



National Audit Office

THE UK DEBT MANAGEMENT OFFICE – BORROWING ON BEHALF OF GOVERNMENT

PREPARED BY THE NATIONAL AUDIT OFFICE
JANUARY 2007

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This briefing is intended to assist the Treasury Sub-Committee. It describes the Debt Management Office's (DMO's) debt management activities and reporting arrangements. This summary sets out our key points. Details of our work are at Appendix 1.

Part 1 - the DMO's role within the Government's long term debt management strategy

- the Treasury has overall responsibility for central government debt management and the DMO, National Savings and Investments and the Bank of England have specific roles as agreed with the Treasury;
- the DMO's activities are guided by the Government's debt management strategy, which is based on the principles of predictability and transparency as the most effective, long term way of minimising government borrowing costs. This strategy reflects the conclusions of the 1995 joint HM Treasury and Bank of England review of debt management;¹
- there is no recognised way of quantifying whether this provides the best approach. But the majority of respondents to our surveys of overseas debt managers, UK market participants and investors viewed this strategy as valid and it is also in accordance with the International Monetary Fund/World Bank "Guidelines for Public Debt Management" (amended December 2003).²
- the DMO's borrowing activities are consistent with the Government's expressed preferences of maintaining:
 - a broadly even split between short, medium and long term borrowing; and
 - approximately 75 per cent of the outstanding debt portfolio in nominal debt (conventional gilts) and 25 per cent in real debt (index-linked gilts and Treasury bills).

Part 2 - the DMO's contribution to the achievement of the primary debt management objective

- the Government's primary debt management policy objective is:

"to minimise, over the long term, the costs of meeting the Government's financing needs, taking into account risk, whilst ensuring that debt management policy is consistent with the aims of monetary policy".
- the primary debt management objective is similar to those used by most overseas debt managers and is consistent with International Monetary Fund/World Bank guidance. However, measuring performance against the primary objective is not straightforward;
- the Treasury states that the primary debt management objective is achieved by:
 - pursuing a policy for the issuance of gilts that is open, transparent and predictable;
 - managing the maturity and nature of the Government's borrowing;
 - selling gilts that achieve a benchmark premium; and
 - developing a liquid and efficient gilt market.
- the DMO's activities are consistent with the Treasury's criteria for achieving the primary debt management objective.

1 *Report of the Debt Management Review*, HM Treasury and the Bank of England, July 1995.

2 *Guidelines for Public Debt Management – Amended*, Prepared by the Staffs of the International Monetary Fund and the World Bank. Amended on 9 December 2003. <http://www.imf.org/external/np/mfd/pdebt/2003/eng/am/index.htm>

Part 3 - the DMO's performance reporting

- the DMO (and the Treasury) publishes a lot of information about debt management activities including DMO specific objectives and targets. However, the structure of the existing published performance information does not provide a clear insight into the DMO's contribution towards achieving the primary debt management objective;
- the DMO is developing a 'Strategic Debt Analysis (SDA) Model' which has the potential to provide further improvements in accountability in the future;
- the DMO is enhancing its performance reporting and (with the Treasury) aims to take forward the following issues raised by the NAO during the preparation of this briefing:
 - the DMO's reporting of its contribution to achieving the primary debt management objective should encompass key initiatives and developments supporting achievement of that objective - for example, the introduction of e-bidding (see paragraph 3.8);
 - the DMO should seek to minimise, within legislative constraints, the number of different documents that need to be examined when considering its performance (see paragraph 3.8);
 - the DMO should publish in its Annual Review a comprehensive list of the sources in which information on its performance is presented and where these can be accessed (see paragraph 3.8);
- to facilitate improvements in the DMO's presentation of information on its performance, the Treasury should publish a statement setting out what it requires from the DMO in the conduct of its debt management operations, both in terms of delivery of the remit and in terms of the DMO's contribution to the achievement of the debt management objective (see paragraph 3.7); and
- the DMO (in consultation with the Treasury) should revisit the factors identified as contributing to achievement of the primary debt management objective, for example, to assess whether there are other ways to measure the benchmark premium given the difficulty of measurement using the current methodology (see paragraphs 2.7, 2.14 and 2.15).

