

# DEBT & RESERVES MANAGEMENT REPORT 2003-04



HM TREASURY

April 2003

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## FOREWORD BY THE FINANCIAL SECRETARY TO THE TREASURY

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

On 20 March 2003, in compliance with the *Code for Fiscal Stability*, HM Treasury published the *Provisional Debt Management Report 2003-04* which reviewed debt management activities in 2002-03 and set out the provisional remits for the Debt Management Office (DMO) and National Savings and Investments (NS&I). We have now updated the financing plans for 2003-04 to reflect the new forecasts for the public finances published in the Budget papers, and new remits for both NS&I and the DMO are published herein. Additionally, the remit for the management of the Official Reserves by the Bank of England has been added to this report.

This report also contains an update of the Government's ongoing work on the structure of the debt portfolio and in particular, how it may be affected by various issuance strategies and exogenous shocks. This work allows us to develop a greater understanding of how better to manage the portfolio in light of potential risks and to look towards developing an "optimal portfolio" and better defining our debt management objective.

Net issuance is projected to be £26.3 billion in 2003-04. An updated auction calendar for 2003-04 is published in this report. Our issuance strategy continues to adhere to our debt management objectives, balancing the needs of the market against the costs and risks to the gilts portfolio.



9 April 2003

**RUTH KELLY**  
**Financial Secretary to the Treasury**

## INTRODUCTION

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

The *Debt and Reserves Management Report* is published in compliance with the *Code for Fiscal Stability*<sup>1</sup> which requires that a debt management report be published every financial year. It was for this reason that HM Treasury decided to publish the *Provisional Debt Management Report 2003-04*<sup>2</sup> on 20 March 2003 in advance of Budget 2003. This publication updates and expands the information published in that report.

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

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

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

## SIZE AND STRUCTURE OF UK GOVERNMENT'S DEBT IN 2002-2003

### Debt stock

The total nominal outstanding stock of United Kingdom Central Government marketable sterling debt (including official holdings by central government) was £307.7 billion at end-March 2003. This comprised of £214.6 billion of conventional gilt-edged stock, £78.1 billion of index-linked gilts (including accrued inflation uplift) and £15.0 billion of Treasury bills (see Table 1). An additional £63.0 billion (including accrued interest) was invested in National Savings and Investments instruments.

**Table 1:**  
**Composition of UK central government sterling debt**

(£ billion, nominal value, including official holdings)

	End-March 2002	End-March 2003
<b>Conventional gilts<sup>1</sup></b>	207.3	214.6
<b>Index-linked gilts<sup>2</sup></b>	71.4	78.1
<b>Treasury bills<sup>3</sup></b>	9.7	15.0
<b>Total</b>	288.4	307.7
<b>National Savings and Investments</b>	62.3	63.0

<sup>1</sup>includes undated stocks.

<sup>2</sup>includes accrued indexation uplift.

<sup>3</sup>includes Treasury bill stock in market hands.

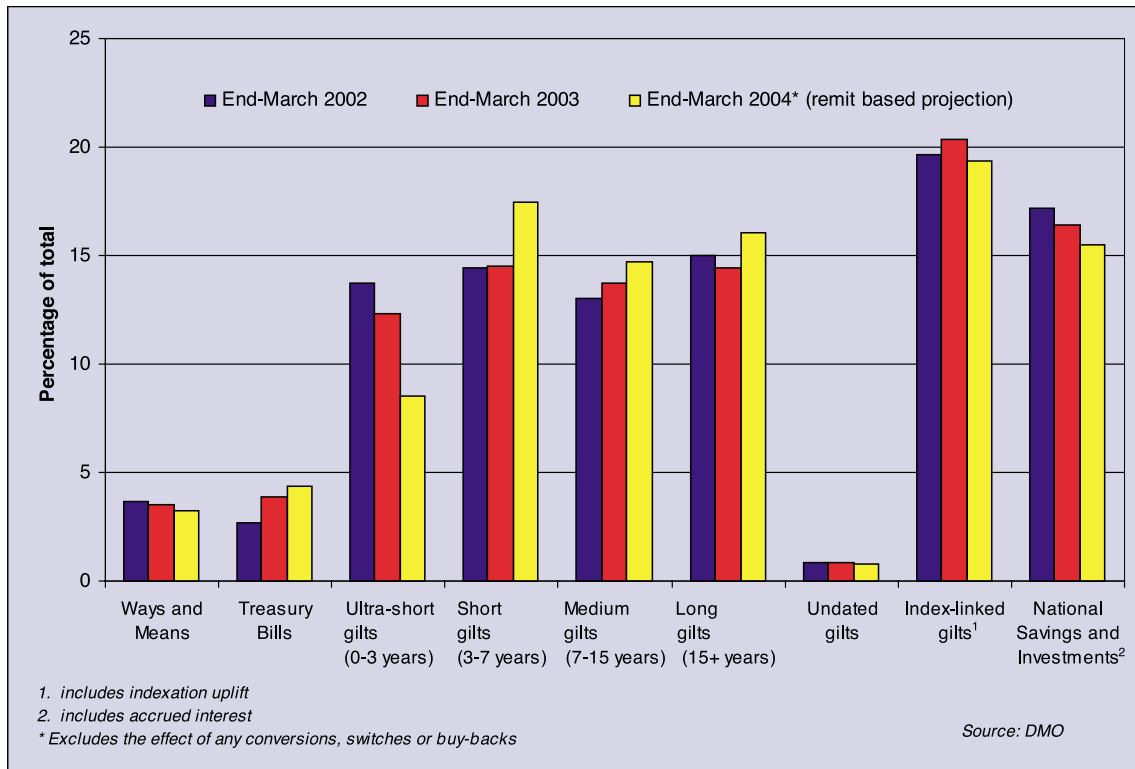
Source: DMO/NS&I

<sup>1</sup> 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](http://www.hm-treasury.gov.uk/documents/uk_economy/fiscal_policy/ukecon_fisc_code98.cfm)

<sup>2</sup> The *Provisional Debt Management Report 2003-04* can be found on HM Treasury's website at:

[http://www.hm-treasury.gov.uk/documents/uk\\_economy/debt\\_management\\_report/ukecon\\_dmr\\_prov03to04.cfm](http://www.hm-treasury.gov.uk/documents/uk_economy/debt_management_report/ukecon_dmr_prov03to04.cfm) and also on the UK Debt Management Office's website at: <http://www.dmo.gov.uk/remit/dmr03-04.pdf>

**Chart 1: Changes in the percentage composition of UK total government marketable debt (including official holdings)**



### Maturity and duration

The average maturity of the stock of all dated gilts rose from 11.00 years to 11.22 years between end-March 2002 and end-March 2003. The average maturity of conventional gilts alone rose from 10.24 years to 10.37 years. Over the same period, the modified duration of the conventional portfolio of marketable gilts rose from 6.56 years to 6.89 years.

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

Chart 1 shows a comparison of the Government's debt portfolio at end-March 2002 through to the proposed composition at end-March 2004. It assumes that new debt is issued in accordance with the forecast financing requirement and the issuance remit and takes into account the ageing of existing debt. It does not, however, make assumptions about possible conversion offers, switch and reverse auctions or buy-backs.

### Distribution of gilt holdings

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

### Interest payments

Gross central government debt interest payments in 2001-02 were £22.1 billion, equivalent to 5.7% of total managed expenditure (TME). In 2002-03, they are forecast to be £20.8 billion (4.9% of TME) and in 2003-04, £21.8 billion (4.8% of TME).

Table 2: Distribution of gilt holdings (market values)

	End-March 2002		End-Dec 2002	
	£ bn	%	£ bn	%
Insurance companies and pension funds	177.2	60.9	202.7	66.2
Banks and building societies <sup>1</sup>	6.1	2.1	-1.6	-0.5
Other financial institutions	22.6	7.8	17.1	5.6
Households	28.1	9.7	29.4	9.6
Other public sector <sup>2</sup>	3.9	1.4	3.4	1.1
Overseas	53.0	18.2	55.2	18.0
<b>Total</b>	<b>291.0</b>	<b>100</b>	<b>306.1</b>	<b>100</b>

1. Negative position results from banks' and building societies' activities in the gilt repo market

2. Other public sector = local authorities and public corporations

Source: ONS

## Public Sector Debt and Sustainability

The Government's fiscal strategy has restored the public finances to a sound and sustainable position, and public sector net debt has been reduced from 44 per cent of GDP in 1996-97 to 31 per cent of GDP in 2002-03. Moreover, the UK now has the lowest net debt to GDP ratio of any country in the G7.

The Government's fiscal policy framework is underpinned by its two fiscal rules - the golden rule and the sustainable investment rule. The latter is that public sector net debt as a proportion of GDP, will be held over the economic cycle at a stable and prudent level. Other things equal, net debt will be maintained below 40 per cent of GDP over the economic cycle.

The Central Government Net Cash Requirement (CGNCR) measures the amount that central government has to borrow to meet all its expenditure commitments. The CGNCR was equal to 3.3% of GDP in 1996-97, whereas in 2002-03 it was 2.0 per cent.

Chart A: Public sector net debt and central government net cash requirement as a percentage of GDP

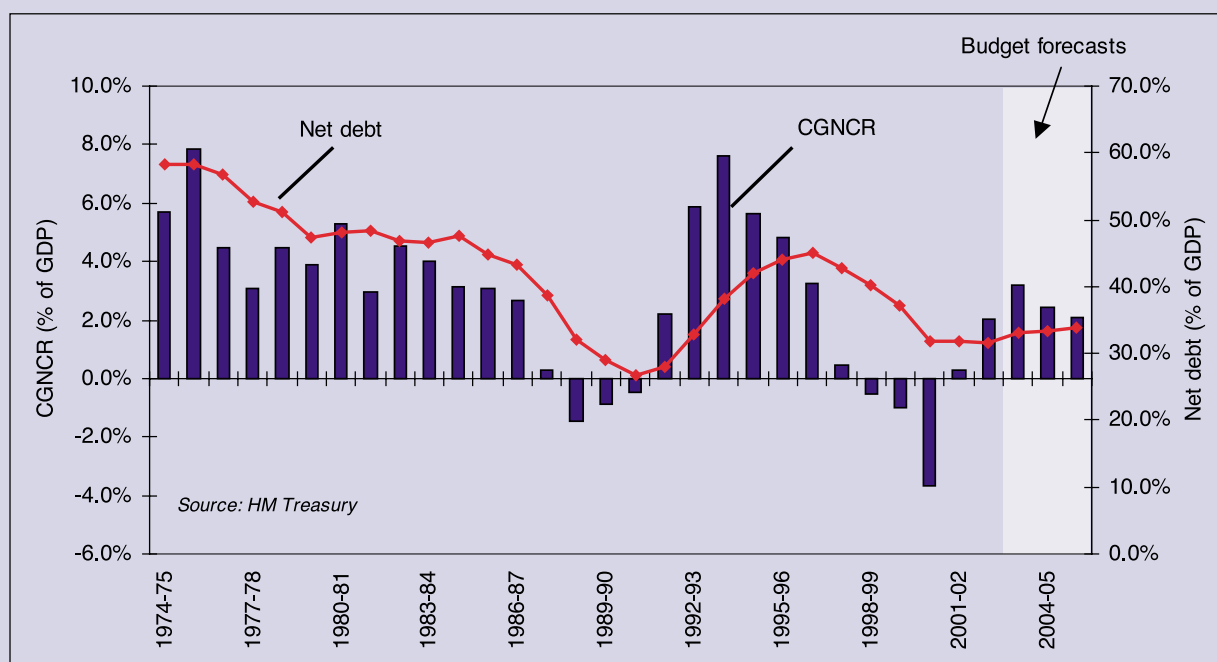


Chart A shows net debt and CGNCR including Budget forecasts to 2005-06. Despite sustained weakness in the world economy, net debt is expected to remain low and stable, rising slightly from 31 per cent to stabilise around 33 per cent of GDP over the forecast period. This comfortably meets the sustainable investment rule by remaining well below 40 per cent. CGNCR is forecast to rise to around 3.2 per cent of GDP in 2003-04, before falling back to around the levels of 2002-03 in the following years.

