HM Treasury

THE FUTURE OF UK GOVERNMENT DEBT AND CASH MANAGEMENT

A response to consultation
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RESPONSE TO CONSULTATION

The Establishment of the New Debt Management Framework

The Chancellor's letter of May 6th to the Governor of the Bank of England set out the details of the new monetary policy framework and the transfer of government debt management responsibilities from the Bank to the Treasury. On 29th July, the Treasury published a consultation document 'The Future of UK Government Debt and Cash Management', setting out the Government's initial proposals for the implementation of the Chancellor's decision by establishing a debt management body as an executive agency of the Treasury. In addition to considering written responses, the Treasury has been discussing these proposals with market participants, representative bodies, the Bank and the Financial Services Authority.

2. This paper summarises the written responses to the consultation paper, sets out the current state of the Treasury's thinking on the issues raised and how the transfer of debt and cash management responsibilities is to be implemented. On the gilt market aspects of the transfer, most of the policy decisions have now been made. However, on the cash management side, the Treasury is essentially developing a new function in actively managing the Exchequer's cash position separate from the Bank of England's money market operations. Its structure will have an important impact on the day-to-day operation of the sterling money markets. Hence, the proposals outlined here on the cash management side are more tentative and will require further discussion with market participants. Any comments that participants in the sterling money markets have on these proposals would be welcome.

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The Debt Management Agency

3. The initial consultation document proposed the establishment of an agency to undertake the debt and cash management functions for central government. Treasury ministers have now confirmed that they wish to set up such a body and it remains their intention that this should be an Executive Agency of the Treasury. Given that the principle of separation of the implementation of monetary policy and debt management was not an issue for consultation, the overall policy decision did not attract a great deal of comment. However, the goal of the clarity of policy implementation that the separation of role is designed to produce was supported where commented upon.

4. A team from the Treasury is currently working at the Bank to plan for the personnel, accommodation and IT needs of the new agency. Various decisions have already been taken:

i. Timetable. The agency will formally be established on 1st April 1998. It will be involved in the discussions over the annual gilt remit for 1998-99 that it will be set. However, the agency will not take over active Exchequer cash management until October 1998 at the earliest.

ii. Agency title. The agency will be called the Debt Management Office and be described as an Executive Agency of the Treasury, (subject to approval of agency status by the Office of Public Service).

iii. Agency Chief Executive. As announced on November 21st 1997, the Chief Executive of the agency will be Mike Williams who will take up his position full-time from mid-January 1998. The Chief Executive will be agency accounting officer both for agency administrative costs and the agency's debt management accounts through which primary gilt issues, secondary market gilt transactions and cash management operations will be audited. The initial appointment of the Chief Executive will be for three years, after which the post will be subject to open competition.

iv. The Agency's relationship with the Treasury. As an Executive Agency, the debt management agency will not require legislation for its establishment and will be able to act legally and transact on behalf of the Treasury. As now, Treasury ministers will outline the annual remit for the agency in the Debt Management Report. Decisions within-year to deliver that remit will be the responsibility of the agency. The Chief Executive will report regularly to Treasury ministers on the delivery of the remit requirements. Any changes required to the remit within-year (due, for instance, to changes in the CGBR forecast), and policy decisions not covered by the remit (eg. conversion offers, new instruments) will need to be agreed with Treasury ministers. The precise relationship of the agency to the Treasury will be set out in a published framework document.

v. Agency staffing. Initially the agency will be staffed by a combination of loans from the Treasury and possibly other government departments as well as secondments from the Bank. Three members of the Bank's current gilts operation, including the chief dealer of the Bank's Gilt-Edged and Money Markets Division, have agreed to be seconded to the agency and other secondments may be agreed later. In addition, the agency is seeking to fill some posts externally.

vi. Office location. Lease negotiations are proceeding on private sector office locations in the City.

Response to Proposals for Changes to the Debt Management System

5. The consultation document stated that the Government was not seeking to change significantly the existing approach to debt management. The current policy of publishing an annual borrowing programme with a quarterly auction schedule, regular consultation meetings with market participants, and building up large liquid benchmark issues will continue. There are no current plans to finance the Government's borrowing requirement with foreign currency issues.[1] In addition, it is not envisaged that there would be any significant change initially in the way in which the agency would operate in the secondary market, compared to the Bank's current practice. Hence, this aspect of the transition to the new arrangements did not attract a great deal of comment.