THE DMO'S ROLE WITHIN THE GOVERNMENT'S LONG TERM DEBT MANAGEMENT STRATEGY

Borrowing by the DMO

1.1 The Debt Management Office (DMO) was established on 1 April 1998 as an Executive Agency of the Treasury. Since then, one of its main roles has been to borrow money to finance government expenditure.³ This is done through the sale of gilts and Treasury bills, which are explained in **Figure 1**.

1.2 At the end of September 2006, the nominal value of outstanding gilts was £433.2 billion. This comprised £322.9 billion conventional gilts and £110.3 billion index-linked gilts. As published in the 2006 Pre Budget

Report, the DMO plans 'gross gilt sales' of £62.5 billion in 2006-07. This is the total amount that is expected to be raised through the sale of gilts. £29.9 billion of gross gilt sales will meet the cost of re-financing maturing gilts.⁴ This leaves 'net gilt sales' (the actual increase or decrease in total borrowing via gilt issuance during the financial year) of £32.6 billion. **Figure 2** shows the Government's gross and net gilt sales since 1998-99.

1.3 In 2006-07 the Government expects to pay interest of £27.4 billion on its borrowings. This represents 4.9 per cent of Total Managed Expenditure (the Government's main measure of public expenditure).

1 Key characteristics of gilts and Treasury bills

Gilts - a long term liability (between 1 and 50 years) of the UK Government. Gilts are identified by their 'coupon' (the total annual interest paid to the gilt holder) and maturity date – for example, 4 per cent Treasury Gilt 2016.

The Government issues two main types of gilt:

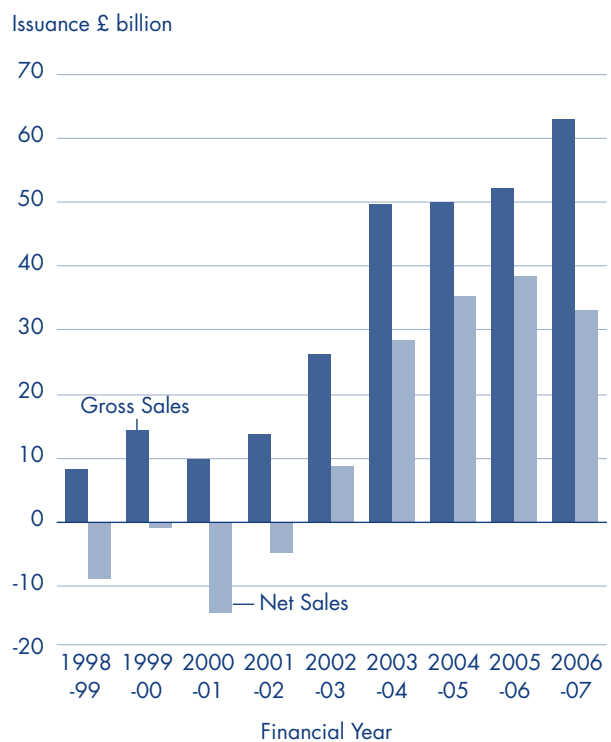
Conventional gilts – the Government's payments are fixed at the time the gilt is first sold. Gilts have a face or 'nominal' value expressed in price terms in units of £100. For example, a holding of £100 (nominal) of four per cent Treasury Gilt 2016 pays £4 a year until 2016 when the nominal value (i.e., £100) is repaid.

Index-linked gilts – the Government's payments are linked to the Retail Prices Index – i.e. coupon payments and repayment at maturity of the principal amount borrowed vary with changes in the Retail Prices Index.

The term 'gilt' refers to their relative security as an investment i.e., they are 'gilt edged'. The UK government has never failed to make interest or principal payments on gilts as they fall due. In the private sector the equivalent form of borrowing is called a 'bond'.

Treasury bills – short term liabilities (up to twelve months) of the Government that to date have been issued with maturities of one, three and six months. Treasury bills are issued at a discount. For example, an investor may pay £98.50 for a Treasury bill that will repay £100 when it matures after six months. Treasury bills are a type of 'variable debt' i.e., the cost to the Government of raising funds through issuance of Treasury bills varies depending on the discount level demanded by investors.

