24.7 billion at end-December 2007, also because of revaluation effects.

Table 9.1: UK Official Holdings of International Reserves

Currency breakdown Assets	US$ million - market value End-December 2006	 End-December 2007
US$	12,563	14,831
Euro	26,895	28,885
Yen	4,063	4,402
Other currencies	9	17
SDR	1,809	1,459
Gold	6,341	8,344
Total Assets[1]	**51,681**	**57,939**
Liabilities	**End-December 2006**	**End-December 2007**
US$	–6,306	–7,682
Euro	–20,638	–21,735
Yen	–940	–823
Other currencies	–3	–13
SDR	–2,878	–3,020
Gold	–	–
Total Liabilities	**–30,765**	**–33,272**
Net Reserves (Assets – Liabilities)	**20,916**	**24,667**

1 Totals and net figures may not sum due to rounding

Source: HM Treasury/Bank of England

Performance evaluation

9.11 In accordance with the SLA, the Bank manages the official reserves consistently with the Government's policy aims. A key objective in that context is to maintain their liquidity and security and, subject to that, to minimise the cost of holding the reserves. HM Treasury sets a target active management return as part of the annual SLA. This target, along with other aspects of management of the reserves makes up the basket of indicators that were agreed for 2007-08 between HM Treasury and the Bank. These key performance indicators are explained further alongside the SLA in chapter 10.

Disclosure of financial data

9.12 Since April 2000, the UK has published reserves data in accordance with the IMF/G10's Special Data Dissemination Standard (SDDS). These monthly releases set out 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)[19].

[19] Reserves data from July 1999 onwards are available on the Bank of England's website at: http://www.bankofengland.co.uk/statistics/reserves/index.htm

9.13 HM Treasury publishes the financial accounts for the EEA as part of the statutory obligations set out in the Exchange Equalisation Account Act 1979 (as amended by the Finance Act 2000). The financial accounts for 2006-07, audited by the National Audit Office, were accordingly published and laid before both Houses of Parliament on 12 July 2007[20].

Intervention

9.14 The Government announced in September 1997, as part of its commitment to openness and transparency with respect to the reserves, that it would publish details of any intervention undertaken to influence exchange rates in the subsequent monthly press release. Since September 1997, the UK authorities have only intervened on one occasion, when the Government joined a concerted intervention by the G7 to support the euro in September 2000.

[20] The Financial Accounts for the EEA can be viewed on HM Treasury's website at: http://www.hm-treasury.gov.uk/media/A/3/eea_accounts120707.pdf

10 The Bank of England's Service Level Agreement for management of the Official Reserves

Introduction

10.1 The Service Level Agreement ('SLA') sets out the arrangements for the Bank of England acting as HM Treasury's agent in managing the Exchange Equalisation Account ('EEA'). It will remain in force indefinitely and be reviewed annually.

10.2 The SLA provides both parties with an understanding of what constitutes an acceptable level of service in managing the EEA.

10.3 The SLA should be read in conjunction with all relevant legislation, particularly the Exchange Equalisation Account Act 1979, as amended by the Finance Act 2000, which provides that the EEA shall be used:

- for checking undue fluctuations in the exchange value of sterling;
- for securing the conservation or disposition in the national interest of the means of making payments abroad;
- for the purpose specified in Section 1(3) of the International Monetary Fund Act 1979 (payment of charges under Section 8 of Article V of the Articles of Agreement of the International Monetary Fund); and
- for carrying out any of the functions of the Government of the United Kingdom under those of the said Articles of Agreement which relate to Special Drawing Rights (SDRs).

Objectives

10.4 The Bank of England will at all times:

- carry out efficiently and cost effectively in a legal and proper form foreign currency and gold transactions on behalf of HM Treasury and other government departments, including the issuance of foreign currency debt on behalf of HM Treasury;
- manage the reserves so as to maintain their liquidity and security within limits agreed with HM Treasury and ensure that the public funds entrusted to the Bank in the EEA are properly and well managed and safeguarded. Subject to these limits, the Bank will manage the reserves to maximise their return;
- advise HM Treasury on the financing of the reserves, including, as necessary, the management of foreign currency borrowing (covering new borrowing, hedging and repayments);
- monitor and report to HM Treasury on the level of risk and return on holding the reserves and provide accurate and timely accounting and management information and statistical analysis pertaining to the reserves as requested by HM Treasury;

- ensure that effective management systems, including financial monitoring and control systems, are in operation and 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; and
- advise HM Treasury as to how to ensure that the EEA assets have the fullest possible protection of sovereign immunity and that the EEA enters into appropriate legal agreements with counterparties, nominees, delegates and agents that provide the fullest possible protection for EEA assets, subject to commercial feasibility.

10.5 To help gauge the effectiveness of the Bank of England's management of the reserves, HM Treasury and the Bank have introduced a set of key performance indicators. Performance against these indicators will be published in the EEA accounts for 2007-08. These performance measures are explained in Box 10.1.

Authorised financial instruments

10.6 The reserves can be invested in a specified range of financial instruments:

- bonds and commercial paper issued by other national governments, supranational organisations and selected official sector agencies;
- foreign currency spot, forward and swap transactions;
- interest rate and currency swaps;
- bond and interest rate futures, swap notes and swap futures;
- sale and repurchase, and buy-sell back, agreements;
- gold deposits;
- forward rate agreements;
- SDRs;
- bank deposits; and
- certificates of deposit and corporate commercial paper.

Active management

10.7 The Bank will actively manage the reserves against a number of benchmarks. The benchmarks will be reviewed regularly and constructed so that they are replicable and represent HM Treasury's long-term investment strategy. They are split into benchmarks for the currency-hedged reserves (on which currency and interest rate exposures are hedged) and the unhedged reserves which are not hedged against exchange rate and interest rate risk. The Bank's scope to deviate from the benchmarks through active management will be constrained by agreed risk limits.

Risk management

10.8 The Bank will:

- ensure that the risks associated with its management of the EEA are properly identified, evaluated and mitigated and that exposures comply with the detailed credit risk, market risk and operational risk framework and limits agreed with HM Treasury at the start of the year;

- monitor the EEA's credit exposures on a daily basis, applying the credit risk framework agreed with HM Treasury. The Bank will review this framework and the credit limits it provides in the light of market or institutional developments, and changes in the nature of the EEA's activities. The Bank will assess the credit rating of each counterparty, issuer and banking sector;

- monitor the exposure of the EEA to market risk and ensure that it complies with the limits agreed with HM Treasury using Value at Risk (VaR) which provides a means of aggregating risk consistently across the components of the portfolio, and stress tests to quantify the potential loss from particular scenarios; and

- confirm to HM Treasury, on a quarterly basis, that sufficient controls were in place to mitigate the operational risks affecting the EEA during that quarter, that appropriate mechanisms were in place to identify and address new risks and that the processes and framework in place adequately meet the "Turnbull" requirements[21] relating to the Bank's management of the EEA. If appropriate, exceptions to such confirmation will be listed.

[21] Internal Control: Guidance for Directors on the Combined Code issued by the Institute of Chartered Accountants in England and Wales.

Box 10.1: Key Performance Indicators in 2007-08

HM Treasury and the Bank of England have agreed a set of performance measures to be introduced during the course of 2007-08. The intent of the performance measures is to provide a basket of indicators that can be used to assess the effectiveness of the management of the EEA.

