

Debt and reserves management report 2005-06

March 2005



HM TREASURY



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**Debt and reserves
management report
2005-06**

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FOREWORD BY THE FINANCIAL SECRETARY TO THE TREASURY

This is the twelfth 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 gilts issuance in 2004-05 is forecast to be some £50.3 billion, a level broadly similar to the previous year. It is a testimony to the efficiency of the UK Debt Management Office (DMO), the Gilt-edged Market Makers (GEMMs) and the gilts market in general that the operational demands of this programme have been met seamlessly. Also, in December 2004, the UK became the first sovereign debt issuer to consult its stakeholders on the possible issuance of 50-year bonds. A notable event in 2004-05 was the successful transfer of the gilts registration function to the private sector. On 20 December 2004, Computershare Investor Services plc took over as the new gilt registrar from the Bank of England, which had performed the registrar function to the highest standard for more than 300 years.

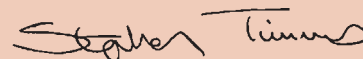
In the retail sector, National Savings & Investments (NS&I) has achieved product sales of approximately £10 billion and a net contribution to financing of around £2 billion in 2004-05. NS&I has now delivered around £5.4 billion of its commitment to achieve £15 billion net financing up to 2007-08. By the end of 2005-06 NS&I will have achieved approximately £8.9 billion. As part of its modernisation strategy, NS&I closed the Ordinary Account in July 2004. The replacement Easy Access Savings Account, launched in January 2004, offers better value for money to both customers and taxpayers.

Net gilts issuance in 2005-06 is projected to be £39.0 billion and gross issuance £53.5 billion including redemptions. The structure of issuance and the planned gilt auction calendar reflect the Government's commitment to a well-functioning gilts market as well as its aim of being responsive to investor demand and the market environment. Our debt management policy is to minimise financing costs whilst taking account of risk. This year the DMO's financing remit includes two innovations that illustrate that commitment to best practise in debt management. From 2005-06:

- the DMO may issue conventional and index-linked gilts with maturities of up to approximately 50 years; and
- any new index-linked gilt will have a three-month indexation lag as opposed to the current eight-month lag.

Finally, this report also provides a considered response to David Miles' recommendation – made in his independent review of the UK mortgage market¹ – that the Government should give further consideration to the potential costs and benefits of Government issuing interest rate derivatives.

16 March 2005



STEPHEN TIMMS

Financial Secretary to the Treasury

¹The UK Mortgage Market: Taking a Longer-Term View, an independent report by David Miles, can be found on HM Treasury's website at: http://www.hm-treasury.gov.uk/consultations_and_legislation/miles_review/consult_miles_index.cfm.

INTRODUCTION

- 1.1** This is the twelfth 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*² which requires that a debt management report be published every financial year covering the following areas:
- the overall size of the gilts issuance programme for the coming financial year;
 - the planned debt maturity structure and the proportions of index-linked and conventional gilts;
 - the gilt auction calendar; and
 - a forecast of net financing through National Savings & Investments (NS&I).
- 1.3** This year the structure of the DRMR has been improved to group together material on debt management, on NS&I and on management of the Official Reserves by the Bank of England, with the relevant remits following each commentary.
- 1.4** In addition, previous DRMRs have reviewed developments in debt management over the previous financial year in some detail. However, the UK Debt Management Office (DMO) already publishes more detailed information in its Annual Reviews. To avoid duplication, from this year much of the material reviewing the gilts market in 2004-05 will feature in the next DMO Annual Review. However, a summary of developments in the gilts market during 2004-05 (up to January 2005) is set out in Annex A of this report.

² 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 2004-05

Debt stock

2.1 The total nominal outstanding stock of United Kingdom central government marketable sterling debt (including official holdings by central government) was £436.1 billion at end-December 2004. This comprised £257.5 billion of conventional gilts, £85.8 billion of index-linked gilts (including accrued inflation uplift) and £25.0 billion of Treasury bills (T-bills) (see Table 2.1). In addition, there was £67.8 billion invested in NS&Is' instruments.

Table 2.1: Composition of UK Central Government sterling debt

	End-March 2004	End-December 2004
<i>(£ billion, nominal value, including official holdings)</i>		
Conventional gilts ¹	242.3	257.5
Index-linked gilts ²	78.7	85.8
Treasury bills ³	19.3	25.0
Total gilts and Treasury bills	340.3	368.3
National Savings & Investments	66.5	67.8
Total central government sterling debt	406.8	436.1

1. Includes undated and double-dated gilts

2. Includes accrued inflation uplift

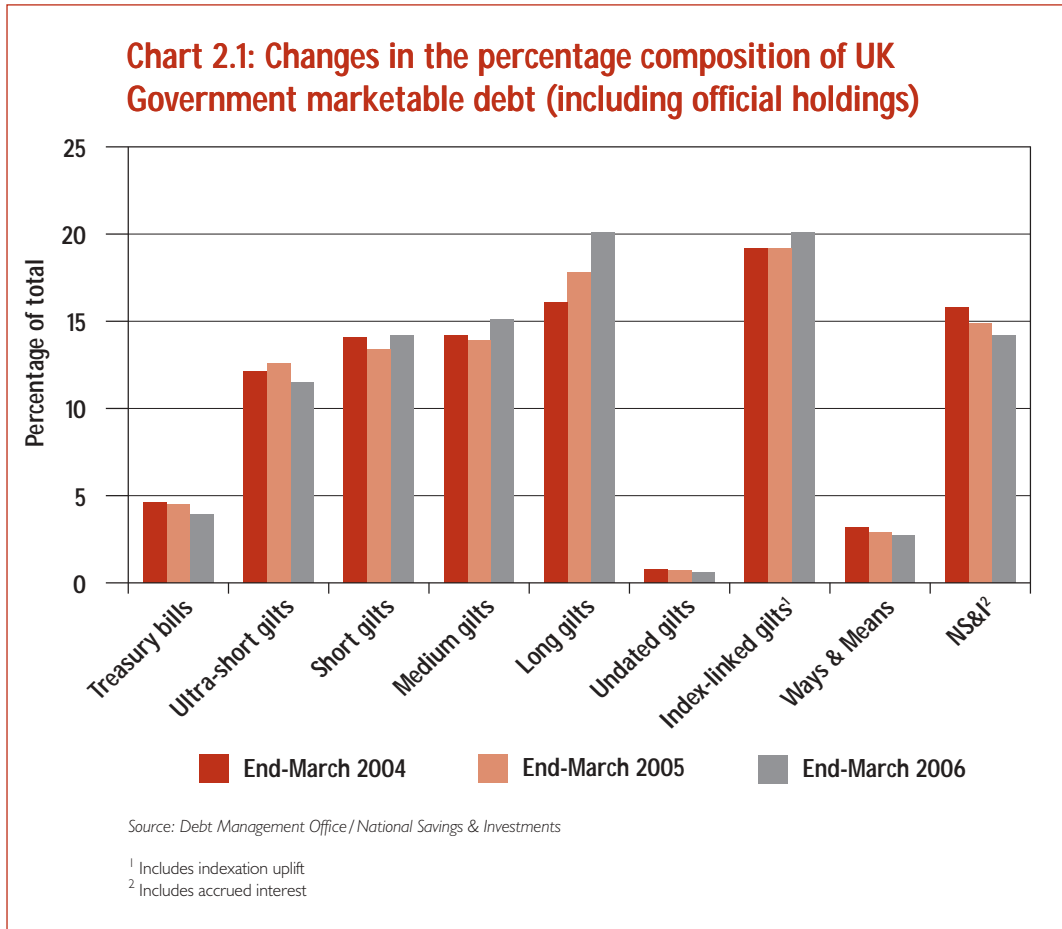
3. Treasury bill stock in market hands

Source: Debt Management Office/National Savings & Investments

Maturity and duration

2.2 The average maturity of the stock of all dated gilts rose from 11.55 years to 12.13 years between end-March 2004 and end-December 2004. Over the same period, the modified duration of the conventional portfolio of marketable gilts rose from 7.19 years to 7.64 years. The maturity and duration of the UK Government's marketable domestic debt continues to be amongst the longest compared with other European countries.

2.3 Chart 2.1 below shows a comparison of the Government's debt portfolio at end-March 2004 through to a projected composition at end-March 2006. It assumes that new debt is issued in accordance with the DMO's financing remit. It also takes into account the ageing of existing debt. It does not, however, make assumptions about possible switch auctions.



Interest payments

2.4 Gross central government debt interest payments in 2003-04 were £22.2 billion, equivalent to 4.9 per cent of total managed expenditure (TME). In 2004-05, they are forecast to be £23.8 billion (4.9 per cent of TME) and in 2005-06, £25.6 billion (4.9 per cent of TME).

Gilts issuance and the gilts 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. In 1998-99, gross issuance was only £8.2 billion but this figure has risen substantially since then, and is expected to reach £50.3 billion in 2004-05, the highest level for over a decade.

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 gilts issuance is derived. The CGNCR for each of the years in which the DMO has been responsible for gilts issuance and the volume of gilt sales in each of those years is shown in Table 2.2 below.

2.7 In the first years of the DMO's operations the size of the gilts 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 £35.6 billion in 2004-05 and significant levels of net issuance are projected over the medium-term reflecting the Government's investment programme in the public services. Chart 2.2 below shows the trend in gross and net issuance since 1990-91 with projections to 2009-10.

2.8 The size of the gilts market reflects these trends: in March 2002 the nominal value of the gilts market (including index-linked uplift) was £278.7 billion, by end-December 2004 it had reached £343.3 billion – an increase of 23 per cent. Chart 2.3 below shows developments in the size of the gilts market since 1990-91.