The soundness and sustainability of the public finances are reflected in the fact that credit rating agencies consistently give the UK government the highest possible credit rating available. Credit ratings provide an assessment both of how robust the government's ability is to service its current level of debt and how sustainable future levels of debt are under current economic and political policies.

The UK government's diversified debt structure also contributes to its consistently high credit rating. For example, the portfolio of central government sterling debt is diversified across a variety of borrowing instruments ranging from conventional gilts (which account for 58% of total UK central government sterling debt); index-linked gilts (21%); Treasury bills (4%); and National Savings and Investments' instruments (17%). Treasury bills are issued for the Exchequer's cash management purposes. Moreover, the long average maturity of the UK Government's debt portfolio reduces the need to refinance large proportions of the debt portfolio at any one time. Additionally, it should be noted that the UK government routinely hedges any foreign currency exposure incurred through foreign currency liabilities, thereby minimising exposure to exchange rate risk.

## UK GOVERNMENT'S DEBT AND CASH MANAGEMENT POLICY

### Objectives of debt management

The Government's debt management policy objective remains:

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

The debt management policy objective is achieved by:

- pursuing an issuance policy that is open, predictable and transparent;
- issuing conventional gilts that achieve a benchmark premium;
- adjusting the maturity and nature of the Government's debt portfolio, by means of the maturity and composition of debt issuance and other market operations including switch auctions, conversion offers and buy-backs;

- developing a liquid and efficient gilts market; and
- offering cost-effective savings instruments through National Savings and Investments.

### Maturity and composition of debt issuance

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

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

## Risk management and the government debt portfolio

### Introduction

HM Treasury and DMO maintain an active research programme keeping the debt management framework under review. This section looks at the progress being made with one element of this programme - the quantitative modelling of the characteristics of the debt portfolio (focussing solely on the gilts portfolio) under different issuance strategies over the long-term. Such modelling can be used to support the decision-making process on the appropriate long-term cost-risk trade-offs facing government and can help to increase public understanding of the decisions underpinning the debt management remit.

Since 1997-98, the *Debt and Reserves Management Report* has included a simple Stock-Flow Dynamics model, which looks at the impact of adopting different issuance strategies over the long-term and the resultant portfolios generated. This analysis is based on a single scenario regarding the path of future interest rates, inflation and the government's financing requirements. The first section updates this work, while the second section introduces the current work programme, which extends that framework to encompass a more explicit model of the macroeconomic environment and to cover a wider range of scenarios.

### Stock-flow dynamics

Table B below compares four issuance strategies under the Stock-Flow Dynamics model: two are extreme corner strategies, involving issuing either all short conventional gilts or all long conventional gilts; one involves a mix of short and long conventional gilts; and one is a fairly evenly balanced strategy which closely matches the issuance pattern pursued in financial year 1997-98. This final strategy is the only strategy that incorporates issuance of index-linked gilts, with this issuance distributed evenly across the curve. As in last year's report, for illustrative purposes, the calculations assume an annual £5 billion central government net cash requirement (CGNCR). Figures include indexation uplift on index-linked gilts. Future prices and inflation are derived from forward curves and break-even inflation rates, respectively, calculated from the observed yield curves on a representative day in February 2003. Table B shows the relationship between the different issuance strategies and their resultant portfolios under these assumptions.



**Table B: Illustrative issuance strategies and the resultant debt portfolio**

Issuance Strategy					Resulting Debt Portfolios (2027)				
Strategy	Issuance Split(%)				Issuance Split(%)				Ave. Maturity (yrs)
	Index-linked	Conventional			Index-linked	Conventional			
		Short (0-7yrs)	Medium (7-15 yrs)	Long (15 yrs+)		Short (0-7yrs)	Medium (7-15 yrs)	Long (15 yrs+)	
FY 1997/98	20	28	24	28	24	35	18	23	10.7
50% short, 50% long	0	50	0	50	1	37	24	39	11.9
All short	0	100	0	0	1	99	0	0	2.9
All long	0	0	0	100	1	27	29	43	13.2

Charts B1 to B4 illustrate the evolution of the current portfolio under the above issuance strategies.

**Chart B1: Portfolio composition if 1997-98 remit issuance pattern is repeated**

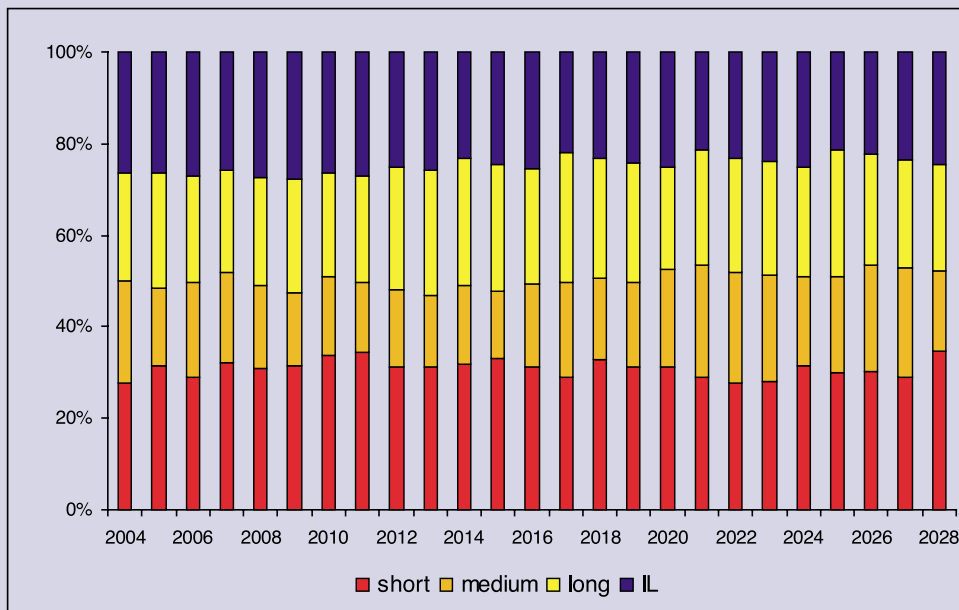


Chart B2: Portfolio composition if 50% short and 50% long conventional issuance

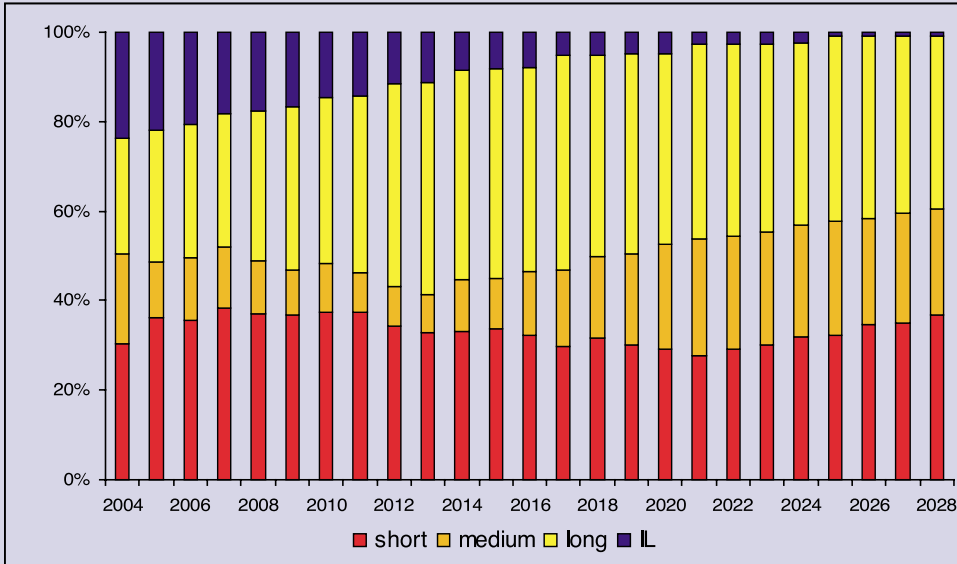


Chart B3: Portfolio composition if only short conventional issuance

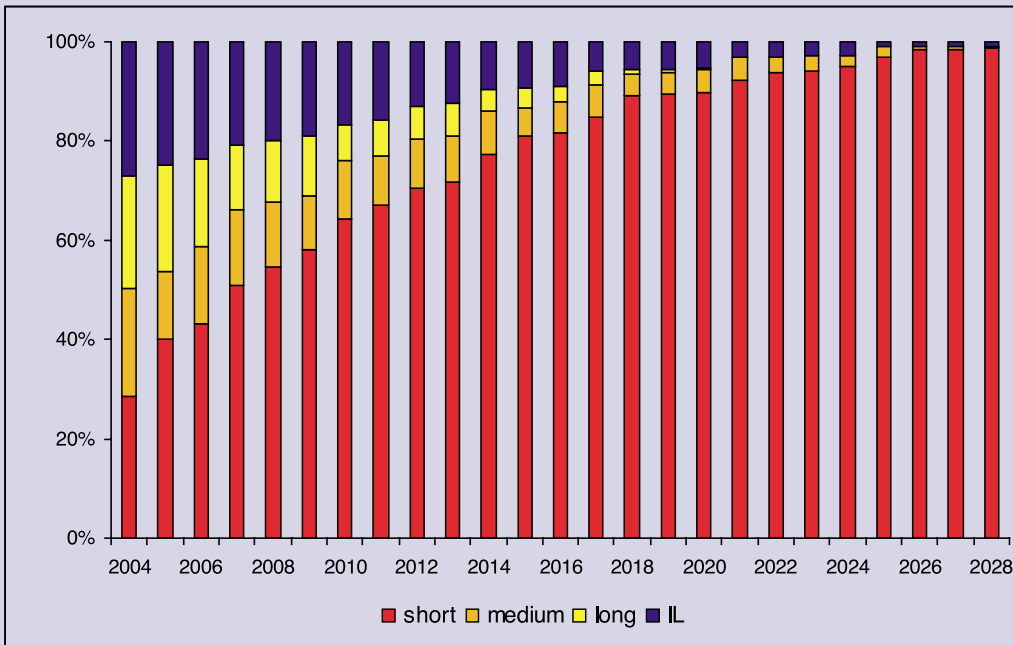
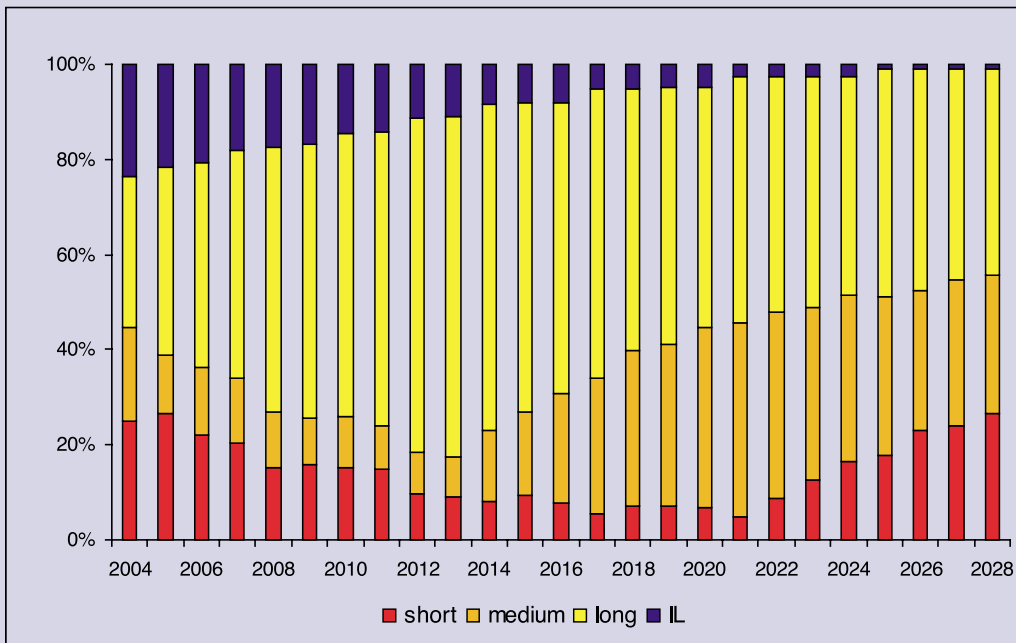


Chart B4: Portfolio composition if only long conventional issuance



Clearly the proportion of index-linked gilts declines to close to zero under all strategies except that illustrated in Chart B1. As discussed in the DMO's Annual Review 2000-01, it may be appropriate to maintain some proportion of index-linked bonds in the debt portfolio to mitigate the impact of deflationary or demand shocks. Under these shocks, index-linked debt offers attractive tax-smoothing properties. The charts also show that even if no medium gilts are issued, then as long as the proportion of long issuance is substantial, the proportion of mediums in the portfolio will recover once the long gilts begin to age.

