Provisional debt management report 2003–04

March 2003

HM TREASURY

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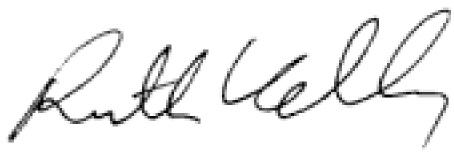
FOREWORD BY THE FINANCIAL SECRETARY TO THE TREASURY

This is a report outlining the Government's debt management activities in 2002-03. It also includes provisional financing plans for 2003-04. The report is being published ahead of the Budget in order to comply with the *Code for Fiscal Stability* which requires the publication of a debt management report every financial year. This allows us to provide market participants with a preliminary indication of the Government's financing plans for 2003-04, thereby maintaining our commitment to transparency in all areas of debt and cash management. A full update for the financing arithmetic will be published with this year's Budget papers on 9 April.

Net issuance in 2002-03 is projected to be £9.2 billion making 2002-03 the first year of net positive gilts issuance since 1997-98. 2002-03 has also seen a return to issuance in the short maturity sector, with the issue of 5% Treasury 2008 on 26 June 2002 which, within six months of issue, had reached £9 billion outstanding. This was the first issue of a new short maturity gilt since 1999. Also notable was the issue of the first new index-linked gilt in almost a decade with the issue on 11 July 2002 of 2% Index-linked Treasury 2035. This also has the distinction of being the first index-linked gilt issued under a redesigned prospectus for index-linked gilts. In other areas of debt management, the Public Works Loan Board and the National Debt Office were integrated into the Debt Management Office over the summer of 2002 thereby concentrating debt management operations in a single organisation and maximising administrative efficiencies. National Savings and Investments also launched their first equity-linked product, the Guaranteed Equity Bond, on 22 March 2002.

The provisional financing plans and auction timetable are included in this report. Our issuance strategy continues to adhere to our debt management objectives, balancing the needs of the market against the costs and risks to the gilts portfolio.



RUTH KELLY

20 March 2003 **Financial Secretary to the Treasury**

INTRODUCTION

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

The *Debt and Reserves Management Report* is usually published on the day that the Chancellor of the Exchequer announces the Budget. However, the *Code for Fiscal Stability*[1] requires that a debt management report be published every financial year. Therefore, HM Treasury has decided to publish a *Provisional Debt Management Report* in advance of the Budget in order to comply with the *Code.*

The report is designed to review developments in debt management over the past financial year and sets out the details of the Government's provisional borrowing programme for the forthcoming financial year. A full update will be published with the Budget papers on 9 April 2003.

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

- the size and structure of the UK Government's debt portfolio;
- UK debt and cash management policy;
- a review of the Government's financing programme in 2002-03;
- developments in National Savings and Investments in 2002-03;
- a preliminary Government financing programme for 2003-04; and
- the preliminary remits for 2003-04 set by HM Treasury for the DMO and National Savings and Investments.

[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

SIZE AND STRUCTURE OF UK GOVERNMENT'S DEBT IN 2002-03

Debt stock

The total nominal outstanding stock of United Kingdom Central Government marketable sterling debt (including official holdings by central government) was £284.0 billion at end-December 2002. This comprised of £190.2 billion of conventional gilt-edged stock, £72.1 billion of index-linked gilts (including accrued inflation uplift) and £21.7 billion of Treasury bills (see Table 1). An additional £61.9 billion (including accrued interest) was invested in National Savings and Investments instruments.

Table 1: Composition of principal UK central government sterling debt

(£ billion, nominal value, including official holdings)

	end-March 2002	end-Dec 2002
Conventional gilts[1]	200.8	190.2
Index-linked gilts[2]	70.4	72.1
Treasury bills[3]	9.7	21.7
Total	**280.9**	**284.0**
National Savings and Investments	62.3	61.9

Source: ONS

[1] *includes undated stocks*
[2] *includes accrued indexation uplift*
[3] *includes Treasury bill stock in market hands*

Maturity and duration

The average maturity of the stock of all dated gilts rose from 11.00 years to 11.39 years between end-March 2002 and end-December 2002. The average maturity of conventional gilts alone rose from 10.24 years to 10.53 years. Over the same period, the modified duration of the conventional portfolio of marketable gilts rose from 6.56 years to 7.04 years.

The maturity and duration of the Government's marketable domestic debt continues to be amongst the longest when compared to other European countries.

Distribution of gilt holdings

Table 2 shows the distribution of the market value of gilt holdings by sector at end-March 2002 and end-September 2002. Insurance companies and pension funds continue to be major investors in gilts and still own the majority of gilts in issue, whilst overseas holdings of gilts have declined slightly as a percentage of total gilt holdings.

Interest payments

Gross central government debt interest payments in 2001-02 were £22.2 billion, equivalent to 5.7% of total managed expenditure (TME). In 2002-03, they are forecast to be £20.8 billion (5.0% of TME) and in 2003-04, £21.6 billion (4.7% of TME).

Table 2: Distribution of gilt holdings (market values)

	End-March 2002		End-Sept 2002	
	£ billion	**%**	**£ billion**	**%**
Insurance companies and pension funds	177.2	60.9%	195.4	64.7%
Banks and building societies	6.1	2.1%	-0.1	0.0%
Other financial institutions	22.6	7.8%	24.2	8.0%
Households	28.1	9.7%	25.3	8.4%
Other public sector*	3.9	1.4%	3.5	1.1%
Overseas	53.0	18.2%	53.8	17.8%
Total	**291.0**	**100%**	**302.1**	**100%**

* = Local authorites and public corporations

Source: ONS

UK GOVERNMENT'S DEBT AND CASH MANAGEMENT POLICY

Objectives of debt management

The Government's debt management policy objective remains:

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

The debt management policy objective is achieved by:

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

Maturity and composition of debt issuance

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

- investors' demand for gilts;
- the Government's own attitude to risk, both nominal and real;
- the shape of both the nominal and real yield curves and the expected effects of issuance policy; and
- changes to the stock of Treasury bills and other short-term instruments required for cash management in 2003-04.

The Government keeps its optimal issuance framework under review. When deciding on the volume, maturity and composition of new issuance, the Government must not only consider the needs of the market but also its own risk appetite and preferences. A fuller description of the optimal issuance framework will be presented in the *Debt and Reserves Management Report 2003-04* which will be published with the Budget Papers on 9 April 2003.

Cash management operations

The DMO's main strategic objective in carrying out its cash management role[2] is:

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

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

Over the course of the financial year, the Exchequer's cash flow has a fairly regular pattern associated with the tax receipt and expenditure cycles and also outflows associated with gilt redemptions. Chart 1 below shows the scale of daily cash flows in 2002-03 to end-January 2003 – the major change from previous years was in the level of the overall central government net cash requirement – which was significantly further in deficit. This chart excludes the effects of Treasury bill issuance on the management of the DMO's net cash position.

The increase in the deficit required a general increase in the stock of outstanding Treasury bills in order to help manage seasonal cash outflows. The stock began the financial year at the remit target of £9.7 billion, but following the introduction of tenders for six-month bills and increases in the sizes of tenders of one- and three-month bills, the stock climbed steadily to around £22 billion by end-December 2002. The stock was reduced to £19.3 billion by end-January 2003 ahead of expected cash inflows associated with payments of corporation tax. The target level for end-March 2003 is £15.0 billion (see Chart 2).