Table 2.2: Central government net cash requirement and gross gilt sales 1998-99 to 2004-05

Financial year	CGNCR (£ billion)	Gross gilt sales (£ billion)
1998-99	-4.6	8.2
1999-00	-9.1	14.4
2000-01 ¹	-35.3	10.0
2001-02	2.8	13.7
2002-03	21.6	26.3
2003-04	39.4	49.9
2004-05 ²	42.9	50.3

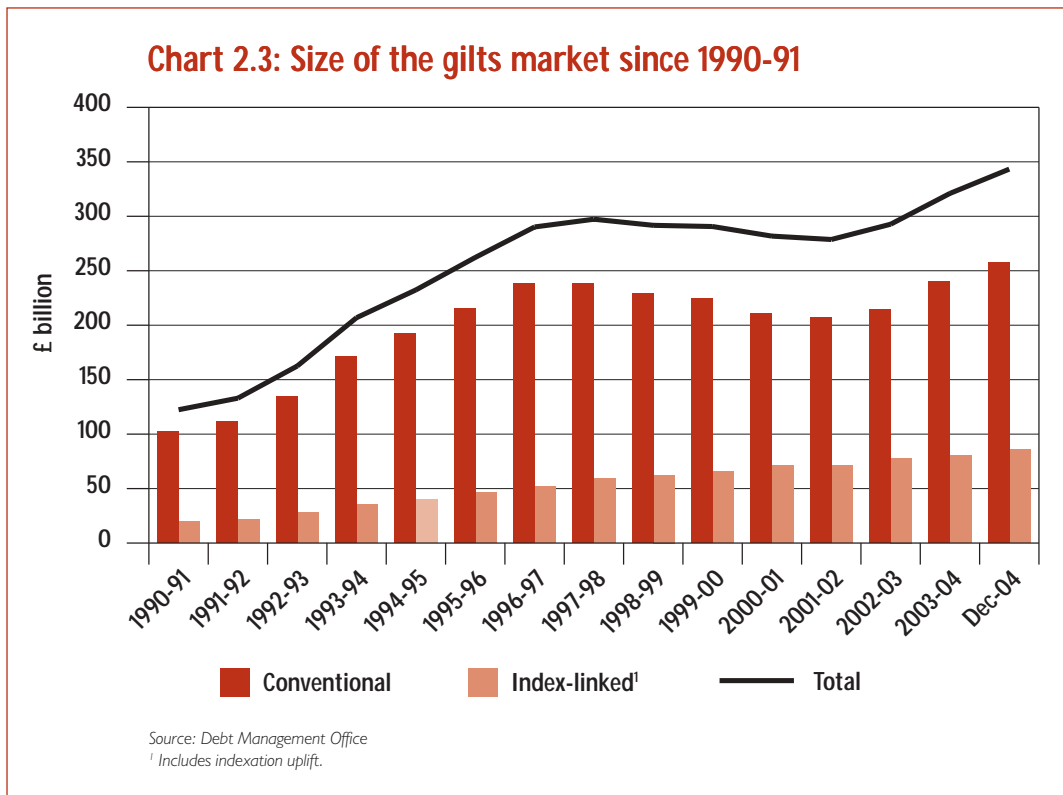
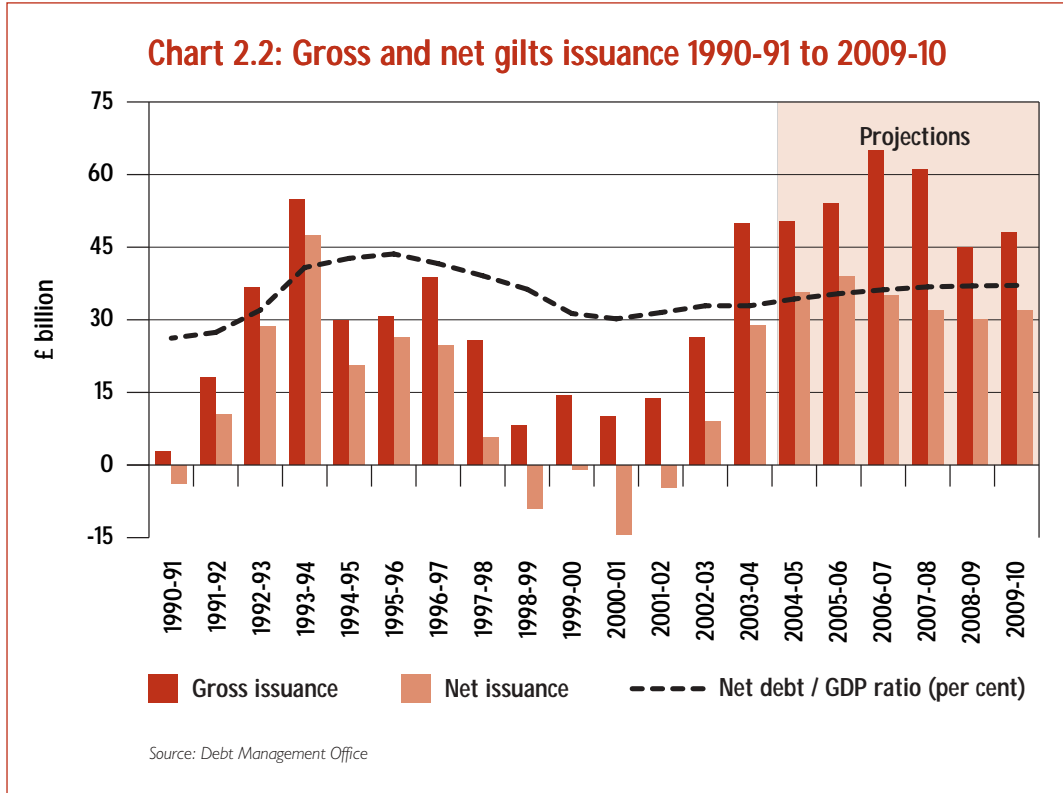
1. Reflecting the proceeds from the 3G Spectrum auction

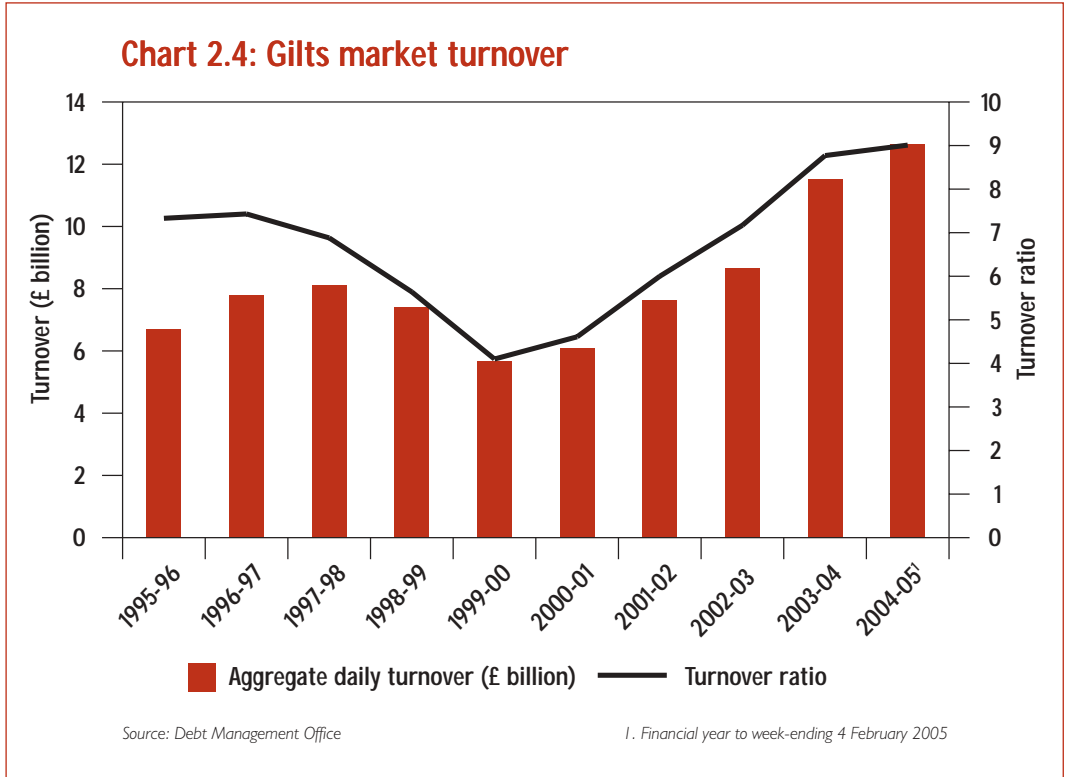
2. Forecasts

Source: HM Treasury/Debt Management Office

2.9 Turnover in the gilts market has been rising since 1999-00. Average daily turnover doubled between 1999-00 and 2003-04 (from £5.7 billion to £11.5 billion). So far³ in 2004-05 this trend has continued, with aggregate daily turnover increasing to £12.7 billion. Trading intensity, as measured by the turnover ratio, has also increased sharply from 4.1 in 1999-00 to 8.7 in 2003-04 and to 9.0 in 2004-05 to date. Chart 2.4 below shows these trends.

³ Data to week-ending 4 February 2005.





3

UK GOVERNMENT'S DEBT MANAGEMENT POLICY

Objectives of debt management

3.1 The Government's debt management policy 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, by means of the maturity and composition of debt issuance and other market operations including switch auctions, conversion offers and buy-backs;
- developing a liquid and efficient gilts market; and
- offering cost-effective savings instruments to the retail sector through National Savings & Investments.

Maturity and composition of debt issuance

3.3 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.

Box 3.1: Appointment of a new gilts registrar

Computershare Investor Services plc ('Computershare') formally took over as the registrar for gilts on 20 December 2004. Following a review of Government debt management arrangements, HM Treasury and the Bank of England (the previous gilts registrar) concluded that the private sector would be better placed to provide any future benefits of economies of scale for this service. The service was put out to tender in Summer 2003, leading to Computershare being identified as the preferred bidder, and subsequently being appointed as the new registrar.