The Government's prime objective in managing the EEA is to ensure the reserves are fit for purpose in order to meet current policy objectives and any potential future changes in policy. In support of that, the Government's objective is to preserve the liquidity and security of the reserves and to ensure that the Government maintains its capability to intervene in the foreign exchange market if required. Subject to this, the aim is to minimise the overall cost of holding the reserves, while ensuring exposure to financial risk is limited through the appropriate choice of portfolio and risk management practices.

HM Treasury's role is to:

- ensure that its choice for the strategic composition for the benchmark asset allocation of the reserves, including gold, meets the policy objectives set out above. Subject to meeting those objectives, HM Treasury will make that benchmark asset allocation choice to trade off risk, return and liquidity in line with its risk preferences. The performance of the reserves, including financial outturns, will be reported in the annual accounts; and
- set an active management return target for the Bank in managing the reserves against the benchmark, subject to the limits detailed in the SLA. This target will be set to at least cover the costs of the Bank in managing the EEA.

The foreign currency reserves will be invested in assets that are liquid and secure. Specifically;

- a minimum of 90 per cent will be held in tradable debt securities and cash;
- a minimum of 90 per cent will be invested in assets that are rated at least AA-; and
- all assets must be investment grade.

The Bank will observe the limits as set out in the SLA. In line with the SLA, any substantive breaches of the limits and/or any operational errors will be reported to HM Treasury as soon as possible, along with advice, if necessary, as to how best to deal with them. Any significant breach will be reported publicly (e.g. in the annual accounts).

In order to aim to at least cover costs, and to ensure that the Bank maintains its capability to intervene in the foreign exchange market if required, the Bank will actively manage the EEA portfolio against the benchmark to meet the active management return target set by HM Treasury, whilst ensuring compliance with the limits as detailed in the SLA.

The Bank will ensure that all transactions that relate to the Government and the IMF shall be handled efficiently, accurately and in a timely fashion.

In carrying out its services, the Bank will as far as possible ensure that:

- its management and staff are of high repute and integrity;
- staff training and experience are appropriate for the tasks they are expected to undertake and consistent with the amount of risk that they are authorised to take;
- its internal systems and controls are adequate for the size, nature and complexity of EEA operations and comply with best market practice so far as possible; and
- appropriate preparations are made for possible policy deployment of the reserves (e.g. foreign exchange intervention).

These performance measures were introduced during the course of 2007-08 and HM Treasury and the Bank will report formally against them in the 2007-08 financial accounts.

Audit arrangements and accounting requirements

10.9 The Bank will agree the annual programme of work of the Bank's Internal Audit Division pertaining to the EEA with HM Treasury by the beginning of the year. The Bank's internal audit arrangements will follow the standards set by the Institute of Internal Auditors UK and Ireland and will accord with the objectives, standards and practices set out in HM Treasury's "Government Internal Audit Standards". The Bank will maintain the EEA's accounts drawn up in accordance with UK GAAP as far as appropriate and in accordance with the relevant Accounts Directions.

National Audit Office access

10.10 For the purposes of:

- the examination and certification of the EEA accounts; or
- any examination pursuant to Section 6(1) of the National Audit Act 1983 or any re-enactment thereof of the economy, efficiency and effectiveness with which the Bank has managed the EEA;

the National Audit Office (NAO) may examine such documents as it may reasonably require which are owned, held, or are otherwise within the control of the Bank, have access to Bank buildings, and may require the Bank to produce such oral or written factual explanations as it considers necessary. However, the NAO will address substantive questions on the management of the reserves to HM Treasury and not the Bank.

HM Treasury's responsibilities

10.11 HM Treasury is responsible for monitoring the risk environment and performance of the Bank of England in managing the reserves. To support this process, the Bank provides the following management information:

- monthly financial reporting, detailing the returns made with respect to the management of the EEA and the market and credit risks incurred;
- quarterly management reports on operational risk issues and the Bank's compliance with the guidance issued by the Turnbull Report (see footnote 21). These reports highlight the Bank of England's role in identifying, assessing, managing and monitoring the risks relating to its management of the EEA;
- quarterly reports from the Bank's Internal Audit Division on the internal audit programme agreed for the EEA; and
- Bank and HM Treasury officials meet at regular reserves meetings to review the performance against the parameters set out in the SLA and to consider wider operational and policy issues. The EEA Accounting Officer and the Bank's Executive Director for Markets meet twice each year to discuss overall strategy and governance issues.

Financing the reserves

10.12 The Bank of England will provide HM Treasury with relevant market intelligence and advice on options for financing the reserves with a view to minimising the costs and risks to the Government. An annual financing programme for the currency-hedged reserves will be agreed between the Bank of England and HM Treasury at the beginning of the financial year. The Bank of England will undertake this programme in accordance with the timetable and guidelines agreed, as well as any changes subsequently agreed with HM Treasury.

10.13 The Bank of England will act as HM Treasury's agent in issuing and managing any foreign currency liabilities associated with the reserves. The Bank of England will provide regular information on the pricing of foreign currency debt and, if agreed with HM Treasury, will appoint managers to undertake an issuance in accordance with HM Treasury's instructions.

Sterling cash management

10.14 The Bank of England will liaise closely with the DMO with respect to managing sterling flows relating to EEA operations. The Bank of England will, so far as is possible, aim to manage the EEA so as to avoid conflict with the DMO's sterling cash management operations while in no way disadvantaging the EEA.

Publication requirements

10.15 The Bank of England will provide the figures for the United Kingdom's official holdings of international reserves monthly Press Notice, by no later than 2pm on the second working day of every month, to be published on the third working day of every month. The format for this Press Notice will be in accordance 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 on the Bank of England's web site. The monthly Press Notice will provide details of the amount and date of any official intervention during the month and an explanation of why it was undertaken.

Intervention

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

11 CENTRAL GOVERNMENT'S FINANCIAL ASSET AND LIABILITY RISK MONITOR

Introduction

11.1 The central government's asset and liability monitor ('the monitor') is produced in order to aid quantification of the risks faced by central government on its balance sheet and forms part of an ongoing HM Treasury work programme. It should be regarded as a 'work in progress' because it records only current financial assets and liabilities of central government and some of the calculations involve approximating assumptions. Therefore, it cannot be reconciled with other central government accounting publications and is not subject to audit.

11.2 The monitor is a precursor to the publication of 'Whole of Government Accounts'[22] and is in accordance with the transparency and accountability recommendations published in the International Monetary Fund's 'Guidelines on Public Debt Management' 2003[23].

11.3 It should be noted that the monitor records only one aspect of the Government's wider financial position as it currently covers only financial assets and liabilities of central government. For example, it does not take account of other significant public sector assets and liabilities such as local authorities' assets, or, non-financial assets and liabilities such as contingent liabilities or future tax revenue streams. Information covering the Government's wider fiscal position and prospects going forward can be found in the 2008 Long-term public finance report[24], which provides a comprehensive assessment of the sustainability of the public finances.

Description of table 11.1

11.4 Table 11.1 below shows total assets and liabilities by type and by managing institution. In addition to nominal and market values of the assets and liabilities, some other key variables are reported, which help to provide greater insight into the characteristics of central government's balance sheet thereby facilitating a better evaluation of the risks that the balance sheet is exposed to. These key variables are explained in Box 11.1.