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[2] A full description of the DMO's cash management objectives and operations can be found in "Exchequer Cash Management in the United Kingdom A DMO Handbook". This is available on the DMO website at: http://www.dmo.gov.uk/publication/f2mon.htm

Chart 1: Daily and cumulative Exchequer cash flows 2002-03

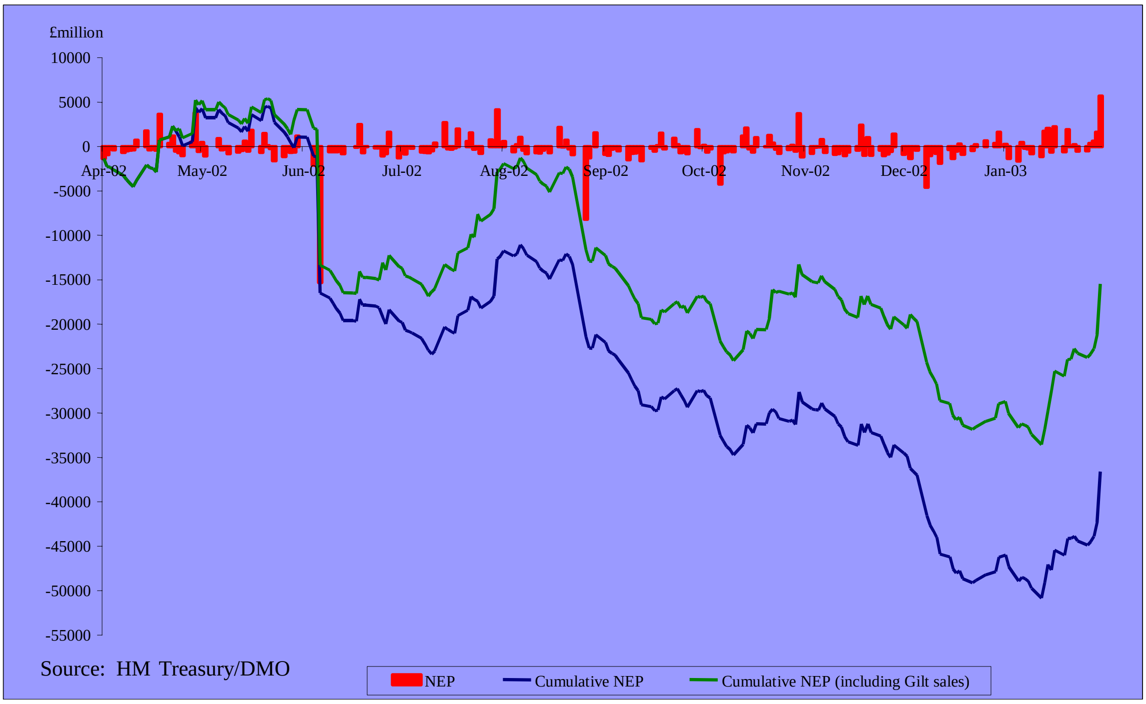
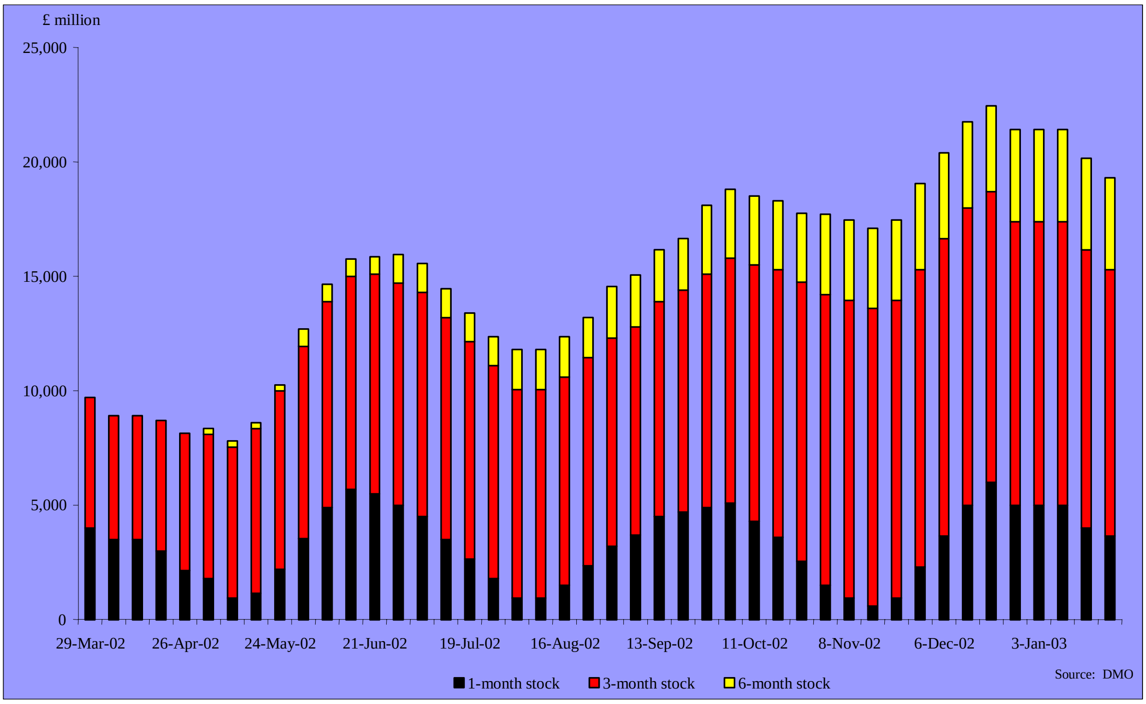


Chart 2: Cumulative Treasury bill stock (April 2002 - January 2003)