Computershare maintains the main register of holdings of gilt-edged securities under a contract from HM Treasury (which is administered by the DMO). Computershare is responsible for sending dividend payments to investors to arrive on the due dates, and redemption monies when each gilt matures. In addition, Computershare, as Agent of the DMO, offers an execution only service for private investors who wish to purchase and sell gilts by post (provided they are members of the 'Approved Group' of Investors).

Box 3.2: UK Debt Management Office consultation on issuance of ultra-long gilt instruments

On 2 December 2004, the Chancellor of the Exchequer asked the UK Debt Management Office (DMO) to consult market participants on the possible introduction of additional gilt instruments, specifically ultra-long (circa 50-year) conventional and index-linked gilts and ultra-long (circa 50-year) conventional and index-linked annuity-type gilts.

Consequently, the DMO issued a consultation paper,⁴ which sought views from any interested parties on the possible introduction of such gilts. The questions raised by the DMO related to the potential demand for new instruments, issuance procedures, instrument design, the timing for introduction of new instruments, potential advantages / disadvantages with issuance of new instruments and market making responsibilities. Views were invited in writing by 21 January 2005.

Fifty-three written responses, representing the views of a broad range of stakeholders, were received by the DMO. Market feedback pointed to the existence of sustainable demand for ultra-long gilts – both conventional and index-linked – but only in bullet format at this stage. Only a minority of respondents expressed interest in gilts structured in annuity format, with many respondents pointing to a risk that such instruments might prove illiquid.

Respondents also pointed to the potential benefits of issuance of ultra-long gilt instruments both for the Government (through a lower expected cost of funding) and for investors (given a reported shortage of high-quality bonds with ultra-long maturities).

A full summary of the responses to the consultation is available on the DMO's website at: <http://www.dmo.gov.uk/gilts/public/consdoc160305.pdf>.

Consistent with the Government's debt management strategy, the Chancellor of the Exchequer has agreed that the DMO may issue conventional and index-linked gilts with maturities of up to approximately 50 years. This is reflected in the DMO's financing remit for 2005-06 (see Chapter 5 below). Decisions on specific maturities for issuance in any one quarter will be announced by the DMO at the end of the preceding quarter, in the regular quarterly announcement on gilt issuance plans.

⁴ The DMO's consultation document on issuance of ultra-long gilt instruments can be found on the DMO's website at: <http://www.dmo.gov.uk/gilts/public/consdoc/cons021204.pdf>.

Box 3.3: Response to the Miles Review recommendation on interest rate derivatives

The Miles Review Final Report⁵, published shortly before Budget 2004, contained a number of recommendations that were intended to improve the efficient functioning of the mortgage market. Recommendation 17 specifically related to debt management policy:

- “[The] Government should give further consideration to the potential costs and benefits of Government issuing interest rate derivatives.”

The motivation for this recommendation was that the existence of a liquid market in longer-term interest rate derivatives (specifically longer-term interest rate call options, denoted ‘longer-term call options’ here) could contribute to improving the efficiency of the mortgage market (and, therefore, the housing market). The Review also suggested that a liquid market for longer-term call options does not currently exist because of a lack of natural writers of these instruments and indicated that the Government may have the characteristics of a natural writer of such instruments. The implication is that if Government were to start writing longer-term call options, it would be helping to complete financial markets in this respect, in addition to any net benefits it might derive itself.

Although completing financial markets is a legitimate objective for government in the presence of such market failure (since it could improve overall economic welfare), it is not a direct objective of debt management policy. However, it can be argued that in some circumstances issuing instruments designed to complete markets would likely be consistent with the objectives of debt management policy. For example, if financial instruments are in short supply they would be likely to command a premium when issued. Completing markets might also support the operation of monetary policy if new instruments were to improve the overall efficiency of financial markets.

There may then be circumstances where a case could be made for issuing longer-term call options, but the threshold for doing so is fairly high. In particular, clear consistency with the Government's primary debt management objective of minimising long-term cost subject to risk would have to be demonstrated. It would also need to be clear that issuing any new instruments would significantly contribute to improving the overall efficiency of financial markets, the housing market and overall macroeconomic volatility; hence supporting government economic policy more broadly.

It also needs to be clear that new instruments are needed to hedge mortgage prepayment risk. A market for longer-term call options exists already and could be developed further by the private sector if there was sufficient demand; it is though unclear that there is significant unmet demand for such instruments. If the Government issues options it would be taking on risk transformation that the private sector is more expert at managing.

The Review also suggested that losses incurred from these instruments might occur when the public finances were not under pressure, and, further, that there could be debt interest cost smoothing effects. Establishing this empirically (based on historical analyses) is fraught with methodological and data difficulties as the longer-term options market is relatively new. Simulation modelling may provide insights, but ultimately the Government would still need to form a subjective judgment about the likely impact of the increased risk under different conditions.

Overall, while the Government recognises that there might be some benefits from issuing these instruments a substantial degree of uncertainty remains over the balance of advantage to the Government from issuing them. In particular, at the moment it is not clear that Government issuance of these instruments would enhance the Government's ability to meet its cost and risk objectives for debt management. Accordingly, the Government does not propose to issue these instruments at this time. The detailed analysis underpinning this response will be published in the *DMO Annual Review 2004-05* (due to be published in Summer 2005).

⁵ The Miles Review Final Report, *The UK Mortgage Market: Taking a Longer-Term View*, can be found on HM Treasury's website at: http://www.hm-treasury.gov.uk/consultations_and_legislation/miles_review/consult_miles_index.cfm.

STOCK-FLOW DYNAMICS

3.4 Since 1997-98 the DRMR has included a simple stock-flow dynamics model to convey the impact that different issuance strategies and levels of financing can have on the composition of the government's debt portfolio.

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

The simulation model

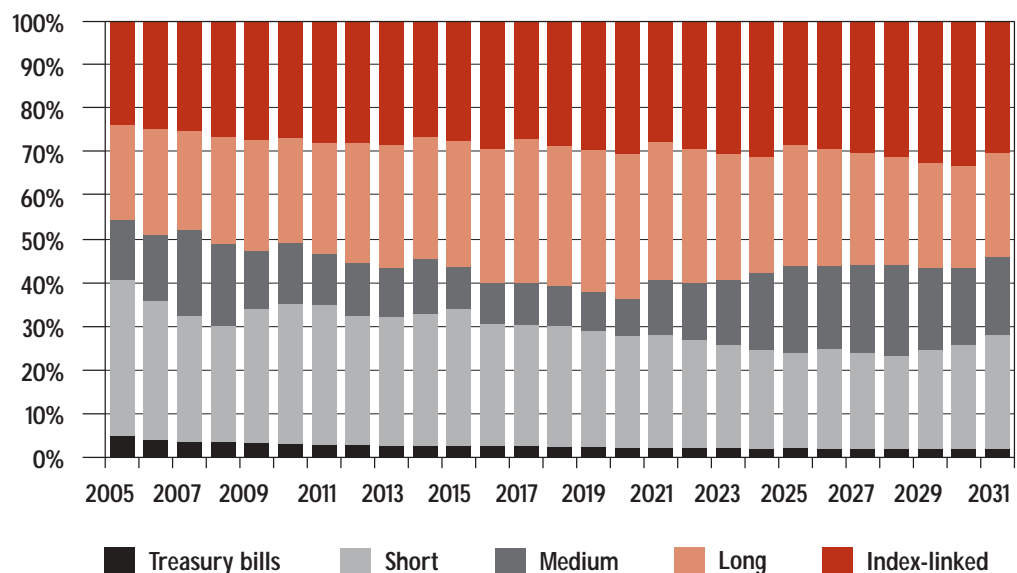
3.6 A number of simplifying assumptions were made in constructing the model. These include assumptions about RPI inflation, the size, timing and structure of gilts issuance and the split between conventional and index-linked issuance.

3.7 In addition to the above fixed assumptions, two scenarios have been generated; one excluding the issuance of ultra-long (50-year) gilts (Scenario 1) and one including issuance of ultra-long gilts (Scenario 2). Both these scenarios are based on £53.5 billion of gilts sales in 2005-06 followed by Budget projections for the gross financing requirement out to 2009-10. A 'high financing environment' is assumed beyond the Budget 2005 projections (i.e. a constant financing requirement of £50 billion per year).

Results

3.8 Charts 3.1 and 3.2 show the maturity composition of the resultant portfolio under Scenarios 1 and 2 referred to above.

Chart 3.1: End-March portfolio composition if default issuance pattern is repeated in a high financing environment (excluding ultra-long gilts)

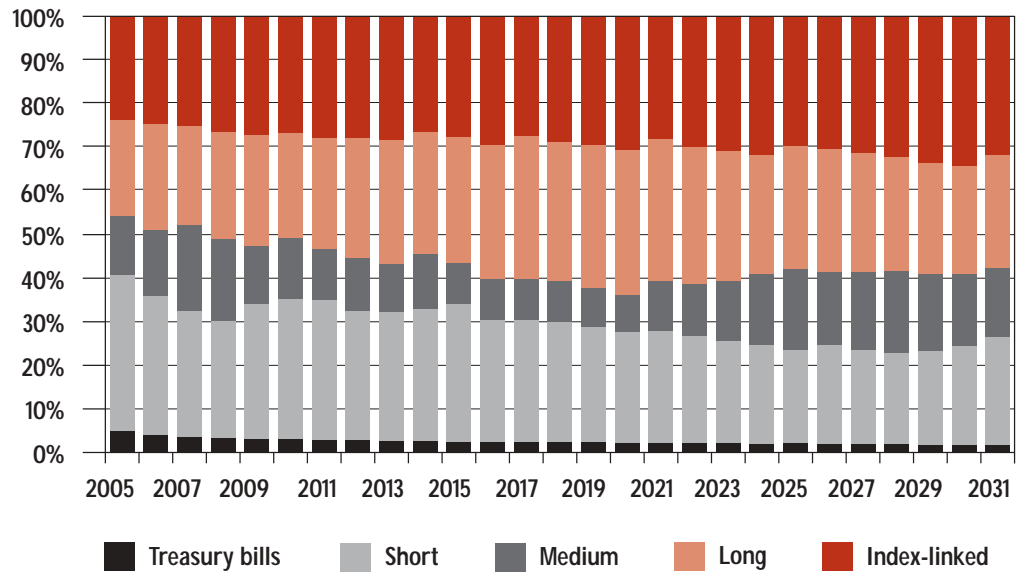


Source: Debt Management Office

3.9 Under both scenarios, the resultant portfolios are reasonably similar until around 2017, at which point they start diverging more noticeably. From 2017 onwards, the share of the portfolio in index-linked gilts (IGs) starts to rise more rapidly for Scenario 2 (including ultra-long gilts) compared with Scenario 1, to a maximum difference of 1.8 per cent by March 2031. Clearly the long sector share also rises more quickly for Scenario 2, with the difference between the two scenarios reaching 1.9 per cent by March 2031. This is offset in Scenario 1 first by a higher share in mediums, and then later also by an increasing share of shorts, when compared against the Scenario 2 portfolio.

