ALL IN THE LINE OF DUTY

EVER WONDERED HOW THE UK DEBT MANAGEMENT OFFICE DOES BUSINESS? **NICK FISHER** AND **STEVE WHITING** REVEAL ALL, INCLUDING A DAY IN THE LIFE OF A GOVERNMENT CASH MANAGER.

The UK Debt Management Office (DMO) is the Treasury's treasury. Since April 2000, we have been responsible for managing the Government's daily cashflow, placing or borrowing an average of £0.5bn a day in the sterling money markets – sometimes much more than that. This article explains what the DMO's cash management task is and how we approach it.

The DMO was established only in April 1998, when it took over the role of the Government's debt manager – issuing gilts and managing the gilts market – from the Bank of England. It took us a little longer to take over cash management because we had to design a completely new function as well as procure the systems to support it.

Before April 2000, the Government's cash position was bound up in the Bank's management of the money market shortage, through which it influences the level of short-term sterling interest rates. The Bank's task is a little simpler now – it can assume that the Government's cash position is flat, because the DMO has ensured that it is (although there still have to be arrangements to deal with late swings, described below).

Although we did not know it at the time, the nature of the task we had been preparing for was about to be transformed by the unexpected scale of the cash proceeds from the auction of 3G Spectrum licences (which at £22bn were £19.5bn more than had been forecast in the March 2000 Budget).

The DMO's main strategic objective in cash management is to: "Offset, through its market operations, the expected outturn cashflow into or out of the National Loans Fund (NLF), on every business day, and in a cost-effective manner taking account of risk".

To deliver this objective we borrow from or lend to the market during each business day to balance the closing daily position on the NLF. These operations are part of a wider Government structure for managing Exchequer cashflows. The NLF is the fund that formally borrows money for the Government.

An arrangement of accounts, known as the Exchequer Pyramid, ensures that any cash balances which remain in Government accounts at the Bank of England at the end of every business day are channelled into the main central Government accounts, thereby minimising the Government's cash borrowing needs.

If the Consolidated Fund (the Government fund into which revenue from taxation and other sources flow) has a surplus, this is automatically transferred to the NLF to reduce its need to borrow. Equally, a transfer from the NLF automatically finances a deficit in the Consolidated Fund.

In seeking to balance the closing daily position on the NLF, we need to have reliable forecasts of each day's significant cashflows into and out of central Government and up-to-date monitoring of actual cashflows as they occur. Responsibility for forecasting and monitoring central government cashflows lies with HM Treasury.

On occasion, sizeable unanticipated cash inflows and outflows may occur too late in the day for their impact to be smoothed by bilateral dealing in the money markets. To take account of this, we have put arrangements in place with the Bank of England and settlement banks to cope with late changes to the forecast without disadvantage to the market.

In circumstances where there is an Exchequer cash surplus, the surplus is taken into the Bank of England's Settlement Bank late repo facility at 4.20pm (the additional refinancing is provided by the Bank at a non-penal rate of interest). An Exchequer cash deficit can be offset by bilateral borrowing from a number of settlement banks through a Special End of Day Transfer Arrangement (SEDTA). As a further contingency the DMO holds a balance of £200m at the Bank of England.

THE PATTERN OF GOVERNMENT CASHFLOWS. Over the course of a year the Exchequer's cashflow usually has a fairly regular monthly pattern associated with the pattern of tax receipts or expenditure cycles and major flows are also associated with gilt redemptions. The impact of these receipts on the cumulative central government net cash requirement (CGNCR) profile for 2000-2001 and 2001-2002 can be seen in *Figure 1*. In 2000-2001, the annual picture was dramatically affected by the extremely large cash proceeds from the sale of the third generation (3G) spectrum licences.

Within the longer-term pattern there is considerable uncertainty as to flows on any one day, associated largely with the unpredictability of the precise timing and size of some tax and expenditure flows. Our approach has been to manage these flows

A DAY IN THE LIFE OF A GOVERNMENT CASH DEALER

After thinking about how to approach this article, I soon realised that there is no such thing as a typical day in the life of a cash management dealer. There are so many potential surprises that you quickly learn to expect the unexpected. The cashflows we manage and the markets we operate in can be unpredictable, which can make strategic decisions sometimes appear as successful as completing a Lotto ticket. But that is what makes this job interesting, as well as challenging.