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[1] The Government's foreign currency borrowing programme, which finances part of the UK's foreign currency reserves, will continue to be managed by the Bank.

6. There are a number of outstanding issues on the precise mechanics of the transition on the debt management front, however.

i. The timing of transition of official operations in the gilts market. The agency will be responsible for the implementation of the 1998-99 Debt Management Remit that will be published by the Treasury before the end of March 1998. Hence, from April 1998, the agency will be responsible for decisions on auction stocks and sizes, taps of stock and any secondary market dealing within the terms of the remit. The current intention is that the agency's dealing capability (eg. running the 'Shop Window', taking bids for taps) will also be operational by April 1st 1998. However, this will depend on the successful installation of dealing and information systems. Consequently, in case of delay, there may be a short period in which the Bank continues to operate for the agency on an 'execution-only' basis.

ii. The conduct of gilts auctions and taps. Subject to the above proviso concerning system readiness, the agency will be the contact point for the market at gilt auctions and taps.[2] Hence, the agency will make gilt auction and tap announcements, originate prospectuses, list the stock, take telephone bids from the market-makers and publish the results. It will then utilize the Bank's settlement and payment services. Consideration will be given to the possibility of moving to an electronic bidding system for gilts auctions and taps and Treasury bill tenders.

iii. Trading on behalf of the NSSR and CRND. Currently, the Bank's dealing operation conducts a number of small trades a day with those market-makers specialising in retail gilt transactions on behalf of the National Savings Stock Register (NSSR). These transactions involve no policy decision-making. The Bank also currently transacts in the gilts market on behalf of the public sector funds managed by the Commissioners for the Reduction of the National Debt (CRND). Sales from these funds to the market are currently processed via the Bank's secondary market 'Shop Window'. Discussions are taking place about the future conduct of these trades.

iv. Debt Management Objectives and the Code for Fiscal Stability. As part of the Pre-Budget measures published in November 1997, the Treasury issued for consultation a

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[2] Conventional gilts are currently predominantly issued by auction whereas taps constitute the current means of issuing index-linked gilts. Taps of conventional stocks are now only used as a market management instrument. The last such issue was in November 1996.

proposal for a Code for Fiscal Stability that could be enshrined in legislation. It was proposed that the Code should affirm the Government's principles for fiscal responsibility (including transparency, stability, responsibility, fairness and efficiency), and commit the Government to more open fiscal reporting and improved standards of accounting.

Part of the Code could deal will the principles behind the Government's debt management strategy which will form the background to the debt management agency's remit and framework document. These principles could be:

- A commitment to an open and transparent debt management policy. The primary motive would be to give market participants as much information as feasible concerning the amount, form and timing of gilt sales so as to plan their sales and investment strategies. From the issuer's point of view, the intention is to minimise any supply uncertainty premium priced into gilt yields.

- A commitment to avoid making debt management decisions solely on the basis of government accounting treatment or cashflow considerations.

Comments would be welcome on whether these, or other principles, ought to be included in the Code for Fiscal Stability.

The Administration of the Central Gilts Office (CGO)

7. The consultation document described the recent history of the CGO, the commitment by the Bank and CREST to keep open the option of future merger of the two systems and the opinion of the authorities that there would be positive merit in the proposal to create a single integrated UK securities settlement system. It stated that, once the two systems' current enhancements have been established, the Bank would consult market participants on the priorities for settlement system developments in the first half of 1998.

8. Almost every respondent to the consultation that mentioned CGO-CREST merger as an issue was strongly supportive of the idea. Respondents felt that user costs would be reduced and systems requirements simplified through only having to deal with one settlement

system for bonds and equities. One representative body supported the concept of merger but stressed the IT constraints on the City and pointed out that a number of linked reforms were needed before an integrated settlement system could operate at maximum efficiency.

9. Since the initial consultation, the cutover to the CGO upgrade occurred on November 10th. The gilt strips market commenced on December 8th.

10. The consultation has reinforced the presumption of the original consultation paper in favour of merger. However, given the IT implications and the potential costs for CGO users, no absolute decision to merge can yet be taken and will be subject to the results of the Bank's consultation of users in the first half of 1998.

