United Kingdom
Debt Management Office

DMO Annual Review

2003|2004

The United Kingdom **Debt Management Office** is an Executive Agency of HM Treasury

July 2004

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Page No

Chapter 1: Introduction

Foreword by the Chief Executive

2003-04 was the sixth year of the DMO's operations and was marked by successfully meeting both our debt and cash management remits issued by HM Treasury. In addition, the vast majority of our objectives and published targets were also met in full. In particular, we successfully delivered the highest level of gilt sales for a decade.

Gross gilt sales have been rising steadily over the past few years from £13.7 billion in 2001-02 to £26.3 billion in 2002-03, £49.9 billion in 2003-04 and plans of £47.1 billion during 2004-05. Current Government forecasts indicate that these relatively high levels are set to continue. Partly as a consequence of this, turnover in the gilts market is rising rapidly as outright issuance rises – average daily turnover has risen from £7.6 billion in 2001-02, to £8.7 billion in 2002-03 and £11.5 billion in 2003-04 – all reflecting increased liquidity in the market.

We also continued to consolidate and expand our range of services throughout 2003-04 by supporting additional issues of National Savings and Investments' (NS&I) Guaranteed Equity Bond (GEB) by hedging the Government's consequential exposure to the equity market. We continued to make available the Deposit Facility which allows local authorities to deposit surplus funds with the Debt Management Account and we also put in place arrangements to support the new prudential borrowing regime for local government, which came into effect on 1 April 2004. The new regime is designed to give local authorities more autonomy over and greater accountability for borrowing.

Looking to the future, we have published a consultation paper outlining our plans to introduce electronic bidding for gilt auctions and Treasury bill tenders. The aim of this is to speed up the 'turnaround time' of auction results thereby reducing the uncertainty and/or risk in the market between the close of bidding deadline and publication of results. This should reduce any inherent risk premium in bids, thereby enhancing value-for-money. This is part of our aim to retain our focus on improving efficiency and reducing operational risk.

This latest edition of the Annual Review covers the market background to our operations, and the operations themselves. These are seen against the context of our overall debt and cash management objectives. The activities of the Public Works Loan Board (PWLB) and the Commissioners for the Reduction of the National Debt (CRND) – which were integrated into the DMO in July 2002 – are also included. The Review also includes an essay in Chapter 7 about the costs, risks and other factors considered in UK debt management policy – and in the Annexes material on the DMO's performance in 2003-04.

Robert Stheeman
Chief Executive
July 2004

Chapter 2: The Economy and Financial Markets

Macroeconomic and fiscal developments

During 2003-04 the world economy, with the exception of the Eurozone, recovered strongly. In the UK, real Gross Domestic Product (GDP) registered above-trend growth and reached 3.4% in the first quarter of 2004.

Inflation in the UK fell over the year. Measured by RPIX, the measure of inflation targeted by the Bank of England until 10 December 2003, inflation fell from 3.0% to 2.1%. Inflation as measured by CPI, the new index now targeted by the Bank of England, fell from 1.6% to 1.1%. Inflation measured by RPI stood at 2.6% at end-2003-04, compared to 3.1% at end-2002-03.

The current interest rate cycle appears to have gone through its trough in 2003-04. Having started the financial year at 3.75% the Bank of England cut its repo rate by 25 basis points (bps) in July for, as it seems, the last time in this cycle. In November 2003 and February 2004 the Bank increased the repo rate by 25bps on each occasion. At end-March 2004 the Bank's repo rate was 4.0%.

A lower than expected growth in wages and salaries reduced receipts from income tax and social security contributions. Current receipts as a percentage of GDP increased from 37.6% in 2002-03 to 37.8% in 2003-04. Furthermore, total managed expenditure as a percentage of GDP increased from 39.7% in 2002-03 to 41.2% in 2003-04. As a consequence, the Central Government Net Cash Requirement (CGNCR) increased to £39.4 billion from £21.4 billion. Net debt increased to an estimated 32.7% of nominal GDP, up from 30.8% in 2002-03.

The UK Government continues to enjoy the highest credit rating on its outstanding liabilities.

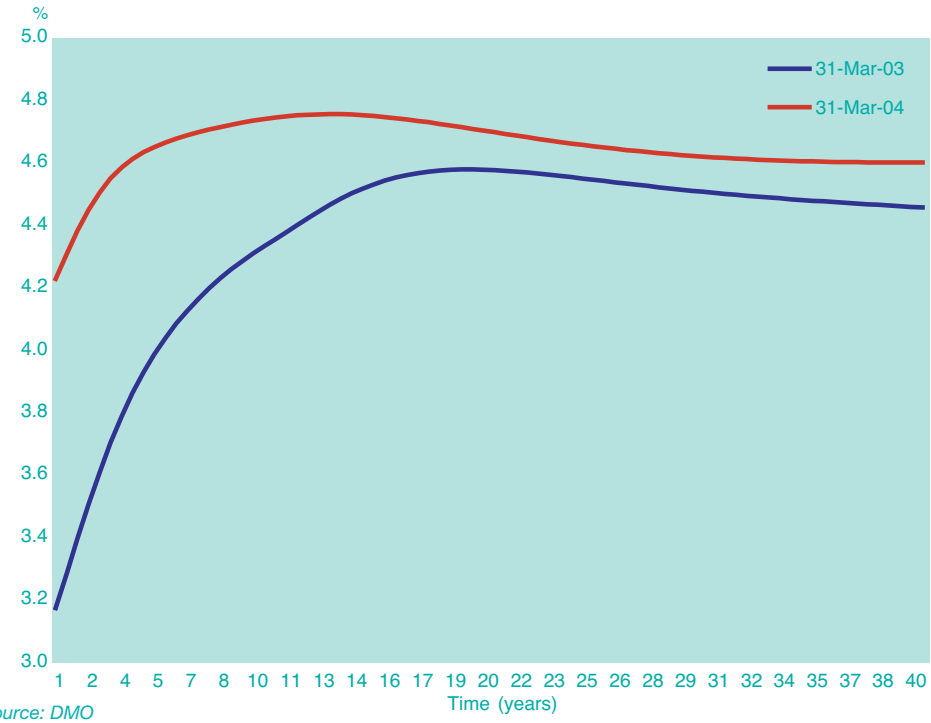
Gilts market developments

Between end-March 2003 and end-March 2004 yields on conventional gilts rose along the curve, but the long-end of the curve out-performed shorter maturities as expectations of interest rate rises increased. Overall, par gilt yields rose by 66 bps at the 5-year maturity, by 41bps at the 10-year maturity and by 11bps at the 30-year maturity (see Chart 1).

The opening of the financial year coincided with the rising geopolitical tension in the Middle East and gilt yields fell along the curve. Continuing weak economic data and expectations of interest rate cuts on both sides of the Atlantic further encouraged a 'flight to quality'. Short gilt yields fell to historic lows at the start of June as the Chancellor announced a planned move to a new inflation target (CPI) and the result of the five euro tests was published. However, by mid-June assessments of the global economy began to improve and yields began to rise accordingly.

Yields continued to rise during the second quarter of the financial year as stronger economic data from the Eurozone, the United States and the UK, combined with a sharp rally in equity market indices, increased market expectations that interest

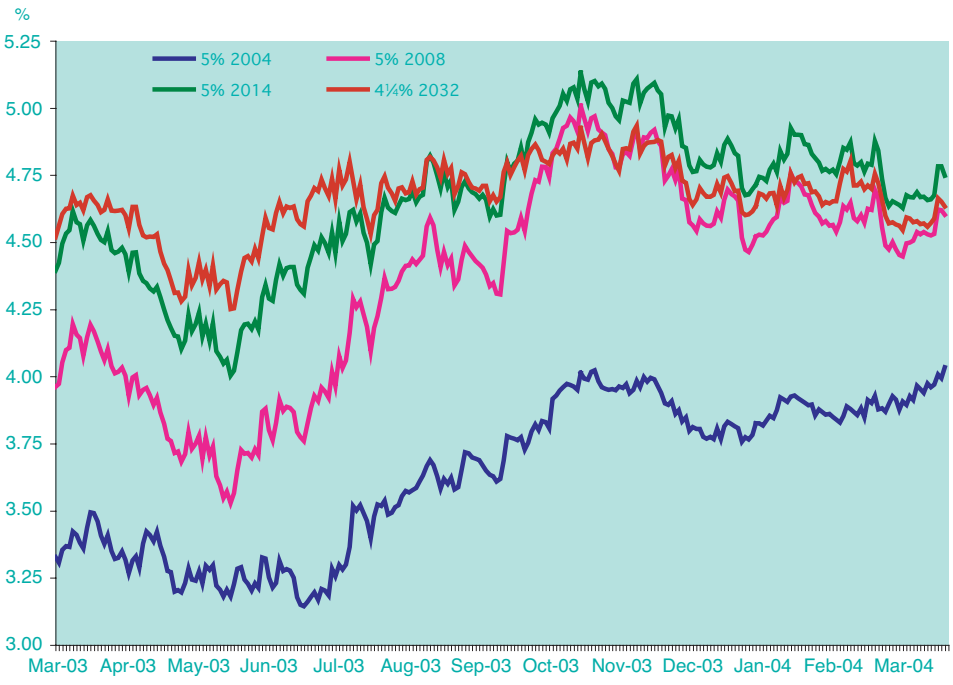
Chart 1
Par gilt yield curves



Source: DMO

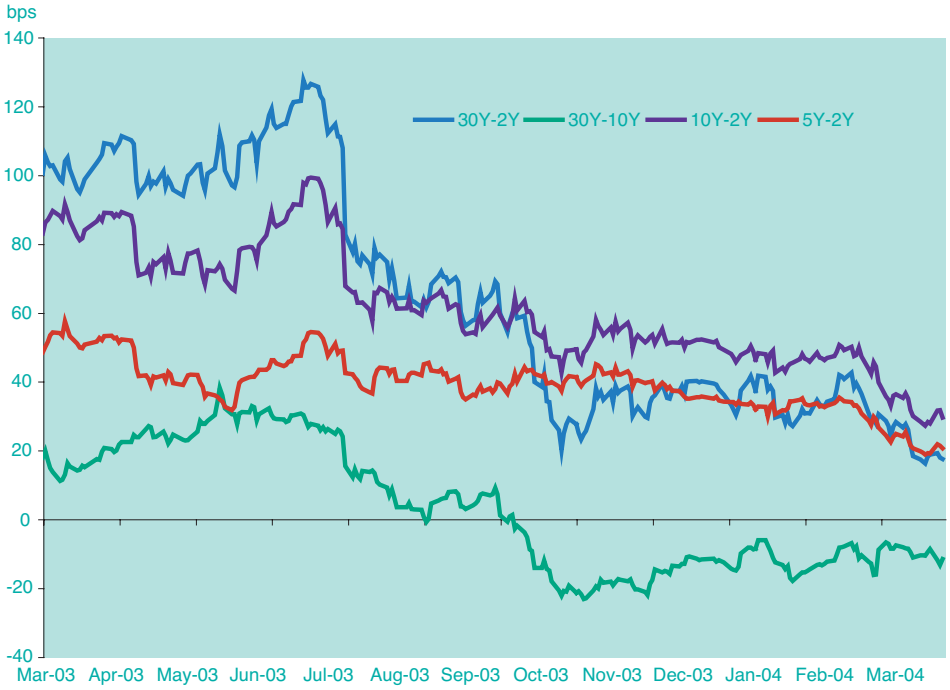
rates had bottomed out. Shorter maturities underperformed relative to other sectors of the curve as investors began switching longer down the curve. However, despite a succession of positive economic data, particularly from the US, market perception was that only a partial global recovery was under way. Central banks began talking down expectations of imminent rate rises and mid-September saw a brief rally in bond markets.

Chart 2
Benchmark conventional gilts yields 2003-2004



Source: DMO

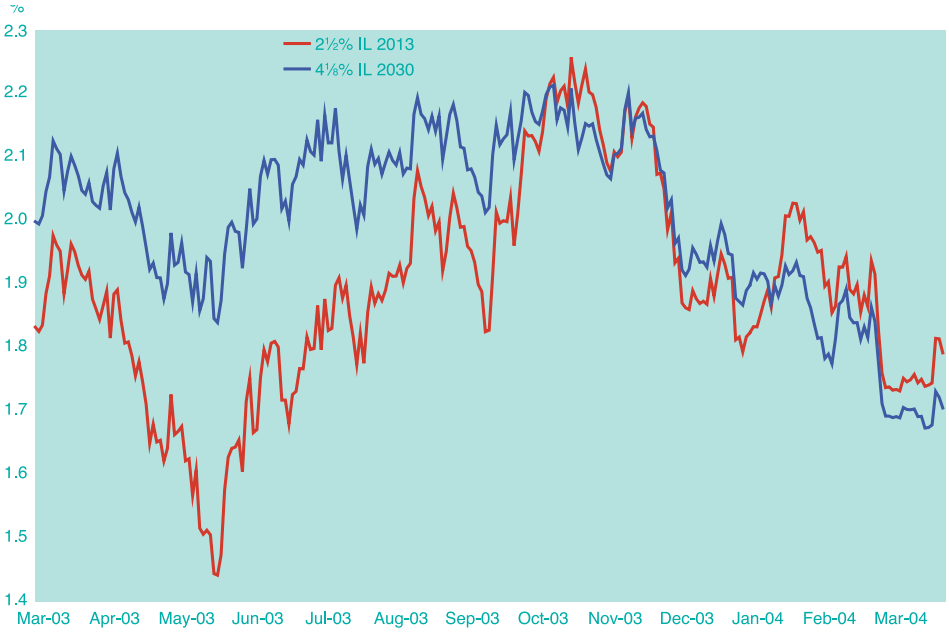
Chart 3
Conventional gilt yield spreads 2003-2004



Source: DMO

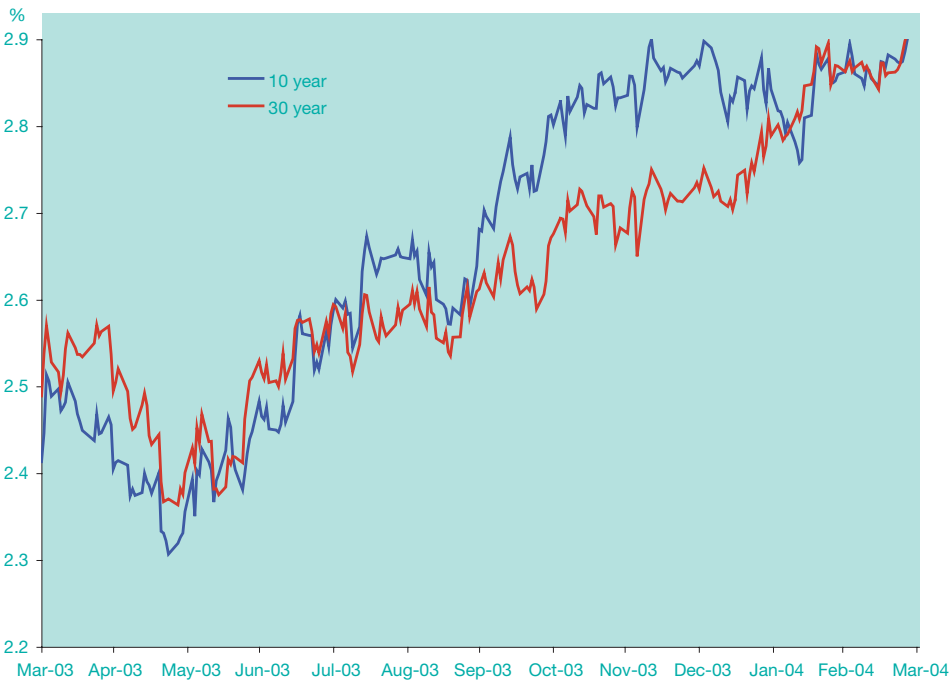
The market turned bearish again at the start of the third quarter as global bond markets factored in more positive indications of economic recovery. The Bank of England responded by raising its repo rate by 25bps to 3.75% on 6 November 2003. Yields reached 16-month highs in early November with gilt yields in the 5-20-year maturities all rising above 5%. The market rallied briefly following terrorist attacks in Istanbul and accompanying threats of targeting the US, UK and other countries. This was not sustainable as continuing robust economic data and business confidence indicators in the US and Eurozone prompted yields to rise

Chart 4
Real yields on 10- and 30-year index-linked gilts 2003-2004



Source: DMO

Chart 5
Break-even inflation rates 2003-2004



Source: DMO

again. A terrorist attack in Spain in March heightened geopolitical uncertainty and briefly sparked a flight to quality, pushing bond yields lower, particularly in short-dated maturities. By mid-March 2004 gilt yields were at new 5-month lows.

As with conventionals, yields on index-linked gilts fell initially then rose reflecting the geopolitical climate. The real yield on 2½% Index-linked Treasury 2013 and 4⅛% Index-linked Treasury 2030 hit lows of 1.44% and 1.84% respectively in June 2003 (see Chart 4). Index-linked gilts outperformed conventional gilts, with break-even inflation rates (BEIRs) rising consistently throughout the financial year.