## Stochastic modelling and simulations

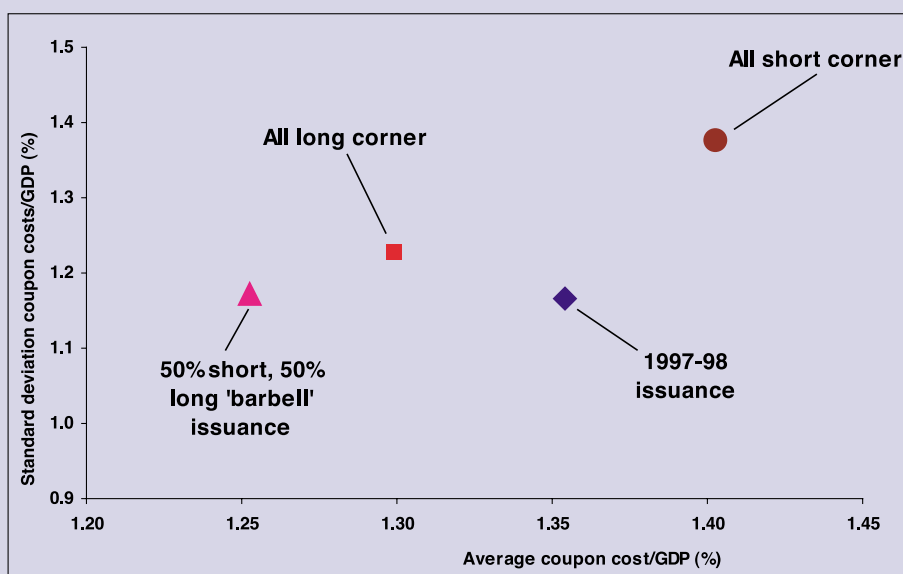
In contrast to the (relatively) basic model outlined above, where only one scenario is generated (i.e. a single term structure and a single set of outcomes for the government financing requirement), debt managers<sup>3</sup> are increasingly using stochastic simulation models to help quantify the dynamic relationships between the evolution of the debt portfolio, debt interest charges and the associated risk(s) to the fiscal agent. The purpose of the stochastic simulation process is to generate a distribution of potential outcomes rather than to forecast any specific future economic state and/or consequent debt service costs.

For the government's risk management purposes the fiscal risk considered below is measured in terms of the volatility of future debt interest costs due to refinancing debt at unknown future interest rates. Consequently, the DMO has focused on developing a model to identify the expected debt service costs relative to the risk of an increase in budgetary outlays due to interest rate rises under differing issuance strategies, commonly called "cost-at-risk"<sup>4</sup>.

The government's budget situation is largely determined by the state of the real economy and inflation, and there is considerable evidence that these factors also affect the shape of the term structure of interest rates. The DMO uses an economic model to simulate future economic cycles in a manner that is broadly consistent with past behaviour and that projects inflation, arbitrage-free term structures of interest rates and the government financial position. The time series of economic variables produced are internally consistent to the degree that the parameters that generate the projections are estimated using historical data observed over the last twenty years. The final output is the evolution of the debt portfolio and debt service costs assuming that a particular issuance rule is adopted.

Charts B5 and B6 summarise two measures of cost-at-risk using 5,000 simulations over a 25-year time horizon for portfolios formed by the same four issuance policies used in the above Stock-Flow Dynamics approach. The "expected cost-at-risk" measure shows the average coupon cost as a proportion of GDP over the 25-year period relative to the standard deviation of those coupon costs as a proportion of GDP. The model focusses on the coupon cost because this represents the debt servicing cost and is part of the primary budgetary outlay. The "absolute cost-at-risk" measure shows the upper bound of the distribution of coupon costs as a proportion of GDP using a 95% confidence level. The optimal issuance strategy would seek to minimise government financing costs for a given level of risk, and hence would tend towards the bottom left portion in Chart B5 and the lowest level in Chart B6.

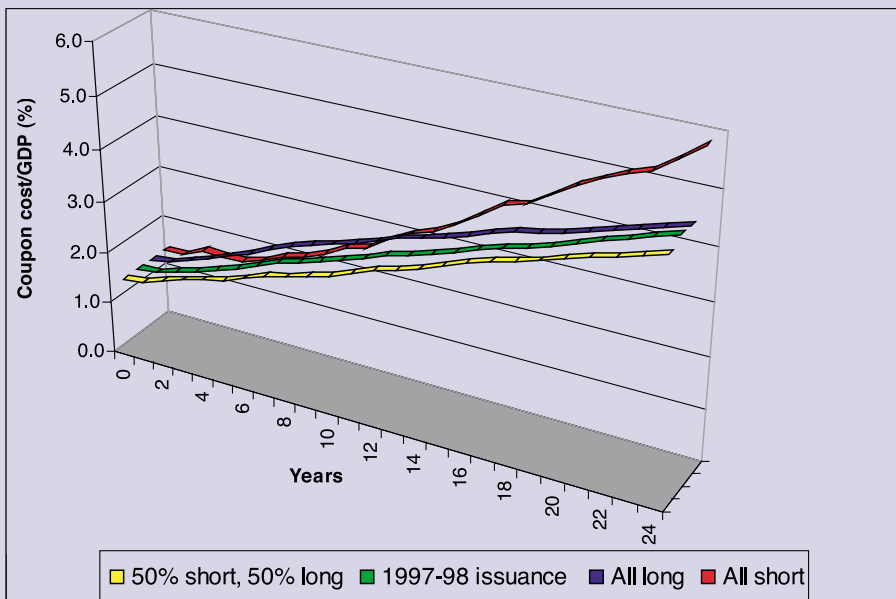
**Chart B5: Expected cost-at-risk**



<sup>3</sup> See for examples, *Dutch Government Securities 2003*, (section 4), Dutch State Treasury Agency, Ministry of Finance of the Netherlands (2003), and *Danish Government Borrowing and Debt 2002*, (chapters 5 and 10), Danmarks Nationalbank (2003).

<sup>4</sup> The DMO has focussed on real costs and risks measured in terms of debt interest costs as a proportion of GDP, (rather than in nominal cash terms).

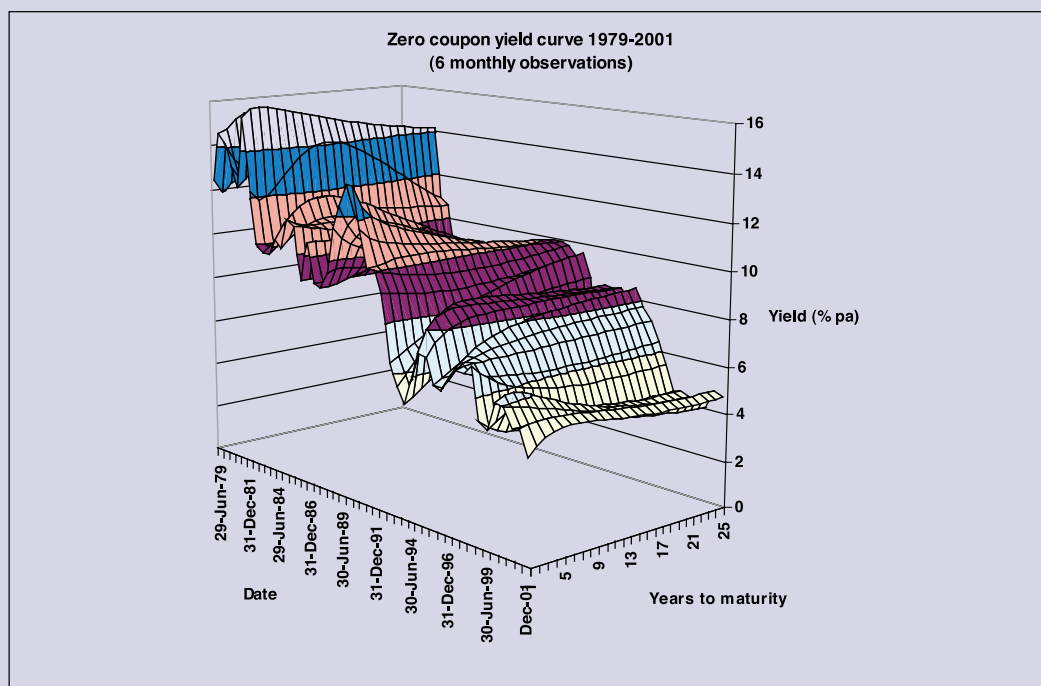
Chart B6: Absolute cost-at-risk



The results in Charts B5 and B6 run counter to standard economic theory, which is predicated on an assumption of a “normal” upward-sloping yield curve and that short maturity interest rates are more volatile than longer maturity rates. That would suggest that short bonds should be on average cheaper than long bonds, but with long-term interest rates less volatile (and hence less risky) than short-term rates. In contrast, Chart B5 indicates that an issuance policy of long maturity bonds, as represented by the all long (30-year) issuance strategy, is more stable, as expected, but cheaper than a strategy of issuing all short maturity bonds. This result would imply that the government should bias issuance toward the long-end.

However, in interpreting these early results it must be remembered that the outcomes are the product of the model's specifications, which are derived from the observed relationships over the last 20 years in the UK. In particular, Chart B7 shows that the UK's yield curve has been inverted for much of the period i.e. interest rates for medium (and often short) maturities were higher than at the long-end. The zero coupon yield on conventional gilts with two years to maturity averaged 9.1%, with a standard deviation of 3.1%, between June 1979 and December 2001, while the average yield and standard deviation for conventional gilts with 25 years to maturity were 8.7% and 2.3% respectively.

Chart B7: Zero coupon gilt yield curves (1979-2001, 6-monthly observations)



## Notes

1. Chart B7 shows that yields were higher at all maturities further back in time (e.g. reading along the "Date" axis from June 2000 back to June 1979, it is clear that yields were higher at all points in 1979 and the early 1980s (light blue area) than in more recent years (yellow area).
2. Chart B7 also shows that the yield curve has been inverted for sustained periods during the last twenty years. For example, reading along the "Years to maturity" axis from 1 to 25 shows yields have often been higher at shorter maturities (e.g. 5-year) than at longer maturities (e.g. 25-year).

Consequently, although the yield curve can be inverted for substantial periods of time (due to specific demand, supply or structural factors), the assumption underlying most financial models, and the experience from most developed countries, would be for a "normal" upward sloping yield curve to hold over the long-run. This would significantly alter the long-term cost-risk trade-off shown in Charts A5 and A6 and consequently the government's decision about its optimal issuance strategy.

This work is at an early stage and the DMO, in consultation with HM Treasury, is working to refine and develop the model further to take account of possible changes to the economic environment, including incorporating different yield curve specifications. Work for the future also includes considering the performance of issuance rules under various stress tests. It is hoped that this work might eventually be widened to take account of the whole of the government's financial balance sheet.

## Central Government's Asset and Liability Risk Monitor

In last year's *Debt and Reserves Management Report* the Government published a preliminary version of the central government's asset and liability risk 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.

Over 2002-03, improvements to the coverage of the monitor have been made. Most notably, these reflect the incorporation of the activities of the Commissioners for the Reduction of the National Debt (CRND) and the Public Works Loan Board (PWLB) into the Debt Management Office in July 2002.

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

The monitor is a precursor to the publication of "Whole of Government Accounts" in 2005-06 and is in accordance with the transparency and accountability recommendations published in the International Monetary Fund's "Guidelines on Public Debt Management", 2001<sup>5</sup>.

Table C below sets out the monitor at end-December 2002. The nominal value of central government financial assets was £128 billion and the nominal value of financial liabilities was £442 billion.