A typical day will begin many weeks, or even months, beforehand. It is important to accurately predict what cashflows are due on any one day as far in advance as possible. Some flows can be predicted with certainty – for example, a gilt redemption – but most are subject to change. Clearly, this forecast, provided by HM Treasury, is essential to our dealing strategies. We try to position ourselves in advance to ensure we are not too long or too short on any particular day taking into account where we think rates will be.

We primarily deal on a secured basis using gilt repo. We also auction UK Treasury bills each Friday morning and have recently started issuing six-month bills, in addition to the previous one-month and three-month bills. The tender ends at 11am and the result and the amounts we want to issue the following week are published on a number of wire services pages, usually within 10 minutes. We also deal in euro repo on a FX swapped basis (everything we do is in sterling or synthetic) and sometimes buy CDs.

Much of our dealing is done in the morning when the money markets are most active and liquid. We have about 40 counterparties and begin talking to them first thing to get a feel for where the market is placed. Our first trade of the day is never far away and typically by 8am we may have lent or borrowed many hundreds of millions of pounds. At 8am, we also start to deal with some local authorities – as part of a pilot scheme we are running, they are able to place deposits on call notice or fixed term.

During the course of the day, we receive updated details of the Exchequer's cash position from HM Treasury, aptly named the "swing". As the name suggests, this can move dramatically, depending on the nature of the flows. Tax receipts, in particular, tend to be volatile, as very large volumes are received "over the counter" (that is, for same day payment). Amounts and timing of these are notoriously difficult to predict – on some, fortunately very rare, occasions the DMO's position can change by £2bn to £3bn, this can seriously impact on any strategy we have in place.

Because of our responsibility not to influence rates and the liquidity of the market unduly, we deliberately do most of our dealing during the morning. However, the potential for large swings is higher in the afternoon. There is little point in borrowing every penny we can, only to find we have to lend the money back out again (or vice versa) with the risk of the market moving in between. We receive a "final" swing figure late afternoon, at which point we square our position. Further swings after the close of CHAPS at 4pm may change our position slightly. This balance can then either be included in the Bank of England's final round of monetary operations (this is the only operational contact the cash managers have with the Bank), if the Debt Management Account is over our target balance – or, if short, we can borrow from a clearing bank under APACS' Special End of Day Transfer Arrangement, which runs after the special end of day transfer scheme (commonly known as the huddle) where the UK clearing banks square off with one another.

The day usually ends by looking at tomorrow's position which may have changed with an updated forecast from HMT – but, of course, whatever we may decide today to do tomorrow may have to change entirely when tomorrow becomes today. **NICK FISHER**

primarily through bilateral dealing in a range of money market instruments and by the issuance of Treasury bills.

CASHFLOW SMOOTHING. Some rough smoothing of the Exchequer's prospective cashflow variation is possible through term lending and borrowing. But the daily variation in the forecast of Exchequer flows means there is also a need to fine tune cashflows on a daily basis. Apart from the weekly issue of Treasury bills, most of our dealing is carried out using secured money market instruments to borrow from, or lend to, wholesale money market participants.

An important part of the DMO's approach is to ensure our actions do not distort market or trading patterns. In particular, we look to managing cashflows without influencing the level of short-term interest rates. We also take account of, and avoid cutting across, the operational requirements of the Bank of England for implementing its monetary policy objectives.

In our bilateral dealings with the market, we are a price-taker and are required to balance the Exchequer cashflows cost-effectively. So, while we take account of market levels in seeking to find a cost-effective way of smoothing the Exchequer cashflows, we do not run the cash management operation with a profit target and would not seek to influence rates to our advantage. We work with the market, responding to market developments and balancing cost and risk in a similar way to other users.

To date, the DMO has principally used the secured markets to effect both long- and short-term Exchequer cash operations. The approach taken has involved purchases from the market when the

FIGURE 1
CUMULATIVE CGNCRS 2000-01 AND 2001-02 (£M).

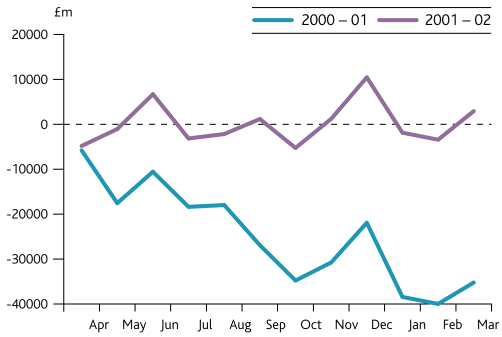
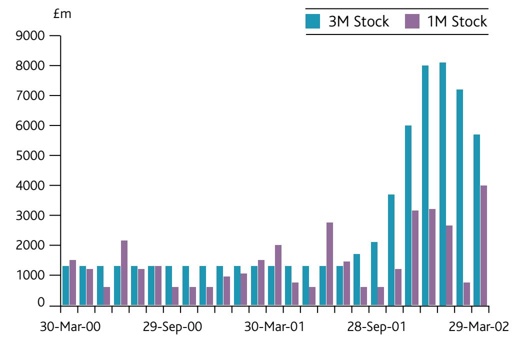


FIGURE 2
TREASURY BILLS: END-MONTH STOCK LEVELS (£M).