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[22] From the 2009-10 financial year onwards, Government Accounts will be prepared using International Financial Reporting Standards, as adapted in the public sector context. The whole of Government Accounts will be presented on the same basis from 2009-10.

[23] The 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

[24] "2008 Long-term public finance report, HM Treasury, March 2008 can be found on HM Treasury's website. See also the 2003 Long-term public finance report, HM Treasury, December 2003, which provides a discussion of the different approaches to assessing long-term fiscal sustainability and can be found on HM Treasury's website at: http://www.hm--treasury.gov.uk/media/8FS/85/pbro4long_term473.pdf.

Box 11.1: Description of variables in the Central Government Financial Asset and Liability Risk Monitor

- **Nominal value and market value**[1] – the nominal value of assets or liabilities is the value at which they would be repaid. The market value is the value of assets or liabilities if they were purchased in the market. For example, the nominal value of central government's gilt liabilities represents the amount that the Government would pay on redemption of these liabilities whereas the market value of the gilt liabilities is their tradable value in the secondary market.
- **Maturities of less than one year** – the nominal value of the assets or liabilities that have less than one year before they are redeemed.
- **Average modified duration** – this is a measure of the sensitivity of the value of assets or liabilities to interest rate movements. In the context of the asset and liability monitor, duration offers some indication of how great an impact small interest rate changes might have on the present value of the central government's balance sheet. Other things equal, longer duration suggests a greater degree of sensitivity to small interest rates changes.
- **Average maturity** – indicates the market value weighted average length of time (in years) before assets and liabilities are due to be redeemed.
- **Floating rate composition** – the value of those assets and liabilities that are indexed to a short-term money market interest rate.

[1] Nominal Value of index-linked gilts includes inflation uplift.

Key facts – central government's financial assets

11.5 The nominal value of the central government's total financial assets was £175.6 billion at end-December 2007. This compares with £156.1 billion at end-December 2006. This change was primarily due to an increase of £30.1 billion in short-term bills held by the Commissioners for the Reduction in National Debt (CRND) in central Government funds, other short-term assets held by the DMO (£6.4 billion), and the Public Works Loan Board (£1.3 billion). These were partly offset by a decrease of gilts held by the DMO (£18.2 billion).

11.6 The market value of central government's total financial assets was £188.0 billion at end-December 2007 compared with £166.1 billion at end-December 2006, an increase of £21.9 billion.

11.7 The average modified duration, which excludes the gold volatility measure and duration for index linked gilts, decreased to 5.8 years at end-December 2007 from 6.6 years at end-December 2006. Average maturity over the period decreased to 11.7 years from 12.5 years.

11.8 The largest single contributor to the central government's financial assets are deposits given to the DMO by the CRND (£50.1 billion), which make up nearly 29 per cent of the total nominal value. Other significant contributors include loans to local authorities from the Public Works Loans Board (£49.0 billion or 28 per cent of total), foreign currency assets managed by the Bank of England (£28.0 billion or 16 per cent of total) and other short-term assets held by the DMO (£11.6 billion or 7 per cent of total).

Key facts – central government's financial liabilities

II.9 The nominal value of central government's total financial liabilities was £677.4 billion at end-December 2007. This is an increase of £43.8 billion compared with end-December 2006 (£633.6 billion). This change is attributable primarily to an increase of £14.7 billion in gross gilts in issue by the DMO to £474.4 billion, an increase of £5.7 billion in NS&I products to £83.8 billion and other short-term liabilities managed by the DMO of £1.4 billion from £12.7 billion. These were partially offset by a decrease in Treasury bills managed by the DMO of £3.9 billion to £16.5 billion.

II.10 The market value of the central government's total financial liabilities at end-December 2007 was £718.4 billion compared with £671.5 billion at end-December 2006, an increase of £46.9 billion.

II.11 The average modified duration of the financial liabilities at end-December 2007 was 6.4 years, a marginal increase of 0.2 years from December 2006 (at 6.2 years) and the average maturity of the financial liabilities was also higher at 11.0 years compared with 10.9 years at end-December 2006, reflecting increases in marketable gilts in issue. There was a 2.7 per cent increase in the nominal value of liabilities with a maturity of less than one year from £111.8 billion to £114.8 billion.

II.12 Gross gilts issued represent the highest proportion of central government financial liabilities (£474.4 billion), accounting for 70 per cent of the nominal value of total financial liabilities. Other significant liabilities include those managed by NS&I (£83.8 billion) accounting for 12 per cent of the nominal value of total liabilities, DMO holdings of other short-term bills (£50.1 billion), Treasury bills (£16.5 billion), Ways and Means Advance (£13.4 billion) and the DMO's repos-outstanding (£12.7 billion).

Table 11.1: Central government's financial asset and liability risk monitor at 31 December 2007

Central government financial assets	Nominal Value[1] (£ billion)	Market Value (£ billion)	Maturities of less than 1 year (£ billion)	Modified duration[2] (years)	Average maturity (years)	Floating rate composition (£ billion)
Managed by:						
Public Works Loan Board (loans to local authorities)	49.0	57.6	0.5	14.5	30.0	0.1
Debt Management Office						
Gilts held by DMO						
Marketable conventionals	14.5	16.0	0.9	7.4	11.4	–
Marketable index-linked	7.8	9.0	–	9.7	11.7	–
Total	22.3	25.0	0.9	8.2	11.5	–
Gilts held in Central Government funds by the Commissioners for the Reduction of the National Debt (CRND)						
Marketable conventionals	0.0	0.0	0.0	1.0	1.4	–
Non-marketable conventionals	0.6	0.6	0.0	1.8	1.9	–
Non-marketable index-linked	–	–	–	–	–	–
Total	0.6	0.6	0.0	–	1.9	–
CRND loans to local authorities	–	–	–	–	–	–
Other short-term bills held by CRND in Central Govermnent funds						
Treasury bills	–	–	–	–	–	–
Deposits given to DMO by CRND	50.1	50.3	50.1	0.1	0.1	–
Total	50.1	50.3	50.1	0.1	0.1	–
Other short-term assets						
Reverse repos - outstanding	10.2	10.3	10.2	0.1	0.1	–
Deposits at commercial banks	0.5	0.5	0.5	0.0	0.0	–
Cash deposits at the Bank of England	0.6	0.6	0.6	0.0	0.0	–
Bonds[3]	0.1	0.1	0.1	0.2	0.2	
Sterling Certificates of Deposit	0.2	0.2	0.2	0.1	0.1	–
Sterling Commercial Paper	–	–	–	–	–	–
FX Commercial Paper	–	–	–	–	–	–
Total	11.6	11.7	11.6	0.1	0.1	–
Bank of England						
Sterling assets						
Sterling leg of swaps and FX liabilities[4]	10.3	10.4	3.1	0.2	1.7	10.3
Foreign currency assets						
Bonds	17.9	18.2	1.6	2.3	2.6	0.0
Money Market Instruments	3.6	3.6	3.6	0.2	0.2	–
Short-term assets[5]	2.2	2.2	2.2	0.1	0.1	–
Gold[6]	4.2	4.2	–	0.3	–	–
IMF Special Drawing Rights	0.2	0.2	–	0.0	–	0.2
Total	28.0	28.4	7.4	1.5	2.0	0.2
HM Treasury						
Sterling assets						
National Loans Fund loans[7]	3.0	3.4	0.0	9.3	15.3	–
Foreign currency assets						
IMF Reserve Tranche Position	0.5	0.5	–	0.0	–	0.5
Total[8,9]	**175.6**	**188.0**	**73.8**	**5.8**	**11.7**	**11.2**