Average maturity in Table C indicates the average length of time before assets and liabilities are due to be redeemed. Average maturity was 10 years (for assets) and 8½ years (for liabilities) at end-December 2002. Changes in average maturity of assets can be brought about by factors such as changes to the average length of loans made by the National Loans Fund. On the liabilities side, changes can be brought about by factors such as the gilts issuance strategy. For example increased issuance of long-dated gilts will increase average maturity, other things equal.

Average modified duration is a measure of interest rate risk. In the context of the monitor, duration offers some indication of how great an impact small interest rate changes might have on the market value of the portfolio of central government financial assets and liabilities. Longer duration suggests a greater degree of sensitivity to interest rates changes.

<sup>5</sup> Guidelines on Public Debt Management can be found on the IMF's website at: <http://www.imf.org/external/np/mae/pdebt/2000/eng/index.htm>

Table C: Central Government's Asset and Liability Risk Monitor at 31 December 2002

## ASSETS

Managing Organisation or HM Treasury Agent	Nominal value  (£ bn) <sup>1</sup>	Market value  (£ bn)	Maturities of less than 1 year (£ bn) <sup>1</sup>	Modified duration  (yrs) <sup>2</sup>	Average maturity  (yrs)	Floating rate composition  (£ bn)
<b>Public Works Loan Board (loans to local authority)</b>	45.9	56.8	2.0	10.4	19.9	1.7
<b>Debt Management Office</b>						
<i>Gilts held by DMO</i>						
Marketable conventionals	8.4	9.8	0.9	5.9	9.1	-
Marketable index-linked	2.0	2.1	0.0	8.2	10.2	-
<b>Total</b>	<b>10.5</b>	<b>11.9</b>	<b>0.9</b>	<b>-</b>	<b>9.3</b>	<b>-</b>
<i>Gilts held in central government funds by the Commissioners for the Reduction of the National Debt (CRND)</i>						
Marketable conventionals	0.1	0.1	0.0	10.7	13.2	-
Non-marketable conventionals	18.6	20.4	5.1	3.4	4.2	-
Non-marketable index-linked	1.4	1.4	0.0	8.1	9.5	-
<b>Total</b>	<b>20.1</b>	<b>21.9</b>	<b>5.1</b>	<b>-</b>	<b>4.6</b>	<b>-</b>
<i>CRND loans to local authorities</i>	0.3	0.3	0.3	0.0	0.0	-
<i>Other short-term bills held by CRND in CG funds</i>	3.6	3.6	3.6	0.1	0.1	-
<i>Other short term assets</i>						
Reverse repos - outstanding	5.3	5.3	5.3	0.0	0.1	-
Deposits at commercial banks	0.0	0.0	0.0	0.0	0.0	-
Cash deposit at the Bank of England	0.2	0.2	0.2	0.0	0.0	-
Sterling Certificates of Deposit	0.0	0.0	0.0	0.0	0.0	-
Sterling Commercial Paper	1.0	1.0	1.0	0.1	0.1	-
FX Commercial Paper	0.9	0.9	0.9	0.1	0.1	-
<b>Total</b>	<b>7.4</b>	<b>7.4</b>	<b>7.4</b>	<b>0.0</b>	<b>0.1</b>	<b>-</b>
<b>Bank of England</b>						
<i>Sterling assets</i>						
Sterling leg of swaps and FX liabilities <sup>3</sup>	11.9	11.9	3.4	1.5	1.7	11.9
<i>Foreign currency assets</i>						
Bonds	15.5	16.8	3.0	2.1	2.4	0.0
Money Market Instruments	0.3	0.3	0.3	0.1	0.1	-
Short-term assets <sup>4</sup>	3.0	3.0	3.0	0.1	0.1	-
Gold <sup>5</sup>	2.1	2.1	-	11.1	-	-
IMF Special Drawing Rights	0.2	0.2	-	0.0	-	0.2
<b>HM Treasury</b>						
<i>Sterling assets</i>						
National Loans Fund loans <sup>6</sup>	3.1	3.1	0.1	9.8	16.7	-
<i>Foreign currency assets</i>						
IMF Reserve Tranche Position	3.8	3.8	-	0.0	-	3.8
<b>Total:<sup>7,8</sup></b>	<b>127.8</b>	<b>143.2</b>	<b>29.1</b>	<b>5.6</b>	<b>10.2</b>	<b>17.6</b>



**DEBT AND RESERVES MANAGEMENT REPORT 2003-04**

**LIABILITIES**

Managing Organisation or HM Treasury Agent	Nominal value (£ bn) <sup>1</sup>	Market value (£ bn)	Maturities of less than 1 yr (£ bn) <sup>1</sup>	Modified duration (yrs) <sup>2</sup>	Average maturity (yrs)	Floating rate composition (£ bn)
<b>National Savings and Investments</b>	61.9	61.9	10.6	4.4	4.5	38.6
<b>Debt Management Office</b>						
<i>Gross gilts in issue<sup>9</sup></i>						
Marketable conventionals <sup>10</sup>	213.0	245.2	23.6	7.0	10.5	-
Non-marketable conventionals	26.1	28.3	7.2	3.2	4.0	-
Marketable index-linked	71.0	75.9	0.0	11.3	14.1	-
Non-marketable index-linked	1.4	1.4	0.0	8.1	9.5	-
<b>Total</b>	<b>311.4</b>	<b>350.7</b>	<b>30.7</b>	<b>-</b>	<b>10.8</b>	<b>-</b>
Treasury bills	21.4	21.3	21.4	0.1	0.1	-
Other short-term bills	5.1	5.1	5.1	0.1	0.1	-
<b>Total</b>	<b>26.5</b>	<b>26.3</b>	<b>26.5</b>	<b>0.1</b>	<b>0.1</b>	<b>-</b>
<i>Other short-term liabilities</i>						
Repos outstanding	6.8	6.8	6.8	0.0	0.1	-
Deposits made by local authorities and commercial banks	0.7	0.7	0.7	0.0	0.0	-
<b>Total</b>	<b>7.5</b>	<b>7.5</b>	<b>7.5</b>	<b>0.0</b>	<b>0.1</b>	<b>-</b>
<b>Bank of England</b>						
<i>Sterling liabilities</i>						
Ways and Means Advance	13.4	13.4	-	0.0	-	13.4
<i>Foreign currency liabilities</i>						
HMG Bonds	1.3	1.4	1.3	0.1	0.1	-
Loans <sup>11</sup>	0.4	0.4	0.2	1.7	2.3	-
Repos	1.6	1.6	1.6	0.1	0.1	-
Swaps & FX liabilities (excludes £ leg) <sup>3</sup>	10.9	11.7	3.0	1.6	1.6	10.9
IMF Special Drawing Rights allocation	1.6	1.6	-	0.0	-	1.6
<b>HM Treasury</b>						
<i>Sterling liabilities</i>						
IMF non-interest bearing securities	5.4	5.4	-	0.0	-	5.4
<b>Total<sup>7,8</sup></b>	<b>441.8</b>	<b>481.9</b>	<b>81.4</b>	<b>4.4</b>	<b>8.5</b>	<b>69.9</b>

*Numbers may not sum due to rounding*

1. Nominal value of index-linked gilts includes inflation uplift. 2. Modified duration of index-linked debt is calculated with respect to changes in real yields.
3. Modified duration covers only swaps. 4. Short-term assets are composed of reverse repos and deposits. 5. Modified duration of gold is calculated as the 30-day moving average volatility of spot gold prices. 6. National Loans Fund loans are composed of loans to nationalised industries and public corporations.
7. Totals for modified duration are weighted by market values (excluding the gold volatility measure and duration of index-linked gilts). 8. Totals for average maturity are weighted by market values. 9. Non-marketable gilts are held by the Commissioners for the Reduction of the National Debt (CRND).
10. Includes the 2½% Index-linked Treasury 2003. At end-December 2002, 2½% Index-linked Treasury 2003 is treated as a conventional gilt because the final inflation uplift on principal and coupon had already been determined.
11. Composed of Canadian and US war debt.

## Cash management operations

The DMO's main strategic objective in carrying out its cash management role<sup>6</sup> is:

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

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

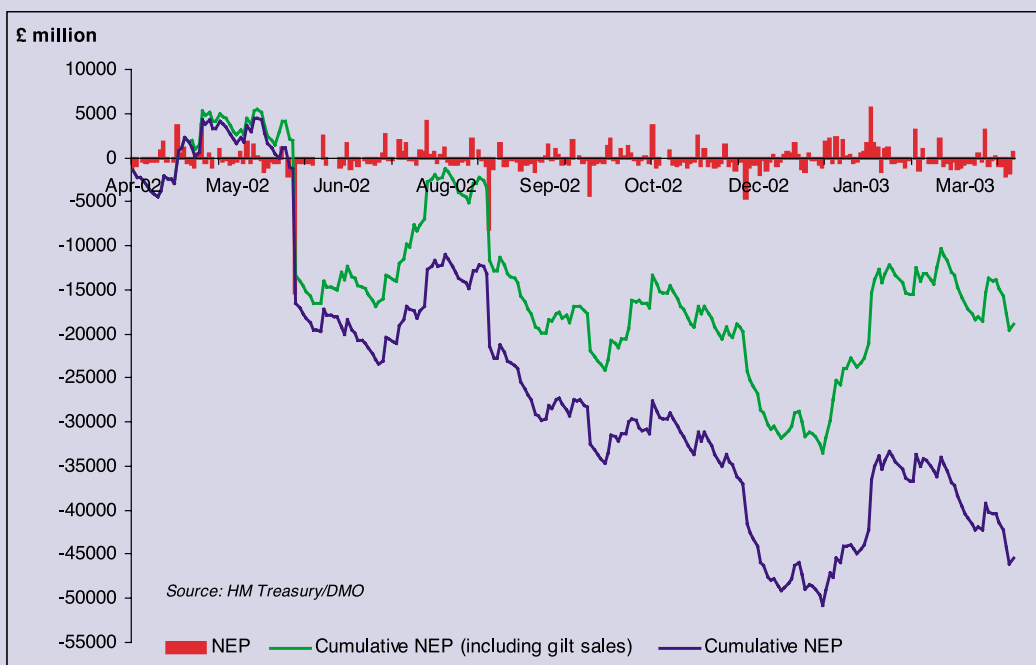
Over the course of the financial year, the Exchequer's cash flow has a fairly regular pattern associated with the tax receipt and expenditure cycles and also outflows associated with gilt redemptions. Chart 2 below shows the scale of daily cash flows in 2002-03 - the major change from previous years was in the level of the overall central

government net cash requirement - which was significantly further in deficit. Chart 2 excludes the effects of the management of the DMO's net cash position of Treasury bill issuance, the rundown of the DMO's net cash position, and NS&I's overall net contribution to government financing.

The increase in the deficit required a general increase in the stock of outstanding Treasury bills in order to help manage seasonal cash outflows. The stock began the financial year at the remit target of £9.7 billion, but following the introduction of tenders for six-month bills and increases in the sizes of tenders of one- and three-month bills, the stock climbed steadily to around £22 billion by end-December 2002. The stock was reduced to £19.3 billion by end-January 2003 ahead of expected cash inflows associated with payments of corporation tax. The stock outstanding at end-March 2003 was £15.0 billion (see Chart 3).

Additionally, in order to aid the efficient execution of the DMO's cash management operations, on 6 June 2002 HM Treasury issued an additional £3.1 billion (nominal) of gilts to the DMO to be used as collateral. This was in line with the provisions of the DMO's cash management remit.