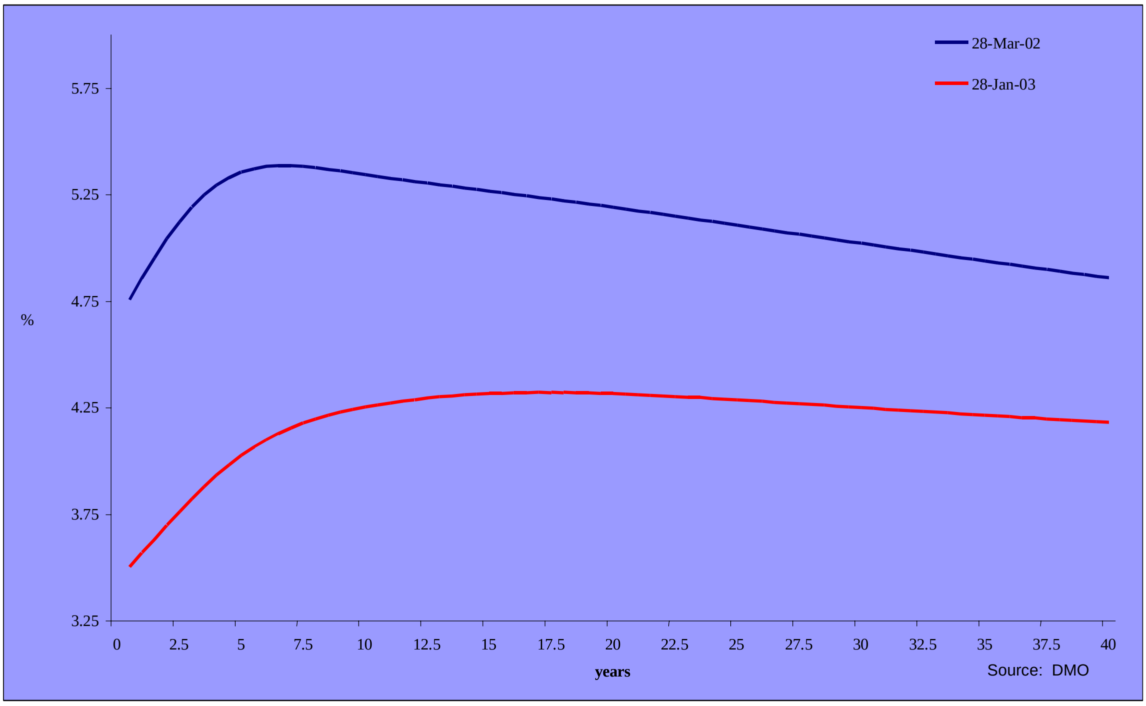


THE GOVERNMENT'S BORROWING PROGRAMME 2002-03

Gilt market review 2002-03

Between April 2002 and end-January 2003, yields on conventional gilts fell along the curve. Overall, the yield curve steepened with par gilt yields falling by 133 basis points (bps) at the 5-year maturity, by 109 bps at the 10-year maturity and by 87 bps at the 30-year maturity (see Chart 3).

Chart 3: Par gilt yield curves



The financial year opened with a gradual decline in gilt yields (see Chart 4). Weak economic data coincided with poor equity market performance to reduce the market's expectations of an early increase in interest rates. By end-June 2002, the Bank of England's Monetary Policy Committee (MPC) had left the Bank's repo rate unchanged for seven consecutive meetings. As a result, the short-end of the yield curve steepened (with the yield on the 2-year benchmark stock 5% Treasury 2004 falling 30 bps). Yields also fell at all other points on the curve in this period, with ultra-long gilts slightly underperforming relative to the medium sector of the curve (see Chart 5).

Chart 4: Benchmark conventional gilt yields (April 2002-Jan 2003)

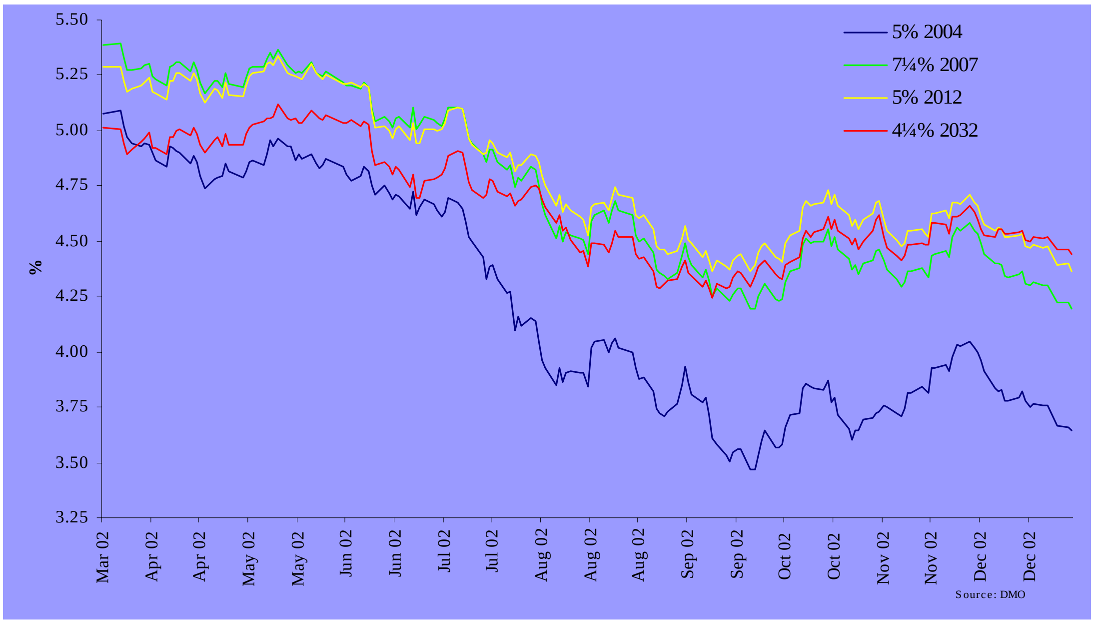


Chart 5: Conventional gilt yield spreads (April 2002-Jan 2003)

Yields continued to fall during the second quarter of the year as further weak economic data from the eurozone, the United States and, in part, the UK combined with further sharp falls in equity market indices to increase market expectations that the MPC would cut its repo rate. The short-end of the yield curve steepened further with the ultra-long sector of the curve continuing its underperformance. In July, the yield on 5% Treasury 2004 fell by 64 bps compared to a 3 bps fall on 4¼% Treasury 2032, while the spread between the yields on 30-year and 10-year benchmark gilts moved from –23 bps to –7 bps over the quarter. The yield on 5% Treasury 2004 reached 3.47% on 30 September 2002 - at the time, the lowest level for 2-year yields since 1954.

In contrast to the first half of the financial year, at the start of the third quarter, yields began to rise. Expectations that the MPC might cut the Bank's repo rate began to be discounted in the face of somewhat more robust domestic economic data. In particular, the continued strength of consumer spending and house price inflation were continually cited by market analysts as the main barriers to a reduction in official interest rates. Rising yields at the long-end of the curve resulted in a marked disinversion of the curve. However, yields resumed their descent in January with continued "flight-to-quality" in response to heightened geopolitical uncertainty and continued equity market volatility.

The real yield[3] on 2½% Index-linked Treasury 2013 and 2½% Index-linked Treasury 2024 hit lows of 2.05% and 1.93% respectively in mid-September (see Chart 6). However, compared to conventional gilts, index-linked gilts underperfomed significantly, with break-even inflation rates (BEIRs) falling sharply in the first half of the financial year before stabilising somewhat. By the end of January, BEIRs had fallen by 63 bps in the 10-year maturity sector and 49 bps in the 30-year area of the curve (see Chart 7).

