Potential innovations in debt management (extract from the DMO Annual Review 2008-09)

During 2008-09 the DMO received a number of suggestions for issuance of new types of debt instruments, and market operations, in particular in response to the DMO's consultation on the possible introduction of supplementary gilt distribution methods in the 2009-10 remit [1].

It was suggested that allocating a small percentage of issuance to niche products, which would not compete with the standard issuance of gilts, could tap into latent demand and might lead to a premium being paid to the Government. Suggestions were also made that wider economic benefits would accrue from the introduction in particular of longevity bonds and the Government's use of interest rate swaps. The Government continues to keep under review the potential for issuance of new instrument types although it has no current plans to launch any new type of debt financing instrument. Amongst the key issues to consider would be the ability of any such instruments to achieve the Government's long-run cost and risk objectives in debt management.

The Government's debt issuance strategy is to issue fixed interest gilts (in bullet form) in large size to build highly liquid benchmark bonds at a range of maturities. This approach has successfully supported achieving long-run cost minimisation by maximising the benchmark premium in prices/yields arising from the issuance of highly liquid bonds. In addition to directly servicing the demand from fixed income investors (pension funds, insurance companies etc) and international investors, an additional effect of this approach is to facilitate the ability of private sector financial institutions to structure other instruments using the basic 'building blocks' of cash flows from gilts. This also allows the private sector to use its greater expertise to generate, more efficiently than may be possible for Government, 'exotic' cash flow structures. The strategy and issuance approach also contribute to the Government's risk objective by fixing future debt servicing costs and by diversifying the refinancing risk across time.

Another long-standing debt issuance strategy has been the issuance of index-linked gilts which offer inflation protection to the bond holder. A similar issuance approach, building up a range of maturities and using standardised formats, has been used with the aim of enhancing the liquidity premium received at issuance and diversifying refinancing risk. This strategy also contributes to Government's debt management risk objective because the way index-linked debt servicing costs evolve can help diversify the evolution of overall debt servicing costs.

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[1] The consultation document on supplementary gilt distribution methods can be found on the DMO's website at:
http://www.dmo.gov.uk/documentview.aspx?docname=publications/giltsmarket/consultationpapers/cons171208.pdf
The response to the consultation can be found on the DMO's website at:
http://www.dmo.gov.uk/documentview.aspx?docname=publications/giltsmarket/consultationpapers/cons20090318.pdf

One example of a proposed new product is longevity bonds. The suggestion has been made that demand for protection against longevity risk exists and the Government could tap into this, potentially achieving an 'insurance' premium at issuance. But by contrast with index-linked issuance, issuance of longevity bonds raises significant policy questions, in particular around the transfer of longevity risk onto the Government's balance sheet. This issue runs wider than the DMO's debt management objectives. In addition the depth of the market for, and the potential liquidity of, this type of product are unclear.

A number of other new instrument types have been suggested from time to time and, indeed the DMO has in the past consulted on different possible structures[2]. For example, there have been calls from time to time for bonds with limited price indexation properties (LPI bonds) that could place a cap and/or a floor on the extent to which inflation uplift would be applied to the cash flows on the bonds. It has been suggested that Government could achieve a premium at issuance from the niche nature of the product. However, in the context of a transparent and predictable framework, such structures could be numerous and each one would be likely to be attractive to a limited group of investors, which could lead to an overall loss of liquidity and fragmentation in the gilt market. These outcomes would probably conflict with achievement of the debt management objective primarily by increasing the long-term costs of debt issuance overall.
A further consideration is the practical implications of introducing new instrument types. The implementation costs associated with introducing new instruments must be weighed against the likely relative cash contribution to the Government's financing needs that could be achieved through issuance of the new instrument type.

The Government remains open to the possibility of launching new instrument types and will continue to apply the following criteria to its consideration of any potential new types of debt financing instrument:

(i) consistency with the debt management objective and the principles on which debt management policy is based;

(ii) impact on liquidity and the good functioning more generally of the gilt market;

(iii) the likely size of demand for the new instrument; and

[2] For example the DMO launched a public consultation in 2004 that included seeking feedback on the possibility of the DMO issuing annuity gilts. The consultation document can be found on the DMO's website at:
http://www.dmo.gov.uk/documentview.aspx?docname=publications/giltsmarket/consultationpapers/cons021204.pdf
The DMO's response to the consultation can be found on the DMO's website at:
http://www.dmo.gov.uk/documentview.aspx?docname=publications/giltsmarket/consultationpapers/cons160305.pdf

(iv) an assessment of the cost and resource commitment required for implementation in comparison with the potential size of demand.

Another suggested innovation in UK debt management has been the proposition that the Government become a payer of interest rate or inflation swaps on the basis of potential benefits to the pension and insurance sectors by providing more of the cash flows these sectors need in order to match their long-term liabilities.

Although paying swaps would not help the DMO in raising cash to meet the Government's financing requirement it is argued that it could help to reduce long term costs of debt by changing the risk profile of issuance. For example, it has been suggested that paying swaps could allow Government to access favourable debt servicing rates available at one maturity whilst facilitating issuance of cash bonds at another maturity in larger size than could otherwise take place.

It is not Government policy to undertake swap transactions to complement its gilt operations and the Government has not done so in the past. In this context it is important to note the importance to Government of debt management adherence to the principles of predictability and transparency. The framework of gilt issuance (primarily via a pre-committed timetable of gilt auctions) was designed explicitly in accordance with the principles. If the Government was to introduce swaps into the debt management programme it would have to think very carefully about how any swaps programme could be designed not to conflict with those principles. Other issues that would also need to be considered include counterparty risk exposure. Although the Government's overall debt management objective cannot specify which risks are taken into account at any point in time, the Government's current approach to debt management does not generate exposure to counterparties in the longer-term. However, if the Government was, for example, to undertake longer-dated swap transactions then is would be incurring a new class of risk (although the risk could be mitigated at least in part).

Supplementary gilt distribution methods such as sales by syndication facilitate higher issuance of long-dated conventional and index-linked gilts than would otherwise be possible (whilst also reducing the market risk of such operations). They are also being conducted in a way which allows the DMO to meet HM Treasury's overarching requirement to raise in-year the quantum of cash set out in the remit while maintaining the Government's firm commitment to the principles of predictability and transparency in debt management. In this sense, the use of supplementary distribution methods for gilt issuance can be seen as an alternative to writing interest rate or inflation swaps as a means by which to provide the pension and insurance sectors with more of the cash flows that they require.