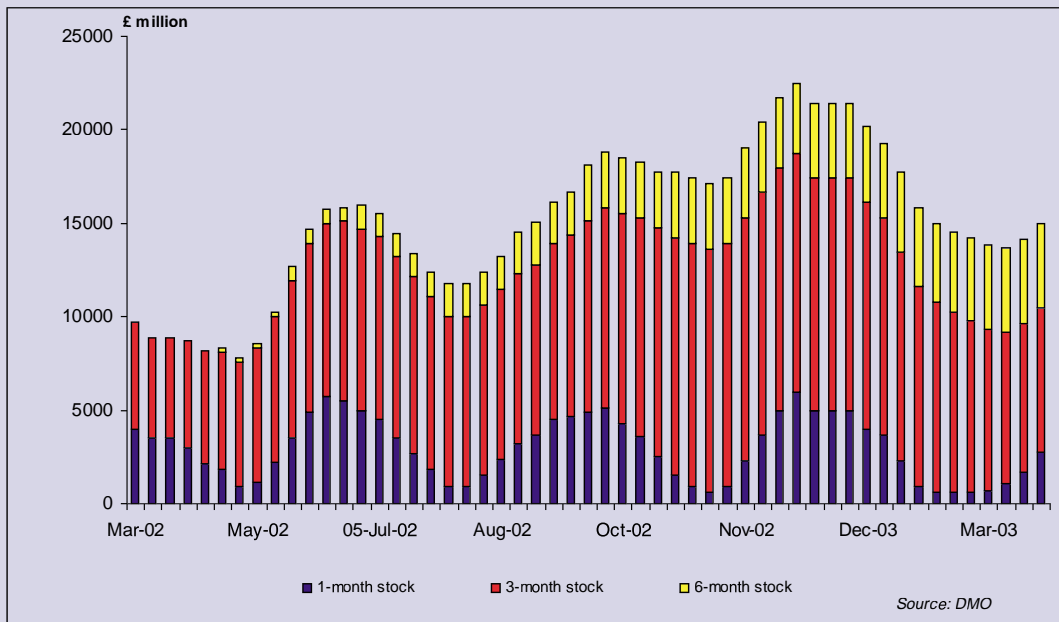
**Chart 2: Daily and cumulative Exchequer cash flows 2002-03**



<sup>6</sup> A full description of the DMO's cash management objectives and operations can be found in "Exchequer Cash Management in the United Kingdom A DMO Handbook", available on the DMO website at:

<http://www.dmo.gov.uk/publication/f2mon.htm>

Chart 3: Cumulative Treasury bill stock 2002-2003

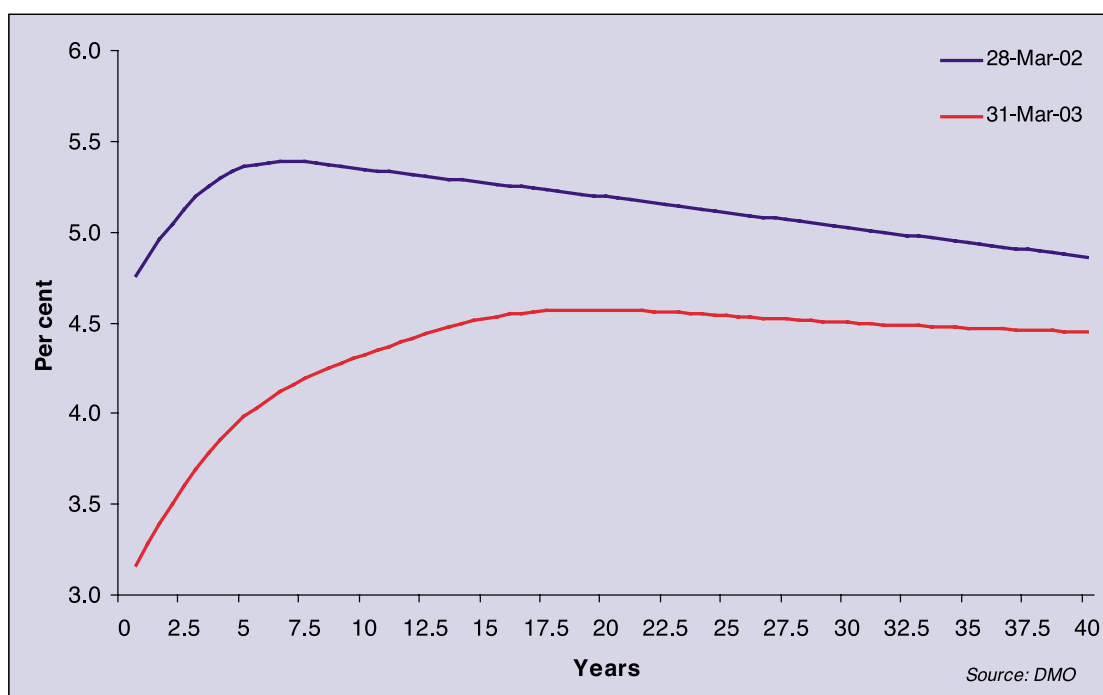


## THE GOVERNMENT'S BORROWING PROGRAMME 2002-03

### Gilt market review 2002-03

Between March 2002 and March 2003, yields on conventional gilts fell along the curve. Overall, the yield curve steepened with par gilt yields falling by 138 basis points (bps) at the 5-year maturity, by 102 bps at the 10-year maturity and by 52 bps at the 30-year maturity (see Chart 4).

**Chart 4: Par gilt yield curves**



The financial year opened with a gradual decline in gilt yields (see Chart 5). Weak economic data coincided with poor equity market performance to reduce the market's expectations of an early increase in interest rates. By end-June 2002, the Bank of England's Monetary Policy Committee (MPC) had left the Bank's repo rate unchanged

for seven consecutive meetings. As a result, the short-end of the yield curve steepened (with the yield on the 2-year benchmark stock 5% Treasury 2004 falling 30 bps). Yields also fell at all other points on the curve in this period, with ultra-long gilts slightly underperforming relative to the medium sector of the curve (see Chart 6).

Chart 5: Benchmark conventional gilt yields 2002-2003

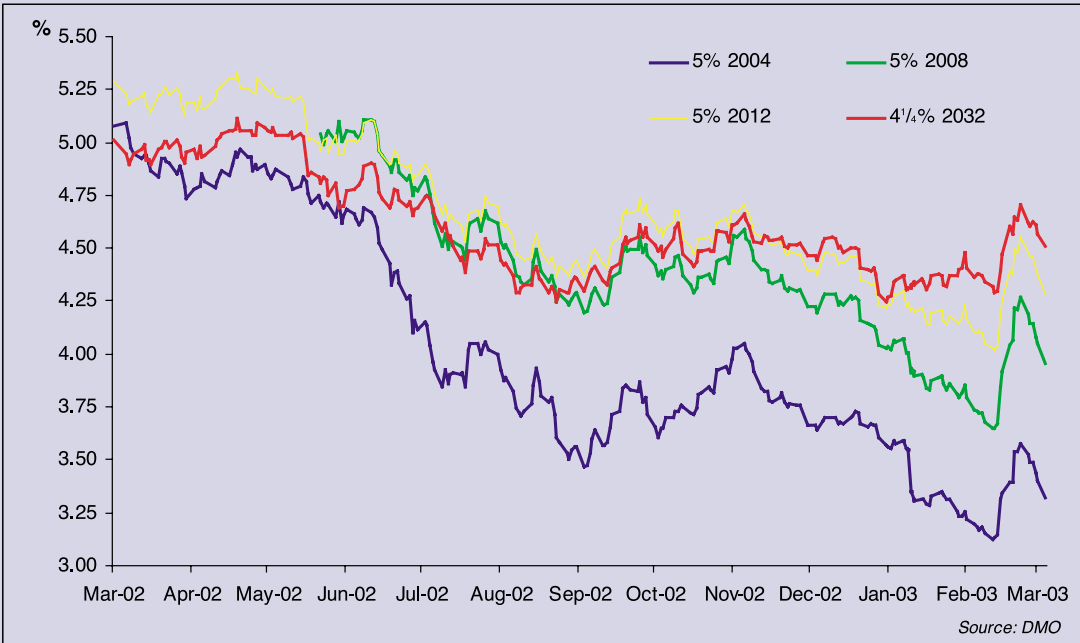
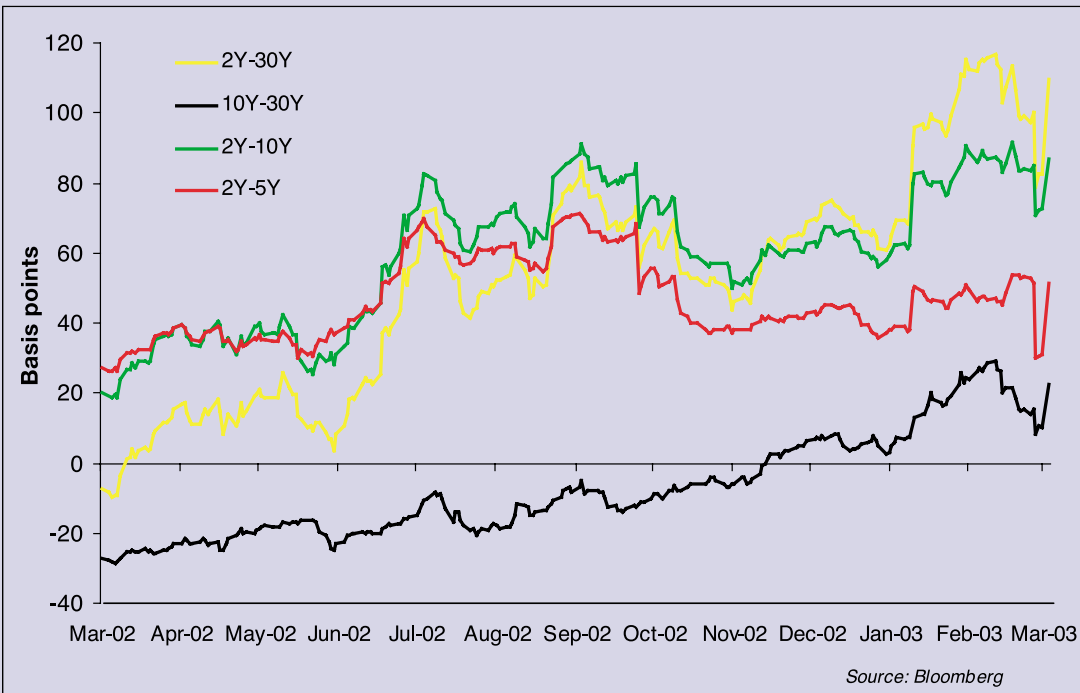


Chart 6: Conventional gilt yield spreads 2002-2003



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

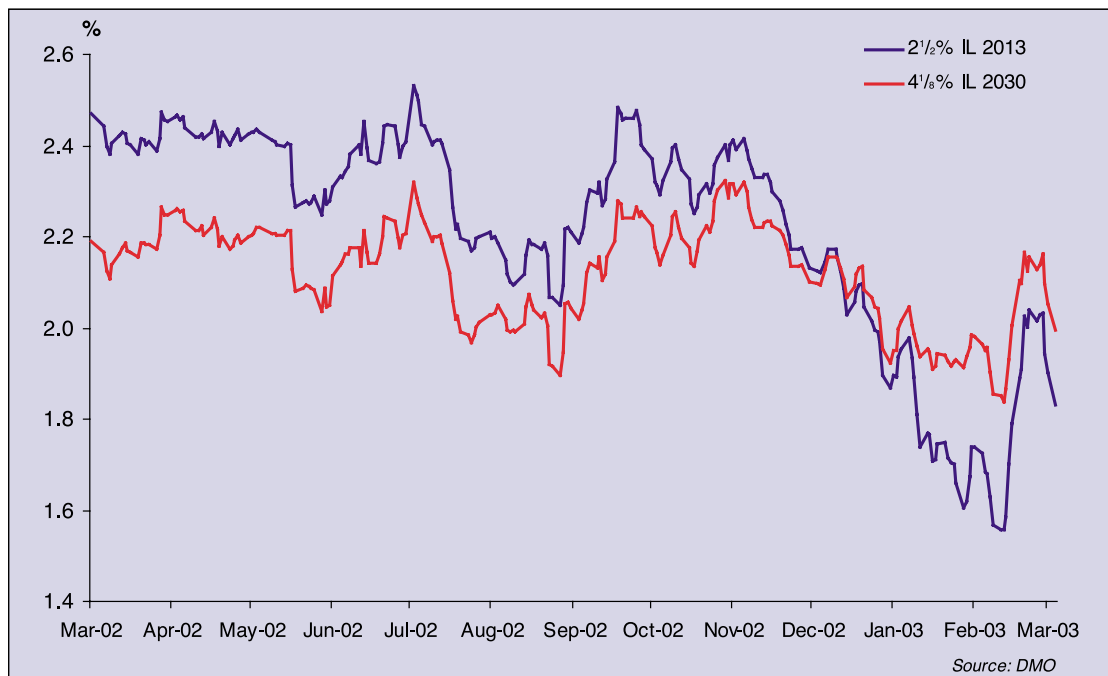
In contrast to the first half of the financial year, at the start of the third quarter, yields began to rise. Expectations that the MPC might cut the Bank's repo rate began to be discounted in the face of somewhat more robust domestic economic data. In particular, the continued strength of both consumer spending and house price inflation were continually cited by market analysts as the main barriers to a reduction in official interest rates. Rising yields at the long-end of the curve

resulted in a marked disinversion of the curve. However, yields resumed their descent in January with continued "flight-to-quality" in response to heightened geopolitical uncertainty and continued equity market volatility.