[3] On a 3% inflation assumption

Chart 6: Real yields on 10- and 20-year index–linked gilts (Apr 2002 – Jan 2003)

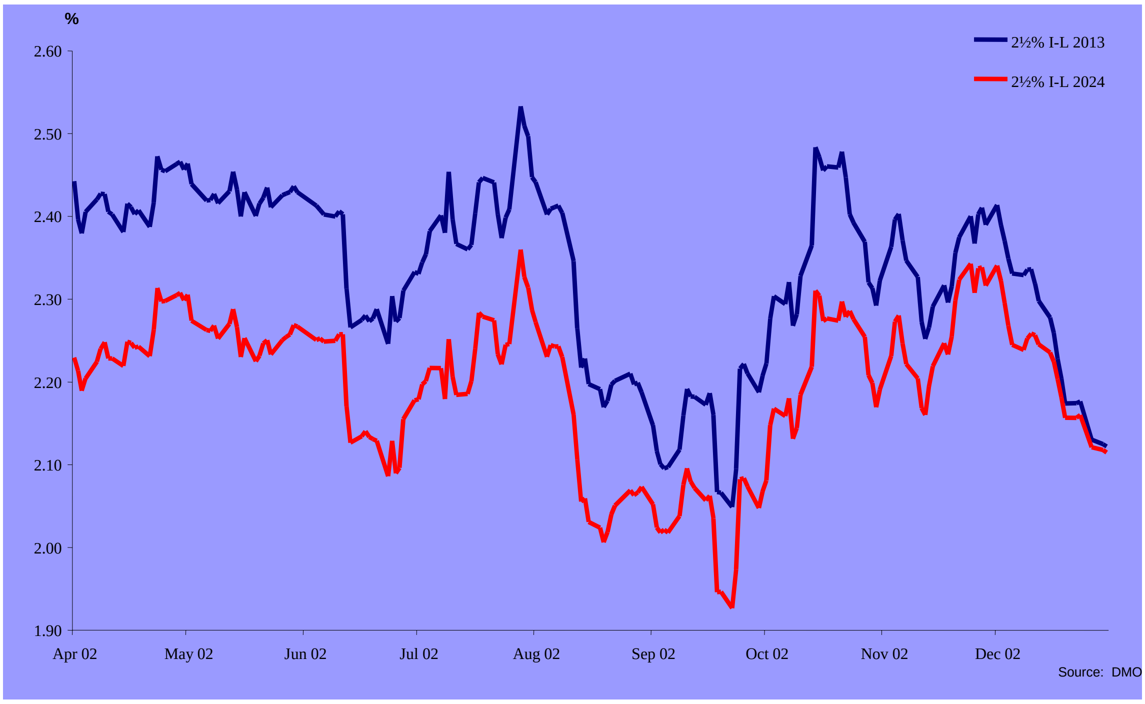
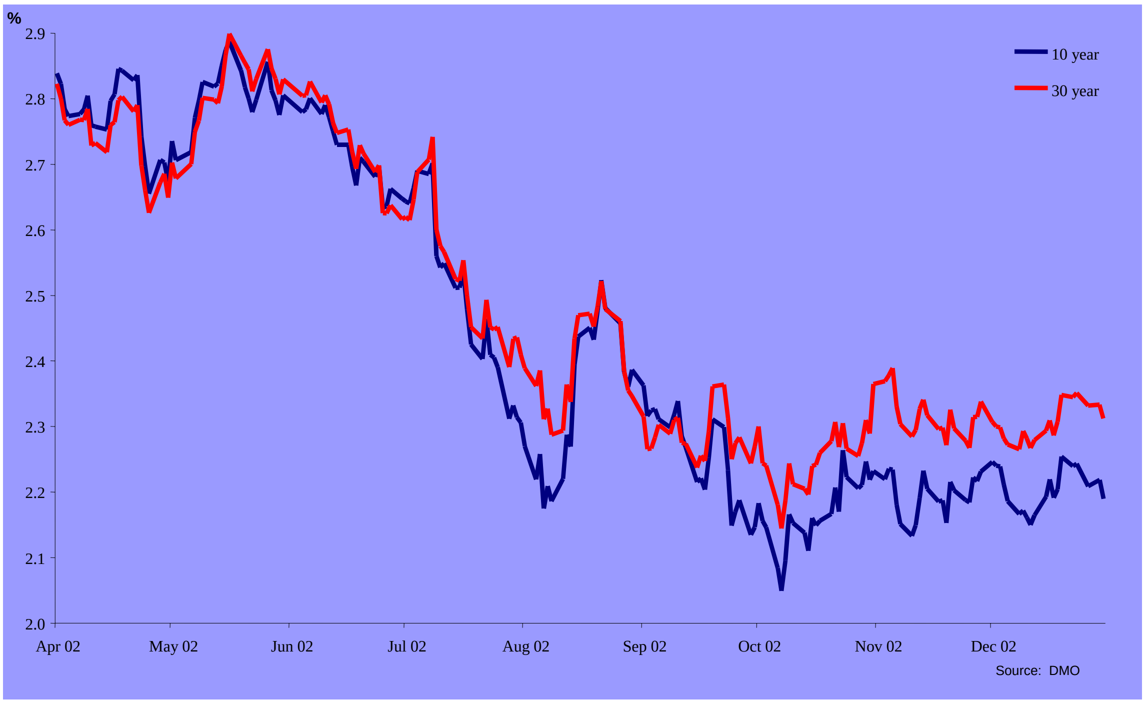


Chart 7: Break-even inflation rates (April 2002-Jan 2003)



Gilt sales and contingencies

This section sets out how the CGNCR forecast for 2002-03 has changed since preliminary financing plans were set out in the *Debt and Reserves Management Report 2002-03* published on 14 March 2002. Subsequent changes to the financing arithmetic for 2002-03 are outlined in Table 3.

The *Code for Fiscal Stability* requires HM Treasury to publish a debt management report, including an outline of the next financial year's financing plans, prior to the start of that financial year. However, Budget 2002 was scheduled for 17 April 2002. Therefore, the *Debt and Reserves Management Report 2002-03* was published on 14 March 2002. It included a provisional remit based on the public finance projections published in the Pre-Budget Report on 27 November 2001. This set out planned gilt sales of £23.0 billion (cash)[4].

On the basis of the PBR forecast for the central government net cash requirement (CGNCR) for 2002-03 of £13.6 billion, a net financing requirement of £32.3 billion was forecast. This was to be financed by:

- gross gilt sales of £23.0 billion split as follows –
  - short conventional issuance of £5.5 billion;
  - medium conventional issuance of £5.5 billion;
  - long conventional issuance of £7.5 billion; and
  - index-linked issuance of £4.5 billion.

- net short-term debt sales of £9.3 billion made up of –
  - a £4.3 billion increase in the stock of Treasury bills (taking it to £14.0 billion); and
  - a run-down of £5.0 billion in the DMO's net cash position (taking it to £2.7 billion).

The provisional remit included contingencies that could be implemented in the event that the Budget forecasts led to changes in the financing requirement. In the event of a falling financing requirement, the first contingencies to be considered would be:

- increasing the size of the DMO net cash position by up to £3.0 billion;

- reducing planned long conventional issuance by up to £2.5 billion; and

- reducing planned index-linked issuance by up to £0.75 billion.

[4] Unless otherwise indicated references to planned gilt sales are in cash terms.

In the event of a rising financing requirement, the first contingencies to be considered would be:

- reducing the size of the DMO's net cash position by up to £1.0 billion;

- increasing planned short conventional issuance by up to £2.5 billion; and

- increasing planned medium conventional issuance by up to £2.5 billion.

Budget 2002

Budget 2002 on 17 April 2002 included the outturn figure for the CGNCR in 2001-02 as well as a new forecast for 2002-03 – these were (with the previous forecasts in brackets):

- 2001-02: £2.9 billion (£6.3 billion)
- 2002-03: £13.5 billion (£13.6 billion).