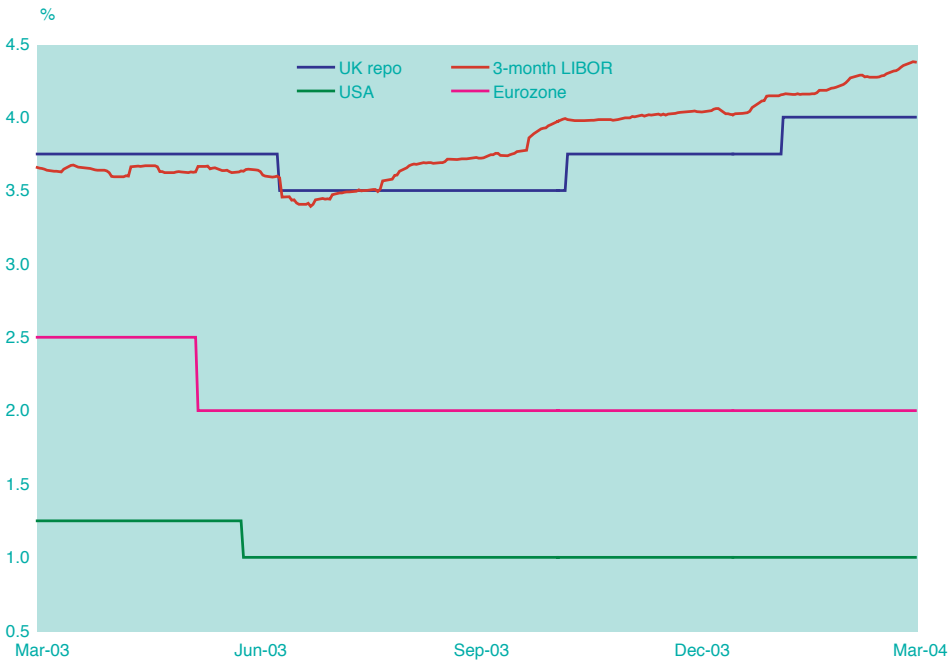
In the last quarter of the financial year sharp falls in real yields occurred following rises in rail fares, gas and water prices and some switching into the sector out of equities. In January 2004 an increase in demand for longs caused an inversion of the BEIR curve. The proposed introduction of the Financial Service Authority (FSA) standard CP195 prompted a brief flight to long-dated gilts in January as investors moved away from lower-rated corporate bonds. As a consequence, 10-year break-even inflation rates fell by 3bps and 30-year rates rose by 6bps. Weaker-than-expected RPI data on 16 March 2004 prompted a general flattening of the curve. Over the financial year BEIRs rose by 50bps in the 10-year area and 43bps in the 30-year area of the curve, with both reaching new highs of 2.9% (see Chart 5).

Money market developments

The financial year began with money markets still anticipating a further downward movement in official interest rates – reflecting continuing weak economic data and the uncertainties caused by conflict in the Middle East. In the UK, 3-month LIBOR[1] was on average 11bps below the Bank of England repo rate for the first quarter of the financial year. The European Central Bank (ECB) was the first of the major central banks to cut rates – by 50bps to 2.0% on 6 June 2003; the US Federal

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

Chart 6
Official interest rates in the UK, US and Eurozone



Source: DMO

Reserve followed with a 25bps cut to 1.0% on 25 June and the Bank of England's Monetary Policy Committee (MPC) voted to cut its repo rate by 25bps to 3.5% on 10 July. These were to be the final reductions in the interest rate cutting cycle that had begun in November 2002. The path of official rates (and 3-month LIBOR in the UK) is shown in Chart 6.

By the second quarter of the financial year, official economic data were beginning to indicate that the global economic recovery was growing in both strength and pace. Therefore, the market's expectations of the scale and speed of future interest rate rises began to increase. This was particularly true in the UK. By mid-August 2003, 3-month LIBOR had risen above the Bank of England's repo rate and by mid-September, was 20bps above it. In the face of increasingly robust economic data, 3-month LIBOR had reached 49bps above the repo rate by the time the MPC raised rates by 25bps to 3.75% on 6 November 2003, the first of the major central banks to do so. Official UK rates were increased by a further 25bps on 5 February 2004. As evidence of strengthening economic growth, albeit not yet reflected in inflation data, persisted into March, expectations about a near term rate rise in the UK continued to gather pace – by end March 2004, 3-month LIBOR had risen to 37.5bps above the Bank's repo rate.

In the United States, increasingly robust economic data were not reflected in the labour market, in particular in the closely watched monthly payrolls data, until late in the financial year. The Federal Reserve maintained a policy stance that was widely interpreted as indicating that rate rises were unlikely until there was solid evidence of a sustained recovery in the labour market. The key phrase in the Federal Reserve's statements "for a considerable period" was dropped in January 2004 and as economic data continued to improve and began to be reflected in payrolls data, expectations grew that a rate rise would come in the second half of 2004.

In general, economic data in the Eurozone were less bullish than in the UK or US and pressures on the ECB to begin its tightening cycle were correspondingly weaker. The appreciation of the euro, in particular against the US dollar in December-February 2004, was also cited as a factor in contributing to slowing economic recovery on the continent.

Chapter 3: Debt Management Operations

Debt management responsibilities and objectives

Objectives of debt management

The Government's debt management policy objective, as implemented by the DMO, is:

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

Assumptions made in carrying out the debt management objectives

In implementing debt management policy the DMO and HM Treasury assume that under its current framework for fiscal policy the Government expects to continue to borrow in the future in a sustainable way (consistent with its two fiscal rules: the "*golden rule*" and the "*sustainable investment rule*"). It is also assumed that the Government's definitions of cost relate to the absolute nominal charges of servicing debt and their relationship to nominal GDP, and that risk relates to the variability of those charges.

The DMO has assumed the Government has a preference for maintaining roughly a quarter of the overall debt portfolio in the form of real exposure (i.e. index-linked, floating rate and variable rate instruments such as Treasury bills).

For conventional gilts the DMO follows a well-diversified issuance strategy. This is the preferred approach because it provides some resilience against a range of economic shocks, by helping to spread refinancing risks over future periods. Drawing on past observations to establish a rough guide the DMO tends to adopt the approach used in the financial year 1997-98 as a starting point – to define a 'neutral' or 'default' strategy. This means that on a cash weighted basis issuance would generally be split fairly evenly between the 3 conventional maturity bands.

Finally, the DMO also assumes that the UK term structure is fairly and efficiently priced and is the best guide to the value of future interest rate expectations.

Further detail about the UK authorities' approach to cost and risk in carrying out debt management strategy is covered in Chapter 7.

The DMO remit for 2003-04

The DMO's remit from HM Treasury for 2003-04 was published on 9 April 2003 in the Debt and Reserves Management Report 2003-04. On the basis of a forecast Central Government Net Cash Requirement (CGNCR) of £35.3 billion, gilt sales of £47.4 billion were planned – the highest level for 10 years. These plans updated those in a provisional remit which had been published on 20 March 2003 and which had been based on the Pre-Budget Report (PBR) 2002 forecast of the 2003-04 CGNCR of £30.2 billion[2]. In the provisional remit gilt sales of £40.0 billion were planned.

The remit published on 9 April 2003 included an increase in planned gilt sales of £7.4 billion compared to the provisional remit – with all the increase being directed at planned conventional sales, as follows:

- short conventional sales rose by £3.0 billion to £16.4 billion;
- medium conventional sales rose by £2.4 billion to £13.2 billion;
- long conventional sales rose by £2.0 billion to £11.3 billion.

Planned index-linked gilt sales remained unchanged at £6.5 billion.

A further auction date (14 August) was added to those previously announced in the provisional remit to accommodate the increase in conventional sales – this took the total number of planned auctions to 23 (five each of short, medium and long conventionals and eight of index-linked).

Other elements contributing to financing announced in the remit of 9 April 2003 were an increase in the planned Treasury bill stock in 2003-04 of £3.2 billion (taking it to £18.2 billion) and a run-down in the level of the DMO short-term cash position of £4.2 billion – completing the planned run down of the assets acquired as a result of the spectrum auctions in 2000.

The split of issuance in part reflected feedback from consultation meetings with gilts market participants held by the Financial Secretary to the Treasury and by the DMO with investors based in Scotland in January-February 2003. These indicated a view that prevailing market capacity for index-linked issuance was in the region of £6-8 billion, a preference by some for continued rebalancing toward short issuance and a continuing interest in long conventional issuance.

Remit contingencies

The remit included contingencies that could be triggered in the event that the financing requirement changed. These were:

In the event that the financing requirement fell:

- a reduction in planned Treasury bill sales by up to £2.0 billion;

- a reduction in planned conventional gilt sales broadly in proportion to the maturity split in the remit.

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[2] The Code for Fiscal Stability requires HM Treasury to publish a debt management report prior to the start of each financial year.

In the event that the financing requirement rose:

- an increase in planned Treasury bill sales by up to £2.0 billion;
- an increase in planned conventional gilt sales broadly in proportion to the maturity split in the remit (this may include an ultra-short (2-3 year) maturity gilt).

Adjustment to reflect the outturn of the 2002-03 CGNCR

The outturn CGNCR for 2002-03 was published on 23 April 2003, and at £21.5 billion, it was £0.1 billion higher than the Budget forecast. The higher financing requirement was accommodated by an increase of £0.1 billion in planned Treasury bill sales in 2003-04 taking the expected level at end-March 2004 to £18.3 billion.

PBR 2003

PBR 2003 was published on 10 December 2003. The forecast for the CGNCR in 2003-04 was increased by £5.2 billion compared to the Budget 2003 forecast, taking it to £40.5 billion. However, planned gilt sales rose by only £2.3 billion, to £49.7 billion, mainly as a result of the release of £1.6 billion back to the NLF as the net result of arrangements made for the financing of the official reserves and an increase of £1.5 billion in the forecast of National Savings & Investments' contribution to financing.

The additional planned gilt sales were all directed at short conventionals, taking them to £18.8 billion. An additional gilt auction was scheduled for 12 February 2004, taking the number of auctions to be held in 2003-04 to 24.

Budget 2004

The Government's forecasts for the public finances were revised in the Budget published on 17 March 2004. The forecast for the CGNCR in 2003-04 was increased by £1.8 billion, to £42.3 billion, compared to the PBR forecast. However, the net financing requirement rose by only £0.9 billion, to £58.0 billion, due to the impact of a higher forecast contribution from NS&I (up £0.7 billion) and £0.2 billion higher sterling proceeds from the financing of the official reserves.

Most of the additional financing requirement was met by additional net short term debt sales of £0.8 billion. Planned gilt sales were increased by only £0.1 billion, to £49.8 billion.

CGNCR 2003-04: outturn

The outturn for the CGNCR in 2003-04 was published on 22 April 2004; at £39.4 billion it was £2.9 billion below the Budget forecast. The outturn for the contribution to financing by NS&I was also £0.2 billion below the Budget forecast at £3.5 billion and final gilt sales were £0.1 billion higher than forecast at Budget at £49.9 billion. Since all gilt and Treasury bill sales for 2003-04 had been completed by the time the outturn was known the impact on the Government's financing position was all reflected in the level of the DMO net cash position; it ended the financial year at £3.2 billion, £2.8 billion above the level forecast in the Budget and £3.0 billion above target. This surplus position has to be run-down in 2004-05 and the DMO remit for 2004-05 adjusted accordingly. See the section below on the 2004-05 remit.

The evolution of the financing arithmetic in 2003-04 is shown in Table 1 below.

Table 1
The financing requirement 2003-2004

(£ billions)	Provisional remit March-2003	Budget 2003* April-2003	PBR 2003 December-2003	Budget 2004 March-2004	CGNCR outturn April-2004
CGNCR forecast	**30.2**	**35.3**	**40.5**	**42.3**	**39.4**
Gilt redemptions	21.1	21.1	21.1	21.1	21.1
Financing for the Official Reserves	0.0	0.0	-1.6	-1.8	-1.8
Buy-backs	0.0	0.0	0.2	0.2	0.2
Financing requirement	**51.3**	**56.4**	**60.2**	**61.8**	**58.9**
less					
National Savings and Investments	1.5	1.5	3.0	3.7	3.5
DMO cash deposit at the Bank of England	0.0	0.1	0.1	0.1	0.1
Net financing requirement	**49.8**	**54.8**	**57.1**	**58.0**	**55.3**
1. Planned gilts sales	**40.0**	**47.4**	**49.7**	**49.8**	**49.9**
of which:					
Short conventional	13.4	16.4	18.8	18.8	18.8
Medium conventional	10.8	13.2	13.1	13.1	13.1
Long conventional	9.3	11.3	11.3	11.4	11.4
Index-linked	6.5	6.5	6.5	6.5	6.5
2. Planned net short-term debt sales	**9.8**	**7.4**	**7.4**	**8.2**	**5.4**
of which:					
Change in Ways & Means	0.0	0.0	0.0	0.0	0.0
Change in T bill stock	3.2	3.3	3.3	4.3	4.3
Change in DMO net cash position**	6.6	4.1	4.1	3.9	1.1
Short term debt levels					
Ways & Means at end of FY	13.4	13.4	13.4	13.4	13.4
T bill stock at end of FY	18.2	18.3	18.3	19.3	19.3
DMO net cash position***	0.2	0.2	0.2	0.4	3.2

** as revised on publication of outturn of 2002-03 CGNCR on 23 April 2003*
*** excluding changes in the DMO's deposit at the Bank of England*
*** including the DMO cash deposit at the Bank of England*

Source: DMO

Table 2 below shows the development of successive gilt sales remits since the DMO became operational in April 1998.

Table 2
DMO remits 1998-99 to 2003-2004

(£ billions)	Conventional			Index-linked	Total
	Shorts	Mediums	Longs		
1998-99					
Original remit	2.7	2.7	5.3	3.6	**14.3**
EFSR*	2.5	2.5	3.1	3.5	**11.6**
PBR	0.0	2.5	3.1	2.5-3.0	**8.1-8.6**
Outturn	**0.0**	**2.5**	**3.1**	**2.6**	**8.2**
1999-00					
Original remit	5.0	3.0	5.8	3.5	**17.3**
PBR	2.4	2.8	5.8-6.2	2.9-3.3	**13.8-14.0**
Outturn	**2.5**	**2.8**	**6.1**	**3.1**	**14.4**
2000-01					
Original remit	0.0	2.2	6.5	3.5	**12.2**
Spectrum	0.0	0.0	6.5	3.5	**10.0**
PBR	0.0	0.0	6.5	3.5	**10.0**
Outturn	**0.0**	**0.0**	**6.5**	**3.5**	**10.0**
2001-02					
Original remit	0.0	4.8	5.0	3.8	**13.5**
PBR	0.0	4.8	5.5	3.8	**14.0**
Outturn	**0.0**	**4.7**	**5.4**	**3.6**	**13.7**
2002-03					
Provisional remit	5.5	5.5	7.5	4.5	**23.0**
Remit	5.5	5.5	6.9	4.5	**22.4**
PBR	8.5	5.5	7.7	4.5	**26.2**
Outturn	**8.4**	**5.6**	**7.7**	**4.6**	**26.3**
2003-04					
Provisional remit	13.4	10.8	9.3	6.5	**40.0**
Remit	16.4	13.2	11.3	6.5	**47.4**
PBR	18.8	13.1	11.3	6.5	**49.7**
Outturn	**18.8**	**13.1**	**11.4**	**6.5**	**49.9**
2004-05					
Original remit	**15.0**	**10.5**	**14.5**	**8.0**	**48.0**
April revision	**14.8**	**10.2**	**14.3**	**7.8**	**47.1**

** EFSR: The Economic and Fiscal Strategy Report* *Source: DMO*

DMO gilt operations 2003-04

The DMO issued three new gilts in 2003-04: 4% Treasury Stock 2009 on 14 May 2003, 4¾% Treasury Stock 2015 on 26 September 2003 and 4½% Treasury Stock 2007 on 13 February 2004. The last of these was the first new current coupon 3-year gilt to be issued by the DMO.

In developing the issuance programme to deliver the remit, the DMO consults with gilts market participants (GEMMs and end-investors) throughout the year. Consultation meetings are held towards the end of each quarter to review auction stock choices for the following quarter (minutes are published on the morning after the meetings). The DMO normally announces the choice of stocks on the last business day of each quarter (i.e. March, June and September), however, the December announcement is made before Christmas.

The consultation meetings to discuss auction stocks for April-June 2003 were held on 24 March 2003 and took as their basis the provisional remit split in Table 2. Seven gilt auctions were scheduled in the first quarter, five conventional and two index-linked. There was general support for two conventional auctions of both shorts and mediums and one long – sequencing was seen as less important than in previous years given the weight of issuance. There was also a fair degree of consensus about the identity of auction stocks within the main conventional maturity bands (a new 2009, 5% Treasury Stock 2014 and 4¼% Treasury Stock 2036). Preferences for index-linked issuance were directed at one short and one ultra-long auction.

The consultation meetings to discuss the July-September calendar were held on 16 June 2003. As with the first quarter there were seven auctions scheduled – again split five conventional to two index-linked. There was virtual unanimity as to the need for two long auctions in the quarter and a short in the August slot but no clear views on the maturity split for the remaining conventionals. There was support however for a new gilt in the 2015 area of the curve. A combination of the 2035 maturity and a medium was preferred for index-linked issuance.

The auction calendar for the third quarter of the financial year was discussed at consultation meetings on 15 September 2003. Five auctions were scheduled – three conventional and two index-linked. There was unanimity in calls for a long auction in November but views were divided as to the scheduling of other conventional maturities. A combination of long and medium maturities was again preferred for index-linked issuance.

Auction stocks for January-March 2004 were discussed on 15 December, following the PBR: an additional auction on 12 February had been added to the calendar at the PBR leaving five auctions scheduled – three conventional (two of which were short) and two index-linked. There was some call for the launch of a new 3-year gilt as part of the short conventional gilt issuance and most supported a stock other than the 2036 conventional maturity for the long. The pattern of issuing a long and short index-linked gilt in a quarter was again requested.

Table 3 shows the results of the outright gilt auctions in 2003-04.