The real yield<sup>7</sup> on 2½% Index-linked Treasury 2013 and 4⅛% Index-linked Treasury 2030 hit lows of 1.84% and 1.56% respectively in March 2003 (see Chart 7). However, compared to conventional gilts, index-linked gilts underperformed significantly, with break-even inflation rates (BEIRs) falling sharply in the first half of the financial year before stabilising somewhat. By the end of January, BEIRs had fallen by 63 bps in the 10-year maturity sector and 49 bps in the 30-year area of the curve.

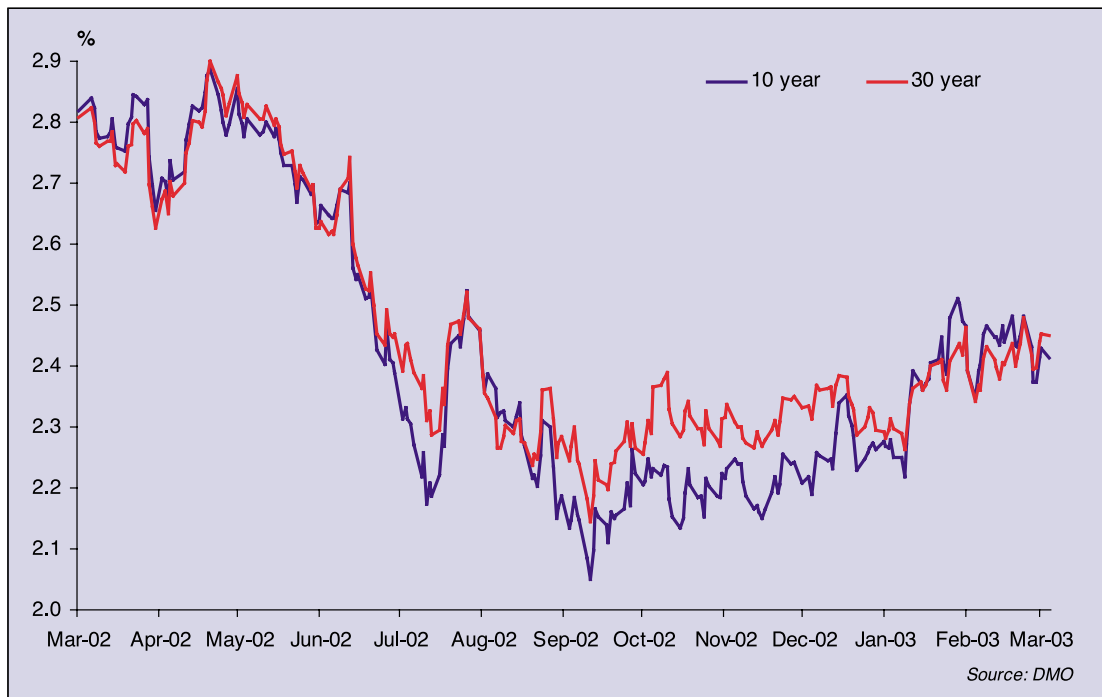
However, in the last quarter of the financial year, as inflationary pressures began to build in the face of higher oil prices and a significant depreciation of sterling, index-linked gilts began to out-perform again and BEIRs increased. Over the course of the entire financial year, BEIRs fell by 43bp in the 10-year area and by 33bp in the 30-year area of the curve (see Chart 8).

**Chart 7: Real yields on 10- and 30-year index-linked gilts 2002-2003**



<sup>7</sup> On a 3% inflation assumption.

Chart 8: Break-even inflation rates 2002-2003



### Gilt sales and contingencies

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

The *Code for Fiscal Stability* requires HM Treasury to publish a debt management report, including an outline of the next financial year's financing plans, prior to the start of that financial year. Given that Budget 2002 was scheduled for 17 April 2002, the *Debt and Reserves Management Report 2002-03* was published on 14 March 2002 to comply with the *Code*. It included a provisional remit based on the public finance projections published in the Pre-Budget Report (PBR) on 27 November 2001. This set out planned gilt sales of £23.0 billion (cash)<sup>8</sup>.

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

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

- index-linked issuance of £4.5 billion.

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

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

- increasing the size of the DMO net cash position by up to £3.0 billion;
- reducing planned long conventional issuance by up to £2.5 billion; and
- reducing planned index-linked issuance by up to £0.75 billion.

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

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

<sup>8</sup> Unless otherwise indicated references to planned gilt sales are in cash terms.

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

## Budget 2002

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

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

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

## Pre-Budget Report 2002

The Pre-Budget Report 2002 published on 27 November 2002 included revised forecasts for the public finances. The forecast for the CGNCR in 2002-03 increased by £5.2 billion to £18.7 billion. The net financing requirement increased by £5.0 billion<sup>9</sup> to £37.1 billion. It was announced that the DMO planned to meet the additional financing requirement by:

- an increase of £3.8 billion in planned gilt sales, including scheduling an additional gilt auction on 15 January 2003, taking them to £26.2 billion; and
- an increased run-down of £1.2 billion in the DMO's net short-term cash position, to £4.4 billion.

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

The change in the DMO's net cash position meant that the

planned run-down for 2002-03 was now £6.6 billion with the level at end-March 2003 expected to be £4.5 billion.

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

Consequently, the net financing requirement was revised from £37.1 billion to £35.9 billion, a decrease of £1.2 billion from the PBR forecast.

Additionally, the planned level of outstanding stock of Treasury bills was increased by £1.0 billion to £15.0 billion in order to facilitate efficient cash management.

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

## Budget 2003

Budget 2003 includes a new forecast for the CGNCR in 2002-03 of £21.4, an increase of £2.7 billion on the forecast published in the Pre-Budget Report 2002. Other changes to the financing arithmetic include adjustments to both the overall level of gross gilt sales, the level of debt buy-backs and the contribution to financing from the adjustment of the DMO's cash deposit at the Bank of England. Additionally, National Saving and Investments' net contribution has increased by £0.5 billion to £0.7 billion. Overall, the net financing requirement for 2002-03 is now forecast to be £38.3 billion. These changes have meant that the end-March 2003 level for the DMO's net cash position is expected to be £4.5 billion, a decrease of £2.3 billion from the forecast level published on 20 March 2003.

## DMO Operations

The DMO issued four new stocks in 2002-03: 5% Treasury 2008, 5% Treasury 2014, 4<sup>1</sup>/<sub>4</sub>% Treasury 2036 and 2% Index-linked Treasury 2035, the first new index-linked stock since 1992.

Table 4 shows the results of the outright gilt auctions held in 2002-03 and those of the mini-tender on 14 November 2002. The latter involved the sale of the residual portion of the (uncovered) index-linked gilt auction held on 25 September. Gilt sales ended the financial year at £26.3 billion.

<sup>9</sup> Secondary market net gilt purchases of £0.3 billion and a reduction of £0.5 billion in National Savings & Investments' expected definancing also impacted on the net financing requirement.



Table 3: Financing Requirement 2002-03 (£ billion)

	DRMR 14 March 2002	Dudget 2002 17 April 2002	PBR 27 November 2002	Provisional DMR 20 March 2003	DRMR April 2003
<b>CGNCR forecast</b>	<b>13.6</b>	<b>13.5</b>	<b>18.7</b>	<b>18.7</b>	<b>21.4</b>
Pre-financing forex debt	0.0	0.0	0.0	0.0	0.0
Gilt redemptions	17.2	17.0	17.0	17.0	17.0
Buy-backs	0.0	0.0	0.3	0.3	0.4
<b>Financing Requirement</b>	<b>30.8</b>	<b>30.5</b>	<b>36.0</b>	<b>36.0</b>	<b>38.8</b>
<i>less</i>					
National Savings and Investments	-1.5	-1.5	-1.0	0.2	0.7
Change in DMO cash deposit at Bank of England	0.0	-0.1	-0.1	-0.1	-0.2
<b>Net Financing Requirement</b>	<b>32.3</b>	<b>32.1</b>	<b>37.1</b>	<b>35.9</b>	<b>38.3</b>
<i>Financed by:</i>					
<b>Planned gilts sales</b>	<b>23.0</b>	<b>22.4</b>	<b>26.2</b>	<b>26.4</b>	<b>26.3</b>
<i>of which:</i>					
Short conventional	5.5	5.5	8.5	8.5	8.4
Medium conventional	5.5	5.5	5.5	5.6	5.6
Long conventional	7.5	6.9	7.7	7.7	7.7
Index-linked	4.5	4.5	4.5	4.6	4.6
<b>Planned net short-term debt sales</b>	<b>9.3</b>	<b>9.7</b>	<b>10.9</b>	<b>9.5</b>	<b>12.0</b>
<b>Short-term debt</b>					
Change in Ways and Means	0.0	0.0	0.0	0.0	0.0
Change in T-bill stock	4.3	4.3	4.3	5.3	5.3
Change in DMO net cash position*	5.0	5.4	6.6	4.2	6.7
<b>End-year short-term debt levels</b>					
Ways & Means	13.4	13.4	13.4	13.4	13.4
Treasury bill stock	9.7	14.0	14.0	15.0	15.0
DMO net cash position **	2.7	5.7	4.5	6.9	4.5

\*Excluding deposit at Bank of England

\*\* Including deposit at Bank of England

Source: HM Treasury

One conversion offer was held in 2002-03, from 9% Treasury 2008 into the then newly-issued 5% Treasury 2008 (first issued on 26 June 2002). The conversion offer was launched on 12 July 2002 and closed on 2 August 2002. Acceptances were received for £4.8 billion (87.5%) of 9% Treasury 2008 and £5.9 billion of 5% Treasury 2008 was created, taking the new stock to almost £9 billion in issue. 9% Treasury 2008 was reduced to a rump stock as a result of the conversion. No switch auctions were held in 2002-03.

Table 4: Results of DMO market operations 2002-03

Date	Stock	Amount auctioned	Cover	Average accepted price (AAP)	Yield at AAP	Tail (bp)*
24 April 2002	2½% IL 2020	£425mn	2.19	£210.17	2.39%	na
29 May 2002	5% 2025	£2,250mn	2.24	£97.62	5.18%	1
25 June 2002	5% 2008	£3,000mn	1.68	£99.63	5.08%	1
10 July 2002	2% IL2035	£950mn	1.38	£97.80	2.09%	na
24 July 2002	5% 2014	£2,750mn	2.02	£101.05	4.88%	2
25 September 2002	2% IL2035	£900mn	0.95	£99.00	2.04%	na
22 October 2002	5% 2014	£2,750mn	1.99	£102.05	4.77%	1
24 October 2002	2½% IL2013	£450mn	3.01	£197.72	2.40%	na
14 November 2002**	2% IL 2035	£74mn	na	£98.76	2.08%	na
03 December 2002	5% 2025	£2,750mn	1.77	£103.21	4.75%	1
15 January 2003	5% 2008	£2,750mn	2.65	£103.27	4.28%	1
22 January 2003	2½% IL 2020	£425mn	2.59	£226.01	2.03%	na
26 February 2003	4¼% 2036	£2,750mn	1.70	£97.65	4.39%	1
26 March 2003	5% 2008	£2,500mn	2.78	£103.63	4.18%	0

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

\*\*mini-tender

Source: HM Treasury

## Cash Market Review

### Developments in the sterling money markets

Market developments in the period from April 2002 to end-March 2003 were characterised by a period of stability in official interest rates. The Bank of England's Monetary Policy Committee (MPC) kept its repo rate unchanged at 4% until 6 February 2003 when the rate was cut by 25 basis points (bps) to 3.75%. During this period, there was one 50 bps reduction in official rates in both the US (to 1.25% on 5 November 2002) and the Eurozone (to 2.75% on 7 December 2002). However, in February 2003, the MPC surprised the market and cut its repo rate by 25bps to 3.75%; this was followed by a further 25bps cut by the ECB in March, taking its official rate to 2.5%. The path of official rates is outlined in Chart 9 below.