Table 11.1: Central government's financial asset and liability risk monitor at 31 December 2007 (continued)

Central government financial liabilities	Nominal Value[1] (£ billion)	Market Value (£ billion)	Maturities of less than 1 year (£ billion)	Modified duration[2] (years)	Average maturity (years)	Floating rate composition (£ billion)
Managed by:						
National Savings & Investments	83.8	83.8	10.7	5.3	5.1	55.6
Debt Management Office						
Gross gilts in issue[10]						
Marketable conventionals	337.9	359.5	15.3	8.8	13.5	–
Non-marketable conventionals	0.6	0.6	0.0	1.8	1.9	–
Marketable index-linked	135.9	155.4	–	12.5	15.0	–
Non-marketable index-linked	–	–	–	–	–	–
Total	474.4	515.5	15.3	–	13.9	–
Treasury bills[11]	16.5	16.4	16.5	0.1	0.1	–
Other short-term bills	50.1	50.3	50.1	0.1	0.1	–
Total	66.6	66.7	66.6	0.1	0.1	–
Other short-term liabilities						
Repos – outstanding	12.7	12.7	12.7	0.1	0.1	–
Deposits made by local authorities and commercial banks	2.0	2.0	2.0	0.1	0.1	
Total	14.7	14.7	14.7	0.1	0.1	–
Bank of England						
Sterling liabilities						
Ways and Means Advance	13.4	13.4	–	0.0	–	13.4
Foreign currency liabilities						
HMG Bonds	1.5	1.5	1.5	0.5	0.5	–
Loans	0.0	0.0	0.0	0.0	0.0	–
Repos	2.8	2.8	2.8	0.0	0.1	–
Swaps & FX Liabilities (*excludes £ leg*)[12]	11.0	10.8	3.2	0.9	1.2	11.0
IMF Special Drawing Rights allocation	1.5	1.5	–	0.0	–	1.5
Total	16.8	16.6	7.5	0.6	0.8	12.5
HM Treasury						
Sterling liabilities						
IMF non-interest bearing securities	7.7	7.7	–	0.0	–	7.7
Total[7,8]	**677.4**	**718.4**	**114.8**	**6.4**	**11.0**	**89.2**

Figures may not sum due to rounding

Source: Bank of England/Debt Management Office/HM Treasury/National Savings & Investments

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 Sterling denominated supranational bonds.
4 Modified duration covers swaps only.
5 Short term assets = deposits + reverse repos.
6 Modified duration gold = 30-day moving average volatility of spot gold prices.
7 NLF loans are composed of loans to nationalised industries and public corporations. Market value is approximated by the nominal value.
8 Totals for modified duration are weighted by market value. Gold volatility measure and duration for index-linked gilts are excluded from this caluculation.
9 Total for average maturity are weighed by market value.
10 Non-marketable gilts are held by the Commissioners for the Reduction of the National Debt (CRND).
11 Nominal value is different from Table 2.1 because Table 11.1 includes transactions made prior to end-December 2007 but due to mature in the first quarter of 2008
12 Modified duration covers swaps only.

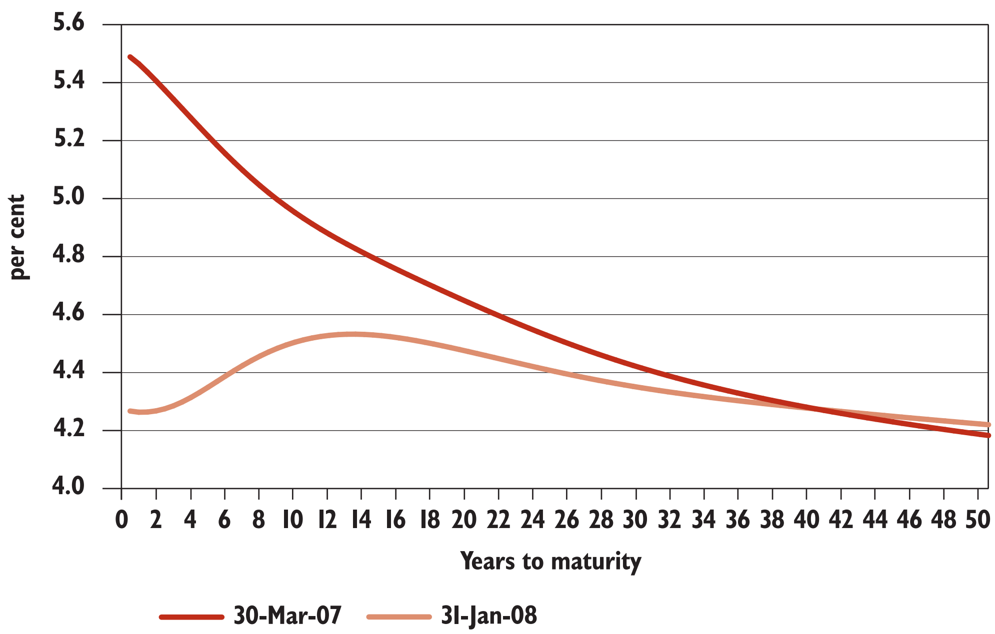
A KEY DEVELOPMENTS IN THE GILT MARKET: APRIL 2007 TO JANUARY 2008

A.1 This annex summarises the key developments in the gilt market in 2007-08 (to end-January 2008). A more comprehensive review of the year as a whole, in the context of developments in other major international bond markets, will be published in the DMO Annual Review 2007-08.

Nominal par gilt yield curves

A.2 The significant disinversion of the nominal par gilt curve between end-March 2007 and end-January 2008 is shown in Chart A1. Yields fell at all maturities except at the very long end (over 40- years) where they increased slightly. 2-year par yields fell by 114 basis points to 4.23 per cent, 5-year yields fell by 87 basis points to 4.35 per cent, 10-year yields fell by 45 basis points to 4.50 per cent and 30-year by 7 basis points to 4.34 per cent. 50- year par yields, on the other hand, rose slightly by 4 basis points to 4.22 per cent over the same period.

Chart A1: Par gilt yield curves



Source: Debt Management Office

Conventional benchmark gilts

A.3 The first quarter of the financial year was characterised by a general and sustained rise in gilt yields. However, strong inflation data published mid-month showed CPI at 3.1 per cent. This led to an increase in the market's expectation of the upward path of future interest rates. The repo rate was increased by 25 basis points to 5.5 per cent in May and yields continued to rise throughout the month. There were further increases towards the end of the month in the wake of strong US economic data – which had pushed US Treasury yields higher. This trend continued into June, with nominal yields rising along the curve by approximately 20 basis points.