Table 3
Gilt auction results 2003-04

Date	Stock	Amount auctioned	Cover	Average accepted price (AAP)	Yield at AAP	Tail (bp)*
16-Apr-03	2½% IL 2009	£425mn	2.22	£234.27	1.74%	na
24-April-03	5% 2014	£2,500mn	2.60	£104.22	4.52%	0
13-May-03	4% 2009	£3,500mn	2.85	£99.82	4.04%	0
28-May-03	4¼% 2036	£2,250mn	1.51	£98.27	4.35%	2
12-Jun-03	5% 2014	£2,500mn	2.48	£107.98	4.11%	1
24-Jun-03	2½% IL 2024	£350mn	2.15	£200.00	1.95%	na
26-Jun-03	4% 2009	£3,250mn	1.76	£100.44	3.91%	1
02-Jul-03	4¼% 2036	£2,250mn	1.51	£93.86	4.62%	2
16-Jul-03	2½% IL 2013	£425mn	2.00	£213.25	1.77%	na
29-Jul-03	5% 2014	£2,500mn	2.67	£103.68	4.57%	0
14-Aug-03	4% 2009	£3,250mn	2.03	£98.12	4.38%	0
10-Sep-03	4¼% 2036	£2,500mn	2.05	£91.39	4.77%	1
23 Sep-03	2% IL 2035	£650mn	2.73	£100.70	2.09%	na
25-Sep-03	4¾% 2015	£2,750mn	2.22	£100.66	4.68%	0
15-Oct-03	4% 2009	£3,250mn	2.16	£96.42	4.76%	0
23-Oct-03	2½% IL 2011	£400mn	1.83	£247.50	2.10%	na
29-Oct-03	4¾% 2015	£2,500mn	1.64	£97.70	5.01%	1
25-Nov-03	4¼% 2036	£2,500mn	1.33	£89.83	4.88%	2
02-Dec-03	2% IL 2035	£675mn	2.45	£101.00	2.10%	na
13-Jan-04	2½% IL 2016	£400mn	3.31	£235.26	1.89%	na
28-Jan-04	5% 2025	£2,500mn	1.49	£102.99	4.77%	1
12-Feb-04	4½% 2007	£3,000mn	1.81	£100.05	4.48%	1
24-Feb-04	2% IL 2035	£600mn	2.35	£107.43	1.85%	na
24-Mar-04	4½% 2007	£2,750mn	2.82	£99.99	4.50%	1

** Index-linked gilts are issued through a uniform price format* *Source: DMO*

The results above (in terms of yield) are compared with a number of counterfactual issuance patterns in Annex C.

Breakdown of gilt sales by maturity 2003-04

Table 4 below shows a proportionate breakdown by type and maturity of planned gilt sales in the remit of April 2004 and the outturn.

Table 4
Gilt sales by type and maturity

	Remit April 2003		Outturn April 2004*	
Type/maturity	% total issuance	% conventional	% total issuance	% conventional
Short convetional	35	40	38	43
Medium conventional	28	32	26	30
Long conventional	24	28	23	26
Index-linked	14		13	

** Planned short conventional gilt sales were increased by £2.4 billion at PBR in December 2003* *Source: DMO*

The DMO remit 2004-05 and future financing projections

The DMO remit for 2004-05 was published with the Budget on 17 March 2004. On the basis of a CGNCR forecast of £35.6 billion in 2004-05 a financing requirement of £50.3 billion was published[3]. After taking account of an estimated contribution to financing of £2.0 billion from NS&I, the DMO was left to meet a net financing requirement of £48.3 billion.

[3] After adding redemptions of £14.7 billion.

Gilt sales were set to contribute the vast majority (£48.0 billion) of the financing requirement, leaving only £0.3 billion to be met by short-term debt sales (£0.1 billion Treasury bills and a £0.2 billion run-down of the DMO net cash position). Planned gilt sales were split as follows:

- £15.0 billion short conventionals
- £10.5 billion medium conventionals
- £14.5 billion long conventionals
- £8.0 billion index-linked

25 auctions were scheduled (15 conventional and 10 index-linked) as shown in Table 5.

Table 5
Gilt auction calendar 2004-05

Thursday 22 April 2004	4¾% 2038
Wednesday 28 April 2004	2% IL 2035
Thursday 20 May 2004	2½% IL 2020
Tuesday 25 May 2004	4½% 2007
Thursday 27 May 2004	4¾% 2038
Thursday 17 June 2004	4¾% 2015
Thursday 24 June 2004	2% IL 2035
Thursday 15 July 2004	4½% 2007
Thursday 22 July 2004	4¾% 2038
Wednesday 28 July 2004	2½% IL 2013
Thursday 12 August 2004	5¾% 2009
Thursday 16 September 2004	4¾% 2015
Tuesday 28 September 2004	4⅛% IL 2030
Thursday 14 October 2004	Conventional
Tuesday 26 October 2004*	Index-linked
Thursday 28 October 2004*	Conventional
Thursday 18 November 2004*	Conventional
Wednesday 24 November 2004*	Index-linked
Wedneday 1 December 2004*	Conventional
Wednesday 12 January 2005	Index-linked
Thursday 27 January 2005	Conventional
Wednesday 2 February 2005	Index-linked
Thursday 24 February 2005*	Conventional
Wednesday 2 March 2005*	Index-linked
Thursday 24 March 2005*	Conventional

** Subject to confirmation following the Chancellor's decisions on the Budgetary timetable* *Source: DMO*

Remit contingencies

As usual, the remit included contingencies that could be implemented in the event that the financing requirement changes in the course of the financial year. The published contingencies for 2004-05 are:

"Rising (falling) financing requirements will be met by increasing (reducing) planned gilt sales broadly in proportion to the splits planned in the remit. Planned sales of Treasury bills may also be revised. Specific decisions will be taken subject to considerations about debt portfolio objectives and evolving market conditions".

There are two main events which can trigger the implementation of contingencies in the remit for a given year:

- the publication (usually in late April) of an outturn CGNCR for the previous financial year which differs significantly from the Budget forecast; or
- the publication of a new forecast for the current financial year (usually at the PBR in November or December).

CGNCR outturn for 2003-04 and subsequent revision to the 2004-05 remit

The remit contingencies were triggered on 22 April 2004 with the publication of the CGNCR outturn for 2003-04 which was £2.9 billion lower than the forecast in the March 2004 Budget (see above). The lower CGNCR combined with a lower contribution to financing by NS&I and slightly higher gilt sales than had been forecast at the Budget left the DMO with a net short term cash position of £3.2 billion at the end of March 2004, an increase of £2.8 billion since the Budget and £3.0 billion above target.

The higher cash position has to be run down in 2004-05 to return it to its target level, reducing the financing requirement in 2004-05 by £2.8 billion compared to the Budget forecast. The DMO announced on 22 April 2004 that this was to be achieved by:

- reducing planned Treasury bill sales by £1.9 billion compared to Budget plans (taking the planned end-March 2005 stock to £17.5 billion); and
- reducing planned gilt sales by £0.9 billion, with the reduction split as follows:

– short conventionals	reduced by £0.2 billion to £14.8 billion
– medium conventionals	reduced by £0.3 billion to £10.2 billion
– long conventionals	reduced by £0.2 billion to £14.3 billion
– Index-linked	reduced by £0.2 billion to £7.8 billion.

There were no changes to the gilt auction calendar for 2004-05.

The financing arithmetic for 2004-05 is shown in Table 6.

Table 6
Financing requirement 2004-05

(£billions)	Budget 17-Mar-04	Revised 22-Apr-04
CGNCR forecast	**35.6**	**35.6**
Gilt redemptions	**14.7**	**14.7**
Financing for the Official Reserves	**0.0**	**0.0**
Buy-backs	**0.0**	**0.0**
Financing requirement	**50.3**	**50.3**
less		
National Savings and Investments	**2.0**	**2.0**
DMO cash deposit at the Bank of Enqland	**0.0**	**0.0**
Net financing requirement	**48.3**	**48.3**
1. Planned net short-term debt sales		
Change in T bill stock	**0.1**	**-1.8**
Change in Ways & Means	**0.0**	**0.0**
Change in short-term cash position	**0.2**	**3.0**
Net change in short-term debt	**0.3**	**1.2**
2. Planned gilt sales	**48.0**	**47.1**
of which:		
Short conventional	**15.0**	**14.8**
Medium conventional	**10.5**	**10.2**
Long conventional	**14.5**	**14.3**
Index-linked	**8.0**	**7.8**
Short term debt levels		
T bill stock at end of FY	**19.4**	**17.5**
Ways & Means at end of FY	**13.4**	**13.4**
DMO net cash position	**0.2**	**0.2**

Figures may not sum due to rounding *Source: DMO*

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

Future financing projections

Budget 2004 included forecasts for the CGNCR as a proportion of gross domestic product out to 2008-09. Table 7 below sets out the CGNCR projections in £ billion, together with the current redemption totals for each year to produce illustrative financing projections. These are not gilt sales forecasts – they take no account of contributions to financing by NS&I or short term debt (e.g. Treasury bill sales).

Table 7
Budget 2004 – financing projections

Illustrative financing projections					
£bn	**2004-05**	**2005-06**	**2006-07**	**2007-08**	**2008-09**
CGNCR projections	**36**	**33**	**31**	**27**	**23**
Redemptions	**15**	**15**	**24**	**29**	**15**
Financing Requirement*	**50**	**48**	**55**	**56**	**38**
CGNCR change since PBR	**2**	**1**	**-1**	**-1**	**-3**

**indicative gross financing requirements 2005-06 onwards* *Source: DMO*

Debt management initiatives

Electronic bidding at auctions and tenders

The year saw progress made towards the introduction of an electronic bidding system for use in DMO auctions (including Treasury bill tenders). The DMO researched a number of systems currently used by other sovereign and agency issuers to identify its generic requirements and has separately undertaken an

assessment of the various procurement options in order to deliver a system that meets its agreed requirements and offers value for money.

Submission of bids by means of an electronic system will replace the current practice of bids being submitted to the DMO's dealing desks by telephone. The principal benefit of using an electronic auction system is the ability to reduce the period between auction close and announcement of the results. During this period, bidders are unaware whether their bids have been successful or not. Consequently, they are exposed to the risk of adverse price movement before they are able to sell stock purchased at auction or, if unsuccessful in the auction, to purchase stock to cover any short positions.

The DMO aims to minimise the period between auction close and announcement of the results in order to reduce this risk for bidders and thus the yield premium/price discount that bidders will factor into their bids to compensate for the risk.

Introduction of electronic bidding will eliminate the time needed for the DMO to key bids into its allocation system and to re-check these, confirm bids with counterparties and reduce the time taken to calculate compliance with any subscription limits.

Currently, the DMO has a target to announce the results of each gilt auction within 40 minutes of the auction close and within 30 minutes of the close of a Treasury Bill tender. However, it is usually able to achieve this comfortably and in 2003-04 the average time taken to announce were 22 minutes and 11 minutes for gilt auctions and Treasury bill tenders respectively. The DMO recognises that a shorter lag in announcing the results would, however, be desirable.

To assist the DMO in identifying the requirements and any potential solutions, a consultation paper was issued to the market on 12 March 2004 with a closing date for responses by end-April 2004. The responses to the consultation have been analysed and a response document published on 9 July 2004. A copy of the response document can be accessed at www.dmo.gov.uk/gilts/public/consdoc/cons090704.pdf. The preferred electronic solution is expected to be implemented during 2005-06.

Gilt registration

In August 2003 HM Treasury issued invitations to tender for a contract to provide the gilts registration services, currently provided by the Bank of England. The DMO was involved in the tender process and will continue to work closely with the Treasury and Bank of England on the transfer of responsibility for the administration of the gilts register. On 16 July 2004 it was announced that Computershare Investor Services plc had been appointed as the new gilts Registrar. It is expected that the registration service will be transferred from the Bank of England to Computershare in December 2004.

Chapter 4: Cash Management Operations

The DMO's main strategic objective in carrying out its cash management role is[4]:

> *"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"*

In pursuit of this objective, 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.

Relationship with the Bank of England

The DMO and the Bank of England work together to avoid clashes in the delivery of their respective objectives in the money markets. The DMO cash remit specifies that 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.

Cash remit 2003-04

The DMO's cash management remit for 2003-04, published on 9 April 2003, specified that the DMO may carry out its cash management 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).

In practice, bilateral market operations constitute the bulk of the DMO's cash management operations, but Treasury bills also play an important role in smoothing cumulative cash positions and as a financing instrument within short-term debt sales (see below). No ad hoc tenders were held in 2003-04.

Level of Treasury bill stocks

The cash management remit for 2003-04 specified that the stock of Treasury bills should rise over the financial year (i.e. contributing to financing) by £3.2 billion to £18.2 billion. This represented a continuation of the process of establishing Treasury bills as an important part of the debt portfolio. Stocks had been increased from £3.3 billion at end-March 2001, to £9.7 billion in March 2002, and £15.0 billion in March 2003.

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[4] A full description of the DMO's cash management objectives and operations can be found in "Exchequer Cash Management – Operational Notice and Treasury bill Information Memorandum" – available on the DMO website at: http://www.dmo.gov.uk/cash/cashops/110903.pdf

Planned Treasury bill sales in 2003-04 were increased by £0.1 billion to £18.3 billion on 23 April 2003 with the publication of the CGNCR outturn for 2002-03 (which showed a £0.1 billion increase in the CGNCR since the Budget forecast).

In the Budget in March 2004 planned Treasury bills sales were increased by a further £1.0 million, taking the stock at end-March 2004 to £19.3 billion to help meet the Budget forecast for the 2003-04 financing requirement.

Cash management operations

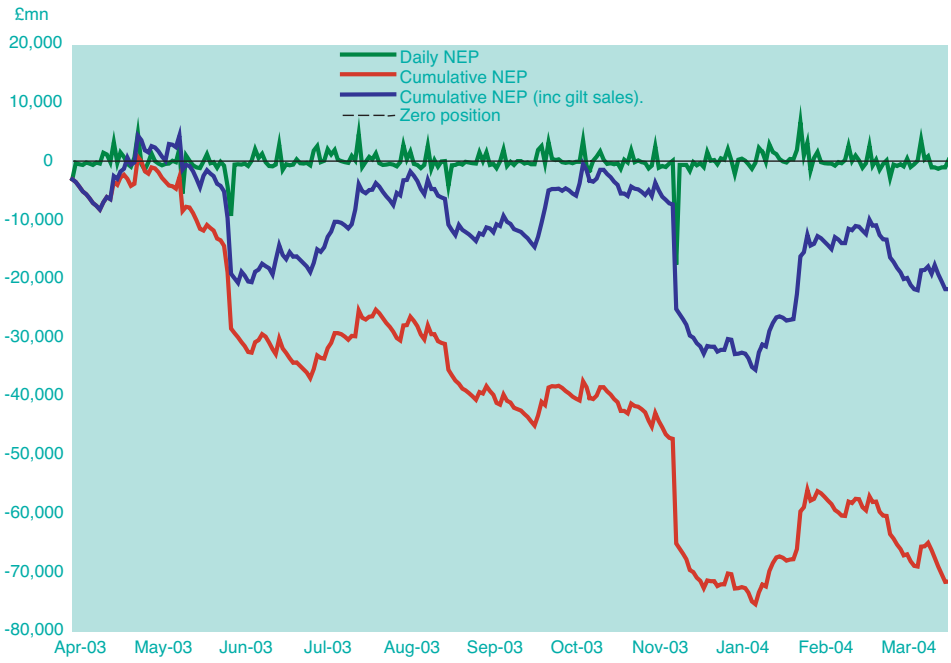
The DMO's money market dealers borrow from, or lend to, the market on each business day to balance the position in the NLF. In order to do so the DMO receives (from HM Treasury) forecasts for each business day's significant cash flows into and out of central government. Additionally, the DMO requires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

Over the course of a financial year, the Exchequer's cash flow has a fairly regular pattern associated with the tax receipts and expenditure cycles and outflows associated with gilt redemptions.

Chart 7 below shows the scale of daily cash flows measured in terms of the Net Exchequer Position (NEP) in 2003-04. It excludes the effects of the management on the DMO's net cash position of Treasury bill issuance, the run down of the DMO net cash position and NS&I's overall net contribution to government financing, but highlights the contribution of gilt sales to reducing the cumulative deficit in year.

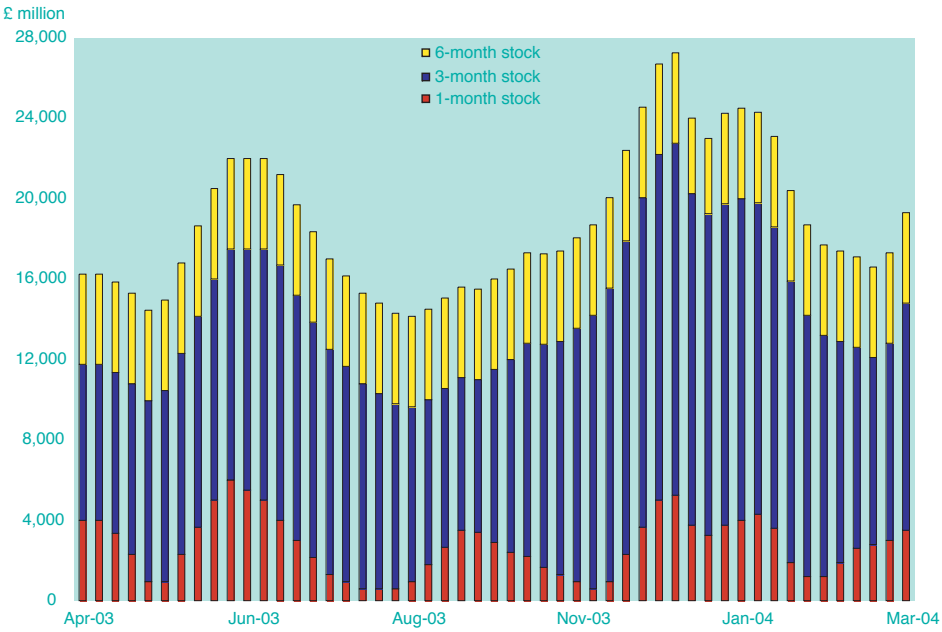
The increase in the deficit required a further increase in the stock of outstanding Treasury bills in order to help manage seasonal cash outflows. The stock began the financial year at £15.0 billion, and reached a peak of £27.25 billion in mid-December 2003, ahead of outflows in early January 2004, and was run down fairly

Chart 7
Exchequer cash flows 2003-04



Source: HMT/DMO

Chart 8
Treasury bill stocks 2003-04



Source: DMO

sharply thereafter until mid-March 2004 when it rose to the revised remit target of £19.3 billion.

The results of all Treasury bill tenders held in 2003-04 can be found in Annex E. A comparison of the average yield achieved at each tender with prevailing GC repo rates can be found in Annex F.

Details of the Treasury bill portfolio at 31 March 2004 are shown in Table 8.