3.10 By the end of the simulation period (March 2031), the portfolio under Scenario 2 has a weighted average maturity of 14.4 years compared with 11.7 years under Scenario 1, an increase of almost a quarter.

Chart 3.2: End-March portfolio composition if default issuance pattern is repeated in a high financing environment (including ultra-long gilts)



Source: Debt Management Office

Evolution of 'real' exposure in the debt portfolio

3.11 An assumption about the share of 'real' exposure in the debt portfolio is set out in the DMO's Annual Review 2003-04⁶:

'...the implications for the structure of the debt portfolio of the Government's attitude to risk are being actively explored but for the time being we continue to draw on past observations of the relative proportions of the debt portfolio in nominal versus real exposures and carry this forward as a guideline in our analysis. This means in practice that we assume a preference for maintaining roughly a quarter of the overall debt portfolio in the form of real exposure (i.e. index-linked, floating rate and variable rate instruments such as Treasury bills). As this is a portfolio assumption, we could take account of previous years' issuance to determine whether issuing more or less of one type of exposure may be appropriate in the next year.'

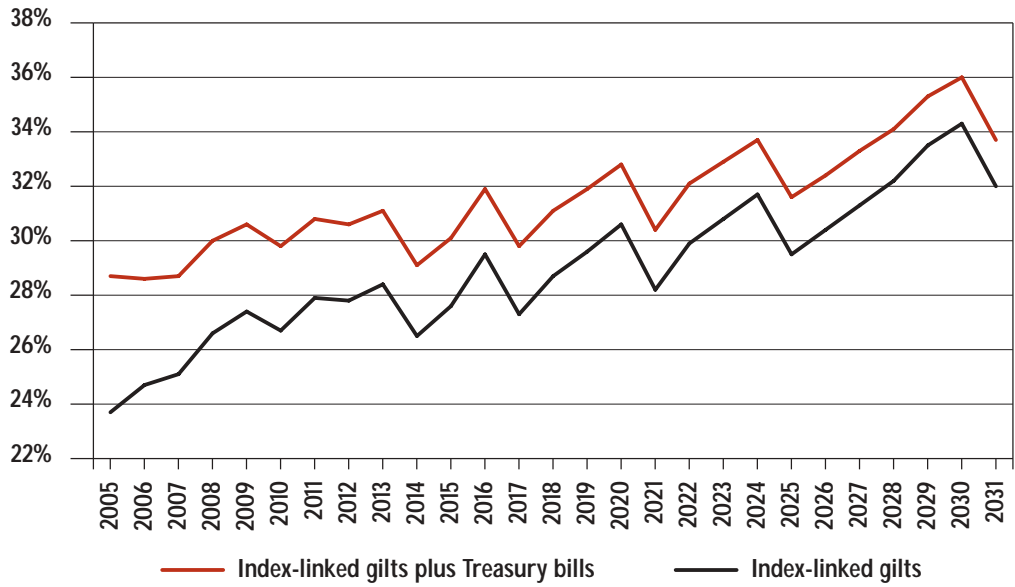
3.12 An application of this assumption about 'real' exposure is made to the stock-flow modelling to produce some purely illustrative examples of the evolution of the proportion of the debt portfolio in the form of 'real' exposure over time. Key points to note from this approach are:

- this is an assumption about the structure of the debt portfolio rather than an assumption about issuance;
- this is an interim assumption which holds whilst the DMO and Treasury explore more fully the implications for debt portfolio structure of the Government's attitude to risk;
- it is assumed that the 'debt portfolio' comprises gilts and T-bills;
- the reference to 'roughly a quarter of the overall debt portfolio' being in the form of real exposure is assumed to include IGs and T-bills; and
- the value of the portfolio is measured in terms of uplifted nominal values as a proxy for market values.

3.13 The projected share of 'real' exposure starts off at 29.1 per cent at the end of 2004-05. Under the issuance assumptions set out in the stock-flow model, a 20 per cent share of index-linked issuance from 2006-07 (together with a zero increase in the T-bill stock) leads to a gradual rise to 32.2 per cent under Scenario 1 and 34.0 per cent under Scenario 2, by 2031. Chart 3.3 below illustrates this evolution under Scenario 2.

⁶ Chapter 7 of the *DMO Annual Review 2003-04*, July 2004, contains this information and can be found at: <http://www.dmo.gov.uk/gilts/public/annual/gar0304.pdf>.

Chart 3.3: End-March share of 'real' exposure in the debt portfolio (including ultra-long gilts)



Source: Debt Management Office

4

UK GOVERNMENT'S FINANCING PROGRAMME FOR 2005-06

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 and reverse auctions of non-benchmark gilts.

Financing arithmetic

4.2 Table 4.1 gives details of the financing arithmetic for 2005-06. It outlines the proposed structure and composition of debt instruments that the Government intends to use to meet its financing requirement in 2005-06.

4.3 The new forecast for the CGNCR in 2005-06 is £40.2 billion, an increase of £4.4 billion from the Pre-Budget Report (PBR) 2004 forecast. Gilt redemptions, excluding official holdings, are expected to be £14.5 billion.

National Savings & Investments

4.4 NS&Is' net contribution to financing (including accrued interest) in 2005-06 is forecast to be £3.5 billion. This assumes gross sales (i.e. sales and deposits including accrued interest) of £11.8 billion. This forecast is not a target but an estimate based on experience in previous years, trends in the retail savings product market over 2004-05 and NS&Is' own forecasts and objectives.

Financing for the Official Reserves

4.5 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 2005-06. Any decisions will be taken on the basis of the least cost comparison set out in paragraph 9.6 below.

4.6 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 the level of the borrowed reserves remains unchanged and new foreign currency bonds are not issued) the net sterling financing requirement will rise by the equivalent amount.

4.7 For the purposes of the financing arithmetic in Table 4.1 it is assumed that swapped sterling will remain the main form of financing the borrowed reserves (as has been the case in recent years) and no new foreign currency debt will be issued in 2005-06. As no Government foreign currency debt matures in 2005-06 the forecast in Table 4.1 shows zero impact due to financing of the Official 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 at the Pre-Budget Report in the autumn or in Budget 2006, depending on when the bond was issued.

Treasury bill sales

4.8 The financing plans for 2005-06 assume that the outstanding stock of T-bills is reduced by £1.0 billion. The planned stock of outstanding T-bills held outside central government is targeted to fall to £19.5 billion.

Table 4.1: Financing arithmetic 2005-06

	£ billion
Central Government Net Cash Requirement	40.2
Gilt redemptions	14.5
Financing for the Official Reserves	0.0
Buy-backs	0.0
Gross Financing Requirement	54.7
<i>less:</i>	
National Savings & Investments	3.5
Net Financing Requirement	51.2
<i>Financed by:</i>	
1. Debt Issuance by the Debt Management Office	
a) Change in Treasury bill stock	-1.0
b) Planned gilt sales	53.5
<i>of which:</i>	
Conventional	12.5
short	11.5
medium	18.5
long	11.0
Index-linked	11.0
2. Planned changes in Government short-term cash position	
Change in Ways & Means	0.0
Change in short-term cash position ¹	-1.3
Net change in short-term debt²	-2.3
3. Unanticipated changes in net short-term debt	
Change in DMO net cash position ¹	—
Short-term debt levels	
Treasury bill stock at end of financial year	19.5
Ways & Means at end of financial year	13.4
DMO net cash position at end of financial year ³	0.2

Figures may not sum due to rounding

1. Including changes in the DMO's cash deposit at the Bank of England

2. Including planned change to Treasury bill stock

3. Including the DMO cash deposit at the Bank of England

Other short-term debt

4.9 The level of the Ways & Means Advance from the Bank of England planned for 31 March 2005 is £13.4 billion and is assumed to remain at this level for 2005-06.

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

4.11 It is anticipated that the level of the DMO's net cash position at end-March 2005 will be -£1.1 billion. This will be increased during 2005-06 to £200 million (the working balance at the Bank of England) through a £1.3 billion increase in the DMO's short-term cash position (i.e. a negative contribution to financing).

Quantity of gilt sales

4.12 The DMO 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 £53.5 billion (cash).

Benchmark gilts

4.13 The Government will aim to establish large, liquid issues at key maturities along the yield curve.

5

THE DEBT MANAGEMENT OFFICE'S FINANCING REMIT FOR 2005-06

Objectives

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

- to meet the annual remit set by HM Treasury Ministers for the sale of gilts, with due regard to long-term cost minimisation taking account of risk;
- to advise Ministers on setting the remit to meet the Government's debt management objectives and to report to Ministers on the DMO's performance against its remit, objectives and targets;
- to develop policy on and promote advances in new instruments, issuance techniques and structural changes to the debt markets that will help to lower the cost of debt financing, liaising as appropriate with the Bank of England, Financial Services Authority, London Stock Exchange, and other bodies and to provide policy advice to HM Treasury Ministers and senior officials accordingly;
- to conduct its market operations, liaising as necessary with regulatory and other bodies, with a view to maintaining orderly and efficient markets and promoting a liquid market for gilts;
- to provide, including in liaison with 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 lower costs of debt issuance.