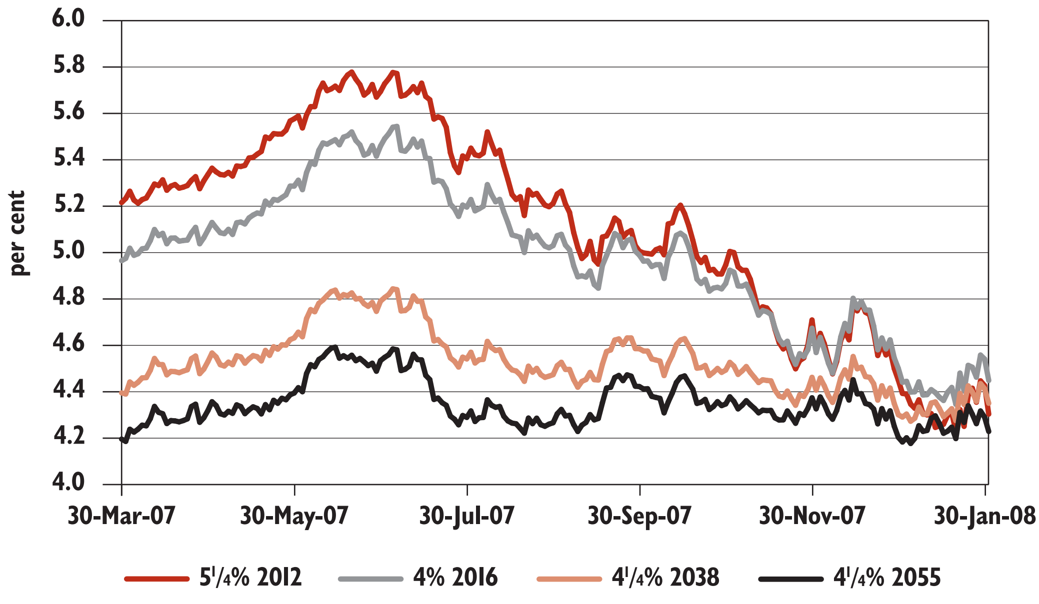
A.4 The upward trend in gilt yields reversed sharply in the second quarter of the financial year as the impact of the developments in the sub-prime mortgage market in the US led to increasing volatility in global credit markets and a flight to quality towards government bonds. Gilt yields fell in July 2007 despite the Monetary Policy Committee (MPC) raising rates. Nevertheless, developments in the US sub-prime sector prompted a (downward) re-evaluation of interest rate expectations. The fall in yields continued into August 2007, as concerns about global credit markets grew and some central banks began to invoke emergency lending facilities. The short-end of the curve benefited most from these developments, as interest rate expectations were revised downwards. Yield curve disinversion also appears to have been influenced by a reported mid-summer flattening in Liability Driven Investment (LDI) activity and, from September, emergent market concerns about longer-term inflationary pressures from rising commodity prices which caused long maturity gilt yields to rise.

A.5 The ongoing disruption in financial markets persisted throughout most of the third quarter of 2007-08. Furthermore, a number of major American and European banks announced significant writedowns on their mortgage-related securities. These conditions led to further downward revisions in the market's expectation of the path of future interest rates, leading to more sharp falls in gilts yields at the short to medium sector of the curve. The MPC cut rates on 6 December 2007.

A.6 January 2008 saw some sharp intra-day gilt yield movements in reverse correlation to the equity markets. Short-dated gilt yields reached long-terms lows on the 21 January 2008. The US Federal Reserve cut US interest rates by 75 basis points to 3.5 per cent at an emergency meeting on 22 January 2008, but, following this, gilt yields rose. Yields at the short end of the curve fell sharply again, however, on the last day of the month, in response to the Federal Reserve's second interest rate cut to 3 per cent.

A.7 The path of benchmark conventional gilt yields over the first ten months of 2007-08 is shown in Chart A2.

Chart A2: Conventional benchmark gilt yields

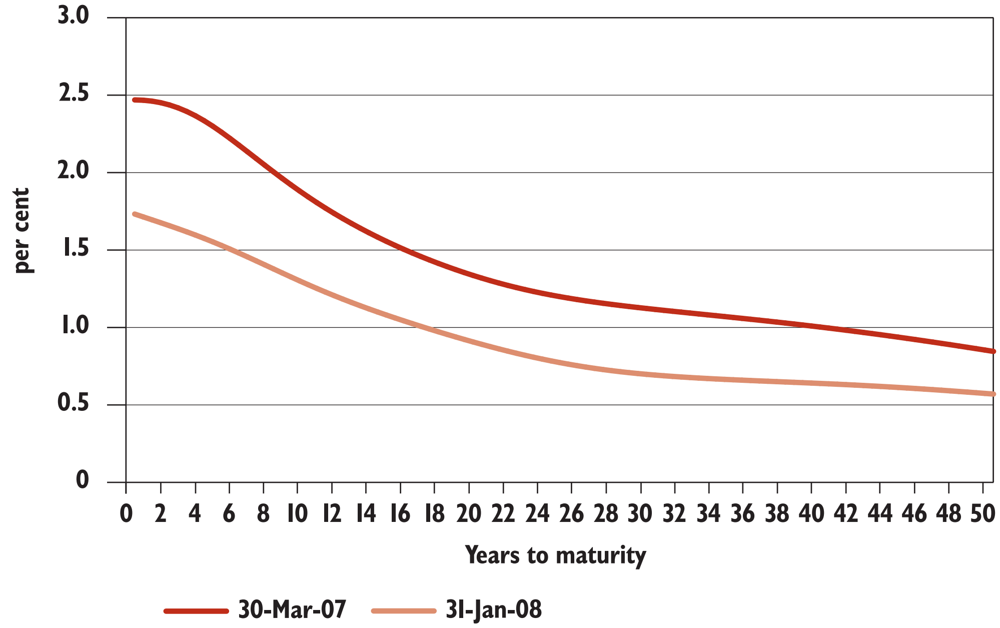


Source: Debt Management Office

Par yield curves (Real)

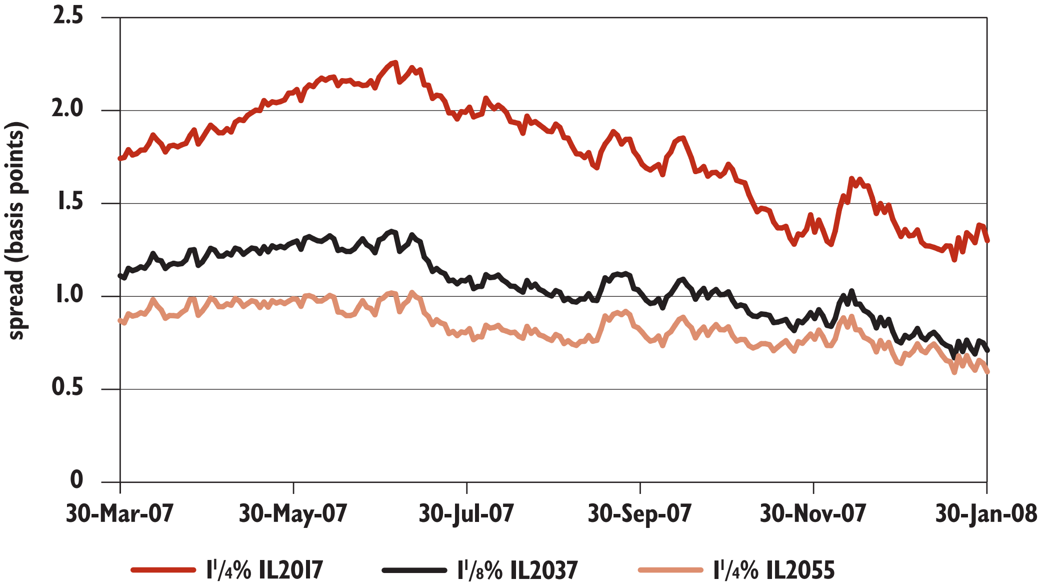
A.8 In contrast to nominal yields, the real par yield curve remained significantly inverted as shown in Chart A3. In the financial year to the end of January 2008, the 10-year real par yield fell by 46 basis points to 1.3 per cent and 50 year yields fell by 18 basis points to 0.5 per cent. Chart A4, shows the real yields on selected benchmark index-linked gilts over the same period. The yield on the 10-year index linked gilt (1¼ per cent Index-linked Treasury Gilt 2017) fell by 49 basis points to 1.3 per cent whilst the 30-year and 50-year index-linked gilt yields fell by 40 and 27 basis points respectively. The yield on the 1⅛ per cent Index-Linked Treasury Gilt 2037 was 0.7 per cent on 31 January 2008. The 1¼ per cent Index-linked Treasury Gilt 2055 yielded 0.6 per cent on same day.