Table 8
Treasury bills outstanding at 31 March 2004

Treasury bills in issue at 31 March 2004 (£mn)						
First issued	**Amt**	**Reopened**	**Reopened Amt**	**Maturity Date**	**ISIN**	**Total in issue**
12-Jan-04	1,500	15-Mar-04	500	13-Apr-04	GB0011420089	2,000
19-Jan-04	1,500	22-Mar-04	500	19-Apr-04	GB0011466249	2,000
26-Jan-04	500	29-Mar-04	1,500	26-Apr-04	GB0011514469	2,000
03-Nov-03	750	02-Feb-04	500	04-May-04	GB0011038238	1,250
09-Feb-04	500	13-Apr-04	500	10-May-04	GB0011608733	1,000
16-Feb-04	500			17-May-04	GB0011648648	500
23-Feb-04	500			24-May-04	GB0011695029	500
01-Dec-03	750	01-Mar-04	500	01-Jun-04	GB0011207478	1,250
08-Mar-04	500			07-Jun-04	GB0011780037	500
15-Mar-04	800			14-Jun-04	GB0011820718	800
22-Mar-04	1,500			21-Jun-04	GB0011889838	1,500
29-Mar-04	1,500			28-Jun-04	GB00B000L176	1,500
05-Apr-04	1,500			05-Jul-04	GB00B0012849	1,500
12-Jan-04	750			12-Jul-04	GB0011419974	750
02-Feb-04	750			02-Aug-04	GB00115607E9	750
01-Mar-04	750			31-Aug-04	GB0011731279	750
29-Mar-04	750			27-Sep-04	GB00B000L283	750
						19,300

Cash management remit 2004-05

The DMO's cash management remit for 2004-05 was published on 17 March 2004; it essentially followed the same structure as in previous years but the Treasury bill stock target was moved into the financing remit – this reflects the Treasury's view that the decisions on the increase or reduction in Treasury bill stocks (between the end of each financial year) are essentially financing and not cash management decisions. Decisions on appropriate adjustments to end financial year Treasury bill stock targets are to be seen primarily in the context of decisions on levels of short-term debt more generally and the debt stock as a whole. (See the Gilt remit section). Intra-year fluctuations in the levels of Treasury bill stocks will continue to be determined by cash management considerations.

As noted above, in the cash remit published with the Budget, Treasury bill stocks were planned to rise by £0.1 billion in 2004-05 to £19.4 billion (following a three year period when stocks had been built up quite aggressively – from £2.05 billion in April 2001 to £19.3 billion in March 2004). However, with the publication of an outturn CGNCR for 2003-04 on 20 April 2004 which was £2.9 billion below the Budget forecast planned Treasury bill and gilt sales for 2004-05 were reduced accordingly. Treasury bill sales were cut by £1.9 billion compared to Budget plans, taking the planned end-March 2005 stock to £17.5 billion.

Cash management developments

Dematerialisation of Treasury bills

Until September 2003 Treasury bills were issued and held in paper form. However, as part of the wider migration of money market instruments into CREST, the DMO began issuing Treasury bills in dematerialised form from 12 September 2003. All remaining bills in physical form were dematerialised over the weekend of 27-28 September and migrated into CREST on 29 September 2003.

Publication of Treasury bill prices

Following dematerialisation of Treasury bills, the DMO began publishing daily reference prices and the relevant ISIN codes for Treasury bills. The reference prices are used by CREST to value Treasury bills in the creation of Delivery by Value (DBVs) for repo purposes as Treasury bills are now eligible for the main traded class of DBV (UBG).

The prices are based on a money market yield to maturity calculation priced around the London Inter Bank Offer Rate (LIBOR). Reference prices in CREST provide an indicative price for CREST valuation purposes and are used for the purpose of valuation of collateral transfers. The reference prices are not intended to represent market prices at which the securities could be traded.

The DMO issued a revised Cash Management Operational Notice and Treasury bill Information Memorandum on 11 September 2003 to reflect changes brought about by dematerialisation.

Money market brokers

On 16 February 2004 the DMO announced that it had entered into agreements with a range of sterling money market brokers to enable the DMO to transact in a wider range of sterling certificates of deposit ("CDs"). This will allow the DMO wider access to the primary and secondary market in CDs.

Debt Management Account Deposit Facility

The DMO's cash dealers continued to operate the Debt Management Account Deposit Facility ("DMADF") (introduced in 2002, initially on a pilot basis for a small number of participants) to enable local authorities to deposit cash in the DMO's Debt Management Account ("DMA"). This was intended to provide local authorities with a flexible and secure facility to supplement their existing range of cash management options. In September 2002 a number of small, mainly technical changes were made to the scheme and an increase in the number of maximum participants was introduced. The DMADF continues to be actively used by participants and the DMO is considering further technical changes to the scheme.

Forthcoming initiatives

The DMO has begun to undertake a review of the delivery of its cash management objectives to-date. The purpose of the review will be to look for improvements, which will enhance the DMO's overall cost effectiveness, robustness and propriety.

The DMO is also embarking on a programme of systems renewal, in particular looking at the cash forecasting system to make best use of available technology and processes.

Chapter 5: Fund management and local authority lending for Central Government

Fund management

CRND responsibilities and objectives

The origins of the Commissioners for the Reduction of the National Debt (CRND) can be traced back to the National Debt Reduction Act of 1786. Six Commissioners for the Reduction of the National Debt were appointed and authorised to employ necessary staff, thereby establishing the original National Debt Office (NDO). In July 2002, the NDO merged with the DMO, since when it has been known as CRND.

The number of Commissioners, who have always been appointed on an ex-officio basis, has been increased to eight by the addition of the Lord Chief Justice and the second Deputy Governor of the Bank of England. At present the Commissioners are:

- *The Chancellor of the Exchequer*
- *The Governor and both Deputy Governors of the Bank of England*
- *The Speaker of the House of Commons*
- *The Master of the Rolls*
- *The Accountant General of the Supreme Court*
- *The Lord Chief Justice.*

Meetings of the Commissioners were at first held regularly, but the last recorded business meeting took place on 12 October 1860; since then the day-to-day decisions have been in the hands of the Comptroller General (currently the Deputy Chief Executive of the DMO) and the Assistant Comptroller, who are civil servants, but are appointed by and act on behalf of the Commissioners.

On the comparatively rare occasions when it is necessary for a fundamental policy matter to be put to the Commissioners for a decision it is referred to the Chancellor of the Exchequer and the Governor and Deputy Governors of the Bank of England, who together constitute a quorum and are sometimes referred to as the ‘active’ Commissioners. In practice, the only references made to them are when it is necessary to make formal appointments, for example of the Comptroller General and the Assistant Comptroller.

The Commissioners’ powers and functions are laid down in the Acts dealing with the individual funds or accounts but there is no statutory provision requiring the production of an annual report or other published information about their activities. However, annual accounts are produced for the various Funds and many of these are published in White Paper form and are available from the Stationery Office (TSO).

CRND operations

From its earliest days CRND had associations with the stock market and this led to a diversification of operations, in particular the responsibility for the investment of major Government funds. This now constitutes the main function of CRND, which has around £39 billion under its control, representing the assets of the various investment funds.

The investment powers differ to some extent from fund to fund, depending upon the provisions of the relevant Acts of Parliament, but essentially investments are restricted to central and local government securities. The largest funds are currently the National Insurance Fund Investment Account, the National Lottery Distribution Fund Investment Account and the Court Funds Investment Account. The full list of managed funds is:

- Court Funds Investment Account
- Crown Estate
- Insolvency Services Investment Account
- National Endowment for Science, Technology and the Arts
- National Heritage Memorial Fund
- National Insurance Fund Investment Account
- National Lottery Distribution Fund Investment Account
- National Savings Bank Fund
- Northern Ireland Court Service Investment Account
- Northern Ireland National Insurance Fund Investment Account.

The objectives of investment are, generally, to maintain sufficient liquid funds to meet withdrawals by the 'client' departments, to maximise income and to maintain or improve the capital value of the fund.

Since the merger with the DMO, CRND's processes and systems have been integrated fully with those of the wider DMO, enhancing added value to CRND's clients and achieving process and cost efficiencies.

During the year an actuarial review of all the funds was undertaken, the scope of which was to look at the investment mandates in place, the type of investments being used and the structure in place for making investment decisions.

The outcome of this review was to update the investment mandates, move towards investments which better suited the liabilities of the funds and introduce clearer more formal arrangements for the investment decision-making process.

Lending to local authorities

PWLB responsibilities and objectives

The PWLB is a statutory body which merged with the DMO in July 2002. It dates from 1793 and became permanently established in 1817. Since 1946 it has consisted of twelve Commissioners appointed by the Crown to hold office for four years; three Commissioners retire each year on 1 April but are eligible for reappointment.

The functions of the Commissioners, derived chiefly from the Public Works Loans Act 1875 and the National Loans Act 1968, are to consider loan applications from local authorities and other prescribed bodies and, where loans are made, to collect the repayments. Nearly all borrowers are local authorities requiring loans for capital purposes. The security for money borrowed by a local authority, together with interest, is charged indifferently on all its revenues; all securities created rank equally without any priority. Before making a loan the Commissioners are legally required to satisfy themselves that there is sufficient security for its repayment.

Loans are sourced from the National Loans Fund and rates of interest are determined by HM Treasury. The Board's accounts are audited by the Comptroller and Auditor General, whose reports on them are laid before Parliament, to which the Board makes its own statutory report.

Since the merger, the Board has operated as a unit of the DMO within the DMO's offices, sharing common services. The Commissioners have retained their statutory role but expect and require the Board otherwise to be subject to the same controls as the DMO's operations as a whole.

PWLB operations in 2003-04

During 2003-04 the Board's staff monitored proposed changes to the system of local government finance expected to result from the Local Government Act 2003, so as to be able to make appropriate corresponding changes to the Board's lending arrangements. The Board's Circular 134 of 15 January 2004 set out the new lending policy that has applied since 1 April 2004, which is as follows:

- The Board recognises that the changes to local government finance give local authorities additional freedoms to borrow, balanced by additional responsibilities on each chief financial officer to ensure that the authority acts prudently. The Board's new lending arrangements support these changes, so that 2003-04 was the final year of quota entitlements, which were based on the system of credit approvals, a system abolished by the 2003 Act. However, any authority undertaking financial transactions with the Board is expected to act prudently and comply with all relevant legislation. It remains the Board's policy not to lend to an authority which has chosen to act unlawfully.

- It continues to be the Government's aim that the Board should be able to meet all of an authority's legitimate need for long-term loans. Accordingly, the Board is generally prepared to lend to an authority up to the available capacity in its legal borrowing limit, also known as the authorised limit for borrowing.

- From 1 April 2004 HM Treasury determines a single set of interest rates, instead of the separate 'Higher' and 'Lower' quota interest rates, which were made obsolete by technical changes in the local government capital finance system. HMT continues to set a special set of rates for certain contractual purposes.

- The Board continues to be the lender of last resort to local authorities, which in practice means that, as previously, applications for loans are considered on their merits against the terms of the Board's circulars and without regard to the authority's ability to raise funds elsewhere.

Summary figures for the Board's operations are below. 2003-04 was the third consecutive year in which net lending had been negative. Further details will be in the Board's Annual Report, which is published separately.

Table 9
PWLB operations 2003-04

Summary of PWLB operations in 2003-04 (£mn)		
Debt outstanding at	**31-March-2003**	**44,589**
Advances to	31-March-2004	4,603
Repayments to	31-March-2004	7,885
Net activity to	31-March-2004	-3,282
Debt outstanding at	**31-March-2004**	**41,307**

Source: PWLB

Chapter 6: The DMO

The DMO was established on 1 April 1998. In institutional terms, the DMO is legally and constitutionally part of HM Treasury, but, as an executive agency, it operates at arms length from Ministers. The Chancellor of the Exchequer determines the policy and operational framework within which the DMO operates, but delegates to the Chief Executive operational decisions on debt and cash management, and day-to-day management of the office.

The separate responsibilities of the Chancellor and other Treasury Ministers, the Permanent Secretary to the Treasury and the DMO's Chief Executive are set out in a published Framework Document (available on the DMO website at www.dmo.gov.uk/publication/fwork0701.pdf), which also sets out the DMO's objectives and its Chief Executive's lines of accountability. The Chief Executive is accountable to Parliament for the DMO's performance and operations, both in respect of its administrative expenditure and the Debt Management Account.

Business planning

The DMO publishes an annual business plan[5]. The plan sets out the DMO's targets and objectives for the year ahead, and the strategies for achieving them. It also reviews the immediately preceding year. The starting point of the DMO's business plan is the strategic objectives given by the Chancellor of the Exchequer to the DMO and set out in the Framework Document.

Organisation and resources

The DMO is organised flexibly to ensure that resources are available as necessary for the respective tasks.

There are two main business areas in the DMO: Policy & Markets, and Operations & Resources. These areas are in turn split into a number of teams across which there is substantial cross-team working to ensure that both policy and operational concerns are adequately met; that the relevant skills are bought to bear on tasks or problems; and that important operations are adequately resourced.

The DMO's Managing Board considers all major strategic decisions and comprises the Chief Executive, the Deputy Chief Executive (and Head of Policy and Markets) and the Chief Operating Officer together with non-executive members from outside the DMO who in 2003-04 were: James Barclay, Colin Price and, from the Treasury, Sue Owen. Colin Price is also Chairman of the DMO's Audit Committee.

Within the DMO most business issues are considered by cross-cutting committees: in particular those on debt management, cash management; and investment. They are supported by a Credit and Risk Committee, which also reports to the Managing Board.

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[5] The DMO Business Plan for 2004-05 was published on 5 May 2004 – it is available from the DMO or the website at www.dmo.gov.uk/publication/busplan04.pdf

Managing risk

During 2003-04 the DMO has been progressing two initiatives to develop the range of both quantitative and qualitative risk information that is available to its business units, risk managers and senior management. The purpose of these projects is to improve both the quality and timeliness of relevant information being available in order to support informed decision-making. The two areas being addressed are:

- Market and liquidity risk analysis
- Operational risk reporting.

Market and liquidity risks, and a small element of credit risk quantification, are the focus of a project to implement specific risk management software. This project has run throughout 2003-04 and is expected to be completed during 2004. It will deliver a suite of standard and customised risk reports together with the capability to perform ad-hoc analysis on particular positions or strategies.

Operational risk reporting has been addressed by the implementation of Enterprise Risk Assessor (ERA) software. During the year the software has been installed and the database populated with business unit leaders' views of the main risks relevant to their areas. These data are now going through a validation process and ultimately will assist senior management to focus on key operational risks on a consolidated basis across the DMO.

Budget

The DMO's resource requirement is largely driven by the need to meet its responsibilities, as well as the wider need within Government to maintain taut administrative budgets. Its budget, which is financed as part of the budget for HM Treasury as a whole, has to reflect a need for both skills and systems that are not available elsewhere within Government. The DMO's net operating costs in 2003-04 were £8.1 million, £0.3 million more than in 2002-03.

Chapter 7: The UK Government's debt management strategy

The UK government's primary strategic objective for debt management is:

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

This chapter explores how the debt management authorities interpret the terms 'over the long term', 'costs' and 'risk'. It also discusses, in generic terms, the factors which are considered by the authorities in determining the debt management strategy each year. It does not examine the interaction of debt management with monetary policy.

'Over the long term'

The Government's fiscal and debt management policy framework is based on the five key principles set out in the *Code for Fiscal Stability*[6] – transparency, stability, responsibility, fairness and efficiency. The Code requires the Government to state its objectives and the rules through which fiscal policy will be operated. The objectives of fiscal policy are implemented through two fiscal rules, against which the performance of fiscal policy can be judged. Box 1 below explains the fiscal aggregates used to measure performance against the fiscal rules. The fiscal rules are:

- *the golden rule:* over the economic cycle, the Government will borrow only to invest and not to fund current spending; and
- *the sustainable investment rule:* public sector net debt as a proportion of gross domestic product (GDP) will be held over the economic cycle at a stable and prudent level. Other things being equal, net debt will be maintained below 40 per cent of GDP over the economic cycle.

The fiscal rules provide flexibility over the economic cycle, allowing the fiscal balances to vary between years in line with the cyclical position of the economy, permitting the automatic stabilisers to operate freely to help smooth the path of the economy in the face of variations in demand. In addition, under the 'sustainable investment rule', the Government may borrow over the economic cycle to fund longer-term investment provided net debt remains below 40% of GDP measured over the economic cycle.

The fiscal rules work together to promote capital investment while ensuring sustainable public finances in the long-term. The golden rule requires the current budget to be in balance or surplus over the economic cycle, allowing the Government to borrow only to fund capital spending over the cycle. The sustainable investment rule ensures that borrowing is maintained at a prudent level.

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[6] The *Code for Fiscal Stability* is available on HM Treasury's website at the following address: http://www.hm-treasury.gov.uk/documents/uk_economy/fiscal_policy/ukecon_fisc_code98.cfm

This is important because it means that when considering debt management the UK authorities assume that the Government expects to continue to borrow in the future, in a sustainable way[7]. This horizon assumption needs to be reflected in the selection of appropriate debt management strategies. For example, it will make sense actively to promote secondary market liquidity because the Government knows it will be a 'repeat' borrower. In addition, the Government is willing to ignore financing strategies with near-term opportunistic gains if those strategies run the risk of adversely affecting investors' attitudes towards the entire debt programme in future, thereby raising costs over the long run.

In summary, then, the term 'over the long run' means that the UK authorities assume an indefinite borrowing horizon when selecting between possible debt strategies. Further work is envisaged to explore this, in particular how best to evaluate the relative value of strategies with different costs and risks across all future periods. Currently, we do not apply our own judgements about the relative value of costs occurring at different times; in practice, our starting point is to assume that the time value of money is fairly and efficiently priced into the term structure of interest rates.

Box 1: Explanation of fiscal aggregates

Under the Government's fiscal framework a number of fiscal aggregates are reported. Set out below is an explanation of the aggregates with most relevance to the fiscal rules and the impact of the Budget on Government borrowing. The fiscal aggregates are usually reported in both nominal terms and as proportions of gross domestic product (GDP), the latter providing a better indicator of trends since they allow for the impact of inflation and real growth in the economy.

Public Sector Net Debt *is the measure of debt against which the sustainable investment rule is assessed* and is defined as gross debt minus liquid financial assets. Public debt can be defined in both gross and net terms with gross figures capturing the total amount of the Government's financial liabilities. Net debt is used in the Government's fiscal framework because it provides a fairer reflection of the Government's immediate solvency. The Government also reports figures for General Government Gross Debt – the Maastricht Treaty debt measure which is comparable across EU Member States.