Over the 2001-02 and 2002-03 forecast period, the financing requirement fell by £3.6 billion compared to the original forecasts published in the *Debt and Reserves Management Report 2002-03*. In line with the published contingencies, £0.6 billion of this difference was taken account of by a reduction in long conventional gilt sales to £6.9 billion (cash), thus reducing total planned gilt sales to £22.4 billion (cash). The remainder (£3.0 billion) was accommodated by an increase in the forecast level of the DMO's net cash position at end-March 2003 to £5.7 billion. This required an increase of £0.4 billion in the planned run-down in 2002-03 to £5.4 billion (excluding the planned change in the DMO's deposit at the Bank of England), from its realised level of £11.0 billion at end-March 2002 (compared to £7.7 billion forecast on 14 March 2002).

Pre-Budget Report 2002

The Pre-Budget Report 2002 published on 27 November 2002 included revised forecasts for the public finances. The forecast for the CGNCR in 2002-03 increased by £5.2 billion to £18.7 billion. The net financing requirement increased by £5.0 billion[5] to £37.1 billion. It was announced that the DMO planned to meet the additional financing requirement by:

- an increase of £3.8 billion in planned gilt sales, including scheduling an additional gilt auction on 15 January 2003, taking them to £26.2 billion; and

- an increased run-down of £1.2 billion in the DMO's net short-

[5] Secondary market net gilt purchases of £0.3 billion and a reduction of £0.5 billion in National Savings & Investment's expected de-financing also impacted on the net financing requirement.

term cash position, to £4.5 billion.

Planned short gilt sales were increased by £3.0 billion to £8.5 billion and planned long conventional gilt sales were increased by £0.8 billion to £7.7 billion.

The change in the DMO's net cash position meant that the planned run-down for 2002-03 was now £6.6 billion with the level at end-March 2003 expected to be £4.5 billion.

The financing arithmetic for 2002-03 has been updated to reflect a revision to the forecast for National Savings and Investments' net contribution. This has been revised from a negative financing contribution of £1.5 billion to a positive contribution of £0.2 billion. This is a reflection of recent strong demand from retail investors for ultra-safe cash products.

Consequently, based on PBR 2002's forecast for the CGNCR in 2002-03, the net financing requirement has been revised from £37.1 billion to £35.9 billion, a decrease of £1.2 billion.

Additionally, it has been decided to increase the planned level of outstanding stock of Treasury bills in market hands at end-March 2003 by £1.0 billion to £15.0 billion in order to facilitate efficient cash management.

Overall, this means that the expected rundown of the DMO's net cash position has been decreased by £2.4 billion to £4.2 billion, leaving an expected end-March 2003 level of £6.9 billion.

DMO Operations

The DMO issued four new stocks in 2002-03: 5% Treasury 2008, 5% Treasury 2014, 4¼% Treasury 2036 and 2% Index-linked Treasury 2035, the first new index-linked stock since 1992.

Table 4 shows the results of the outright gilt auctions held in 2002-03 and those of the mini-tender on 14 November 2002. The latter involved the sale of the residual portion of the (uncovered) index-linked gilt auction held on 25 September.

One conversion offer was held in 2002-03, from 9% Treasury 2008 into the then newly-issued 5% Treasury 2008 (first issued on 26 June 2002). The conversion offer was launched on 12 July 2002 and closed on 2 August 2002. Acceptances were received for £4.8 billion (87.5%) of 9% Treasury 2008 and £5.9 billion of 5% Treasury 2008 was created, taking the new stock to almost £9 billion in issue. 9% Treasury 2008 was reduced to a rump stock as a result of the conversion.

No switch auctions were held in 2002-03.

Table 3: Financing Requirement 2002-03

(£ billion)	DRMR 14 March 2002	Budget 17 April 2002	PBR 27 November 2002	Update 20 March 2003
CGNCR forecast	**13.6**	**13.5**	**18.7**	**18.7**
Gilt redemptions	17.2	17.0	17.0	17.0
Buy-backs	0.0	0.0	0.3	0.3
Financing Requirement	**30.8**	**30.5**	**36.0**	**36.0**
less				
National Savings and Investments	-1.5	-1.5	-1.0	0.2
DMO cash deposit at Bank of England	0.0	-0.1	-0.1	-0.1
Net Financing Requirement	**32.3**	**32.1**	**37.1**	**35.9**
Financed by:				
Planned gilts sales	**23.0**	**22.4**	**26.2**	**26.4**
of which:				
Short conventional	5.5	5.5	8.5	8.5
Medium conventional	5.5	5.5	5.5	5.6
Long conventional	7.5	6.9	7.7	7.7
Index-linked	4.5	4.5	4.5	4.6
Planned net short-term debt sales	**9.3**	**9.7**	**10.9**	**9.5**
of which:				
Change in Ways & Means	0.0	0.0	0.0	0.0
Change in Treasury bill stock	4.3	4.3	4.3	5.3
Change in DMO net cash position*	5.0	5.4	6.6	4.2
End-year short-term debt levels				
Ways & Means at end of FY	13.4	13.4	13.4	13.4
Treasury bill stock at end of FY	9.7	14.0	14.0	15.0
DMO net cash position**	2.7	5.7	4.5	6.9

Note: Table may not sum due to rounding

Source: HM Treasury/DMO

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

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

Table 4: Results of DMO Market Operations

Date	Stock	Amount auctioned	Cover	Average accepted price (AAP)	Yield at AAP	Tail (bp)*
24 April 02	2½% IL 2020	£425mn	2.19	£210.17	2.39%	na
29 May 02	5% 2025	£2,250mn	2.24	£97.62	5.18%	1
25 June 02	5% 2008	£3,000mn	1.68	£99.63	5.08%	1
10 July 02	2% IL 2035	£950mn	1.38	£97.80	2.09%	na
24 July 02	5% 2014	£2,750mn	2.02	£101.05	4.88%	2
25 September 02	2% IL 2035	£900mn	0.95	£99.00	2.04%	na
22 October 02	5% 2014	£2,750 mn	1.99	£102.05	4.77%	1
24 October 02	2½% IL 2013	£450mn	3.01	£197.72	2.40%	na
*14 November 02***	*2% IL 2035*	*£74mn*	*na*	*£98.76*	*2.08%*	*na*
03 December 02	5% 2025	£2,750mn	1.77	£103.21	4.75%	1
15 January 03	5% 2008	£2,750mn	2.65	£103.27	4.28%	1
22 January 03	2½% IL 2020	£425mn	2.59	£226.01	2.03%	na
26 February 03	4¼% 2036	£2,750 mn	1.70	£97.65	4.39%	1