Chart A3: Real par gilt yield curves



Source: Debt Management Office

Chart A4: 10- 30- and 50-year index-linked gilts

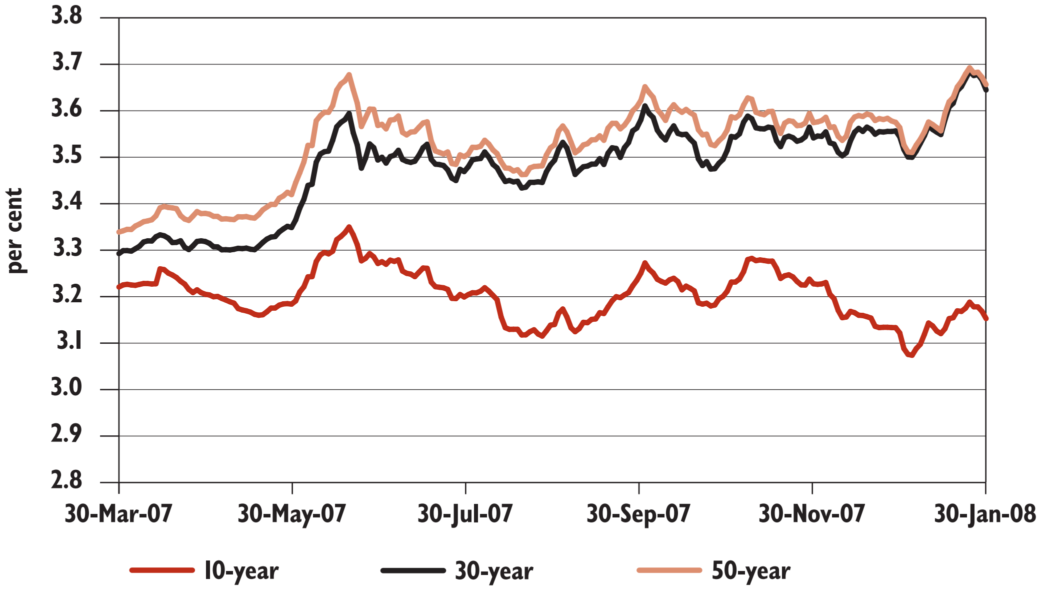


Source: Debt Management Office

Breakeven inflation rates[25]

A.9 Over the financial year to end-January 2008, index-linked gilts generally outperformed their conventional counterparts at longer maturities. The 10-year breakeven rate inflation rate fell by 7 basis points to 3.15 per cent while the 30-year and 50-year breakeven inflation rates rose by 35 basis points (to 3.65 per cent) and 31 basis points (to 3.66 per cent) respectively (see Chart A5).

Chart A5: 10- 30- and 50-year breakeven inflation rates



Source: Debt Management Office

[25] The breakeven inflation rate is the difference between the yield on a conventional gilt of a particular maturity and the yield on an index-linked gilt of the same maturity. It can be interpreted as a measure of inflation expectations.

B The Strategic Debt Analysis model and a comparison of debt issuance strategies

B.1 The Strategic Debt Analysis (SDA) model – which is described in detail in Chapter 6 of the *DMO Annual Review 2005-06* and in a DMO discussion paper[26] – is a debt strategy simulation model used by the DMO to illustrate the debt service cost and risk of different debt issuance strategies, given assumptions about the shape of both the nominal and real yield curves. The model is not used to determine a single optimal debt issuance strategy but to illustrate the cost and risk trade-off of different issuance strategies. Simulations using this model are set out below.

Design of simulation exercises – debt service cost and risk measures

B.2 The cost of the debt in any given period is defined as the sum, in cash flow terms, of all nominal coupon payments[27]. The debt service cost is measured as a ratio with respect to nominal GDP as this provides a clearer indication of the debt cost burden to the Government than does the nominal cost of debt on its own and is consistent with the Government's fiscal rules.

B.3 The risk measures capture the concept of financing risk, that is, the uncertainty in the financing or cash flow cost related to a given borrowing strategy. The financing risk associated with a given debt strategy is evaluated by:

- the standard deviation of the debt cost ratio, which measures its volatility in terms of deviations around the average (i.e. a symmetric measure); and
- the debt service cost ratio-at-risk, which is the largest debt cost ratio only exceeded by five percent of possible realisations according to the probability distribution of the debt cost ratio[28]. The debt service cost ratio-at-risk is a useful risk measure especially when the Government is concerned about avoiding extremely high debt costs (i.e. a tail measure).

Initial conditions for the simulation

B.4 The initial conditions for the simulation exercises in the SDA model are the:

- initial portfolio – gilt portfolio as at 18 December 2007 (excluding all undated gilts);
- initial values for the macroeconomic variables[29], which are their respective long-run average values; and

[26] Pick, A and ML Anthony (2006), "A simulation model for the analysis of the UK's sovereign debt strategy", UK DMO working paper. This paper can be found on the DMO's website at: http://www.dmo.gov.uk/documentview.aspx?docname=research/sda160806.pdf

[27] The sum of interest payments on nominal bonds, inflation compensated interest payments on inflation-linked bonds and the realised inflation compensation effects on maturing inflation-linked bonds.

[28] Or the upper 95th percentile of the debt service cost ratio distribution.

[29] The macroeconomic variables in the SDA model are the output gap, the net primary financing requirement (CGNCR, excluding interest payments), the short interest rate, CPI inflation and RPI inflation.

- initial nominal and real yield curves, which are generated from the long-run average values of those macroeconomic variables that are used to explain how the yield curves vary through time. The yield curves extend to the 30 year maturity[30].

B.5 The simulation horizon is 30 years (120 quarters) and 10,000 replications for each simulation exercise are completed.

Issuance strategies

B.6 Table B1 contains five issuance strategies. All strategies comprise around 70 per cent conventional gilts and 30 per cent index-linked gilts. In terms of maturity breakdown, Strategy 1 has a fairly even allocation across buckets while Strategy 2 is more clearly skewed towards long-term issuance. The latter strategy is similar to the actual issuance programme followed in 2007-08. The next two issuance strategies – Strategy 3 and Strategy 4 – both increase the proportion of short-term issuance with respect to Strategy 2. In Strategy 3, all of the increase in short issuance comes from a reduction in medium-term gilts issued while Strategy 4 also takes away some long-term gilt issuance. Finally, Strategy 5 represents an extreme issuance programme with 100 per cent allocation to 30-year nominal gilts. It is useful to include this last strategy as it provides a floor in terms of debt service cost and a ceiling in terms of cost at risk given the prevailing downward sloping yield curve[31].