Public Sector Current Budget is the difference between current receipts and current expenditure including depreciation. The *golden rule* commits the Government to borrow only for net investment over the economic cycle and not to fund current spending. *The key indicator of progress against the golden rule is the average surplus on current budget over the economic cycle*. The golden rule is met when the average current budget over the economic cycle is in balance or surplus. (The average is taken of the current budget as a proportion of nominal GDP.)

Public Sector Net Borrowing (PSNB) is the sum of current spending (including depreciation) and net investment, less total revenues. *The key indicator for assessing the overall fiscal impact of the Budget is the change in PSNB*. Although

[7] In recent years public sector net debt levels have been around 31% to 33% of GDP and are forecast in Budget 2004 to rise to around 36% of GDP by 2006-07.

the primary objective of fiscal policy is to ensure medium-term sustainability of the public finances, fiscal policy can also play a short-term role in supporting monetary policy. It is for this reason that the Government's fiscal rules are set over-the-cycle, allowing PSNB to vary between years, in keeping with the cyclical position of the economy. PSNB differs from the surplus on the current budget because it includes net investment – investment spending will have an impact on economic activity and so should be included when assessing the impact of fiscal policy.

The Central Government Net Cash Requirement (CGNCR) is the measure of Central Government's requirement (after re-financing of maturing debt),

To move from PSNB to CGNCR it is necessary to deduct local authority borrowing and borrowing by public corporations and to add in Central Government financial transactions (such as lending and accrual adjustments).

A more detailed explanation of the relationship between PSNB and CGNCR is presented in Table C20 on page 274 of Budget 2004.

Costs, for any debt manager, refer to the charges associated with servicing the debt portfolio[8]. These arise directly from any interest income payable (coupons) and from any difference between the issuance proceeds and redemption payments. Although accounting treatment may vary for these elements of debt servicing costs, from a debt management perspective the UK does not see any meaningful distinction between them and treats them as one in the cost minimisation task.

Thus, the costs we consider are the realised costs of the debt and not those related to a complete mark-to-market value of the debt. This is not to imply that changes in the market value of the debt do not matter; they clearly have an impact on the net worth of the Government. However, the bulk of the debt is not (and indeed cannot be) refinanced at short notice and is left outstanding until maturity. This implies that short-term changes in market values arising from fluctuations in market interest rates have little consequence for the realised costs of the debt. This focus on the nominal value of the debt and its associated realised costs is also consistent with the definition of the public sector net debt used in defining the "sustainable investment rule".

When the UK authorities talk about cost minimisation, sometimes the reference is to absolute nominal debt servicing costs. For example, nominal cost projections are needed for planning purposes in the budgetary process (see Box 2). But when the concept is discussed in a longer-term context it usually refers to the nominal costs of servicing the national debt over time as a proportion of nominal GDP. This latter ratio also serves another useful purpose: it is an approximate way of capturing balance sheet considerations, since it reflects the costs associated with the government's liabilities relative to the source of its tax revenues, which are its principal asset.

Risk

In considering risk from the debt management perspective, it is worth bearing in mind that the health of the public finances over the economic cycle is closely linked to developments in the national economy. Real government income and

[8] There are also transactions and administration costs, but these are relatively insignificant in relation to the value of transactions involved in the UK government debt programme.

expenditure show a reasonably predictable relationship to variations in real GDP growth (and to real interest rates). In particular, the value of government's main asset – future tax receipts – and of some of its expenditures – welfare payments and so on – vary with the economic cycle.

Box 2: Public finance projections and public expenditure

Projections of the public finances are published as part of the Budget each year. These include five-year projections for the public sector current budget and public sector net debt, the key fiscal aggregates for assessing performance against the fiscal rules.

The fiscal balances (including current budget and net borrowing) represent the difference between two large aggregates of expenditure and receipts, and forecasts are inevitably subject to wide margins of uncertainty. For this reason, the Government has created a margin against unexpected events that might impact on the accuracy of the public finances forecast through the use of cautious assumptions (audited by the National Audit Office) and the 'cautious case' to stress test the resilience of public finance projections to unexpected events. Details of the cautious assumptions and the cautious case can be found in Chapter C of Budget 2004.

Projections presented in the Budget for public expenditure, covering the whole of the public sector, use the National Accounts aggregate Total Managed Expenditure (TME). For the purposes of the fiscal aggregates, TME is split into national accounts components covering public sector current expenditure (including debt interest costs), public sector net investment and depreciation. For budgeting and other purposes, TME is split into; (i) Departmental Expenditure Limits (DELs) – three year limits for departments' programme expenditure which are set in cash terms; and (ii) Annually Managed Expenditure (AME) – expenditure that is not easily subject to firm multi-year limits (for example benefit payments covering unemployment). Debt interest costs are captured in AME.

It is, therefore, the impact of nominal expenditures on the fiscal projections that is of most importance over the three-year horizon of the Spending Review, because expenditure limits are set in nominal terms. In the medium- to long-term, however, it is the impact of expenditure on the economy that is the focus from a fiscal perspective. This is because the primary medium term objective for fiscal policy is to ensure sustainability of the public finances. Measuring the fiscal aggregates as proportions of GDP gives a reasonable indication of affordability by taking into account the growth in the Government's nominal financing requirement and fiscal position.

For these reasons, the fiscal aggregates are presented in the Budget in both nominal terms and as a proportion of nominal GDP. Table 2.5 in Budget 2004 presents projections to 2008/09 for current surplus and net borrowing in nominal terms and Table C4 presents nominal year-end net debt stocks. Table 2.6 of Budget 2004 presents projections for these aggregates as proportions of GDP.

From a fiscal policy perspective the key risk comes from unanticipated volatility in debt servicing costs. Whether nominal or real debt servicing cost volatility is of more concern will depend on the time horizon over which costs are being considered. The public finance forecasts presented in successive Budgets and updated in each Pre-Budget Report cover a five-year horizon and a profile for debt servicing costs is forecast as part of the overall public finance forecast. Over a one-year horizon, it is unanticipated volatility in nominal debt servicing costs relative to this profile that is the key risk. Unanticipated volatility may impact on near-term budgetary planning, requiring budgetary decisions to be re-visited at subsequent forecasts. Although the need for re-visiting decisions will not arise if unanticipated volatility is 'small' or temporary, it will become increasingly likely if unanticipated volatility one-year ahead is 'large' or reflects some structural change. Unanticipated volatility in nominal rather than real debt servicing costs is also likely to be of concern from a fiscal perspective up to three years ahead because this is the horizon over which departmental expenditure limits are set (in cash terms) as part of the Spending Review (see Box 2 above).

In the medium- to long-term, however, it is nominal debt servicing costs as a proportion of GDP that will be the focus from a fiscal perspective. Ultimately, it is the affordability of debt servicing costs that is the key concern. Measuring debt servicing costs as a proportion of GDP gives a reasonable indication of affordability by taking into account the growth in the Government's nominal financing requirement and fiscal position.

In principle, a balance sheet approach to risk management of the Government's debt portfolio is feasible: broadly this would equate to trying to make debt servicing costs vary countercyclically – in particular increases in debt servicing cost would be avoided in recessions. (This is linked to the concept behind the 'golden rule' whereby changes in borrowing levels are permitted to help stabilise the economic cycle). This concept is known as 'fiscal insurance'. HM Treasury and the DMO believe that work is still needed to explore how desirable and feasible fiscal insurance is in practice (e.g. the optimal debt strategy to achieve fiscal insurance against a demand shock could be very sub optimal for a supply shock). Further work may also be needed to enable us to measure the intended gain from fiscal insurance against which to assess any possible adverse impact on cost minimisation.

The specific debt management risks taken into account by the UK authorities may be defined as follows: interest rate risk, inflation risk, liquidity risk and operational risk.

● Interest rate risk

This arises in the following three ways:

i) *Financing risk* – the interest rate risk associated with raising new principal borrowing. The Government is exposed to interest rate risk since an exposure arises to the yield at issue on new borrowings. This can occur:
   a) as the Government's financing needs evolve as planned; or
   b) if the Government's financing needs evolve in an unexpected way, e.g. due to unexpected changes in Government revenues and expenditure (budget risks). This could be called contingent financing risk.

ii) *Refinancing risk* – the interest rate risk associated with the rolling over of the principal borrowing of any maturing debt. This can occur:
  a) as redemptions occur as planned; or
  b) if early redemptions are triggered, for example, by embedded options (debt portfolio risks). This could be called contingent refinancing risk.

iii) *Refixing risk* – the interest rate risk associated with resetting coupons on variable rate debt[9]. (Embedded conversion options could also cause refixing risk – this could be called contingent refixing risk.)

The interest rate risk exposure is managed jointly by HM Treasury and DMO primarily through the choices made each year for issuance with regard to the proportions of different types of exposures in the debt portfolio over time and by management of the redemption profile of the debt portfolio. Refixing risk is managed through the choices made each year for issuance with regard to the proportion of variable relative versus fixed rate debt, although no formal target is indicated for this ratio. (Note that the UK authorities do not consider interest rate risk in the sense of the risk of near-term changes in the marked to market value of the debt portfolio. This is because the UK's debt management approach does not involve significant active management of the debt portfolio and so the basic assumption is that debt once issued will not be redeemed before maturity, as was stated above).

● Inflation risk

Inflation risk is the exposure to inflation arising on index-linked debt, which arises from both coupons and principal due to index-linked uplift on coupons and principal. This risk is managed jointly by HM Treasury and DMO primarily through the choices made each year for issuance with regard to the proportion of index-linked versus other debt. Although no formal target is indicated for this ratio, as explained below, broadly a quarter of the debt portfolio has tended to be in the form of index-linked debt (in the period the DMO has been in operation).

● Liquidity risk

The risk that difficulties will be experienced in raising borrowing due to, for example, unexpected changes in market capacity. This risk is managed by the DMO by ensuring, for example, the target investor base is well diversified, instrument design is kept up-to-date and an effective primary dealer arrangement is in place.

● Operational risk

The risk that the processes of raising funds will not work smoothly due to error, systems and procedures failures etc. Management of this risk falls to the DMO, and is managed through its operational and business continuity strategy.

The cost / risk trade off

Like any other economic agent (the best analogy, but in reverse, might be an investor), a government debt manager may face a basic trade off between cost and risk minimisation. The following example illustrates the position of many sovereign debt managers.

[9] Including Floating Rate Notes.

For a debt manager focussing on nominal debt servicing cost, minimising cost is often in conflict with minimising risk, a tension that arises because of the fundamental characteristics of nominal debt instruments. If we consider a fixed rate bond, the longer the maturity of the bond, the longer the period during which interest payments are known. Issuance of a longer bond reduces the extent to which the Government will be exposed to unanticipated nominal debt servicing cost volatility. However, economic theory and cross-country experience suggest that for many sovereign debt managers the yield curve is on average upward sloping. Hence, bonds with longer maturities will tend to be issued with higher average interest rates attached to them than bonds with shorter maturities. Ideally the debt manager seeking to minimise costs will prefer to issue shorter bonds. Shorter maturity bonds, though having lower average interest rates, will have to be refinanced in the relatively near future. As short-term interest rates tend to be more volatile than long term interest rates this implies that there is greater risk that the refinancing of shorter maturity bonds will take place when conditions are adverse. Therefore, the choice of the maturity structure of the nominal issuance strategy is a trade-off between average cost and nominal debt servicing cost volatility.

The theoretical literature on debt management has provided useful insights, particularly on the trade-off between cost and risk. Box 3 below summarises what insights can be drawn from the theoretical literature for debt management policy.

Box 3: Theoretical literature on public debt management

Research into the main theoretical motivations for debt management has provided some useful insights for policy particularly in respect of the trade-off between cost and risk and the allocation of risk. However, it does not yet offer strong guidance as to the 'optimal' composition of the debt portfolio. The key conclusions that can be drawn from the literature are:

- the first step towards lower debt financing costs is likely to be a *liquid and efficient secondary market* for government debt. Moreover, the government may be able to reduce the cost of financing through its choice of institutional design for the market;
- *predictability and transparency* in debt management policy will help to reduce uncertainty over the 'true' price for government debt, which in turn reduces the risk premium attached to government debt;
- if markets are efficient, there will tend to be a *trade-off between risk and return*. Hence, government could in principle aim at debt cost minimisation by issuing instruments which carry lower risk from the investors' perspective, although only to the extent that this did not exceed its own risk appetite; and
- the optimal taxation literature makes a strong case for the *debt management objective being to minimise budgetary risk* (i.e. insuring against unexpected fluctuations in government revenue and expenditure). However, further work is needed before this could be used to provide a practical basis for debt management. In particular, given uncertainty over the nature of future shocks, there does not appear to be a consensus in the literature on the 'optimal' risk minimising portfolio.

On this basis, UK debt management policy is consistent with a number of aspects of the literature; (i) the UK government debt market has a good level of secondary market liquidity. Moreover, the Government's objective is that of cost minimisation which, as explained in this chapter, is primarily focussed at the microeconomic level (e.g. concentration on benchmark issuance, introduction of the strips market and the choice of auction format) thereby enhancing market efficiency; (ii) issuance policy is strongly focussed on transparency and predictability; (iii) the portfolio is reasonably diversified and, as a result, it provides insurance against a range of possible shocks making it attractive to a broad base of investors; and (iv) issuance policy tends to result in a relatively smooth redemption profile which reduces the exposure at any point in time to unpleasant shocks, thereby reducing some budgetary risks.

Further reading

Balls E, and G O'Donnell (Eds.), *Reforming Britain's Economic and Financial Policy*, Palgrave, 2002. An analysis of debt management theory and practice can be found in chapter 16. The foreword can be found on the HM Treasury website at: http://www.hm-treasury.gov.uk/Documents/UK Economy/UKecon reform.cfm)
Barro R, *On the determination of the Public Debt*, Journal of Political Economy (1979) 87(5) pp 940-91.
Missale A, Public Debt Management, Oxford University City Press, 1999.
Wheeler G, Sound Practice in Government Debt Management, the World Bank, 2004

Factors considered in determining the UK's debt management strategy

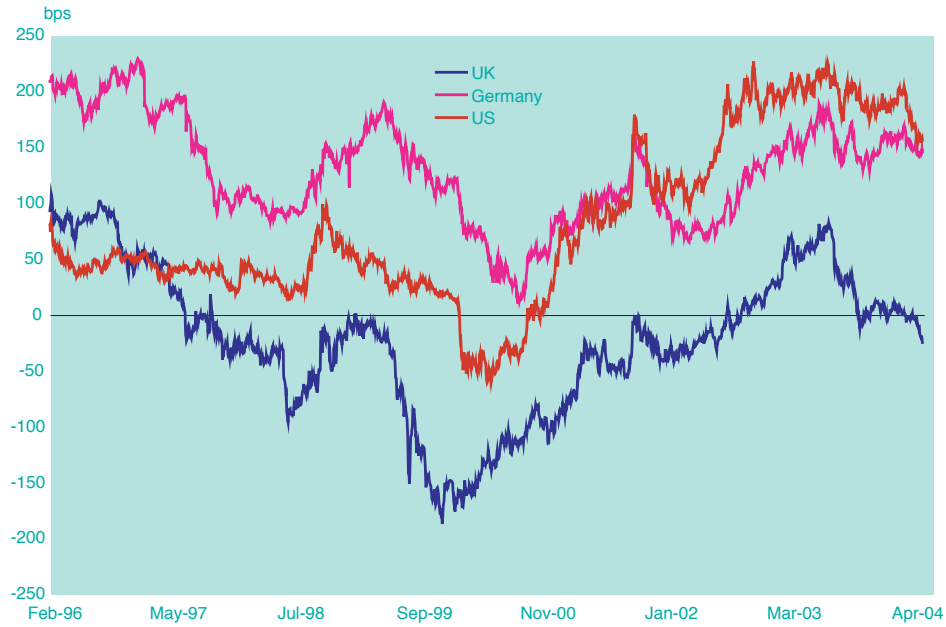
The example above does not necessarily reflect the position facing the UK debt management authorities, for two key reasons. First, the relative importance of nominal debt servicing cost volatility to the issuer needs to be assessed before embarking on such a trade-off exercise. As noted above, the UK authorities are currently further refining analytical work in this area. Secondly, there have been relatively long periods when the UK yield curve has not been normally shaped (upward sloping). Chart 9 below shows the spread between 5-year and 30-year yields in the UK, USA and Germany since February 1996. This clearly illustrates the inverted nature of the UK yield curve for most of the period from 1997 onwards and is in sharp contrast to the upward sloping nature of the US and German curves.

As mentioned above, the interest rate and inflation exposures of the debt portfolio are managed over time by HM Treasury and the DMO through the plans for the maturities and instrument types which will be issued over the year ahead. This results in an annual debt management 'Remit', which is described in more detail in Box 4.

In arriving at the issuance plans, the UK authorities have indicated in previous publications that the following factors are taken into account:

- 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;
- investors' demand for gilts; and
- cash management requirements for Treasury bills and other short-term debt instruments.

Chart 9
International spreads between 5- and 30-year bonds



Source: Bloomberg

We consider the first three in more detail below. (In practice, we have integrated analysis of the Treasury bill programme into our analysis of the overall debt programme; we do not separately consider Treasury bills but consider them as part of the same continuum of debt instruments as gilts).

Box 4: Gilt financing annual remit

The UK authorities hold an annual remit setting process which results in HM Treasury publishing a 'Remit' for the financial year ahead, which indicates what issuance the DMO will undertake. This is published in conjunction with the Government's annual Budget, usually in March. The Remit sets out the total of planned gilt sales, along with the planned split between fixed rate ('conventional') and index-linked issuance. Further, within the 'conventional' sector, there is a breakdown of planned issuance across the 3 maturity groups, categorised as follows: 'short' (1 -7 years maturity), 'medium' (7-15 years maturity) and 'long' (over 15 years maturity). The UK believes that this approach is a transparent way to communicate to the market its plans for the different maturity sectors.