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

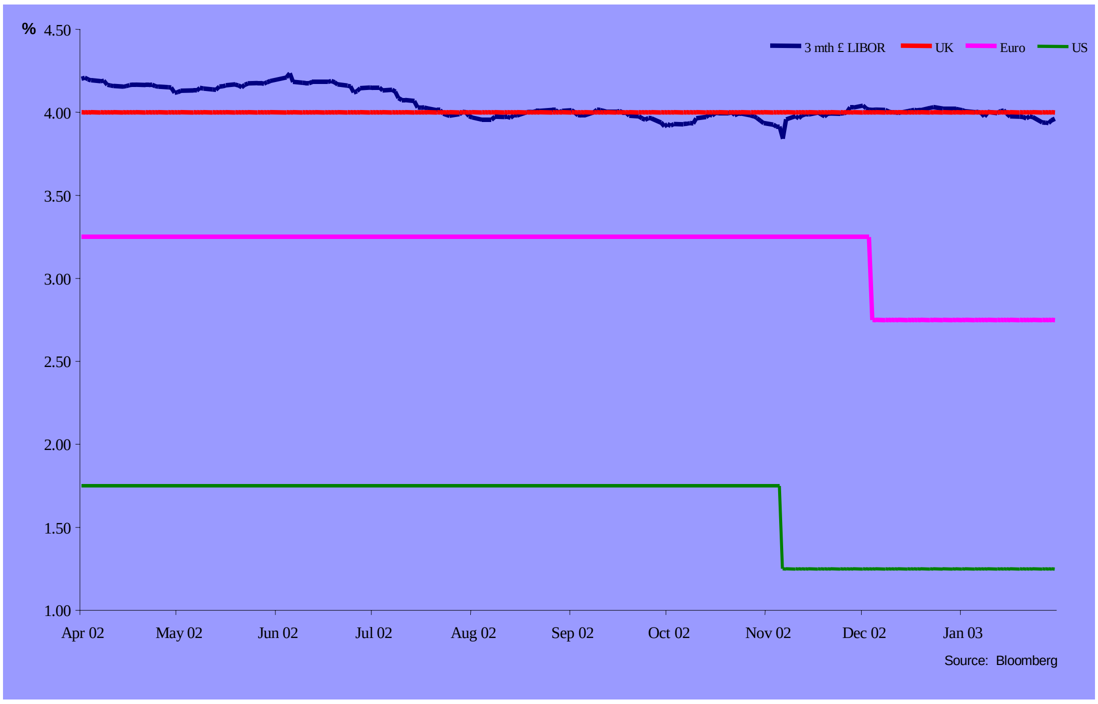
Source: DMO

Cash Market Review

Developments in the sterling money markets

Market developments in the period from April 2002 to end-January 2003 were characterised by a period of stability in official interest rates. The Bank of England's Monetary Policy Committee (MPC) kept its repo rate unchanged at 4%. During this period, there was one 50 basis points (bps) reduction in official rates in both the US (to 1.25% on 5 November 2002) and the Eurozone (to 2.75% on 7 December 2002). The path of official rates is outlined in Chart 8 below.

Chart 8: Official central bank interest rates and LIBOR (April 2002- Jan 2003)



In the UK, the spread between 3-month LIBOR[6] and the Bank's repo rate started the financial year at +20bp and was as high as +23 bps (i.e. pricing in a rate rise) in early June.

However, as less robust economic data was published throughout the summer, the expectations of a rate rise began to be discounted. In July 2002, 3-month LIBOR fell below the Bank's repo rate and stayed at or below that rate for the remainder of the period. There was a sharp spike down to –16 bps on 5 November after the unexpectedly large cut by the US Federal Reserve, but the

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

spread ended the period at –4 bps and averaged –4.5 bps over the period.

The cuts in key interest rates by the US Federal Reserve and the European Central Bank were reactions to continuing poor economic data, exacerbated by rising geopolitical tension in the Middle East. In the UK, resilient house prices and the general strength of consumer spending acted as a brake on similar rate reductions. However, UK rates were cut by 25 bps on 6 February 2003 with the Bank of England citing the deterioration in the global economy and revisions to the Bank's inflation projections (published in its *Inflation Report* on 12 February) as the main reasons for the cut, which was largely unanticipated by the market.

National Savings and Investments

The outstanding balance of National Savings and Investments' (NS&I) instruments at the start of the financial year was £62.3 billion. During 2002-03, NS&I were initially expected to make a negative net contribution to financing of £1.5 billion. However, with relatively low nominal interest rates and the weakness in equity markets, there was strong demand for NS&I products, particularly Premium Bonds. The net contribution to financing for 2002-03 is now estimated to be £0.2 billion with gross sales (including accrued interest) of £13.0 billion.

NS&I's overall cost of financing remained lower than that of comparable gilts throughout the year after taking into account management costs and imputed tax foregone.

NS&I have announced seven packages of rate changes during the financial year to date. For new issues of fixed rate products, these reflected changes in medium-term gilt yields. For variable rate products, there was one rate cut which reflected movements by their competitors and the cut in the repo rate announced by the MPC on 6 February 2003.

Table 5: Change in NS&I product stock

	End-March 2002		End-March 2003*	
	£ billion	per cent	£ billion	per cent
Variable rate	36.7	58.9	37.8	60.5
Fixed rate	16.4	26.3	16.8	26.9
Index-linked	9.2	14.8	7.9	12.6
Total	**62.3**	**100**	**62.5**	**100**

*estimate

The Guaranteed Equity Bond

On 7 March 2002, National Savings and Investments (NS&I) launched the first tranche of its Guaranteed Equity Bond (GEB). This was the first new product that they had issued under the "National Savings and Investments" brand name and also had the distinction of being the first product they had ever sold that was linked to equities.

The GEB offers NS&I's customers a return linked to the performance of the FTSE 100 Share Index. Over the 5-year life of the product, investors are offered a return linked to the performance of the index subject to a pre-defined maximum (known as the "cap"). If the index falls over the life of the GEB, investors are guaranteed their initial capital invested.

The GEB raised the question of how the Government protected itself from equity exposure. This protection was achieved using a financial instrument known as an *"equity index swap"*. The stages of the transaction are outlined below:

i) NS&I take the money from the sale of the product and pass it to the National Loans Fund (NLF). Upon maturity of the product, the NLF is liable to repay this capital and any accrued equity-related return.

ii) The NLF does not possess the legal authority to enter into the swap directly so this was undertaken via the Debt Management Account (DMA) which is operated by the DMO. The DMA enters into an equity index swap with a counterparty (an investment bank chosen after a tendering process). A LIBOR-based interest rate is exchanged for a FTSE-based return. The swap is collateralised to protect the DMA from counterparty risk.

iii) Simultaneously, as the swaps mature, NS&I pay the investor his/her initial investment plus, if FTSE has risen, the growth in the FTSE subject to the cap. If the FTSE has gone down the customer's capital is returned in full.

iv) At the maturity date, the DMO pays the counterparty the compounded value of the agreed LIBOR-based interest payment; and, if the FTSE has risen, the counterparty pays the DMO the relevant return from the index subject to the cap. The net profit or loss on the swap is passed back from the DMA to the NLF via the periodic reconciliation payment between the two accounts. In effect the NLF has paid a LIBOR-based rate.

The GEB saves the taxpayer money because the LIBOR-based rate paid to the counterparty is at a rate lower than the Exchequer would have paid to borrow in the cash markets once all operating costs are factored in.