Table B1: Composition of issuance strategies (per cent)

	5-year conventional gilt	10-year conventional gilt	30-year conventional gilt	10-year index-linked gilt	30-year index-linked gilt	Total index-linked
Strategy 1	23.3	23.3	23.4	15	15	30
Strategy 2	16	16	40	14	14	28
Strategy 3	20	12	40	14	14	28
Strategy 4	25	12	35	14	14	28
Strategy 5	0	0	100	0	0	0
Actual 2007-08	17	17	40	6	20	26

Source: Debt Management Office

Simulation results

B.7 The debt service cost-risk trade-off of each of the five issuance strategies has been calculated assuming that the nominal and real yield curves are downward sloping at the long end of the curve. Specifically, the simulated average shape and slope of the nominal yield curve have similar properties to the average nominal yield curve from 1998 to 2004 as the SDA model was calibrated on the basis of this dataset. This can be seen in Table B2 when comparing the mean and standard deviation of selected maturity points on the actual nominal yield curve with those on the simulated yield curve.

[30] Consequently, the actual gilt portfolio is adjusted to be consistent with this maturity range. All gilts of maturity greater than 30 years are re-classified as 30-year gilts. This adjustment has no implications for the results of the simulations because it affects all issuance strategies equally. In addition, as the frequency of the SDA model is quarterly, when several conventional gilts mature in the same quarter they are combined and treated as a single gilt. A similar transformation is done for index-linked gilts. These additional minor adjustments have no implications for the results of the simulations because they affect all issuance strategies equally.

[31] As discussed in Chapter 6: Strategic Debt Analysis (SDA), DMO Annual Review 2005-06.

B.8 The slope of the yield curve has disinverted in 2007-08 (refer to Annex A). In this context, it is useful to extend the dataset used for the initial calibration of the SDA model to include the last three years of actual yields up to end-2007 and check whether the results for the mean are significantly different. It appears that the means are the same[32] and the standard deviation has changed only very marginally. More formally, t-tests carried out on the difference between the means at each maturity bucket confirm that there is no statistical difference at the 99 per cent confidence level between both sample means. This confirms the validity of the original calibration of the yield curve in the SDA model, which is a downward sloping yield curve on average.

Table B2: Actual and simulated nominal interest rates (per cent)

	Actual (1998 Q1 – 2004 Q4)		Actual (1998 Q1 – 2007 Q4)		Simulated (1998 Q1 – 2004 Q4)	
	Mean	Standard deviation	Mean	Standard deviation	Mean	Standard deviation
5-year	4.9	0.7	4.9	0.6	4.6	0.6
10-year	4.8	0.4	4.8	0.4	4.5	0.4
30-year	4.5	0.2	4.5	0.3	4.3	0.2

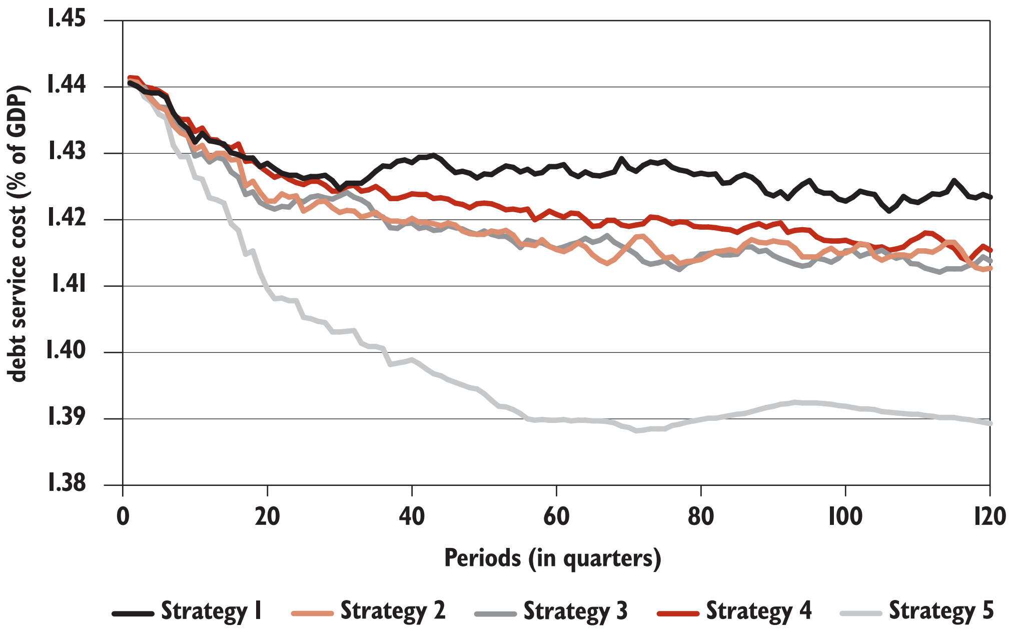
Source: Debt Management Office

B.9 The results for the average debt service cost (see Chart B1) show that all the issuance strategies which are skewed to long maturity gilts have lower average debt service cost than Strategy 1, which is the most expensive. Strategy 5 is the cheapest strategy as it contains the largest share of the relatively cheaper long maturity gilts than the other strategies. Strategies 2 and 3 exhibit similar costs and are slightly cheaper than Strategy 4 as they maintain a relatively larger proportion of long maturity gilt issuance while increasing somewhat the share of short maturity gilts issued.

B.10 The downward trend in the average debt service cost of Strategies 2 to 5 in Chart B1 reflects the fact that, over time, the maturity of the portfolio is being altered by the assumed issuance strategies replacing older and more expensive maturing gilts with new and relatively cheaper gilts.

[32] The results have been rounded to one decimal place.