In addition, a calendar of scheduled auction dates is published for the whole financial year ahead. This specifies which type of instrument will be auctioned on which date but does not indicate which specific bond will be auctioned nor the precise amount for sale, although an indication is given of the possible size range.

All of this gives the market a long period of notice of (together with precommitment to) issuance plans – probably the longest internationally. The adoption of this very transparent approach was the outcome of a debt management review in 1995 and represented a clear break with the previous policy. It reflects the UK's judgement that this approach will help to reduce the long run financing costs because it lowers the risk premium investors demand from the issuer as compensation for the unpredictability in issuance supply to the market.

Government's attitude to risk

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

We also follow a well-diversified issuance strategy for nominal gilts (conventionals). This is our preferred approach because it helps to spread our refinancing risks over future periods, thereby reducing the risk of refinancing when conditions are adverse. Drawing on past observations to establish a rough guide we tend to adopt the approach used in the financial year 1997-98 as a starting point – to define a 'neutral' or 'default' strategy. This means that on a cash weighted basis issuance would generally be split fairly evenly between the 3 conventional maturity bands. As this is an annual issuance assumption we would not necessarily take account of the patterns of issuance in previous years, which have deviated from this 'neutral' strategy, in determining the next year's issuance even though this could have portfolio consequences over time.

Another area under investigation currently is the extent to which the UK's debt management portfolio strategy should take account of other elements of Central Government's financial assets and liabilities, in particular those elements bearing interest rate exposures. In principle, we see this as a very desirable objective. However, how this would work in practice has not yet been fully worked through and, as a more immediate practical matter, sufficient information is not currently available. For this reason, we do not currently take explicit account of other interest rate exposures in Central Government's financial assets and liabilities.

As noted above, assumptions need to be made about the Government's refinancing risk appetite. Currently, we assume that past preferences for maintaining a fairly even redemption profile for each financial year continue to be valid. In deciding maturity dates of new lines of stock, consideration is therefore given to the interplay between redemption dates of existing stocks and proposed new issuance for the current (and near future) financial year(s). Hence there will be a preference to 'fill in' any gaps in the maturity profile of the portfolio as redemption years get nearer. As an alternative, it could be argued that the debt issuer should target larger redemptions at those years where the public finances are forecast to be at their healthiest, but given the uncertainty that would inevitably surround such forecasts, this might turn out to be a risky (and costly) strategy. A regular flow of redemptions (and associated new issuance) is also likely to be of benefit to the ongoing liquidity of the market.

Shape of the yield curve and investor demand

As noted above, we assume that current policy suggests the Government will continue to borrow in a sustainable way in the future. This is important because it

means that any issuance strategy will need to be rolled over indefinitely and, therefore, will tend eventually to have a cost and risk profile which is representative of the long run average for that strategy. We also take as a starting point that the UK term structure is fairly and efficiently priced and is the best guide to the value of future interest rate expectations. This means that there is unlikely to be a long run benefit from pursuing an opportunistic issuance strategy since, as the implied forward rates at which the strategy will be rolled forward are fairly priced, there would be likely to be an offsetting future disbenefit and thus, on average, no net gain. Finally, the annual Remit process, described above, delivers the market a predictable and transparent issuance regime but it also means that the gap between when issuance choices are made at the start of the year and when they can be put into practice is very long. As a result of all these considerations, we do not give a high weight to prevailing observations of absolute yield levels (i.e. we do not weight issuance towards the absolutely lowest yielding part of the curve) in determining the annual Remit.

We do, however, investigate the shape of the yield curve to see if there are any significant medium- or long-term demand factors – 'preferred habitats' – at particular maturity sectors which indicate that the term structure is not fully reflecting expectations about future interest rates. A preferred habitat is said to exist where a distinct group of investors strongly prefers to hold bonds within a specific maturity range, or a specific instrument type, to hedge its liabilities or to comply with regulatory requirements, which depresses yields for these types of bonds. The preference can be so strong that such investors dominate demand and do not substitute alternative strategies which would be cheaper but which would move them away from their preferred risk profile. Based on consultations with market participants, as well as observations of the shape of the yield curve, the UK authorities may seek to meet preferred habitat demand, which means relatively lower funding costs, by skewing issuance slightly from the neutral maturity issuance strategy. For example, in 2000-01 against the background of a low financing requirement, 92% of total gilt issuance in that financial year (including all conventional gilt issuance) was long-dated, reflecting the issuance premium available because of strong demand for these instruments primarily from pension funds.

Other relative value indicators, which we may consider – although with different weightings – are implied break-even inflation rates, and major sovereign yield spreads. Where any major shifts in break-even inflation rates are determined to be structural and permanent in nature, these can be useful in informing the marginal issuance split between conventional and index-linked gilts. Although we monitor the level and shape of the UK yield curve relative to those of other major sovereigns – for example as a possible indicator of preferred habitats and of potential issuance demand at auction – we do not give a high weighting to these relative differences in determining the annual issuance split.

As explained earlier, the UK authorities are also concerned about managing the debt portfolio's liquidity risk. Thus issuance decisions may also need to take account of market capacity considerations. These would include strategic decisions such as those taken in 2000-01 to continue gross issuance, even though there was no net financing requirement, in order to maintain the infrastructure of and liquidity

in the UK government debt market, as it was anticipated that issuance would rise again in the following years. A clear example of such a strategy was the commitment to issue a minimum amount of index-linked stock to support the introduction of index-linked auctions and specialist index-linked GEMMs. At the other end of the scale, there may also be a maximum amount of issuance that the market is able to accommodate, without forcing the Government to pay an unacceptable premium. For example, this concern was a factor that led us to indicate a maximum of £6.5 billion of index-linked issuance in 2003-04. In addition, there may be operational considerations surrounding implied auction size and calendar that we may also take into account when determining the precise quantities of sales by gilt type.

In relation to ensuring both the minimisation of long run costs and the reduction of liquidity risk, we also take account of market structure and market management considerations. These would include for example ensuring that there are and will continue to be sufficient bonds, in size and number, eligible for delivery under gilt futures contracts. Another example would be responding to the market's preference for liquid, benchmark stocks available at key points on the yield curve, such as in each of the first ten years, and other dates further out, for the benefit of cross border trading, corporate issuance, swaps and other derivatives markets. There may also be times where secondary market supply-and-demand imbalances mean particular stocks are 'squeezed', either in the repo market or the gilt market, making it difficult for market makers to sustain liquidity. In such circumstances, the DMO might provide temporary issuance solutions, under its standing or special repo facilities, or it may decide to bring forward issuance planned for the future, as was the case in August 1999.

Conclusion

This chapter has explored what is meant by the terms 'over the long term', 'costs' and 'risk' in the UK Government's primary strategic objective for debt management. Debt management strategies are implemented on the assumption that the UK Government has an indefinite borrowing horizon. This implies that as a repeat borrower the promotion and maintenance of secondary gilts market liquidity is important to the Government and it has a preference for debt strategies that offer long-term benefits over ones that provide short-term opportunist gains but which may raise its long-term financing costs.

Depending on the time-horizon, both the absolute nominal costs of servicing the debt portfolio and their relationship to nominal GDP are of interest to the Government. Nominal debt servicing costs are considered in the short-term (one- to three-year horizons) because of their impact on the near-term budgetary planning process. However, in the medium- and long-term, nominal debt servicing costs measured as a proportion of GDP are more important from a fiscal perspective.

The Government may be concerned about a variety of risks that are associated with the management of its debt portfolio. From a fiscal perspective, and depending on the time-horizon being considered, it is the unanticipated volatility of both nominal and real debt service costs that is relevant. Financing, refinancing, refixing, inflation and operational risks are other types of risk that the Government

takes into account in the management of its debt portfolio. HM Treasury and the DMO jointly undertake the management of these risks, with the exception of operational risk, which is solely the responsibility of the DMO.

The factors that are considered by the authorities in determining the annual debt management Remit have also been discussed. Three main factors have been looked at in some detail: the Government's attitude to risk; the shape of both the nominal and real yield curves; and investors' demand for gilts.

Work is currently being done to clarify further the implications for the structure of the debt portfolio of the Government's attitude to risk. Our current practices are therefore based on past observations on the structure of the debt portfolio and issuance strategies, which we use as broad guidelines. The previous share of the debt portfolio with nominal versus real exposures demonstrates a preference for having approximately a quarter of the overall debt portfolio in the form of real exposure. We also maintain a well-diversified issuance strategy for nominal gilts such that our 'default' issuance strategy is broadly an even split between the three conventional maturity bands, on a cash weighted basis. Further, we retain a preference for maintaining a fairly even redemption profile.

For a number of reasons, the issuance strategy is not tilted towards the absolutely lowest segment of the yield curve. However, issuance in nominal gilts may deviate from our 'default' strategy, when there is evidence that the shape of the nominal yield curve implies the existence of a "preferred habitat" premium.

Finally, both market capacity and market management or market structure considerations may be taken into account in deciding the issuance strategy in a given financial year and might also lead to a deviation from the 'default' strategy.

ANNEX A: Gilts in issue at 31 March 2004

Gilts in issue at 31 March 2004 (£mn nominal)
Total amount in issue (inc IL uplift) £mn 320,997

Conventional gilts	Redemption date	Dividend dates	Amount in issue (£mn nom)	Amount held in stripped form	Central Govt holdings (DMO & CRND)
Shorts: (maturity up to 7 years)					
5% Treasury 2004	07-Jun-04	7 Jun/Dec	7,504	48	461
6¾% Treasury 2004	26-Nov-04	26 May/Nov	6,597	-	477
9½% Conversion 2005	18-Apr-05	18 Apr/Oct	4,469	-	102
8½% Treasury 2005	07-Dec-05	7 Jun/Dec	10,486	156	313
7¾% Treasury 2006	08-Sep-06	8 Mar/Sep	3,955	-	439
7½% Treasury 2006	07-Dec-06	7 Jun/Dec	11,807	163	275
4½% Treasury 2007	07-Mar-07	7 Mar/Sep	5,750	-	7
8½% Treasury 2007	16-Jul-07	16 Jan/Jul	4,638	-	370
7¼% Treasury 2007	07-Dec-07	7 Jun/Dec	11,103	144	249
5% Treasury 2008	07-Mar-08	7 Mar/Sep	14,221	5	157
5½% Treasury 2008/2012	10-Sep-08	10 Mar/Sep	1,026	-	182
4% Treasury 2009	07-Mar-09	7 Mar/Sep	13,250	1	9
5¾% Treasury 2009	07-Dec-09	7 Jun/Dec	8,937	90	357
6¼% Treasury 2010	25-Nov-10	25 May/Nov	4,958	-	477
Mediums: (maturity 7 to 15 years)					
9% Conversion 2011	12-Jul-11	12 Jan/Jul	5,396	-	205
7¾% Treasury 2012/2015	26-Jan-12	26 Jan/Jul	805	-	339
5% Treasury 2012	07-Mar-12	7 Mar/Sep	13,346	41	235
8% Treasury 2013	27-Sep-13	27 Mar/Sep	6,181	-	386
5% Treasury 2014	07-Sep-14	7 Mar/Sep	13,050	76	57
4¾% Treasury 2015	07-Sep-15	7 Mar/Sep	5,250	13	2
8% Treasury 2015	07-Dec-15	7 Jun/Dec	7,377	374	172
8¾% Treasury 2017	25-Aug-17	25 Feb/Aug	7,751	-	380
Longs: (maturity over 15 years)					
8% Treasury 2021	07-Jun-21	7 Jun/Dec	16,741	244	346
5% Treasury 2025	07-Mar-25	7 Mar/Sep	12,922	0	177
6% Treasury 2028	07-Dec-28	7 Jun/Dec	11,756	180	309
4¼% Treasury 2032	07-Jun-32	7 Jun/Dec	13,829	280	251
4¼% Treasury 2036	07-Mar-36	7 Mar/Sep	12,250	8	3

**It is assumed that double-dated gilts (which have not been called) currently trading above par will be redeemed at the first maturity date.*

Index-linked gilts	Redemption date	Dividend dates	Amount in issue (£mn nom)	Nominal including inflation uplift	Central Govt holdings (DMO & CRND)
4⅜% I-L Treasury 2004	21-Oct-04	21 Apr/Oct	1,338	1,814	38
2% I-L Treasury 2006	19-Jul-06	19 Jan/Jul	2,037	5,315	37
2½% I-L Treasury 2009	20-May-09	20 May/Nov	3,098	7,132	74
2½% I-L Treasury 2011	23-Aug-11	23 Feb/Aug	4,342	10,559	70
2½% I-L Treasury 2013	16-Aug-13	16 Feb/Aug	5,597	11,376	105
2½% I-L Treasury 2016	26-Jul-16	26 Jan/Jul	6,455	14,339	169
2½% I-L Treasury 2020	16-Apr-20	16 Apr/Oct	5,093	11,129	68
2½% I-L Treasury 2024	17-Jul-24	17 Jan/Jul	5,751	10,676	112
4⅛% I-L Treasury 2030	22-Jul-30	22 Jan/Jul	3,171	4,255	71
2% I-L Treasury 2035	26-Jan-35	26 Jan/Jul	3,775	3,942	1

Undated gilts (non-rump)	Redemption date	Dividend dates	Amount in issue (£mn nom)	Central Govt holdings (DMO & CRND)
2½% Treasury	Undated	1 Apr/Oct	493	22
3½% War	Undated	1 Jun/Dec	1,939	30

Rump gilts are not available for purchase

Rump gilts	Redemption date	Dividend dates	Amount in issue (£mn nom)	Central Govt holdings (DMO & CRND)
10% Treasury 2004	18-May-04	18 May/Nov	20	6
9½% Conversion 2004	25-Oct-04	25 Apr/Oct	307	158
10½% Exchequer 2005	20-Sep-05	20 Mar/Sep	24	16
9¾% Conversion 2006	15-Nov-06	15 May/Nov	6	3
9% Treasury 2008	13-Oct-08	13 Apr/Oct	687	141
8% Treasury 2009	25-Sep-09	25 Mar/Sep	393	118
9% Treasury 2012	06-Aug-12	6 Feb/Aug	403	156
12% Exchequer 2013/2017	12-Dec-13	12 Jun/Dec	58	9
4% Consolidated	Undated	1 Feb/Aug	358	62
2½% Consolidated	Undated	5 Jan/Apr/Jul/Oct	272	47
3½% Conversion	Undated	1 Apr/Oct	89	73
3% Treasury	Undated	5 Apr/Oct	53	7
2½% Annuities	Undated	5 Jan/Apr/Jul/Oct	3	0.4
2¾% Annuities	Undated	5 Jan/Apr/Jul/Oct	1	0.3

**It is assumed that double-dated gilts (which have not been called) currently trading above par will be redeemed at the first maturity date.*

ANNEX B: List of GEMMs and Inter Dealer Brokers at 31 March 2004

(*indicates additional IG GEMM status)

GEMMs	Website
ABN Amro Bank NV 250 Bishopsgate London EC2M 4AA	www.abnamro.com
Barclays Capital* 5 The North Colonnade Canary Wharf London E14 4BB	www.barcap.com
Citigroup Global Markets Limited Citigroup Centre 33 Canada Square London E14 5LB	www.citigroup.com
CS First Boston Limited One Cabot Square London E14 4QJ	www.csfb.com
Deutsche Bank AG (London Branch)** Winchester House 1 Great Winchester Street London EC2N 2DB	research.gm.db.com
Dresdner Bank AG* (London Branch) PO Box 18075 Riverbank House 2 Swan Lane London EC4R 3UX	www.drkw.com
Goldman Sachs International Limited Peterborough Court 133 Fleet Street London EC4A 2BB	www.gs.com
HSBC Bank PLC* 8 Canada Square London E14 5HQ	www.hsbcgroup.com
JP Morgan Securities Limited 125 London Wall London EC2Y 5AJ	www.jpmorgan.com

**became an IG GEMM on 10 June 2004

Lehman Brothers International (Europe)* www.lehman.com
25 Bank Street
Docklands
London E14 5LE

Merrill Lynch International* www.ml.com
Merrill Lynch Financial Centre
2 King Edward Street
London EC1A 1HQ

Morgan Stanley & Co. International Limited* www.msdw.com
20 Cabot Square
Canary Wharf
London E14 4QW

Royal Bank of Canada Europe Limited* www.royalbank.com
Thames Court
One Queenhithe
London EC4V 4DE

Royal Bank of Scotland PLC* www.rbsmarkets.com
135 Bishopsgate
London EC2M 3UR

UBS Limited* www.wdr.com
1 Finsbury Avenue
London EC2M 2PP

Winterflood Gilts Limited* www.wins.co.uk
The Atrium Building
Cannon Bridge
25 Dowgate Hill
London EC4R 2GA

Inter Dealer Brokers

BrokerTec Europe Limited www.btec.com
2 Broadgate
London EC2M 7UR

Cantor Fitzgerald International www.cantor.com
One America Square
London
EC3N 2LS

Dowgate www.ksbb.com
Old Mutual Place
2 Lambeth Hill
London EC4V 4GG

ICAP WCLK Ltd www.icap.com
2 Broadgate
London EC2M 7UR

ANNEX C: Performance

Gilt issuance counterfactuals

The DMO has been publishing the results of its measurement of auction performance against counterfactuals in its Annual Review since 2001 and, over time, has extended the range of the counterfactuals which are designed to indicate whether different non-discretionary issuance patterns during the year would have resulted in higher or lower costs of financing.

Actual issuance

The benchmark is the actual cash weighted yield of gilt issuance at the auctions in 2003-04, which was 4.55% (the lowest in any year of the DMO's operations). See Table 10.