Quantity of gilt sales

5.2 The DMO, on behalf of the Government, will aim for gilt sales of £53.5 billion (cash) in 2005-06.

Amount and maturity mix of index-linked gilt issuance

5.3 Over 2005-06, the DMO aims to sell £11.0 billion (cash) in index-linked gilts.

5.4 11 auctions of index-linked gilts are planned in 2005-06. This will include regular issuance at long maturities. From 2005-06, any new index-linked gilt will have a three-month indexation lag, but the DMO may also re-open any existing eight-month lag index-linked gilt.

5.5 The Government has an ongoing commitment to the index-linked gilt market. The current assumption is that issuance of index-linked gilts will be consistent with approximately a quarter of the Government's marketable debt portfolio being in the form of real exposure.

5.6 Amount and maturity mix of conventional gilt issuance:

- 15 auctions of conventional gilts are planned in 2005-06:
- 4 in the short (1-7 years) maturity area, aiming to raise £12.5 billion cash;
- 4 in the medium (7-15 years) maturity area, aiming to raise £11.5 billion cash;
- 7 in the long (15 years and over) maturity area, aiming to raise £18.5 billion cash.

5.7 The gilt sales targets in paragraphs 5.3 and 5.6 above are specified in cash terms, but the gilt auctions are sized in nominal terms, typically in £0.25 billion increments. Therefore all gilt sales targets are expressed in approximate terms.

Ultra-long gilt issuance

5.8 From 2005-06 the DMO may issue conventional and index-linked gilts with maturities of up to approximately 50 years. Decisions on specific maturities for issuance in any one quarter will be announced at the end of the preceding quarter, in the regular quarterly announcement on gilt issuance plans. Auctions remain the preferred means of issuance for all gilts. However, the DMO, with the agreement of HM Treasury, reserves the right to issue ultra-long gilts initially by syndicated offerings. Syndicated offerings would only take place in cases where HM Treasury was satisfied that this method of issuance would better meet the Government's debt management policy objective of minimising long-term costs, whilst taking account of risk.

Contingencies

5.9 Any changes in the published financing requirement will be met by: (a) increasing or reducing planned gilt sales broadly in proportion to the splits planned in the remit; and/or (b) increasing or decreasing planned sales of T-bills; and/or (c) adding or cancelling gilt auctions. Adding or cancelling gilt auctions will only be undertaken when changes in the published financing requirement are judged to be sufficiently large to warrant such actions. Decisions to modify gilt and T-bill sales plans or revise the gilt auction calendar will be taken subject to considerations about debt portfolio objectives and evolving market conditions.

Method of issuance of gilts

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

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

5.12 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 will be announced by the DMO at 3.30pm on 31 March 2005. Full details of these, and subsequent, auctions will generally be announced at 3.30pm on the Tuesday of the week preceding the auction.

Table 5.1: Gilt auction calendar 2005-06

Date	Type
2005	
12 April	Index-linked
14 April	Conventional
28 April	Conventional
24 May	Index-linked
26 May	Conventional
7 June	Conventional
23 June	Index-linked
14 July	Conventional
26 July	Index-linked
2 August	Conventional
6 September	Conventional
22 September	Index-linked
27 September	Conventional
11 October	Index-linked
13 October	Conventional
25 October	Index-linked
8 November ¹	Conventional
24 November ¹	Index-linked
6 December ¹	Conventional
2006	
10 January	Conventional
24 January	Index-linked
26 January	Conventional
7 February	Index-linked
16 February ¹	Conventional
1 March ¹	Conventional
7 March ¹	Index-linked

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

In the event that the General Election is held in the week of an auction date(s), the DMO will reschedule the auction(s).

5.13 The programme of conventional and index-linked gilt auctions 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 conditions of temporary excess demand in a particular gilt or sector. The DMO would only contemplate taps in exceptional circumstances.

5.14 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. Such gilts will only be issued if there is a clear market management case for doing so.

5.15 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.

Reverse auctions

5.16 The DMO has no plans for a programme of reverse auctions in 2005-06.

Coupons

5.17 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

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

Conversions and switch auctions

5.19 The DMO may conduct such operations in accordance with the prevailing issue of its Operational Notice on operations in the gilt-edged market.

Reviews to the remit

5.20 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.

5.21 Any revisions to this remit will be announced.

6

THE DEBT MANAGEMENT OFFICE'S EXCHEQUER CASH MANAGEMENT REMIT FOR 2005-06

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 operations in the light of the forecast; and its objective in so doing is to minimise the costs of cash management while operating within a risk appetite approved by Ministers.

Exchequer cash management objective

6.4 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

6.5 The range of instruments and operations that the DMO may use for cash management purposes is set out in its Operational Notice.⁷

6.6 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 T-bills (excluding bills issued solely for collateral purposes). This change is announced as part of the financing remit given by HM Treasury to the DMO (see Chapter 5 above).

6.7 During the financial year the DMO will manage the level of the T-bill stock and may increase or reduce the stock vis-a-vis the end year target level, in order to support the implementation of Government cash management. The DMO will announce the dates of T-bill tenders on a quarterly basis. The precise details of the maturity and amount of the T-bills on offer at specific tenders will be announced one week in advance.

⁷ The current edition of *Exchequer Cash Management Operational Notice and Treasury Bill Information Memorandum* is available on the money market section of the DMO website and can be found under "Press Releases" at: <http://dmo.gov.uk/cash/flmoney.htm>.

6.8 The DMO may also issue T-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 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. T-bill issues made at the request of the Bank will be identical in all respects to T-bills issued in the normal course of DMO business.

DMO collateral pool

6.9 To assist the DMO in the efficient execution of its cash management operations a combination of T-bills and gilts, which shall be chosen to have a negligible effect on relevant indices, shall be issued to the DMO on the third Wednesday of April, July and October 2005 and January 2006. 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.

Box 6.1: Explanation of the new Exchequer cash management objective

The cash management objective has been re-phrased this year to provide a stronger statement that clarifies the primacy of the cost minimisation goal, within the context of an approved risk appetite.

The introduction of the approved risk appetite will make it easier to form objective and measurable parameters within which the DMO will conduct its cash management operations and be accountable to Ministers.

This change is part of a series of improvements being introduced over the next year or so, which are all aimed at upgrading the effectiveness and accountability of Exchequer cash management.

In particular, the new wording replaces terms used in the old objective that could be interpreted as more or less demanding or constraining by different stakeholders. Thus it will better facilitate delegation, accountability and performance measurement.

The new wording also extends the application of the cash management objective to the wider arrangements supporting Exchequer cash management, such as banking arrangements.

7

NATIONAL SAVINGS & INVESTMENTS' ACTIVITIES IN 2004-05

Introduction

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

7.2 Throughout the year, NS&I's overall cost of financing remained lower than that of comparable gilts, taking into account management costs and imputed tax foregone. NS&I announced six packages of interest rate changes during 2004-05. 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 repo rate as announced by the Monetary Policy Committee.

7.3 The net contribution to financing in 2004-05 is estimated to be £2.0 billion with gross sales (including accrued interest) of approximately £10 billion. Table 7.1 below outlines changes in NS&I's product stock during 2004-05.

Table 7.1: Change in National Savings & Investments' product stock during 2004-05

	End-March 2004 £ billion	End-March 2005 ¹ £ billion
Variable rate	42.0	43.4
Fixed rate	16.4	16.4
Index-linked	8.1	8.7
Total	66.5	68.5

1. Estimates

Source: National Savings & Investments

Premium Bond Migration

7.4 As part of NS&I's modernisation strategy within the Direction 2007 corporate strategy, 2004-05 saw the migration of over 750 million Premium Bond records from the old Legacy system to the new Thaler system, one of the largest data migration projects in Europe. The migration to the new system has allowed NS&I to introduce a number of product improvements including purchase by telephone in July 2004, a regular purchase scheme in October 2004 and purchase via the Internet in January 2005.

Ordinary Account

7.5 Also as part of its modernisation strategy, NS&I closed the Ordinary Account on 31 July 2004 after 147 years, and launched a replacement Easy Access Savings Account in January 2004. The new account offers customers better interest rates, easy access to cash deposits through an ATM card and the Post Office, as well as providing better value for money for taxpayers.

7.6 Although an extensive communications programme was launched to inform the 13 million Ordinary Account holders of the closure and the benefits of the new account, a greater proportion of customers than expected did not take up the offer and withdrew their savings from the Ordinary Account rather than transferring to the new Easy Access Savings Account. The estimated negative impact on Net Financing up to January 2005 was approximately £600 million.

7.7 NS&I overcame these challenges through the implementation of the Direction 2007 corporate strategy. Further information on Direction 2007 can be found in NS&I's Annual Report 2003-04.⁸

Telephony channel

7.8 In 2004-05, the telephony channel was notably successful. Sales through the telephony channel in 2003-04 were approximately £800 million, but the latest forecast for 2004-05 is for telephone sales of around £1.6 billion, higher than planned and double the figure achieved the previous financial year.

Conclusion

7.9 Despite a challenging year due to necessary modernisations in NS&I activities, NS&I has increased its ability to provide better services for customers, while delivering better value for taxpayers. Additionally the success of the telephony channel has been instrumental in ensuring NS&I will achieve its overall net financing target in 2004-05.

⁸ NS&I's Annual Report 2003-04 can be found on NS&I's website at: http://www.nsandi.com/pdf/annual04_report.pdf.

Introduction

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

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

8.2 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 HM Treasury.

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

Responsibility for setting product terms

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

8.5 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 2005-06

8.6 Sales and deposits (including accrued interest) of NS&I products are assumed to be around £11.8 billion in 2005-06. After meeting expected maturities and withdrawals, NS&I is expected to make a net contribution to Government financing of £3.5 billion.