Exchequer Cash Management

11. The one new element of the system proposed in the consultation paper was the active management of the Exchequer's cash position, separate from the Bank's money market operations. The predominant reaction from the sterling markets has been a cautious welcome - if implemented carefully, the changes could bring greater efficiency and liquidity. In particular, the main features of the proposals that have been welcomed have been:

- A clarification of the separation of roles between the monetary authority and the Exchequer's cash manager;

- The prospect of a wider range of Treasury bill maturities being offered.

12. The main concerns and questions of consultation respondents and market participants have been:

- The agency should not be seen to take or hedge large positions on the sterling yield curve in order to avoid signals being read into its actions;

- The structure of the agency's operations must be carefully dovetailed with the Bank's money market operations to avoid overlap;

- There may be an insufficient stock of private sector bills for the agency to buy in large amounts for asset management purposes;

- How will the agency's counterparties be chosen and monitored? What will the attitude to credit risk be? How will any end-of-day facilities with the settlement banks be structured?

- The accuracy of the Exchequer's cash forecast.

13. Discussions with the market have not thrown up any insuperable problems with the cash management proposals, although there is intense interest over counterparty selection, the end-of-day facilities and the interaction with the Bank's operations. The current state of the Treasury's thinking on some of these issues is given below. **However, it must be stressed that these are preliminary conclusions and market participants' further views would be welcome.** Primary legislation will be needed to reform various aspects of how government accounts for debt issues and to give the Treasury vires to issue Treasury bills. It is intended that this will be included in the 1998 Finance Bill.

14. **What will be the agency's objective in the management of the Exchequer's cash position?** The agency will take the forecast of Exchequer's day-to-day and month-to-month cash position and rough-tune the forecast cashflows through adjustments to the quantities and maturities of Treasury bills offered for sale. (Very short-term cash needs could be met through offering bills of only a few days to maturity.) The agency will then take the Exchequer forecast at the start of each working day and seek to offset its impact on the Exchequer's accounts at the Bank of England by transacting in the money markets. The agency will need to react during the day as the Exchequer forecast is revised in the light of the latest information on that day's spending and receipts.

15. **What trading ethos will the agency follow in the money markets?** The predominant influence behind the agency's decisions over the maturities of instrument in which it deals will be the aim of smoothing the profile of cashflows through the Exchequer's accounts. Within that overall remit, the agency will aim to achieve the finest rates available to minimize costs to the Exchequer.

16. Since the agency will not roll over its borrowing or lending solely on an overnight basis, it may need to operate in instruments of several days or weeks to maturity. Hence, the agency will have exposures over Monetary Policy Committee decision dates. No signals should be read into these positions by the market since the agency will transact in order to smooth anticipated Exchequer cashflows. It will not take speculative positions on short-term interest rate movements.

17. **What will be the attitude of the agency towards credit risk?** The agency will take a conservative attitude towards credit risk. Hence, it will deal as far as possible in its own paper or in collateralized instruments (general collateral gilt and bill repo). When lending surplus funds, it will request relatively conservative margins from its repo counterparties and will set proportionate limits on its exposure to any particular counterparty.

18. **How will the agency structure the Treasury bill tender programme?** The agency will seek to manage the large changes in the Exchequer's short-term cash position in as transparent a way as possible. This can be best achieved through adjusting the quantities and maturities issued in the Treasury bill tender programme. This will be used to rough-tune the seasonality in the Exchequer cashflows with the stock of bills being run down at those times of the year when tax receipts are high relative to spending (eg. January) and built up when spending exceeds receipts (eg. March).

19. In order to achieve an optimal profile within-year for the Treasury bill stock, it is expected that the agency will need to issue bills with a wider range of maturities than the recent practice of predominantly offering 3-month bills at the weekly tender. With a wider range of bill maturities potentially available, and the need to sustain a minimum bill stock in existence in order to maintain market liquidity, there should be no insuperable difficulties in the agency publishing a regular programme for Treasury bill tenders. For instance, hypothetically the market might be informed in advance that 'every third week of the month, tenders would be held of 6 month and 1 month bills' with a minimum tender size.

20. With regard to the development of the Treasury bill programme, the Treasury is keen to ascertain market participants' views on the following questions:

- What is the likely demand for different maturities of Treasury bill? For instance, should the agency issue a wide range of maturities (12, 6, 3 and 1 month bills) or should the range be more focused?

- Is there any difficulty for the market in the agency meeting very short-term cash needs with bills issued of a few days maturity?