Table 10
Average issuance yield 2003-2004

Weighted average yield of outright issuance: 2003-04

Date	Gilt	Real yield %	Nom yield %	Cash (£mn)
16-Apr	2½% IL 2009	1.74	4.74	**995**
24-Apr	5% 2014		4.52	**2,603**
13-May	4% 2009		4.04	**3,492**
28-May	4¼% 2036		4.35	**2,210**
12-Jun	5% 2014		4.11	**2,698**
24-Jun	2½% IL 2024	1.95	4.96	**699**
26-Jun	4% 2009		3.91	**3,264**
02-Jul	4¼% 2036		4.62	**2,111**
16-Jul	2½% IL 2013	1.77	4.77	**906**
29-Jul	5% 2014		4.57	**2,590**
14-Aug	4% 2009		4.38	**3,189**
10-Sep	4¼% 2036		4.77	**2,285**
23-Sep	2% IL 2035	2.09	5.10	**654**
25-Sep	4¾% 2015		4.68	**2,768**
15-Oct	4% 2009		4.76	**3,131**
23-Oct	2½% IL 2011	2.10	5.11	**990**
29-Oct	4¾% 2015		5.01	**2,441**
25-Nov	4¼% 2036		4.88	**2,245**
02-Dec	2% IL 2035	2.10	5.11	**681**
13-Jan	2½% IL 2016	1.89	4.90	**941**
28-Jan	5% 2025		4.77	**2,574**
12-Feb	4½% 2007		4.48	**3,000**
24-Feb	2% IL 2035	1.85	4.86	**644**
24-Mar	4½% 2007		4.50	**2,744**
			4.55	**49,855**

The counterfactuals

Counterfactual 1 assumes that:

- *For conventional issuance* the total cash raised in 2004-05 (£43.344 billion) was achieved through sales split equally between alternative benchmark stocks of 5% 2008, 5% 2012 and 4¼% 2032[10] using the average close of business (cob) yield of each of the stocks over the quarter;

[10] The choice of counterfactual stocks is re-assessed annually.

- For index-linked issuance the total cash raised (£6.511 billion) was achieved by sales of equal amounts of all index-linked stocks eligible for auction (2009[11] maturity or longer) using the average of the cob yield of the relevant stocks in the quarter.

These test an alternative issuance scenario both in terms of stocks issued and timing in that issuance is assumed to be spread out evenly over each business day of the year and not on specific auction dates.

Counterfactual 2 assumes that:

- *For conventional issuance* the cash amounts of the auctions are raised at the average of the close of business yields of three counterfactual stocks (5% 2008, 5% 2012 and 4¼% 2032) at:

  a) the day before the auction
  b) the day of the auction.

- *For index-linked issuance* the cash amounts of the auctions are raised at the average close of business yields of all index-linked stocks eligible for auction (2009 maturity or longer) using the cob yields from:

  a) the day before the auction and;
  b) the day of the auction.

These test an alternative stock issuance pattern but in terms of timing, link them to the pre-announced auction dates.

Results

The performance over the financial year is summarised in the table below, with actual issuance sitting roughly in the middle of the range of counterfactuals, out-performing counterfactual 1 by 2.8bps, but under-performing against counterfactual 2 by 1.4-2.8bps. See Table 11.

Table 11
Actual and counterfactual issuance yields 2003-2004

Gilt issuance yields 2003-04	%	Relative (bps)
Actual	**4.554**	
Counterfactual 1	4.582	2.8
Counterfactual 2a	4.526	-2.8
Counterfactual 2b	4.540	-1.4

Counterfactual 1

Actual issuance was outperformed by counterfactual 1 by 2.8bps – reflecting the greater proportion in actual issuance of relatively low yielding short conventional issuance compared to the counterfactual (43% compared to 33%).

Counterfactuals 2a and 2b

Actual issuance under-performed counterfactuals 2a and 2b – by 2.8bps and 1.4bps respectively (see tables below). Divergence reflects the prevailing shape of the yield curves at the time of each auction relative to the maturity of the auction stock.

[11] 2011 or longer for 2004-05.

Auction concession analysis

Table 12 below compares the (nominal) yield of all auction stocks at the close of business on the day before each auction and the day of the auction, with the auction yield. This gives an impression of the extent of any concessions around the auctions. On average the cob yields on the day before the auction were 2bps lower than the average auction yields (this figure was 3.7bps in 2002-03). Cob yields on the day of the auction averaged 1bp lower than the average auction yield (this figure was 2.2bps in 2002-03). Auction concessions, on this basis, were generally smaller than in 2003-04; but there was a wide variety – the largest concession was 11bps at the auction of 4% 2009 on 24 July 2003 (the day after the US Federal Reserve disappointed international bond markets by cutting rates only by 25bps).

Table 12
Movement in yields around gilt auctions in 2003-2004

Date	Gilt	Yield cob day before (%)	Auction yield nominal (%)	Yield cob day after (%)
16-Apr	2½% IL 2009	4.71	**4.74**	4.68
24-Apr	5% 2014	4.53	**4.52**	4.46
13-May	4% 2009	4.02	**4.04**	3.98
28-May	4¼% 2036	4.27	**4.35**	4.37
12-Jun	5% 2014	4.04	**4.11**	4.06
24-Jun	2½% IL 2024	4.99	**4.96**	4.93
26-Jun	4% 2009	3.80	**3.91**	3.96
02-Jul	4¼% 2036	4.54	**4.62**	4.60
16-Jul	2½% IL 2013	4.68	**4.77**	4.72
29-Jul	5% 2014	4.57	**4.57**	4.50
14-Aug	4% 2009	4.36	**4.38**	4.43
10-Sep	4¼% 2036	4.79	**4.77**	4.73
23-Sep	2% IL 2035	5.12	**5.10**	5.07
25-Sep	5% 2014	4.70	**4.68**	4.69
15-Oct	4% 2009	4.74	**4.76**	4.78
23-Oct	2½% IL 2011	5.09	**5.11**	5.15
29-Oct	4¾% 2015	5.03	**5.01**	5.07
25-Nov	4¼% 2036	4.83	**4.88**	4.89
02-Dec	2% IL 2035	5.14	**5.11**	5.11
13-Jan	2½% IL 2016	4.91	**4.90**	4.88
28-Jan	5% 2025	4.73	**4.77**	4.76
12-Feb	4½% 2007	4.47	**4.48**	4.45
24-Feb	2% IL 2035	4.87	**4.86**	4.81
24-Mar	4½% 2007	4.49	**4.50**	4.48
	Average	**4.64**	**4.66**	**4.65**

Benchmark premia

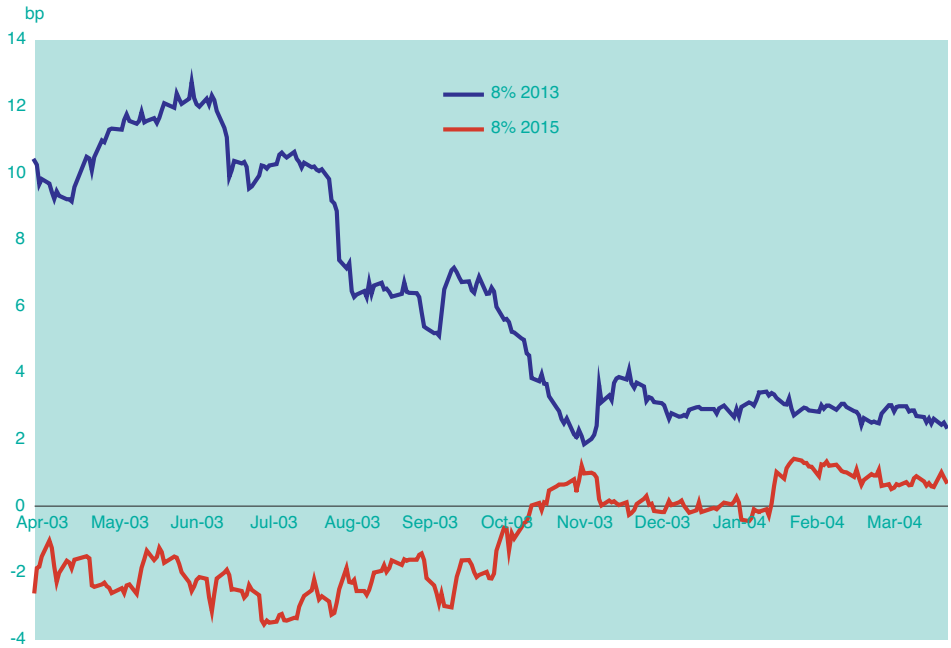
One of the ways in which the DMO seeks to deliver its debt management objectives is to issue gilts that deliver a benchmark premium, i.e. they acquire a premium relative to adjacent stocks on the yield curve by virtue of their size and liquidity. The chart below shows how the yield on 5% Treasury Stock 2014 moved relative to the yields on 8% Treasury Stock 2013 and 8% Treasury Stock 2015 in 2003-04.

5% Treasury Stock 2014 was first issued on 25 July 2002 and had been built up to £5,550 million (nominal) in issue by the end of 2002-03; it was issued a further three times between April and July 2003, taking it to £13,050 million (nominal) in issue.

5% Treasury Stock 2014 began the 2003-04 financial year yielding 10-12bps more than 8% Treasury Stock 2013 (the prevailing 10-year benchmark stock), but from July onwards in particular 5% Treasury Stock 2014 began to outperform – with the spread narrowing to around 2bps as it began to acquire 10-year benchmark status (from 8% Treasury Stock 2013). See Chart 10.

Against 8% 2015 there was less of a trend, with the spread relative to 5% Treasury Stock 2014 moving from –2bps to 1bp, but this is likely primarily to reflect changes in the shape of the yield curve.

Chart 10
5% 2014 yield spreads



Source: DMO

APPENDIX D: Gilt redemptions and the gilt portfolio

Gilt redemptions

£21.05 billion of gilts in market hands redeemed in 2003-04, as detailed in table 13.

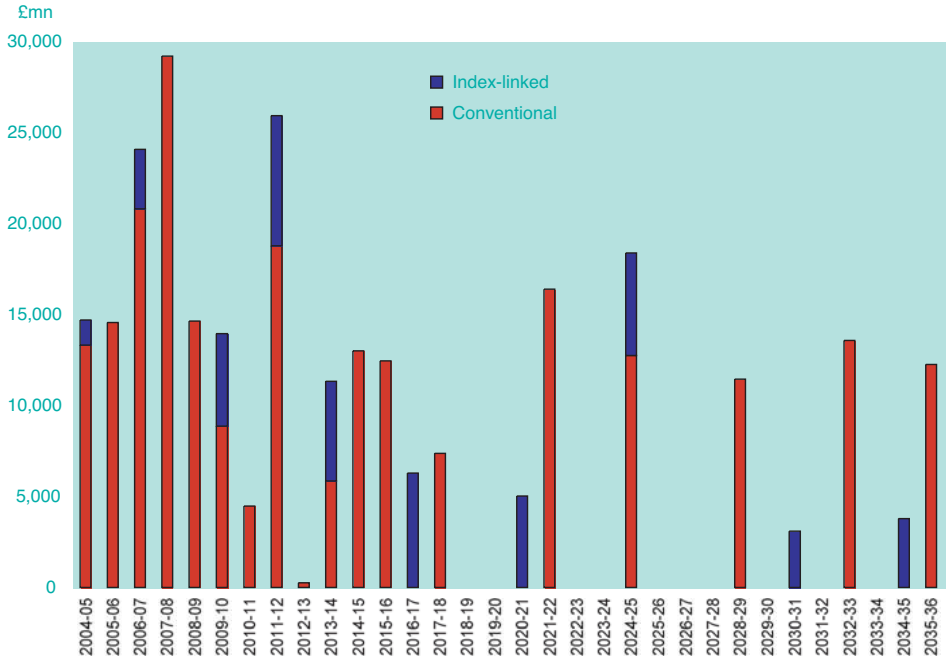
Table 13
Gilt redemptions 2003-2004

Gilts redeeming in 2003-04 (£ million)				
Gilt	**Redemption date**	**Nominal amount outstanding**	**Government holdings (end Mar 2003)**	**Redemption to market**
9¾% Conversion 2003	7-May-03	12	10	2
2½% IL Treasury Stock 2003	20-May-03	2,734	268	4,253
3½% Funding 1999/2004	6-Jun-03	561	55	506
8% Treasury 2003	10-Jun-03	7,102	522	6,580
10% Treasury 2003	8-Sep-03	1,872	107	1,765
12½% Treasury 2003/2005	21-Nov-03	152	54	981
6½% Treasury 2003	7-Dec-03	8,095	316	7,779
13½% Treasury 2004/2008	26-Mar-04	96	26	701
		20,624	**1,358**	**21,053**

[1] *Redemption total includes accrued inflation uplift of £1.7 billion.*

The future profile of gilt redemptions at end-March 2004 is shown in Chart 11.

Chart 11
Gilt redemption profile as at 31 March 2004



Source: DMO

The Gilt portfolio

The key statistics of the gilt portfolio at end-March 2004 compared to the position at the end of the previous financial year are shown in Table 14 below.

Table 14
Key portfolio statistics

	28-Mar-03	31-Mar-04
Nominal value*	£292.71 bn	£321.00bn
Market value	£332.31 bn	£352.57bn
Weighted ave market yields		
Conventional gilts	4.09%	4.61%
Index-linked gilts	1.80%	1.73%
Average maturity	11.22 years	11.55 years
Average modified duration		
Conventional gilts	6.89 years	7.19 years
Index-linked gilts	11.21 years	11.08 years
Average coupon**	6.79%	6.35%

** including index-linked uplift*
*** of conventional, double-dated and undated gilts*

The nominal value of the gilt portfolio rose by £28.3 billion (9.7%) as gilt issuance greatly exceeded gilt redemptions (see above). The market value of the portfolio rose by £20.3 billion (6.1%), significantly less than the rise in nominal terms, reflecting the falling prices of conventional gilts as evidenced by the 52bps (12.7%) rise in conventional gilt yields. In contrast, yields on index-linked gilts fell over the course of the financial year by 7bps, as they out-performed conventionals.

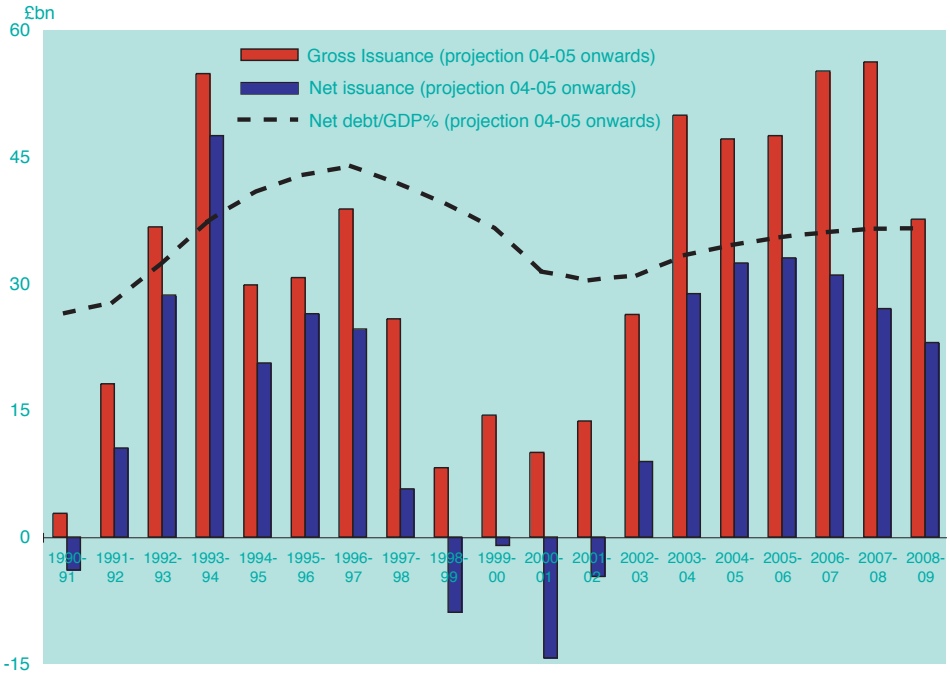
The rise in nominal and market values of the portfolio continued the trend of the previous financial year reflecting the step change in levels of gilt issuance from 2002-03 onwards. Chart 12 below shows the nominal and market values at the end of March in each year since 1999.

Chart 12
Nominal and market values of the gilt portfolio (as at end-March)

Source: DMO

The trend of rising nominal values can be expected to continue on the basis of future financing projections. Chart 13 below shows past and projected gross and net gilt issuance levels (and net debt/GDP data).

Chart 13
Gross and net issuance history and projections



Source: HMT/DMO

Breakdown of the gilt portfolio by type and maturity

Table 15 and Chart 14 show the evolution of the gilt portfolio by type and maturity since March 1999. They show the steadily rising proportion of long conventional gilts (from 15% to 21% of the portfolio), and until 2003-04 an increasing proportion of index-linked gilts, currently accounting for 25% of the gilt portfolio.

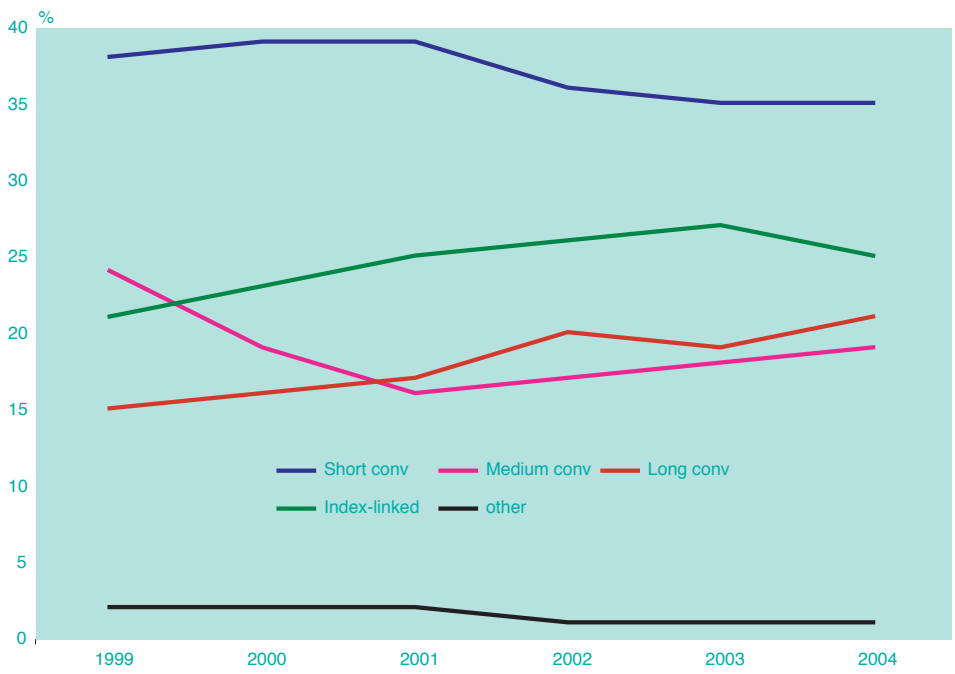
Table 15
Portfolio composition 1999-2004

At end-March	1999	2000	2001	2002	2003	2004
Conventional						
0-3 years	16	17	17	18	16	16
3-7 years	22	22	22	18	19	19
7-15 years	24	19	16	17	18	19
Over 15 years	15	16	17	20	19	21
Total	**76**	**75**	**73**	**73**	**73**	**74**
Index-linked*	**21**	**23**	**25**	**26**	**27**	**25**
Undated	1	1	1	1	1	1
Floating rate	1	1	1	0	0	0

** including index-linked uplift*
*** of conventional, double-dated and undated gilts*

Chart 14 includes both the 0-3 years and 3-7 years data within the "short conventional" category and undated and floating rate gilts in "other".