Cost of financing

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

8.8 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 2005-06 in the light of any relevant factors.

9

MANAGEMENT OF THE OFFICIAL RESERVES IN 2004-05

Introduction

9.1 The UK Government's official holdings of international reserves⁹ comprise of gold, foreign currency assets and International Monetary Fund (IMF) Special Drawing Rights (SDRs)¹⁰. These reserves, with the exception of the SDR assets that constitute the UK's reserve tranche position (RTP) at the IMF, are held in the Exchange Equalisation Account (EEA).

Origin and purpose

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

Management of the Exchange Equalisation Account

9.3 The EEA is under the control of HM Treasury, which appoints the Bank of England (the Bank) as its agent to carry out the day-to-day management of the international reserves (the reserves). An annual Service Level Agreement (previously known as the Remit) between HM Treasury and the Bank specifies the parameters under which the reserves are managed. This Service Level Agreement (SLA) includes investment benchmarks and limits for controlling credit, market and other risks. A summary of the current SLA is set out in Chapter 10.

Financing of the reserves

9.4 It is possible for reserves to be generated in two ways; either sterling can be sold for foreign currency or foreign currency can be borrowed. Reserves financed by borrowing are known as 'the borrowed reserves'. Reserves that are not funded by borrowed foreign currency are known as the 'net reserves'. Net reserves are in effect the Government's net asset position in foreign currency and gold and have broadly been generated over time by sales of sterling for foreign currency or through retained earnings.

9.5 Foreign currency can be borrowed directly by issuing Government securities denominated in foreign currency. In this event the Bank acts as HM Treasury's agent for the issue¹¹. Alternatively, sterling gilts may be issued (by the Debt Management Office) and the proceeds 'swapped' into foreign currency, which also gives rise to a foreign currency liability.

⁹ The Bank of England may also hold foreign currency reserves on its own balance sheet in pursuit of the Monetary Policy Committee's monetary policy objective as set out in the Chancellor's letter to the Governor of May 1997 which is available at: http://www.hm-treasury.gov.uk/media/ED3/C6/foi_boeindep_nremonetypolicy_40205.pdf.

¹⁰ 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.

¹¹ The most recent example is the Government's US dollar bond issued in July 2003 (for more information see the *Debt and Reserves Management Report 2004-05*, page 36, which can be found at: http://www.hm-treasury.gov.uk/media/92B/27/debt_res.pdf). The Bank of England may also issue foreign currency securities in its own name.

9.6 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.

Composition and size of the UK Reserves

9.7 EEA assets need to be highly liquid in order that they can be made available quickly for intervention purposes (or other permitted uses) if necessary. Inevitably, these investments carry some element of credit risk. In order to reduce this risk and to ensure relative 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 with the debt instruments of highly rated banks.

9.8 The level of the UK's net reserves increased over the year from US\$ 18.0 billion at end-December 2003¹² to US\$19.1 billion at end-December 2004 mainly because of valuation effects as a result of the weakening of the dollar over the year. The value of the gross reserves also rose over the year from US\$ 46.1 billion at end-December 2003 to US\$ 49.4 billion at end-December 2004 because of valuation effects and short-term increases related to repo trading. Table 9.1 below sets out developments in UK official holding of international reserves.

Table 9.1: UK Official Holdings of International Reserves

Currency breakdown Assets	US\$ million – market value	
	End-December 2003	End-December 2004
US\$	13,254	11,802
Euro	16,481	21,636
Yen	5,428	5,691
Other currencies	2	2
SDR	6,711	5,861
Gold	4,202	4,397
Total	46,079	49,389
Liabilities	End-December 2003	End-December 2004
US\$	-9,304	-7,801
Euro	-12,528	-16,913
Yen	-3,449	-3,326
Other currencies	-1	-2
SDR	-2,845	-2,958
Gold	—	—
Total	-28,127	-30,281

Source: HM Treasury/Bank of England

¹² Figures for 2003 have been amended since last year's report as a result of revisions to the valuation of SDR assets and liabilities.

Performance evaluation

9.9 HM Treasury undertakes “to minimise the cost of holding the Government’s foreign currency reserves, while managing risk within limits agreed between the Bank and HM Treasury” within a three-year cycle. Details of this Service Delivery Agreement target are reported in detail in HM Treasury’s annual report on the expenditure plans of the Chancellor of the Exchequer’s Departments.

Disclosure of financial data

9.10 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)¹³.

9.11 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 2003-04, audited by the National Audit Office, were accordingly published and laid before both Houses of Parliament on 19 July 2004¹⁴.

Intervention

9.12 The UK Government last intervened in the foreign exchange markets in September 2000 when the Government joined a concerted intervention by the G7 to support the Euro.

¹³ Reserves data from July 1999 onwards are available on the Bank of England’s website at: www.bankofengland.co.uk.

¹⁴ The Financial Accounts for the EEA can be viewed on HM Treasury’s website at: www.hm-treasury.gov.uk.

Introduction

10.1 This Service Level Agreement ('SLA') sets out the arrangements for the Bank 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 This SLA provides both parties with an understanding of what constitutes an acceptable level of service in managing the EEA.

10.3 This 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 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 (these market sensitive limits are not published) and ensure that the public funds entrusted to the Bank in the EEA are properly and well managed and safeguarded. Subject to these limits manage the reserves to maximise their return.
- Advise HM Treasury on foreign exchange market conditions and advise HM Treasury on the financing of the reserves, including as necessary the management of foreign currency borrowing (covering new borrowing, hedging and repayments) and implement agreed strategy in this area.
- Monitor and report to HM Treasury on the level of risk and return on holding the reserves and provide accurate and timely accounting and statistical information and 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.

Authorised financial instruments

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

- bonds 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, gold loco and gold quality swaps;
- forward rate agreements;
- SDRs;
- bank deposits; and
- certificates of deposit and corporate commercial paper.

Active management

10.6 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 borrowed reserves, on which currency and interest rate exposures are hedged; and the net 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

10.7 The Bank will:

- Ensure that the risks associated with its management of the EEA are properly identified, evaluated and mitigated. Detailed limits and measures are attached to this SLA (but are market sensitive so are not publicly available).
- 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 at least annually.

- 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 case scenarios.
- Confirm to HM Treasury on a quarterly basis that sufficient controls were in place to mitigate the 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 relating to the Bank’s management of the EEA. If appropriate, exceptions to such confirmation will be listed.

Audit arrangements and accounting requirements

10.8 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 accounts drawn up on the UK GAAP as far as appropriate and in accordance with the relevant Accounts Directions.

National Audit Office access

10.9 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,

10.10 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 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 risk issues and the Bank’s compliance with the guidance issued by the Turnbull Report (Internal Control: Guidance for Directors on the Combined Code issued by the Institute of Chartered Accountants in England and Wales). These reports highlight the Bank’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 conducted an agreed internal audit programme as part of the SLA.
- Bank and Treasury officials meet at monthly reserves meetings to review the performance against the parameters set out in the SLA and to consider wider operational and policy issues. The Accounting Officer and the Bank's Executive Director for Markets meet in April and October each year to discuss overall strategy and governance issues.

Financing the reserves

10.12 The Bank will provide HM Treasury with relevant market intelligence and advice on options for financing the reserves (bearing in mind considerations of cost, overall reserves management and any public expenditure constraints) and government foreign currency operations with a view to minimising the costs and risks to the government. On the basis of this advice the annual financing programme will be agreed between the Bank and HM Treasury and as part of the SLA at the beginning of the financial year.

10.13 The Bank will act as HM Treasury's agent in issuing and managing any foreign currency liabilities associated with the reserves. The Bank 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 will liaise closely with the Debt Management Office (DMO) with respect to managing sterling flows relating to EEA operations. The Bank 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 will provide the figures of the United Kingdom's official holdings of international reserves for the 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 Standards 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 the 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 will subsequently report on the extent to which any such authority was used, and to what effect, by letter.

11.1 The central government's financial asset and liability monitor ('the monitor') is being 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 un-audited.

11.2 The monitor is a precursor to the publication of 'Whole of Government Accounts'¹⁵ for 2006-07 onwards and is in accordance with the transparency and accountability recommendations published in the International Monetary Fund's 'Guidelines on Public Debt Management' 2001.¹⁶

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 such as local authorities' assets or future tax revenue streams; nor does it take account of non-financial assets and liabilities such as contingent liabilities of central government. Information covering the government's wider fiscal position and prospects going forward can be found in the 2004 long-term public finance report, which provides a comprehensive assessment of the sustainability of the public finances, for example by taking account of future government revenues and expenditures.¹⁷

Description of Table 11.1

11.4 Table 11.1 below breaks up total assets and liabilities by type and by managing institution. In addition to nominal and market values of 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. Box 11.1 explains these key variables.

Key facts – central government's financial assets

11.5 The nominal value of central government's total financial assets was £104.3 billion at end-December 2004. This compares with £107.0 billion at end-December 2003. The composition of assets has remained largely unchanged over the year to end-December 2004

11.6 The market value of central government's total financial assets was £115.6 billion at end-December 2004 compared with £118.3 billion at end-December 2003.

¹⁵ The Government announced in 2003 that it will publish Whole of Government Accounts (WGA) for the 2006-07 financial year onwards, once the methodological issues that have been raised by the development work have been addressed through the dry-run processes.

¹⁶ 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>.

¹⁷ 2004 *Long-term public finance report: an analysis of fiscal sustainability*, HM Treasury, December 2004 can be found on HM Treasury's website at: http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr04/assoc_docs/prebud_pbr04_adlongterm.cfm. 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/735/41/longterm_fiscal_l1to6_436.pdf#page=48.

11.7 The average modified duration of assets at end-December 2004 was slightly longer at 6.2 years compared with 5.7 years at end-December 2003, partly due to the increase in average maturity over the period from 10.3 to 11.1 years and the £6.9 billion reduction in assets with maturities of less than one year from £20.8 billion to £13.9 billion.