THE GOVERNMENT'S PROVISIONAL FINANCING PROGRAMME FOR 2003-04

Financing framework

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

The Government's financing plans are usually published in the *Debt and Reserves Management Report* on the day that the Chancellor of the Exchequer announces the Budget. However, the *Code for Fiscal Stability* requires that a debt management report be published every financial year. Therefore, in compliance with the *Code*, HM Treasury has decided to publish this *Provisional Debt Management Report* in advance of the Budget which sets out a preliminary Government financing programme for 2003-04.

Financing Arithmetic

Table 6 gives details of the preliminary financing arithmetic for 2003-04. It outlines the proposed structure and composition of debt instruments that the Government intends to use to meet its financing requirement in 2003-04.

The forecast for the CGNCR for 2003-04 as published in PBR 2002 was £30.2 billion. Gilt redemptions, excluding official holdings, are expected to be £21.1 billion (see Table 7).

National Savings and Investments

NS&I's net contribution to financing (including accrued interest) in 2003-04 is forecast to be £1.5 billion. This assumes gross sales (i.e. sales and deposits including accrued interest) of £12 billion. This forecast is not a target but an estimate based on experience in previous years, trends in the retail savings product market over 2002-03 and NS&I's own forecasts and objectives.

Financing for the Official Reserves

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

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

Table 6: Financing Arithmetic 2003-04
(£ billion)

Central Government Net Cash Requirement			**30.2**
Gilt redemptions			21.1
Gross financing requirement			**51.3**
less National Savings and Investments			1.5
Net financing requirement			**49.8**
Financed by:			
Gross gilt sales			**40.0**
	Conventional	short	13.4
		medium	10.8
		long	9.3
	Index-linked		6.5
Changes in net short-term debt			**9.8**
Change in the Ways & Means Advance			0.0
Increase in Treasury bill stock			3.2
Decrease in the DMO net cash position			6.6
Memo			
End-year short-term debt levels			
Ways & Means Advance			13.4
Treasury bill stock			18.2
DMO net cash position*			0.2

** including the DMO's cash deposit at the BoE*

Short-term net debt position

It is forecast that the short-term net debt position will change by £9.8 billion. This change is made up of:

- an increase in the planned end-year stock of Treasury bills; and

- a completion of the unwinding of the DMO's net cash position.

The level of the Ways and Means Advance from the Bank of England planned for 31 March 2003 is £13.4 billion and is assumed to remain at this level for 2003-04.

The financing plans for 2003-04 assume that the outstanding stock of Treasury bills is increased by £3.2 billion. The planned stock of outstanding Treasury bills held outside central government is targeted to rise to £18.2 billion.

It is assumed that the DMO will further unwind the net cash position by £6.6 billion over 2003-04 thereby meeting the commitment given in PBR 2000 to unwind the net cash position by end-March 2004. The DMO will continue to maintain a working balance of £200 million at the Bank of England.

Quantity of gilt sales

The DMO, under instruction from HM Treasury and on behalf of HM Government, will aim to meet the remainder of the financing requirement by selling gilts to the private sector. On the basis of the CGNCR forecast, this means gross gilt sales of approximately £40.0 billion (cash).

Nature of stocks

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

Maturity structure of issuance

Based on the PBR 2002 forecast for the CGNCR in 2003-04, net gilts issuance will be £18.9 billion. The financing programme for 2003-04 assumes fourteen outright auctions for conventional gilts, five for short maturities, five for medium maturities and four for long maturities.

Despite the provisional nature of the financing remit, the Government undertakes to issue a maximum of £6.5 billion (cash) of index-linked gilts in 2003-04. This assumes eight outright auctions and reflects the Government's continued commitment to the index-linked market against a background of sustained low inflation.

DMO cash collateral

As described in the DMO's Exchequer Cash Management Remit (see pages 27-30), over the course of 2003-04, HM Treasury may issue gilts to the DMO for collateral purposes in order to aid the DMO in the efficient execution of its cash market operations. Any such issuance will be wholly transparent and fully reported to the market. It will be designed in such a way as to minimise the effect on key market indices.

Contingencies

The preliminary financing arithmetic is based on the PBR2002 forecasts for the CGNCR in 2002-03 and 2003-04. Updated forecasts for both fiscal years will be published in the Budget papers on 9 April 2003.

The following contingencies may be exercised if there are any changes to either the forecast (in Budget 2003) or subsequent outturn for the CGNCR in 2002-03. These will be accommodated by an analogous adjustment in the net short-term debt position by either:

- a change in the unwind of the DMO's net cash position; or

- an increase/decrease in the planned stock of Treasury bills in market hands at the end of the fiscal year.

The following contingencies may be exercised in the event that the forecast for the CGNCR in 2003-04 changes.

If there are any downward revisions (i.e. a smaller cash requirement), then HM Treasury would consider accommodating such revisions by:

- decreasing the planned stock of Treasury bills in market hands at the end of the fiscal year (by up to £2 billion); or

- decreasing its planned conventional gilt sales in 2003-04 broadly in line with the relative proportions outlined in the provisional plans.

If the CGNCR rises (i.e. a greater net cash requirement), then HM Treasury would consider meeting the increased financing requirement by:

- increasing the planned stock of Treasury bills in market hands at the end of the fiscal year (by up to £2 billion); or
- increasing planned sales of conventional gilts broadly in line with the relative proportions outlined in the provisional plans.
- the Government may also consider issuance of an ultra-short maturity gilt within any planned increase in sales of short gilts.

Specific decisions on the exercising of contingencies would be made in the light of circumstances.

Table 7: Stocks maturing in 2003-04

(£ million)

Redemption date	Stock	Nominal amount outstanding	Official holdings (end-Dec 2002)	Nominal value of stocks outside central government (end-Dec 2002)
07 May 2003	9¾% Conversion 2003	12	12	0
20 May 2003	2½% Index-linked Treasury 2003	2,734	238	4,283*
06 June 2003	3½% Funding 1999-2004**	561	50	511
10 June 2003	8% Treasury 2003	7,102	522	6,580
08 September 2003	10% Treasury 2003	1,872	104	1,768
21 November 2003	12½% Treasury 2003-2005***	152	54	98
07 December 2003	6½% Treasury 2003	8,095	316	7,779
26 March 2004	13½ Treasury 2004-2008***	96	25	71
Total		**20,624**	**1,321**	**21,090**

** including accrued inflation uplift of £1,787 million*

*** call notice issued on 3 March 2003*

*** assuming redemption on earliest date

Source: DMO

THE DEBT MANAGEMENT OFFICE REMIT FOR 2003-04

A) Gilt Remit

Objectives

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

- to meet the annual remit set by HM Treasury Ministers for the sale of gilts, with high regard to long-term cost minimisation taking account of risk;

- to advise Ministers on setting the remit to meet the Government's debt management objectives and to report to Ministers on the DMO's performance against its remit, objectives and targets;

- to develop policy on and promote advances in new instruments, issuance techniques and structural changes to the debt markets that will help to lower the cost of debt financing, liaising as appropriate with the Bank of England, Financial Services Authority, London Stock Exchange, and other bodies; and to provide policy advice to HM Treasury Ministers and senior officials accordingly;

- to conduct its market operations, liaising as necessary with regulatory and other bodies, with a view to maintaining orderly and efficient markets and promoting a liquid market for gilts;

- to provide, including in liaison with the Bank of England and CRESTCo, a high quality efficient service to investors in government debt, and to deal fairly and professionally with market participants in the gilt and money markets, consistent with achieving low cost issuance;

- to contribute to HM Treasury's work on the development of the strategy for the debt portfolio; and

- to make information publicly available on the debt markets and DMO policies where that contributes through openness and predictability to efficient markets and lower costs of debt issuance.