In the UK, the spread between 3-month LIBOR<sup>10</sup> and the Bank's repo rate started the financial year at +20bps and was as high as +23bps (i.e. pricing in a rate rise) in early June.

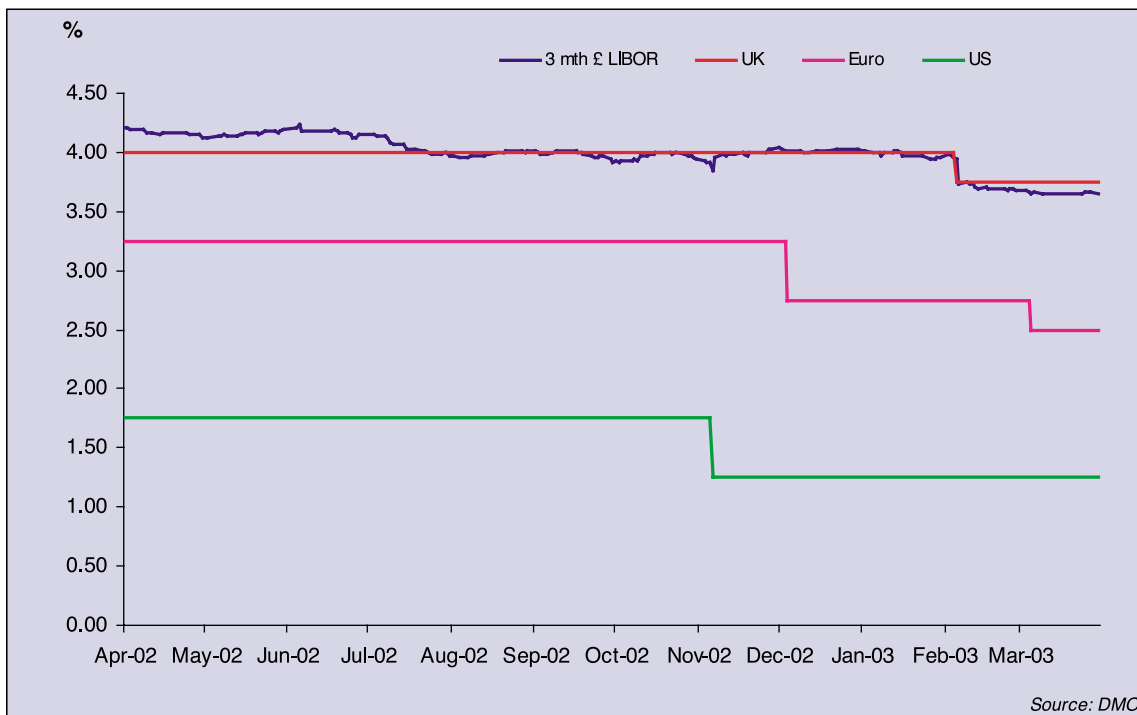
However, as less robust economic data was published throughout the summer, the expectations of a rate rise began to be discounted. In July 2002, 3-month LIBOR fell below

the Bank's repo rate and stayed at or below that rate for most of the rest of 2002-03. There was a sharp spike down to -16 bps on 7 November after the unexpectedly large cut by the US Federal Reserve, but the spread ended the period at -9bps and averaged 3bps over the period.

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

The ECB cut its repo rate again by 25bps (to 2.50%) on 6 March 2003 but rates were held in the US and the UK, despite growing geopolitical turbulence culminating in the start of military conflict in Iraq on 18 March 2003. In the UK, 3-month LIBOR ended the financial year 9bps below the repo rate.

**Chart 9: Official central bank interest rates and LIBOR 2002-2003**



<sup>10</sup> London Interbank Offer Rate - the rate at which AA-rated banks lend to each other. LIBOR is a key market rate.

## National Savings and Investments

The outstanding balance of National Savings and Investments' (NS&I) instruments at the start of the financial year was £62.3 billion. During 2002-03, NS&I were initially expected to make a negative net contribution to financing of £1.5 billion. However, with relatively low nominal interest rates and the weakness in equity markets, there was strong demand for NS&I products, particularly Premium Bonds. The net contribution to financing for 2002-03 is now estimated to be £0.7 billion with gross sales (including accrued interest) of £12.0 billion.

NS&I's overall cost of financing remained lower than that of comparable gilts throughout the year after taking into

account management costs and imputed tax foregone.

NS&I announced seven packages of rate changes during 2002-03. For new issues of fixed rate products, these reflected changes in short-term gilt yields. For variable rate products, there was one rate cut which reflected movements by their competitors and the cut in the repo rate announced by the MPC on 6 February 2003.

NS&I's primary objective remains to raise cost-effective financing from the retail sector. In the medium-term, it is expected that NS&I's net contribution will primarily be driven by their business plan and that they will, on average, make a positive contribution of between £1-2 billion to net financing in each fiscal year.

**Table 5: Change in NS&I product stock**

	End-March 2002		End-March 2003*	
	£ bn	Per cent	£ billion	Per cent
Variable Rate	36.7	58.9	38.2	60.6
Fixed Rate	16.4	26.3	16.8	26.7
Index-linked	9.2	14.8	8.0	12.7
<b>Total</b>	<b>62.3</b>	<b>100</b>	<b>63.0</b>	<b>100</b>

\* estimates

Source NS&I

## The Guaranteed Equity Bond

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

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

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

- i) NS&I take the money from the sale of the product and pass it to the National Loans Fund (NLF). Upon maturity of the product, the NLF is liable to repay this capital and any accrued equity-related return.
- ii) The NLF does not possess the legal authority to enter into the swap directly so this was undertaken via the Debt Management Account (DMA) which is operated by the DMO. The DMA enters into an equity index swap with a counterparty (an investment bank chosen after a tendering process). A LIBOR-based interest rate is exchanged for a FTSE-based return. The swap is collateralised to protect the DMA from counterparty risk.
- iii) Simultaneously, as the swaps mature, NS&I pay the investor his/her initial investment plus, if the FTSE has risen, the growth in the FTSE subject to the cap. If the FTSE has gone down the customer's capital is returned in full.
- iv) At the maturity date, the DMO pays the counterparty the compounded value of the agreed LIBOR-based interest payment; and, if the FTSE has risen, the counterparty pays the DMO the relevant return from the index subject to the cap. The net profit or loss on the swap is passed back from the DMA to the NLF via the periodic reconciliation payment between the two accounts. In effect the NLF has paid a LIBOR-based rate.

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

## THE MANAGEMENT OF THE OFFICIAL RESERVES IN 2002-03

### Introduction

The United Kingdom holds official reserves of gold, foreign currency assets and International Monetary Fund (IMF) Special Drawing Rights (SDRs). Apart from those SDR assets which constitute the UK's reserves tranche position at the IMF, these reserves are held in the Exchange Equalisation Account (EEA). The EEA is under the control of HM Treasury but the Bank of England, acting as HM Treasury's agent, manages the EEA by carrying out day-to-day tasks such as foreign exchange dealing and portfolio investment, within the framework of an annual remit set by HM Treasury (see the summary remit on pages 37-38).

### Origin and purpose

The EEA was established in 1932 as a fund for stabilising the exchange value of sterling. Its uses were later extended to cover the financing of payments abroad (the EEA continues to provide extensive foreign currency dealing services to Government) and also aspects of the UK's membership of the IMF.

The EEA is closely linked to the National Loans Fund (NLF), which finances nearly all of the EEA's investments through a combination of sterling and foreign currency borrowing. Any NLF foreign currency exposures are managed alongside those of the EEA by the Bank of England, which also acts as HM Treasury's agent for foreign currency liability management.

### Disclosure of financial data

In keeping with the Government's commitment to greater openness and transparency in reserves data, the UK's international reserves have, since April 2000, been published in accordance with the IMF/G10's Special Data Dissemination Standard (SDDS). Data from July 1999 onwards can be found on the Bank of England's website. These data disclose the value and composition of the UK's gold and foreign currency assets, liabilities and derivatives on a "marked-to-market" basis (that is, using current market valuations). The press release also reports the size(s) and date(s) of any intervention in the foreign exchange markets, either by HM Treasury or by the Bank of England, and gives an explanation of any intervention carried out.

In addition, HM Treasury now has a statutory obligation, as set out in the Finance Act 2000, to publish a full set of

financial accounts for the EEA every year. The financial accounts for 2001-02 were prepared and laid before Parliament on 16 January 2003. For the second year, the accounts were published under accruals accounting consistent with UK Generally Accepted Accounting Practice (UK GAAP).

**Table 6: UK Official Holdings of International Reserves**

Currency Breakdown as at 31 December 2002

*US\$ million: market value*

<b>Assets</b>	
US\$	8,729
Euro	18,596
Yen	5,128
Other currencies	1
SDR	6,510
Gold	3,459
<b>Total</b>	<b>42,423</b>
<b>Liabilities</b>	
US\$	-5,423
Euro	-15,288
Yen	-3,478
Other currencies	-4
SDR	-2,582
Gold	-
<b>Total</b>	<b>-26,775</b>

## Evaluation of performance in reserves management

For the period 2000-03, the Government had a Service Delivery Agreement (SDA) target to minimise the cost of holding the foreign currency reserves within agreed risk guidelines. Performance is reported on in detail in HM Treasury's annual report on the expenditure plans of the Chancellor of the Exchequer's Departments<sup>11</sup>. For the three years covered by the target the cost associated with holding foreign currency reserves was £170 million and that was largely the result of exchange rate fluctuations.

## Gold sales

The gold sales programme associated with the rebalancing of the UK's net reserves that was announced in May 1999 was completed in March 2002. Consequently, there were no gold auctions in 2002-03. The EEA's gold holdings fell by 0.6 tonnes over the year as a result of routine operations in the gold market.

## Financing the reserves

As in the previous year, the Bank continued its programme of swapping out of sterling aimed at obtaining better value-for-money in the financing of the reserves than the alternative of foreign currency borrowing, given the relative cost advantage of borrowing via gilts.

Some £3.12 billion of such swaps were completed in the twelve months to end-March 2003.

For 2003-04, foreign currency borrowing continues to be an option for financing the reserves. The UK's last US dollar borrowing was in 1996 and the last euro borrowing in 2000. As then, the Bank of England would manage the issuance of the foreign currency liability, under the authorisation of HM Treasury. The justification for renewed foreign currency borrowing would be to obtain better value-for-money, compared with the cost of financing through gilts, on an equivalent currency swapped basis. Financing through foreign currency borrowing would release sterling, which would return to the National Loans Fund, so reducing the sterling financing requirement.

## Intervention

There was no intervention in the foreign exchange markets in the 2002-03 financial year.

## Size of UK reserves

Over the financial year to end-March 2003, the level of the UK's net reserves had increased to US\$15.8 billion compared to US\$13.7 billion at end-March 2002. The gross reserves had risen to US\$42.4 billion at end-March 2003 from US\$38.9 at end-March 2002. A reduction in the value of the gross reserves following the redemption of foreign currency debt (the US\$3 billion bond which matured in December 2002 and the €2 billion note which matured in January 2003) was offset by a rise in the dollar value of that part of the reserves not denominated in dollars, as the dollar depreciated in 2002-03. There will be no further redemptions of foreign currency bonds in 2003-04.

<sup>11</sup> HM Treasury departmental reports can be found on HM Treasury's website at: [http://www.hm-treasury.gov.uk/about/departmental\\_reports/deptreport\\_index.cfm](http://www.hm-treasury.gov.uk/about/departmental_reports/deptreport_index.cfm)

## THE GOVERNMENT'S FINANCING PROGRAMME FOR 2003-04

### Financing framework

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

The Government's provisional financing plans for 2003-04 were published in the *Provisional Debt Management Report 2003-04* on 20 March 2003. These plans have now been updated to reflect the new forecasts for the public finances published in the Budget papers.