11.8 The largest single contributor to central government's financial assets is loans to local authorities (£42.7 billion nominal value), which make up over 40 per cent of the total nominal value. Other significant contributors include sterling and foreign currency assets (£32.1 billion) managed by the Bank of England and gilts held in central government funds by the Commissioners for the Reduction of the National Debt (£15.2 billion).

Box 11.1 Description of variables in central government's financial asset and liability risk monitor

- **Nominal value and market value** – 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 1 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 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.

Key facts – central government's financial liabilities

11.9 The nominal value of central government's total financial liabilities was £533.6 billion at end-December 2004. This is an increase of £54.5 billion compared with end-December 2003 (£479.1 billion). This large change is attributable primarily to a £30.6 billion increase in gross gilts in issue to £362.8 billion and a £9.4 billion increase in Treasury bills and other short-term bills.

11.10 The market value of central government's total financial liabilities at end-December 2004 was £571.4 billion compared with £510.2 billion at end-December 2003.

11.11 The average modified duration of liabilities at end-December 2004 was the same as at end-December 2003 (4.5 years). The average maturity of liabilities at end-December 2004 was 8.8 years; very similar to end-December 2003 (8.7 years). There was an increase in the nominal value of liabilities with a maturity of less than one year of £10.4 billion to £100.7 billion over the same period.

11.12 Gross gilts in issue represent the highest proportion of central government financial liabilities (£362.8 billion), accounting for 68 per cent of the nominal value of total liabilities. Other significant liabilities include those managed by National Savings & Investments (£67.8 billion).

Table 11.1: Central government's financial asset and liability risk monitor at 31 December 2004

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)
<i>Managed by:</i>						
Public Works Loan Board (loans to local authorities)	42.7	51.1	1.6	10.9	20.4	0.8
Debt Management Office						
<i>Gilts held by DMO</i>						
Marketable conventionals	6.5	7.5	0.4	6.3	9.8	—
Marketable index-linked	1.5	1.7	0.0	9.9	12.1	—
Total	8.0	9.2	0.4	—	10.2	—
<i>Gilts held in Central Government funds by the Commissioners for the Reduction of the National Debt (CRND)</i>						
Marketable conventionals	0.0	0.0	0.0	5.4	10.1	—
Non-marketable conventionals	14.4	15.3	1.5	2.9	2.9	—
Non-marketable index-linked	0.9	0.9	0.0	7.2	7.2	—
Total	15.2	16.2	1.5	—	3.2	—
CRND loans to local authorities	0.0	0.0	0.0	0.0	0.0	—
Other short-term bills held by CRND in Central Government funds	0.0	0.0	0.0	0.0	0.0	—
<i>Other short-term assets</i>						
Reverse repos – outstanding	0.1	0.1	0.0	0.0	0.0	—
Deposits at commercial banks	0.0	0.0	0.0	0.0	0.0	—
Cash deposits at the Bank of England	0.4	0.4	0.4	0.0	0.0	—
Sterling Certificates of Deposit	0.0	0.0	0.0	0.0	0.0	—
Sterling Commercial Paper	0.0	0.0	0.0	0.0	0.0	—
FX Commercial Paper	0.0	0.0	0.0	0.0	0.0	—
Total	0.6	0.5	0.4	0.0	0.0	—
Bank of England						
<i>Sterling assets</i>						
Sterling leg of swaps and FX liabilities ³	10.0	10.0	3.4	0.2	1.7	10.0
<i>Foreign currency assets</i>						
Bonds	16.4	17.2	3.2	2.2	2.3	0.0
Money Market Instruments	1.0	1.0	1.0	0.2	0.2	—
Short-term assets ⁴	2.2	2.2	2.2	0.0	0.0	—
Gold ⁵	2.3	2.3	—	11.9	—	—
IMF Special Drawing Rights	0.2	0.2	—	0.0	—	0.2
HM Treasury						
<i>Sterling assets</i>						
National Loans Fund loans ⁶	2.9	2.9	0.1	8.7	15.1	—
<i>Foreign currency assets</i>						
IMF Reserve Tranche Position	2.9	2.9	—	0.0	—	2.9
Total^{7,8}	104.3	115.6	13.9	6.2	11.1	13.8

Table 11.1: Central government's financial asset and liability risk monitor at 31 December 2004 (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)
<i>Managed by:</i>						
National Savings and Investments	67.8	67.8	9.3	4.8	4.9	44.1
Debt Management Office						
<i>Gross gilts in issue⁹</i>						
Marketable conventionals	257.5	283.4	15.0	7.6	11.7	—
Non-marketable conventionals	18.6	19.8	2.0	3.3	4.3	—
Marketable index-linked	85.8	96.0	0.0	10.9	13.4	—
Non-marketable index-linked	0.9	0.9	0.0	6.3	7.1	—
Total	362.8	400.2	17.0	—	11.7	—
<i>Treasury bills¹⁰</i>						
Treasury bills ¹⁰	40.0	39.8	40.0	0.1	0.1	—
Other short-term bills	15.3	15.3	15.3	0.1	0.1	—
Total	55.3	55.1	55.3	0.1	0.1	—
<i>Other short-term liabilities</i>						
Repos – outstanding	12.8	12.9	12.8	0.1	0.1	—
Deposits made by local authorities and commercial banks	0.6	0.6	0.6	0.0	0.0	—
Total	13.4	13.5	13.4	0.1	0.1	—
Bank of England						
<i>Sterling liabilities</i>						
Ways and Means Advance	13.4	13.4	—	0.0	—	13.4
<i>Foreign currency liabilities</i>						
HMG Bonds	1.6	1.5	0.0	3.4	3.5	—
Loans ¹¹	0.1	0.1	0.0	0.9	2.0	—
Repos	2.6	2.6	2.6	0.1	0.1	—
Swaps & FX Liabilities (excludes £ leg) ¹²	9.3	9.9	3.1	1.4	1.2	9.3
IMF Special Drawing Rights allocation	1.5	1.5	—	0.0	—	1.5
HM Treasury						
<i>Sterling assets</i>						
IMF non-interest bearing securities	5.8	5.8	—	0.0	—	5.8
Total^{7,8}	533.6	571.4	100.7	4.5	8.8	74.2

¹ Nominal value of index-linked gilts includes inflation uplift

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

³ Modified duration covers swaps only

⁴ Short term assets = deposits + reverse repos

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

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

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

⁸ Total for average maturity is weighed by market value

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

¹⁰ Includes £15 billion of Treasury bills created for collateral purposes held by the DMO.

£5.0 billion of these bills matured on 31 January 2005 and the remaining £10.0 billion matured on 14 February 2005.

¹¹ Composed of Canadian and US war debt

¹² Modified duration covers swaps only

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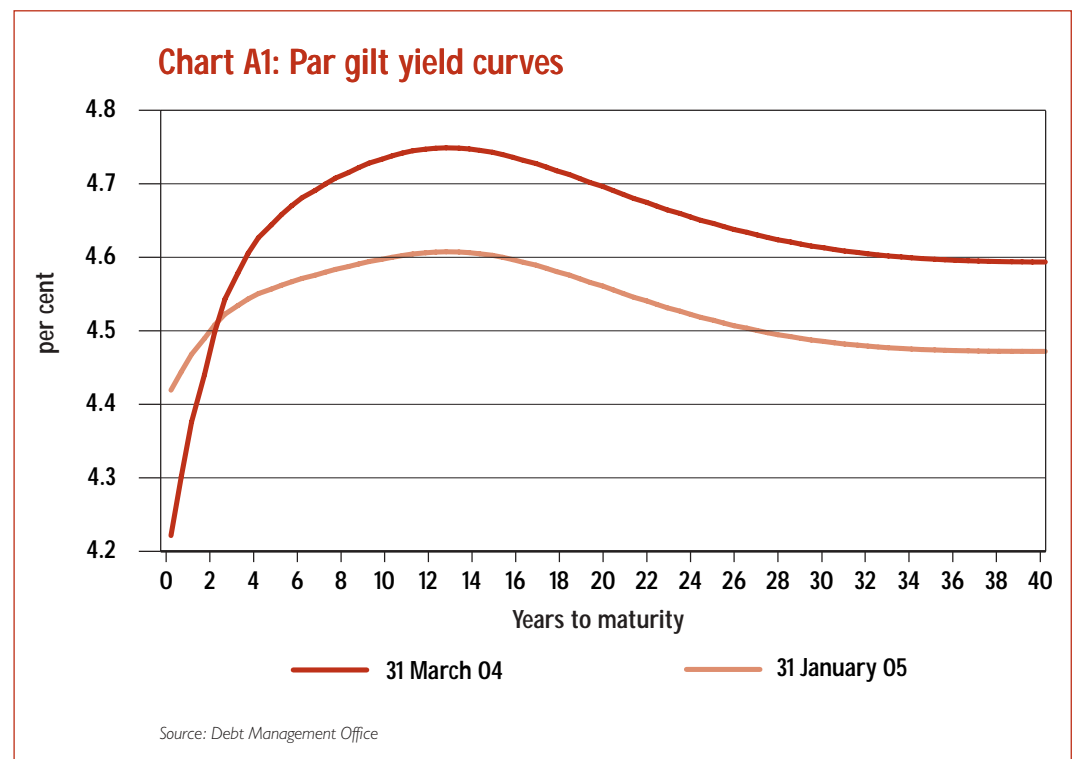
KEY DEVELOPMENTS IN THE GILTS MARKET APRIL 2004 TO JANUARY 2005

Introduction

A.1 This annex summarises key developments in the gilts market in 2004-05 (to end-January 2005). A more comprehensive review of the financial year as a whole, in the context of developments in other major international government bond markets, will be published in the DMO Annual Review 2004-05.