Chart 14
Gross and net issuance history and projections



Source: DMO

APPENDIX E: Treasury bill tender results 2003-04

One month bills

Date	Maturity date	Size £mn	Cover	Avg Yield %	Avg price £	Yield tail (bps)
04-Apr-03	06-May-03	1,500	5.63	3.5324	99.7201	2
11-Apr-03	12-May-03	500	5.99	3.6174	99.7233	2
17-Apr-03	19-May-03	150	6.39	3.5100	99.7410	0
25-Apr-03	27-May-03	150	7.47	3.5391	99.7196	0
02-May-03	02-Jun-03	150	7.37	3.4465	99.7457	0
09-May-03	09-Jun-03	500	7.18	3.5760	99.7264	4
16-May-03	16-Jun-03	1,500	5.18	3.5781	99.7263	0
23-May-03	23-Jun-03	1,500	4.72	3.5578	99.7375	1
30-May-03	30-Jun-03	1,500	4.48	3.5705	99.7268	1
06-Jun-03	07-Jul-03	1,500	5.31	3.5790	99.7262	1
13-Jun-03	14-Jul-03	1,000	5.31	3.5779	99.7263	0
20-Jun-03	21-Jul-03	1,000	5.09	3.5499	99.7284	1
27-Jun-03	28-Jul-03	500	5.20	3.5779	99.7263	2
04-Jul-03	04-Aug-03	500	4.81	3.5373	99.7294	0
11-Jul-03	11-Aug-03	150	8.64	3.2500	99.7513	0
18-Jul-03	18-Aug-03	150	8.78	3.2808	99.7490	2
25-Jul-03	26-Aug-03	150	6.93	3.3480	99.7347	3
01-Aug-03	01-Sep-03	150	7.79	3.3649	99.7425	1
08-Aug-03	08-Sep-03	150	8.39	3.3438	99.7441	1
15-Aug-03	15-Sep-03	150	7.45	3.3160	99.7463	4
22-Aug-03	22-Sep-03	500	7.28	3.4436	99.7459	1
29-Aug-03	29-Sep-03	1,000	7.03	3.4988	99.7323	0
05-Sep-03	06-Oct-03	1,000	6.52	3.5198	99.7307	0
12-Sep-03	13-Oct-03	1,000	8.05	3.5042	99.7319	1
19-Sep-03	20-Oct-03	700	8.46	3.5081	99.7316	0
26-Sep-03	27-Oct-03	700	6.65	3.5305	99.7299	2
03-Oct-03	03-Nov-03	500	9.37	3.5165	99.7310	0
10-Oct-03	10-Nov-03	500	7.03	3.5050	99.7318	1
17-Oct-03	17-Nov-03	500	7.77	3.5155	99.7310	0
24-Oct-03	24-Nov-03	150	7.51	3.5857	99.7257	3
31-Oct-03	01-Dec-03	150	9.42	3.6856	99.7181	0
07-Nov-03	08-Dec-03	150	8.26	3.6896	99.7178	0
14-Nov-03	15-Dec-03	150	9.60	3.6986	99.7171	0
21-Nov-03	22-Dec-03	500	7.04	3.7189	99.7155	0
28-Nov-03	29-Dec-03	1,500	6.24	3.7147	99.7158	2
05-Dec-03	05-Jan-04	1,500	4.98	3.7308	99.7146	2
12-Dec-03	12-Jan-04	1,500	5.20	3.7499	99.7132	0
19-Dec-03	19-Jan-04	750	5.05	3.7877	99.7103	1
02-Jan-04	02-Feb-04	1,000	7.66	3.7500	99.7132	0
09-Jan-04	09-Feb-04	2,000	6.25	3.7496	99.7132	0
16-Jan-04	16-Feb-04	1,000	6.98	3.7724	99.7114	1
23-Jan-04	23-Feb-04	300	5.87	3.8313	99.7070	1
30-Jan-04	01-Mar-04	300	8.75	3.8933	99.7022	1
06-Feb-04	08-Mar-04	300	10.04	3.9382	99.6988	2
13-Feb-04	15-Mar-04	300	6.87	3.9628	99.6969	1
20-Feb-04	22-Mar-04	300	9.17	3.9637	99.6969	1
27-Feb-04	29-Mar-04	1,000	5.28	3.9968	99.6943	0
05-Mar-04	05-Apr-04	1,000	7.39	4.0111	99.6932	1
12-Mar-04	13-Apr-04	500	9.09	3.9495	99.6872	0
19-Mar-04	19-Apr-04	500	10.03	3.9777	99.6958	1
26-Mar-04	26-Apr-04	1,500	6.92	4.0845	99.6876	1

Three month bills

Date	Maturity date	Size £mn	Cover	Avg Yield %	Avg price £	Yield tail (bps)
04-Apr-03	07-Jun-03	1,000	6.03	3.4743	99.1412	2
11-Apr-03	14-Jul-03	1,000	6.43	3.4971	99.1357	2
17-Apr-03	21-Jul-03	1,000	5.12	3.4898	99.1468	0
25-Apr-03	28-Jul-03	1,000	7.29	3.4731	99.1415	2
02-May-03	04-Aug-03	1,000	6.35	3.4067	99.1670	3
09-May-03	11-Aug-03	1,000	6.02	3.5250	99.1288	0
16-May-03	18-Aug-03	1,000	5.95	3.5213	99.1297	0
23-May-03	26-Aug-03	1,000	4.90	3.4391	99.1490	1
30-May-03	01-Sep-03	1,000	5.44	3.4392	99.1499	1
06-Jun-03	08-Sep-03	1,000	6.61	3.5152	99.1312	1
13-Jun-03	15-Sep-03	1,000	7.06	3.5228	99.1294	1
20-Jun-03	22-Sep-03	1,000	5.35	3.4747	99.1412	1
27-Jun-03	29-Sep-03	700	6.31	3.4983	99.1354	0
04-Jul-03	06-Oct-03	500	8.83	3.4443	99.1486	1
11-Jul-03	13-Oct-03	500	9.81	3.2995	99.1841	2
18-Jul-03	20-Oct-03	500	8.58	3.2672	99.1920	0
25-Jul-03	27-Oct-03	500	7.32	3.3236	99.1782	1
01-Aug-03	03-Nov-03	500	7.80	3.3626	99.1686	1
08-Aug-03	10-Nov-03	500	8.49	3.3565	99.1701	0
15-Aug-03	17-Nov-03	500	7.41	3.3732	99.1660	2
22-Aug-03	24-Nov-03	500	6.94	3.4597	99.1541	2
29-Aug-03	01-Dec-03	500	6.44	3.5256	99.1287	0
05-Sep-03	08-Dec-03	700	6.81	3.5431	99.1244	1
12-Sep-03	15-Dec-03	700	7.19	3.5386	99.1255	1
19-Sep-03	22-Dec-03	700	7.28	3.5479	99.1232	1
26-Sep-03	29-Dec-03	1,000	4.90	3.5909	99.1127	1
03-Oct-03	05-Jan-04	1,500	6.15	3.5981	99.1109	0
10-Oct-03	12-Jan-04	1,500	5.09	3.6063	99.1089	1
17-Oct-03	19-Jan-04	1,500	6.92	3.6493	99.0984	0
24-Oct-03	26-Jan-04	1,000	5.96	3.7570	99.0720	2
31-Oct-03	02-Feb-04	1,000	6.86	3.8140	99.0581	2
07-Nov-03	09-Feb-04	1,500	5.30	3.8442	99.0507	1
14-Nov-03	16-Feb-04	1,500	6.06	3.8475	99.0499	0
21-Nov-03	23-Feb-04	1,500	5.57	3.8294	99.0543	0
28-Nov-03	01-Mar-04	1,500	6.55	3.8568	99.0476	1
05-Dec-03	08-Mar-04	1,500	5.23	3.8668	99.0451	1
12-Dec-03	15-Mar-04	1,500	5.85	3.8936	99.0386	1
19-Dec-03	22-Mar-04	1,000	4.01	3.8994	99.0372	2
02-Jan-04	05-Apr-04	1,000	6.65	3.8841	99.0409	2
09-Jan-04	13-Apr-04	1,500	5.99	3.9027	99.0259	2
16-Jan-04	19-Apr-04	1,500	6.89	3.8956	99.0381	0
23-Jan-04	26-Apr-04	500	8.03	3.9555	99.0235	0
30-Jan-04	04-May-04	500	8.32	3.9930	99.0036	1
06-Feb-04	10-May-04	500	9.74	3.9990	99.0128	0
13-Feb-04	17-May-04	500	8.06	3.9850	99.0163	1
20-Feb-04	24-May-04	500	8.42	4.0161	99.0087	0
27-Feb-04	01-Jun-04	500	5.92	4.0743	98.9835	1
05-Mar-04	07-Jun-04	500	10.42	4.1068	98.9865	1
12-Mar-04	14-Jun-04	800	7.81	4.0999	98.9882	0
19-Mar-04	21-Jun-04	1,500	9.23	4.1584	98.9739	1
26-Mar-04	28-Jun-04	1,500	6.55	4.2143	98.9602	1

Six month bills

Date	Maturity date	Size £mn	Cover	Avg Yield %	Avg price £	Yield tail (bps)
02-May-03	03-Nov-03	750	6.15	3.3720	98.3554	1
30-May-03	01-Dec-03	750	4.79	3.3991	98.3334	1
27-Jun-03	29-Dec-03	750	6.05	3.4440	98.3117	4
01-Aug-03	02-Feb-04	750	7.21	3.4511	98.3083	1
29-Aug-03	01-Mar-04	750	6.19	3.5753	98.2485	0
26-Sep-03	29-Mar-04	750	6.01	3.6667	98.2045	1
31-Oct-03	04-May-04	750	5.79	3.9933	98.0372	2
28-Nov-03	01-Jun-04	750	5.66	4.0915	97.9899	0
09-Jan-04	12-Jul-04	750	4.95	4.0453	98.0228	0
30-Jan-04	02-Aug-04	750	5.95	4.1564	97.9696	1
27-Feb-04	31-Aug-04	750	4.83	4.2055	97.9350	0
26-Mar-04	27-Sep-04	750	6.23	4.3420	97.8808	1

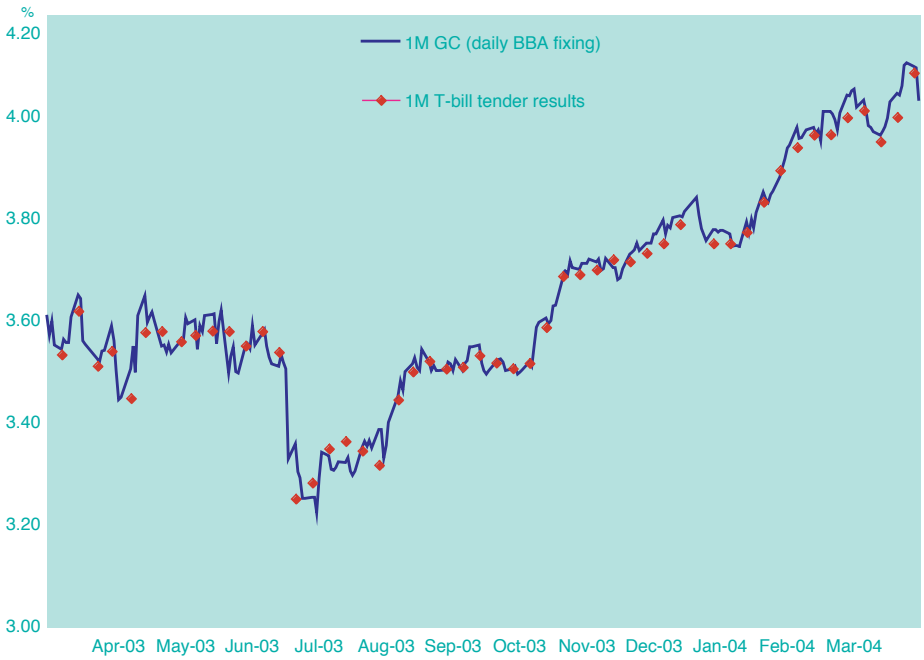
ANNEX F: Treasury bill tender performance

Table 16 and Charts 15-17 compare the results (average yield) of all Treasury bill tenders in 2003-04 with the average fixing of the relevant GC repo rate on the day of the settlement of the tenders. 1- and 3-month tenders outperformed GC repo (albeit only marginally by 0.35bps in the case of 3-month tenders). 6-month tenders under-performed relative to GC repo by 0.5bps. This represents a deterioration in the relative attractiveness of Treasury bill issuance at all maturities since 2002-03 (when the range of out-performance was 0.3-2.8bps, see Table 16). This may be attributed in part to reaction to the greater level of supply and the possibility that the market is operating close to capacity.

Table 16
Comparison of average tender yields with GC repo

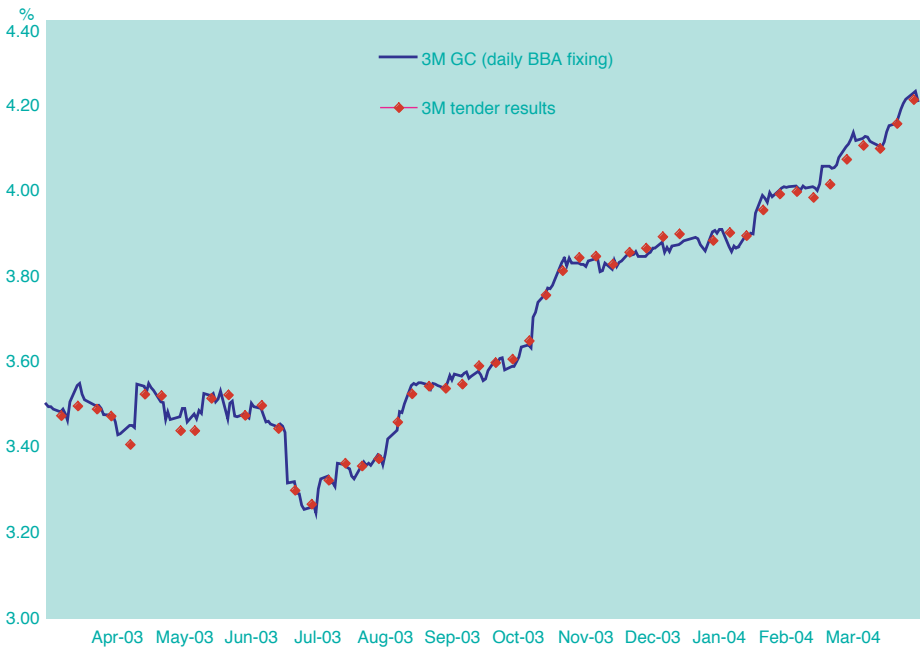
2003-04	**1 month**	**3-month**	**6-month**
Tender average yield	3.636	3.680	3.812
GC repo	3.650	3.683	3.807
Tender rel to GC repo (bps)	**-1.32**	**-0.35**	**0.52**
2002-03	-2.81	-1.95	-0.27

Chart 15
One-month tenders 2003-04



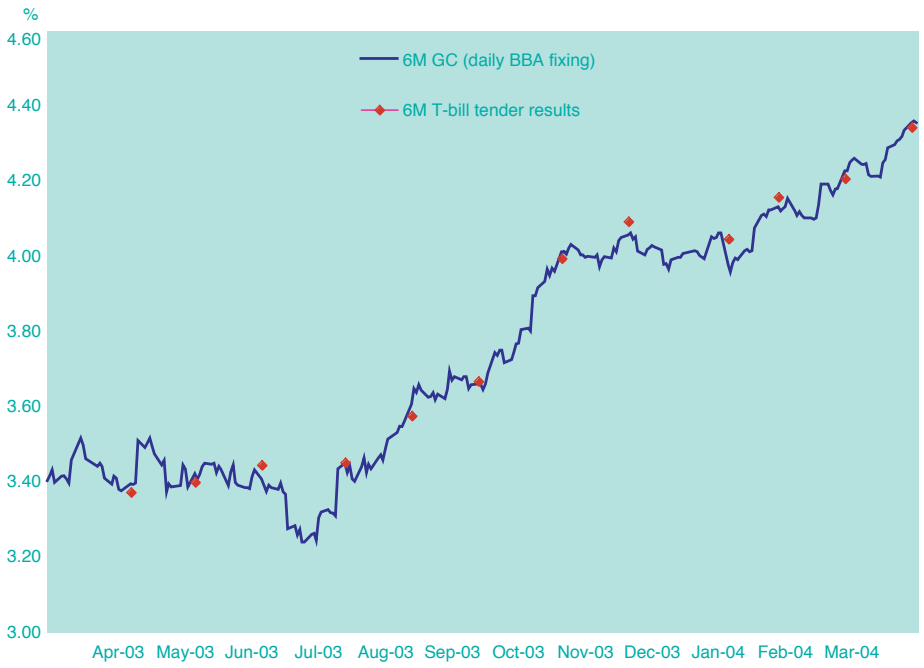
Source: DMO/BBA

Chart 16
Three-month tenders 2003-04



Source: DMO/BBA

Chart 17
Six-month tenders 2003-04



Source: DMO/BBA

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Debt Management Office

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