### Financing Arithmetic

Table 7 gives details of the financing arithmetic for 2003-04. It outlines the proposed structure and composition of debt instruments that the Government intends to use to meet its financing requirement in 2003-04.

The forecast for the CGNCR for 2003-04 as published in PBR 2002 and used in the *Provisional Debt Management Report 2003-04* was £30.2 billion. The new forecast for the CGNCR in 2003-04 is £35.3 billion, an increase of £5.1 from the PBR 2002 forecast. Gilt redemptions, excluding official holdings, are expected to be £21.1 billion (see Table 8 for breakdown).

### National Savings and Investments

NS&I's net contribution to financing (including accrued interest) in 2003-04 is forecast to be £1.5 billion. This assumes gross sales (i.e. sales and deposits including accrued interest) of £12.0 billion. This forecast is not a target but an estimate based on experience in previous years, trends in the retail savings product market over 2002-03 and NS&I's own forecasts and objectives.

### Financing for the Official Reserves

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

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

**Table 7: Financing Arithmetic 2003-04**

<b>Central government net cash requirement</b>	<b>35.3</b>
Gilt redemptions	21.1
<b>Gross Financing Requirement</b>	<b>56.4</b>
Less	
National Savings & Investments	1.5
Change in DMO cash deposit at the Bank of England	0.1
<b>Net Financing Requirement</b>	<b>54.8</b>
Financed by	
<b>Gross Gilt Sales</b>	<b>47.4</b>
Conventional	
Short	16.4
Medium	13.2
Long	11.3
Index-Linked	6.5
<b>Changes in net short-term debt</b>	<b>7.4</b>
Changes in the Ways & Means Advance	0.0
Changes in Treasury bill stock	3.2
Change in DMO net cash position	4.2
<b>Memo</b>	
<i>End-year short-term debt levels</i>	
Ways & Means Advance	13.4
Treasury bill stock	18.2
DMO net cash position*	0.2

\* Including the DMO's cash deposit at the Bank of England.



### Short-term net debt position

It is forecast that the short-term net debt position will increase by £7.4 billion. This change is made up of:

- an increase in the planned end-year stock of Treasury bills; and
- completion of the unwinding of the DMO's net cash position.

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

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

It is assumed that the DMO will further unwind the net cash position by £4.2 billion over 2003-04 thereby meeting the

commitment given in PBR 2000 to unwind the net cash position by end-March 2004. The DMO will continue to target a working balance of £200 million at the Bank of England.

### Quantity of gilt sales

The DMO, under instruction from HM Treasury and on behalf of HM Government, will aim to meet the remainder of the financing requirement by selling gilts to the private sector. On the basis of the CGNCR forecast, this means gross gilt sales of approximately £47.4 billion (cash).

### Nature of stocks

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

**Table 8: Stocks maturing in 2003-04 (£ million)**

Redemption Date	Stock	Nominal amount outstanding	Official holdings (end-March 2003)	Nominal value of stocks outside Central Government (end-March 2003)
07 May 2003	9¾% Conversion 2003	12	10	2
20 May 2003	2½% Index-linked Treasury 2003	2,734	268	4,253*
06 June 2003	3½% Funding 1999-2004**	561	55	506
10 June 2003	8% Treasury 2003	7,102	522	6,580
08 September 2003	10% Treasury 2003	1,872	107	1,765
21 November 2003	12½% Treasury 2003-2005***	152	54	98
07 December 2003	6½% Treasury 2003	8,095	316	7,779
26 March 2004	13½% Treasury 2004-2008***	96	25	71
<b>Total</b>		<b>20,624</b>	<b>1,357</b>	<b>21,054</b>

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

\*\* call notice issued on 3 March 2003

\*\*\* assuming redemption on earliest date

Source: DMO

### Maturity structure of issuance

Net gilts issuance in 2003-04 is forecast to be £26.3 billion. The financing programme for 2003-04 assumes fifteen outright auctions for conventional gilts, five for short maturities, five for medium maturities and five for long maturities.

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

### DMO cash collateral

As described in the DMO's Exchequer Cash Management Remit (see pages 35-36), over the course of 2003-04, HM Treasury may issue gilts to the DMO for collateral purposes in order to aid the DMO in the efficient execution of its cash market operations. Any such issuance will be wholly transparent and fully reported to the market. It will be designed in such a way as to minimise the effect on key market indices.

### Contingencies

In the event that the financing requirement for 2003-04 is revised downwards, HM Treasury would consider

accommodating such a revision by:

- decreasing the planned stock of Treasury bills in market hands at end-March 2004 by up to £2.0 billion; or
- decreasing planned conventional gilt sales broadly in line with the relative proportions of sales in the financing remit.

In the event that the financing requirement for 2003-04 is revised upwards, HM Treasury would consider accommodating such a revision by:

- increasing the planned stock of Treasury bills in market hands at end-March 2004 by up to £2.0 billion; or
- increasing planned conventional gilt sales broadly in line with the relative proportions of sales in the financing remit; or
- possible issuance of an ultra-short (2-3 year maturity) gilt within the planned increase of short conventional sales.

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

## Index-linked uplift and redemptions

The redemption total for 2003-04 of £21.1 billion does not include the full value of the index-linked uplift on 2½% Index-linked 2003. Within the National Accounts, the nominal amount in issue plus any uplift of nominal on an index-linked gilt which has accrued before the issue date of a re-opened stock counts toward redemptions. However, uplift which accrues after an issue date is aggregated and counts toward the CGNCR in the financial year in which the stock redeems.

Since all cash flows on 2½% Index-linked 2003 are now known, it is possible to calculate the final breakdown between its cash flows which count towards the CGNCR in 2003-04 and redemptions. The nominal in issue of 2½% Index-linked 2003 is £2.73 billion, and the total uplifted amount by the time of redemption will be £6.17 billion, so the total uplift is £3.44 billion.

The nominal in issue (less government holdings at end-March 2003) will count toward redemptions. Of the £3.44 billion of uplift, £1.79 billion will count towards redemptions and £1.64 billion will count towards the CGNCR in 2003-04.

## THE DEBT MANAGEMENT OFFICE REMIT FOR 2003-04

### A) Gilt Remit

#### Objectives

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

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

#### Quantity of gilt sales

2 The DMO, on behalf of the Government, will aim for gilt sales of approximately £47.4 billion in 2003-04.

#### Pace of gilt sales

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

#### Amount and maturity mix of index-linked gilt issuance

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

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

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

#### Amount and maturity mix of conventional gilt issuance

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

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

- decreasing the planned stock of Treasury bills in market hands at end-March 2004 by up to £2.0 billion; or
- decreasing planned conventional gilt sales broadly in line with the relative proportions of sales in the financing remit.

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

- increasing the planned stock of Treasury bills in market hands at end-March 2004 by up to £2.0 billion; or
- increasing planned conventional gilt sales broadly in line with the relative proportions of sales in the financing remit; or
- possible issuance of an ultra-short (2-3 year maturity) gilt within the planned increase of short conventional sales.

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

### Buy-backs of debt

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

### Method of issuance of gilts

12 Auctions will constitute the primary means of issuance of all gilts (conventional and index-linked). The DMO plans to hold fifteen auctions of conventional gilts and eight auctions of index-linked gilts. All auctions will be single auctions held on the day indicated (see Table 9).

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

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

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

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

### In-year consultation and announcements on auctions

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

**Table 9**  
**Gilt Auction Calendar 2003-04**

Date		Type
16 April	2003	2½% Index-linked Treasury 2009
24 April	2003	5% Treasury 2014
13 May	2003	New Conventional Treasury 2009
28 May	2003	4¼% Treasury 2036
12 June	2003	5% Treasury 2014
24 June	2003	2½% Index-linked Treasury 2024
26 June	2003	New Conventional Treasury 2009
2 July	2003	Conventional
16 July	2003	Index-linked
29 July	2003	Conventional
14 August	2003	Conventional
10 September	2003	Conventional
23 September	2003	Index-linked
25 September	2003	Conventional
15 October*	2003	Conventional
23 October*	2003	Index-linked
29 October*	2003	Conventional
25 November*	2003	Conventional
10 December	2003	Index-linked
13 January	2004	Index-linked
28 January	2004	Conventional
24 February*	2004	Index-linked
24 March*	2004	Conventional

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

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

### Coupons

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

### Buy-ins of short maturity debt

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

## Conversions and switch auctions

21 In order to build up the pool of benchmark stocks further, the DMO may make offers for the conversion of non-strippable stocks into benchmarks of similar maturity during 2003-04. The DMO may consider converting out of stocks with up to £5.5 billion (nominal) in issue. Such offers may be supplemented by switch auctions into benchmark stocks during 2003-04. The DMO may also consider using switch auctions to help smooth the redemption profile or to help smooth the market impact of large changes in relevant gilt indices. Details of any future switch auction stocks will be announced at the same time as the end-quarter announcements of forthcoming outright auctions.

## Reviews to the remit

22 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.

23 Any revisions to this remit will be announced.

## B) Exchequer Cash Management Remit

### Objective

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

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

The DMO aims to:

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

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

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

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

### Treasury bill tenders

#### Timing and schedule of announcements

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

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

### Maturities

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

- one month (approximately 28 days);

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

### Level of stocks

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

### Interaction with the Bank of England's money market operations

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

### Ad hoc tenders

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

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

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

### Timing of ad hoc tenders

12 The DMO will usually announce its intention to hold ad hoc tenders in the announcement of the weekly tender result. Such announcements will indicate the day(s) of the following week on which ad hoc tender(s) are expected

to be held, together with a guide to the expected maturity and size.

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

### Bilateral operations with the market

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

15 The DMO's bilateral operations may comprise of:

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

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

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

### DMO cash collateral

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

## BANK OF ENGLAND'S REMIT FOR THE MANAGEMENT OF THE OFFICIAL RESERVES 2003-04

### Introduction

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

### Objectives

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

- carry out in a legal and proper form foreign currency and gold transactions on behalf of HM Treasury and other Government Departments efficiently and cost-effectively;
- manage the official reserves so as to maintain their liquidity and security within limits agreed with HM Treasury and ensure that the published funds entrusted to the Bank in the EEA are properly and well managed and safeguarded;
- subject to the above paragraph, manage the official reserves so as to maximise their return within the agreed risk parameters;
- monitor and report on the level of risk and return on holding the reserves;
- ensure that effective management systems, including financial monitoring and control systems, are in place;
- ensure that proper financial procedures are followed and that accounting records are maintained in a form suited to the requirements of management as well as in the form prescribed for the published accounts;
- provide accurate and timely accounting and

statistical information and analysis as requested by HM Treasury;

- advise HM Treasury on foreign exchange market conditions; and advise HM Treasury on the financing of the reserves, including as necessary the management of foreign currency borrowing (covering new borrowing, hedging and repayments) and implement agreed strategy in this area.

### Composition of the Reserves and discretionary management

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

### Operational standards

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

### Monitoring and controlling risk

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

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

### Audit arrangements

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

### Accounting and NAO access

8 The Bank will maintain accounts for the EEA based on UK Generally Accepted Accounting Practice UK (GAAP UK) in accordance with the relevant Accounts Direction, and will prepare draft accounts for the EEA for 2002-03 by 31 July 2003 for immediate submission to the National Audit Office.

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

### Review of reserves management

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

11 The Accounting Officer for the EEA, or delegated senior officials, will meet the Bank every six months in order to review strategy and to agree on analysis to be commissioned from the Bank. Changes to this remit and meetings to discuss individual issues may be proposed by

HM Treasury or by the Bank, and in such cases the Bank will provide relevant information as requested by HM Treasury.

### Publications policy

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

### Cash management

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

### Intervention

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



## NATIONAL SAVINGS AND INVESTMENTS' FINANCING REMIT 2003-04

### Introduction

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

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

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

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

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

### Responsibility for setting product terms

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

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

### Volume of financing in 2003-04

6 Sales and deposits (including accrued interest) of NS&I products are assumed to be around £12.0 billion in 2003-04. After meeting expected maturities and withdrawals, NS&I is expected to make a net contribution to Government financing of £1.5 billion.

### Cost of financing

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

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

### Review of remit

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

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