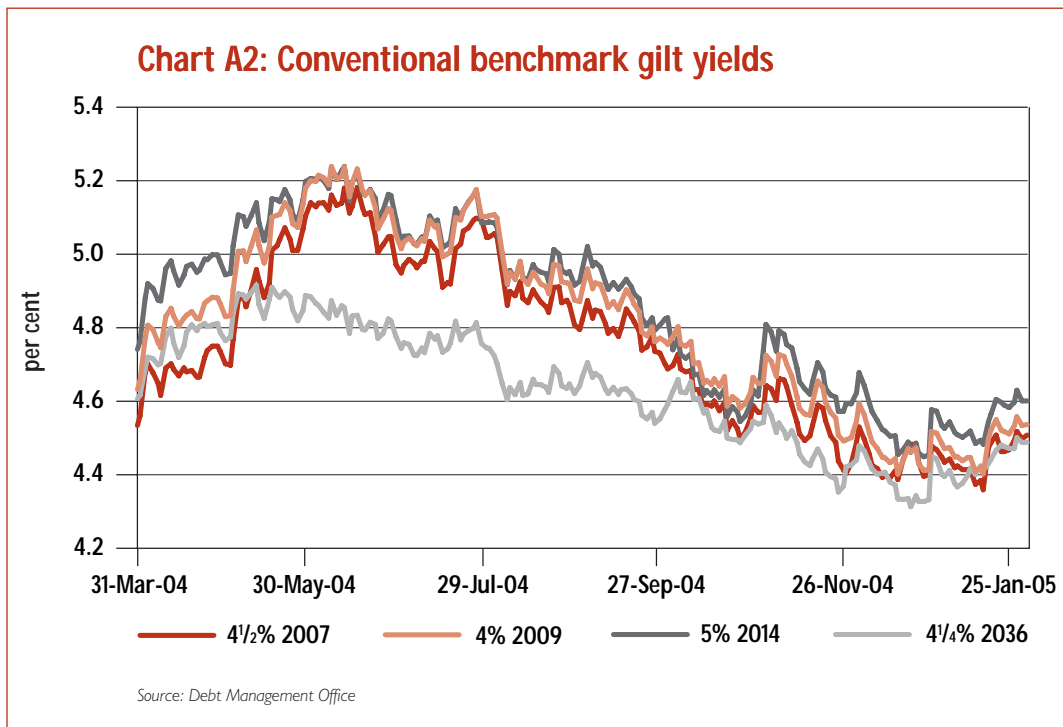
Par gilt yield curves

A.2 The changing shape of the par gilt yield curve between end-March 2004 and end-January 2005 is shown in Chart A1 below. For all but the shortest maturities (out to 2½ years) par yields fell over the first 10 months of the financial year, by 9 basis points (bps) at 5-years, by 14bps at 10-years and by 13bps at 30-years – to stand at 4.56 per cent, 4.60 per cent and 4.49 per cent respectively.



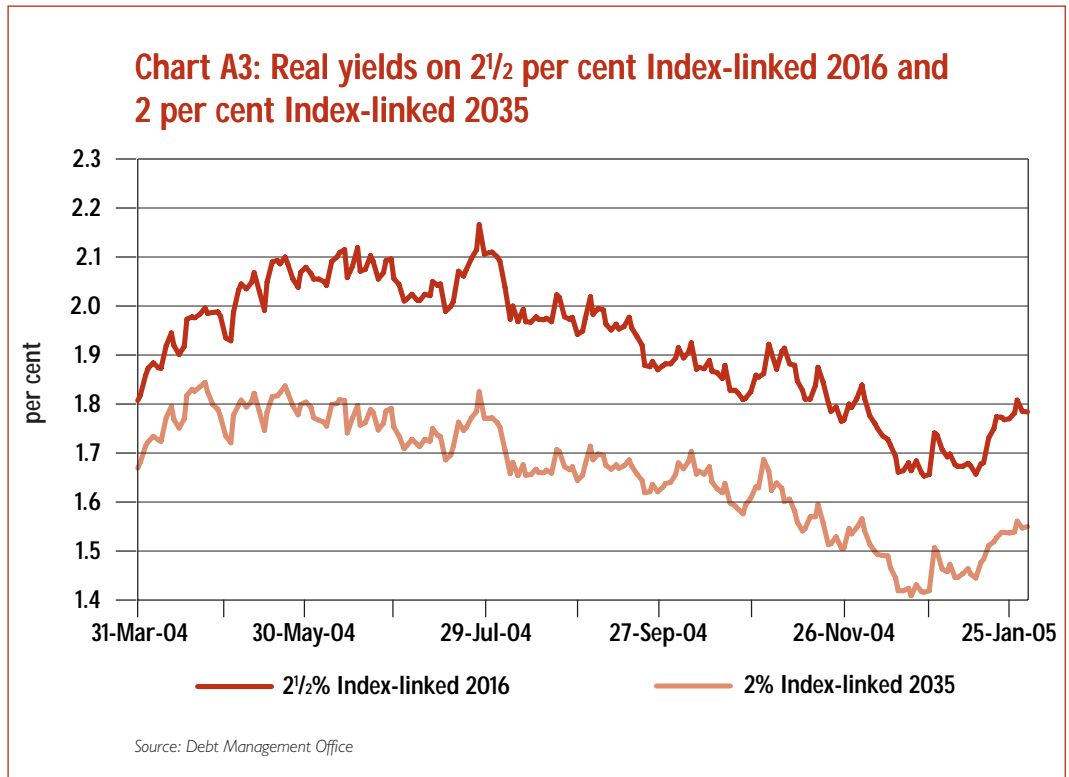
Conventional benchmark gilts

A.3 Gilt yields began the financial year continuing the upward trend observed since Summer 2003. UK monetary policy continued to tighten with the Bank of England's repo rate being increased by 25bps in each of the first three months of the financial year and then again in August – peaking at 4.75 per cent. The yields on 4 per cent 2009 and 5 per cent 2014 peaked at 5.24 per cent in early June, and the yield on 4¼ per cent 2036 peaked at 4.91 per cent in mid-May. However, from the second quarter onwards yields fell, as did expectations about the extent of future interest rate rises, in the face of weakening UK economic data. The yields on the key benchmarks hit lows around Christmas of 4.40 per cent, 4.45 per cent and 4.31 per cent, falls of some 75bps for the 5- and 10-year benchmarks and 60bps for the 30-year. However, yields rose again in January 2005, prompted in particular by much stronger than anticipated CPI data. Chart A2 below shows the evolution of benchmark conventional yields during the year to end-January 2005.



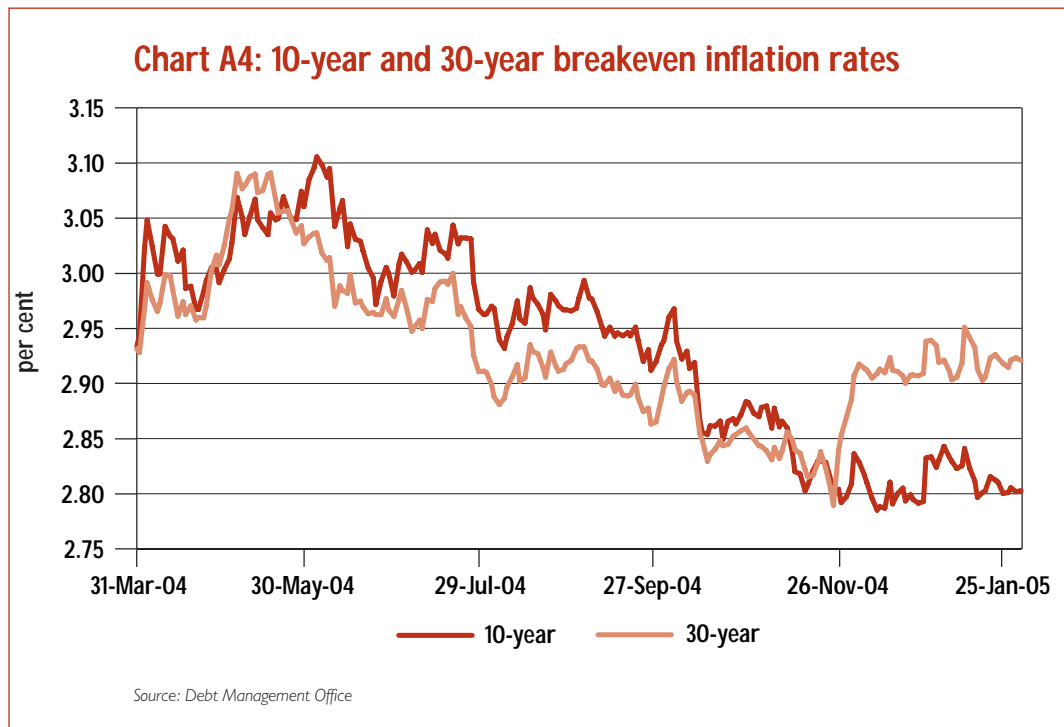
Index-linked real yields

A.4 Real yields on the 2016 and 2035 index-linked gilts followed the same broad trends as conventionals – with real yields hitting highs last summer of 2.17 per cent (2016) and 1.84 per cent (2035) and lows around Christmas of 1.65 per cent and 1.41 per cent respectively. Over the period to end-January 2005 the yield on the 2016 fell by 2bps to 1.78 per cent whilst the yield on the 2035 fell by only 12bps to 1.55 per cent (see Chart A3).



Breakeven inflation rates

A.5 Breakeven inflation rates (BEIRs) fell for most of the financial year to end-January 2005, indicating a modest underperformance of index-linked gilts relative to conventionals. However, these declines came after BEIRs had reached record highs in late-May/early-June of 3.11 per cent (10-year) and 3.10 per cent (30-year). 30-year breakevens moved sharply higher again from end-November, reportedly reflecting continuing pension fund demand for long-dated index-linked gilts. Over the period to end-January 10-year BEIRs fell by 13bps to 2.80 per cent whilst 30-year rates fell by only 1bp to 2.92 per cent. Chart A4 below sets out 10-year and 30-year breakeven inflation rates for the financial year to end-January 2005.



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