Exchequer is in surplus for future sale at a time when deficits are expected, and vice versa. The length of particular repo or reverse repo operations has reflected the projected profile of Exchequer cashflows. Some operations can be targeted some months in advance (ahead of days when significant cash inflows or outflows are expected (for example, gilt redemptions), but others are managed over a much shorter period.

TREASURY BILLS. The DMO can hold weekly tenders for Treasury bills of one-, three-, six- and 12- month maturities. From April 2000 to end-April 2002, the DMO issued only one-and three-month bills. The first tender of six-month bills was held on 3 May 2002.

The priority early on was to establish the stocks of the shorter maturity bills. We began the 2000-2001 financial year with a Treasury bill stock of only £2.8bn and plans to increase it to £10bn by end-March 2001 were thwarted by the size of the surplus and the need to protect gilt sales as far as possible.

The stock ended the 2000-2001 financial year at £3.3bn. In 2000-2001, the DMO used changes in the stock of one-month bills as a means of intra-year cashflow smoothing. The stock of one-month Treasury bills varied between £600m and £2.75bn. Three-month Treasury bill issuance remained unchanged at £100m per week throughout the year and the stock steady at £1.3bn.

‘IN THE CONTEXT OF CASH MANAGEMENT, WE HAVE NO CONTACT WITH THE MPC WITH REGARD TO INTEREST RATE DECISIONS OR ITS THINKING’

With a higher financing requirement in 2001-2002, the DMO was able to increase the stock of Treasury bills significantly – this peaked at £11.4bn In January 2002 and ended the financial year at the remit target of £9.7bn. Issuance amounts of both one- and three- month bills were varied with one-month issuance at tenders ranging from £150m to £1bn. Three-month issuance ranged from £100m to £700m. Stocks were increased sharply from September 2001 onwards – coinciding with a period of cash outflows from the Exchequer.

The increase in stock levels coincided with the introduction from 5 October 2002 of new arrangements for Treasury bill issuance, the most important of which was moving the close of bid time to 11am, from 12.30pm. The DMO also announced that a group of nine banks had agreed to act as primary participants in connection with the issuance of Treasury bills. Primary participants will bid on behalf of other investors at tenders and also agreed to provide secondary dealing levels for Treasury bills for their customers.

The end-month stock levels for the first two years of Exchequer cash management by the DMO are shown in *Figure 2*.

RELATIONSHIP WITH EXTERNAL BODIES. One of the fundamental reasons Government debt and cash management were separated from the Bank of England after the Bank acquired responsibility for the conduct of monetary policy in May 1997 was to ensure that debt management decisions could not be perceived to be influenced by inside information on interest rate decisions, and to increase transparency in debt and cash management.

In the context of cash management, we have no contact with the Monetary Policy Committee (MPC) with regard to interest rate decisions or its thinking. Neither do we receive from the Treasury, the Office for National Statistics or other parts of Government advance notice of policy statements or data releases that will affect the market’s short-term interest rate expectations. The only exceptions are data and forecasts relating to the Government’s financing needs, or any policy announcement that could involve significant short-term cashflow implications.

The DMO receives an annual remit from HM Treasury covering its operations in the gilts and money markets. The Exchequer cash remit covers the maturity of Treasury bills the DMO may issue and the planned stock build. It also covers the types of instrument the DMO may trade in our bilateral operations with the market. Full operational details are published in the DMO’s Cash Management Operational Notice (see web address below).

On 20 February 2002 the DMO published a handbook describing more fully its role in Exchequer cash management – including all the relevant operational notices. This is available on the DMO website at www.dmo.gov.uk/cash/public/cmbook200202.pdf and includes the Treasury bill Information Memorandum originally published on 21 September 2001.

Nick Fisher is head of Cash Dealing and Steve Whiting is Press Officer at DMO.
steve.whiting@dmo.gov.uk
nick.fisher@dmo.gov.uk
www.dmo.gov.uk