- What is the minimum stock of Treasury bills required to maintain adequate market liquidity?

- What should be the minimum tender size of any one bill issue?

- Are there any perceived difficulties with issuing more than one maturity of bill at the same time? (The Bank has issued one- and three-month Treasury bills simultaneously before with no logistical problems for bidders.)

- Should a weekly pattern of Treasury bill tenders be maintained for the core elements of the bill programme. If so, what is the optimal day and time of the week to conduct bill tenders? (NB. Given the need of the agency for certainty over the timing of receipts, the current practice of successful tenderers choosing the date of settlement in the following week would cease. Bill tenders would be for next day settlement).

21. **How will the agency select its counterparties?** The agency will need to sign counterparty legal agreements with a number of sterling money market participants prior to the commencement of operations. These will be selected along standard commercial criteria such as likely provision of liquidity in adequate bargain size in the instruments that the agency will wish to deal. Creditworthiness will also be a consideration. Willingness to participate in Treasury bill auctions is likely to be a requirement of counterparty status. Consideration will be given to the agency's use of brokers.

22. **Will the agency publish its list of counterparties?** The Bank currently does not publish its list of counterparties for money market operations. The agency intends to follow this example. The danger is that agency counterparty status might be perceived as an informal stamp of approval on the creditstanding of a particular institution by the Government, which could be misinterpreted. Conversely, if a counterparty ceased transacting with the agency and was removed from any published list, an unwarranted adverse signal about creditstanding might be perceived. Consequently, it is safer for both sides if agency counterparty status is not publicised.

23. Whilst there may be some overlap between the lists of agency and Bank of England counterparties, each institution will come to an independent choice over the list of its counterparties. Hence, being a counterparty of the Bank will not necessarily entail similar status with the agency (and *vice versa*). The Bank and agency will **not** be mutual counterparties in each other's daily rounds of dealing.

24. **Will the change in cash management arrangements improve the accuracy of the daily Exchequer forecast?** At present, the Treasury forecasts the daily movement in the Exchequer's cashflows and communicates this, and updates throughout the day, to the Bank. The initial forecast is published by the Bank as a component of the daily expected money

market shortage as the background to its operations during the day. Due to uncertainty over the precise scale and timing of receipts and expenditures on some days, the daily Exchequer forecast can move sharply on occasion, leading to uncertainty for the money markets concerning the size of the shortage. This can lead to volatility in overnight interest rates.

25. The agency will need to cope with fluctuations in the Exchequer cashflow forecast during the day in its transactions with the market. Its adoption of the cash management role will not of itself improve the accuracy of the forecast but reforms under Resource Accounting and Budgeting aim to provide greater accuracy in the forecasting of transactions.

26. **How will the agency deal during the day? Will there be a structured dealing round?** The agency will be faced with a difficult trade-off in its daily operations. On the one hand, it will be charged with being as open and transparent as feasible in meeting the government's borrowing and cashflow needs. On the other, it will be charged with meeting those needs at the keenest rates. In certain circumstances, these objectives may conflict if the market knows precisely how long or short the Exchequer is forecast to be on particularly heavy days.

27. A compromise between these two considerations would be for the agency not to publish that day's Exchequer forecast. However, it could hold a structured dealing round in mid-morning, publicised on its screen pages. This would comprise a competitive tender process open to the agency's counterparties for the quantity, instruments and maturity that the agency wished to deal in at that time. (This could also include a tender for Treasury bills of only a few days' maturity when appropriate.) This approach would permit the agency to conduct the majority of its daily business in an open manner, on a competitive basis, but leave it the flexibility to react to changes in the Exchequer forecast later in the day. Such a structured dealing round would differ from the Bank's current operational rounds in that the agency would be borrowing some days and lending on others, the tender would be competitive and the maturity of the operation could vary from day to day.

28. **How will the agency's transactions interact with the Bank's money market operations?** It is important for the credibility of the Bank of England's implementation of monetary policy decisions and the smooth running of the money market that the agency's operations do not compete with those of the Bank. Hence, the time of the agency's daily

dealing round will not coincide with those of the Bank and the agency will not transact in instruments of a maturity close to those of the Bank's operations. Conversely, if the Bank deems it necessary in due course to issue its own bills for money market management, the two bodies would expect to avoid holding tenders for bills of the same maturity on the same day. Both the Bank and the agency will accept each other's bills as collateral in their respective lending operations.