Quantity of gilt sales

2 The DMO, on behalf of the Government, will aim for gilt sales of

approximately £40.0 billion in 2003-04.

Pace of gilt sales

3 The DMO will aim to sell gilts at a broadly even pace throughout the year. Within-year seasonal fluctuations in the pattern of central government expenditure and revenue will be met by other financing means governed by the Exchequer Cash Management Remit.

Amount and maturity mix of index-linked gilt issuance

4 Over 2003-04, the DMO aims to sell a maximum of £6.5 billion (cash) in index-linked stocks.

5 Eight auctions of index-linked stocks are planned in 2003-04. Issuance will be directed at stocks dated 2009 and longer.

6 To ensure the medium-term viability of the index-linked auction programme, the authorities remain committed to a minimum supply of £2.5 billion (cash) of index-linked stocks for the foreseeable future.

Amount and maturity mix of conventional gilt issuance

7 Fourteen auctions of conventional stocks are planned in 2003-04; four in the long (15 years and over) maturity area, five in the medium (7-15 years) and five in the short (1-7 years) maturity area. The last may include the issuance of a floating rate gilt.

8 HM Treasury will consider accommodating reductions in the forecast 2003-04 financing requirement by:

- decreasing the planned stock of Treasury bills in market hands at the end of the fiscal year (by up to £2 billion); or

- decreasing its planned conventional gilt sales in 2003-04 broadly in line with the relative proportions outlined in the provisional plans.

9 Increases in the financing requirement will be accommodated by a combination of:

- increasing the planned stock of Treasury bills in market hands at the end of the fiscal year (by up to £2 billion); or

- increasing planned sales of conventional gilts broadly in line with the relative proportions outlined in the provisional plans.

- the Government may also consider issuance of an ultra-short maturity gilt within any planned increase in sales of conventional gilts.

10 Specific decisions on the exercising of contingencies would be made in the light of circumstances.

Buy-backs of debt

11 The DMO has no plans for a programme of reverse auctions in 2003-04.

Method of issuance of gilts

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

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

Provisional Gilt Auction Calendar 2003-04

Date	Type
16 April 2003	Index-linked
24 April 2003	Conventional
15 May 2003	Conventional
28 May 2003	Conventional
12 June 2003	Conventional
24 June 2003	Index-linked
26 June 2003	Conventional
2 July 2003	Conventional
16 July 2003	Index-linked
29 July 2003	Conventional
10 September 2003	Conventional
23 September 2003	Index-linked
25 September 2003	Conventional
15 October 2003*	Conventional
23 October 2003*	Index-linked
29 October 2003*	Conventional
25 November 2003*	Conventional
10 December 2003	Index-linked
13 January 2004	Index-linked
28 January 2004	Conventional
24 February 2004*	Index-linked
24 March 2004*	Conventional

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

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

15 After an auction, the DMO will generally refrain from issuing stocks of a similar type or maturity to the auctioned stock for a reasonable period. Such stock

will only be issued if there is a clear market management case.

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

In-year consultation and announcements on auctions

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

18 The auction plan for the first quarter of the financial year will be announced at 3:30 p.m. on 28 March 2003.

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

Coupons

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

Buy-ins of short maturity debt

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

Conversions and switch auctions

22 In order to build up the pool of benchmark stocks further, the DMO may make offers for the conversion of non-strippable stocks into benchmarks of similar maturity during 2003-04. The DMO may also consider converting out of stocks with up to £5.5 billion (nominal) in issue. Such offers may be supplemented by switch auctions into benchmark stocks during 2003-04. The DMO may consider using switch auctions to help smooth the redemption profile or to help smooth the

market impact of large changes in relevant gilt indices. Details of any future switch auction stocks will be announced at the same time as the end-quarter announcements of forthcoming outright auctions.

Reviews to the remit

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

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

24 Any revisions to this remit will be announced.

B) Exchequer Cash Management Remit

Objective

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

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

The DMO aims to:

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

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

- weekly Treasury bill tenders;

- bilateral market operations with DMO counterparties; and

- ad hoc tenders of Treasury bills (and repo or reverse repo transactions).

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

Treasury bill tenders

Timing and schedule of announcements

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

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

Maturities

6 The DMO's Treasury bill tenders in 2003-04 may be of the following maturities:

- one month (approximately 28 days);

- three months (approximately 91 days);

- six months (approximately 182 days); and

- twelve months (approximately 364 days).

Level of stocks

7 The DMO will manage Treasury bill transactions with a view to running down the stock of bills in months of positive cash flows and increasing it in months of higher net expenditure. The DMO will aim to build up the stock of Treasury bills in market hands to £18.2 billion by end-March 2004.

Interaction with the Bank of England's money market operations

8 The DMO may also issue Treasury bills to the market to assist the Bank of England in its management of the sterling money markets. In response to a request from the Bank, the DMO will add a specified amount to the size(s) of the next bill tender(s) and deposit the proceeds with the Bank, remunerated at the weighted average yield(s) of the respective tenders. The amount being offered to accommodate the Bank's request will be identified in the DMO's weekly structured bill tender announcement. Treasury bill issues at the request of the Bank will be identical in most respects with the rest of the stock of Treasury bills outstanding.

Ad hoc tenders

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

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

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

Timing of ad hoc tenders

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

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

Bilateral operations with the market

14 In pursuit of its cash management objectives, the DMO expects to trade on a daily basis with its counterparties across a range of instruments. The full range of instruments is set out in the DMO's

Exchequer Cash Management Operational Notice.

15 The DMO's bilateral operations may comprise of:

- purchase from the market for future resale (reverse repo);
- sale to the market for future repurchase (repo);
- outright sale and purchase of gilts, Treasury bills and eligible bills, certificates of deposit, commercial paper, selected bank bills and other short-term debt issued by high quality issuers, including supranationals and foreign governments;
- unsecured cash borrowing and lending with its counterparties; and
- short-term foreign currency swaps, Forward Rate Agreements (FRAs) and interest rate futures may also be used to manage foreign currency and interest rate exposures. All foreign currency exposure will be hedged back into sterling.

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

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

DMO cash collateral

18 If required, in exceptional circumstances, gilts or Treasury bills may be issued to the DMO for collateral purposes.

NATIONAL SAVINGS AND INVESTMENTS' FINANCING REMIT 2003-04

Introduction

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

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

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

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

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

Responsibility for setting product terms

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

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

Ministers would expect to endorse them.

Volume of financing in 2003-04

6 Sales and deposits (including accrued interest) of NS&I products are assumed to be around £12 billion in 2003-04. After meeting expected maturities and withdrawals, NS&I is expected to make a net contribution to Government financing of £1.5 billion.

Cost of financing

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

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

Review of remit

9 HM Treasury or NS&I may initiate a review of this remit during the course of 2003-04 in the light of any relevant factors.