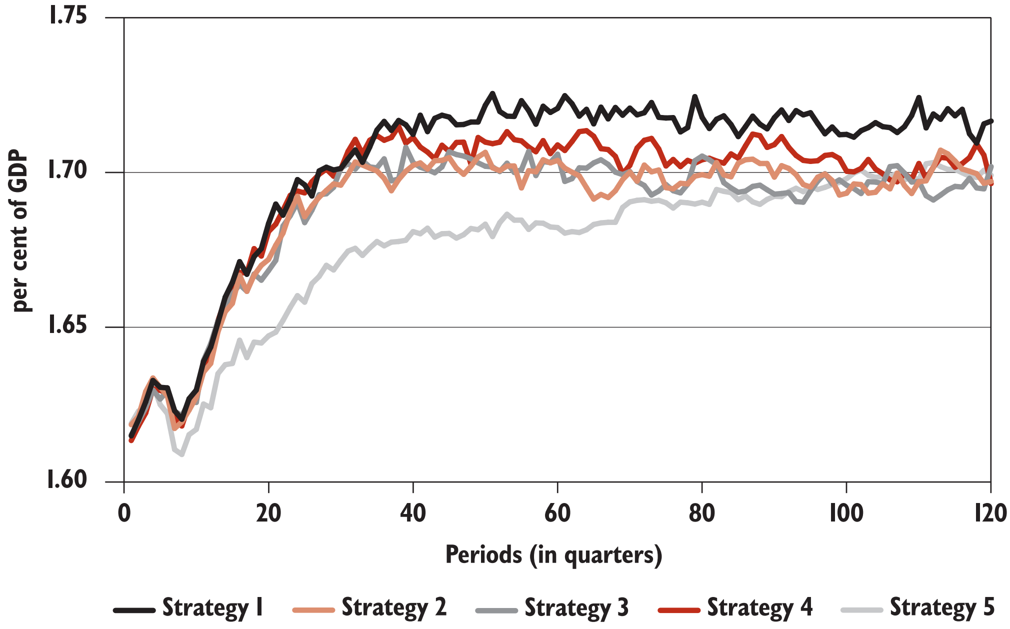
Chart B1: Average debt service cost



Source: Debt Management Office

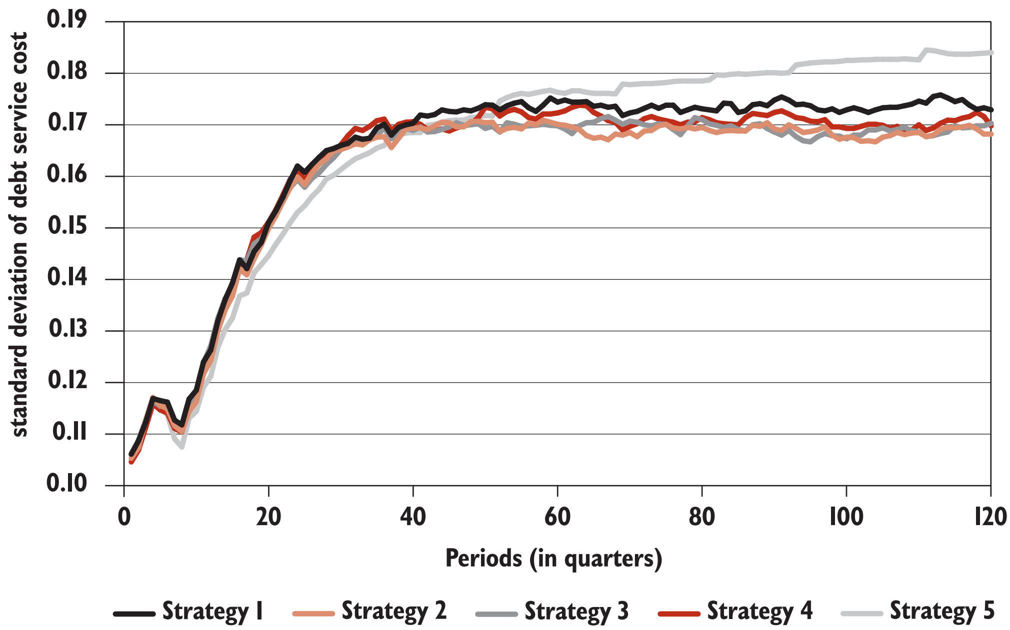
B.11 The results for risk show that overall Strategies 2 and 3, closely followed by 4, are less risky than the other issuance strategies (see Charts B2 and B3 below). This reflects the larger shares of long maturity gilts compared to Strategy 1. Strategy 5 seems to be the least risky during the first half of the simulation horizon but later becomes progressively riskier. This is because, as time progresses and more of the existing portfolio consists of longer-term gilts, Strategy 5 only samples 30-year yields and, although these yields vary across replications and time periods, they are highly correlated affecting negatively the risk measures.

Chart B2: Debt service cost at risk



Source: Debt Management Office

Chart B3: Standard deviation of debt service cost



Source: Debt Management Office

B.12 There are two striking features of the two measures of risk. First, during the early period of the simulation horizon the risk measures do not differ significantly for the respective strategies. That is to be expected because, during this early period, the initial portfolio is the dominant force driving the debt service cost distributions and the marginal impact of the issuance strategies is correspondingly small. Second, both measures of risk rise sharply in the early phase of the simulation horizon. This feature occurs because the range of the debt service cost widens immediately after the initial period of the simulation.

B.13 Simulation results from the SDA model confirm its initial finding that the Government could achieve a better debt service cost – risk trade-off by skewing issuance towards long maturity gilts in circumstances where the average yield curve is downward sloping. The model suggests that an issuance strategy that has a larger proportion of long maturity gilts would be cheaper and less risky than issuance strategies with a smaller allocation of these gilts. This result is robust to extending the underlying yield curve dataset considered to end-2007. Furthermore, a strategy such as Strategy 3 or 4 in which the long-term skew is maintained but tempered somewhat to increase the proportion of short-term issuance still achieves lower cost and risk than an issuance strategy of even allocation of issuance across maturity buckets. In this way the cost and risk characteristics of Strategy 3 or 4 would not deviate significantly from those attributed to the actual issuance programme followed in 2007-08.

B.14 It is worth bearing in mind that the simulation modelling only captures one risk to which the Government's gilt issuance plans expose the Exchequer (i.e. the variability in debt servicing costs over time). However, debt issuance exposes the Exchequer to other risks that lie outside the scope of the model. In practice, consideration of these risks will be included in the Government's decisions about gilt issuance.

C The Exchequer's cash management objective and key performance indicators and controls

CASH MANAGEMENT OBJECTIVE	KEY PERFORMANCE INDICATORS AND CONTROLS
The Debt Management Office (DMO) must supply sufficient cash each day to enable government to meet its payment obligations. This is fundamental and unconditional.	Way and Means transfers must be avoided for cash management purposes by ensuring that there is always a positive Debt Management Account (DMA)[33] balance. (NB: HM Treasury is responsible for monitoring and reporting performance of the forecasting function against outturns).
Cash management operations and arrangements should be conducted in a way that does not interfere with monetary policy operations.	The DMO will conduct market operations with a view to achieving, within a very small range, the weekly cumulative target balance for the DMA at the Bank of England. The DMO will maintain formal and informal channels of communication with the Bank on conditions in the sterling money markets. The DMO will seek to avoid holding weekly or ad hoc Treasury bill tenders when the Bank conducts its weekly open market operations.
Cash management operations and arrangements should be conducted without impeding the efficient working of the sterling money markets.	The DMO will advise HM Treasury as appropriate on the impact of Exchequer cash flows on liquidity conditions in the sterling money markets.
The DMO should maintain a system in which the costs and risks are transparent, measured and monitored and the performance of government cash management is assessed. The DMO maintains an ethos of cost minimisation rather than profit maximisation.	The DMO will report to HM Treasury on a quarterly basis the details of its cash management activity, its active management performance against the Government's marginal cost of funds and the market and credit risks incurred. Performance may also be reported in the DMO Annual Review.
The DMO should maintain a credible reputation in the market that leads to lower costs in the long term and a cash management system that is sustainable.	The DMO should maintain channels of communication with money market participants and Treasury bill counterparts both formally and informally to explain, as far as possible, the nature and intent of its operations in the money markets. The DMO should monitor compliance with its operational notices; provide complete, accurate and timely instructions to counterparties, agents, external systems and operators; and achieve the successful settlement of agreed trades on the due date.

[33] The Debt Management Account is the government's cash management account at the Bank of England.

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