29. **What will happen to the Ways and Means balance?** At present, the Exchequer's short-term cashflow requirements are ultimately met by a Ways and Means advance to the Exchequer. This advance is an asset of the Bank's Issue Department and acts as an overnight overdraft to the Exchequer. Such a facility currently allows considerable flexibility in the timing of Exchequer cashflows. The Ways and Means advance stood at £14.3 billion at end-March 1997. In line with the move to manage the Exchequer's cashflow separately from the Bank's operations, the Bank and the Treasury will freeze the size of the Ways and Means advance at the time of transition in cash management arrangements. Methods will then be explored to repay the balance. This is in accord with the Maastricht Treaty (Article 104) and will constitute a preparation for Stage 3 EMU entry by the Government.

30. **How will the agency's end-of-day facilities with settlement banks be structured?** The freezing and eventual repayment of the Ways and Means balance implies that the agency will need to maintain a net deposit in Banking Department of the Bank of England. This is to ensure against the need to resort to overnight borrowing from the Bank which would constitute a breach of the Maastricht Treaty (Article 104) if the UK had entered Stage 3. The deposit will be of sufficient size to cater for the possibility that the agency fails to cover a forecast borrowing need on the day; that the forecast alters significantly late in the settlement day (not giving the agency enough time to borrow the funds from the market); or that when the National Loans Fund accounts at the Bank are 'swept' overnight to produce the final net position at the close of the day, the Exchequer is not found to have been overdrawn at the Bank unintentionally. The more insurance that the Exchequer requires against these contingencies, the greater the deposit with the Bank needs to be.

31. There are two drawbacks to this approach. First, building up a large deposit in Banking Department increases the government's gross debt. It is also impossible to put a ceiling on the size of the required working balance with Banking Department. If this were to be the only protection against resorting to central bank financing, it would need to be set greater

than the maximum possible overshoot in the Exchequer's cash daily requirement relative to forecast.

32. Secondly, large day-to-day movements in the Exchequer's net position with the Bank will translate into opposite movements in the position of the settlement banks with the Bank. This would mean large unforeseen deposits or overdrafts with the Bank and probably greater instability in overnight interest rates. From the Exchequer's point of view, there is more difficulty in being unexpectedly short of cash at the end of the day due to the absolute prohibition against borrowing overnight from the central bank. However, whilst there are no constraints on the Exchequer building up an unexpectedly large deposit with the Bank, this will cause most difficulties for the settlement banks in the form of unplanned overdrafts with the Bank of England. Hence, any arrangements for limiting the change in the Exchequer's position should not disrupt the overnight money market.

33. These considerations imply that the agency needs the ability to deal with the settlement banks on a collateralised basis as late as possible so as to offset any late, unexpected changes in the Exchequer's net cash position. In practice, the agency will be constrained by the need to settle these late operations before the closure of the CHAPs system for customer payments (probably at 4pm from April 1998).

34. In addition, the agency will need facilities whereby if, during the sweep of its accounts overnight, a discrepancy is found between the actual and forecast cash position, any unanticipated shortfall can be met via remunerated loan arrangements with the settlement banks. However, it is envisaged that if the Exchequer was unexpectedly long of cash at the close of the day, this would not be put back into the market through automatic facilities due to the difficulties surrounding uncollateralised credit exposures. Whilst this may leave some settlement banks with unanticipated overdrafts at the Bank, as now the Bank would not charge a penal rate on these as long as the Bank's forecast shortage had been taken out by the market in its official operations. Hence, the settlement banks would not be penalised for overdrafts that were the result of errors in the Exchequer forecast.

35. Each morning, the agency would then publish its final net position for the preceding day.

36. With regard to the end-of-day arrangements, the questions on which the Treasury would welcome the views of the market are:

- To what degree should the Exchequer position at the Bank be permitted to fall on any one day before automatic lending facilities from the settlement banks are brought into play? Should this occur even if the Exchequer is still in net credit with the Bank?

- If the last transactions that the agency can make on a collateralised basis are at around 4pm, will the money markets be able to cope if the Exchequer's accounts turn out to be unexpectedly long of cash, as long as the Bank does not charge a penal rate on settlement bank overdrafts?

- Are there any other ways in which the agency could transact in a collateralised way after the closing of the CHAPs system in order to eliminate any late positions?