2 Gross and Net Gilt Sales



Source: UK Debt Management Office

³ The DMO has a range of responsibilities in addition to government borrowing. These are: government cash management, stewardship of the Commissioners for the Reduction of the National Debt and the Public Works Loans Board functions, operating the Debt Management Account Deposit Facility, managing the Government's liabilities associated with the Guaranteed Equity Bond issued by National Savings & Investments and managing the gilt purchase and sale service. These are outside the scope of this briefing.

⁴ Governments frequently 'roll-over' their borrowing – i.e. undertake new borrowing to meet the cost of maturing debt.

Institutional arrangements

1.4 The DMO operates as part of the overall institutional arrangements for government debt management in the UK (**Figure 3**). These arrangements stem from 1997 when the Chancellor of the Exchequer transferred operational responsibility for setting official interest rates from the Treasury to the Monetary Policy Committee of the Bank of England. At the same time the Government announced that the Bank's debt management responsibilities were being transferred to the Treasury. Subsequently the DMO was established as an executive agency of the Treasury with responsibility to undertake the government's debt and cash management operations. The key reasons for this institutional separation between debt management and monetary policy were:

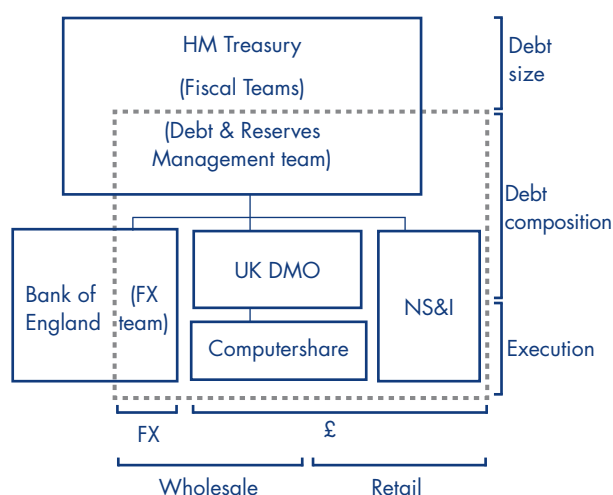
- separation of responsibilities – a separate debt manager helps to ensure that debt management decisions are not influenced by 'inside information' not available to the market about future interest rate decisions; and
- conflicting priorities – these could arise if a single body was responsible for monetary policy and debt management. The intention of institutional separation was to ensure that the implementation of debt management policy would be uninfluenced by short-term considerations over monetary policy, which required the debt manager to be distanced from the body responsible for monetary policy.

1.5 The Treasury has overall responsibility for central government debt management. It:

- determines the overall amount of borrowing;
- approves the composition of the Government's borrowing;
- appoints debt management agents to advise on and implement borrowing programmes and sets the framework and parameters within which each agent operates; and
- monitors the performance of its debt management agents.

3 Institutional framework for debt management in the UK

The area inside the dotted line identifies the 'debt management authorities'



Source: UK Debt Management Office

1.6 The Treasury uses three debt management agents:

- DMO – in addition to selling gilts and Treasury bills, the DMO advises the Treasury on debt management issues and performs market management activities.⁵ Gilt registration and administration functions are outsourced to Computershare, a commercial service provider;
- National Savings and Investments (NS&I) - develops and markets a portfolio of investment products to the domestic retail market. NS&I's forecast net contribution to government financing as published in the 2006 Pre Budget Report showed that it expects to contribute some £5.2 billion during 2006-07; and
- Bank of England – advises on and arranges the sale of government bonds denominated in foreign currencies to finance the UK's foreign exchange (FX) reserves. The most recent bond sold was a \$3 billion five-year US\$ denominated bond issued in June 2003. No sales are planned for financial year 2006-07.

⁵ Sales of new gilts by the DMO represent 'primary' market activity. Subsequent onward sales represent 'secondary' market activity. The DMO's market management activities seek to promote active and healthy primary and secondary markets in UK government debt.

1.7 In 2002, as part of the International Monetary Fund's Financial Sector Assessment Programme, a mission team visited the UK and concluded that central government debt management practices were fully consistent with IMF/World Bank guidelines.⁶ This independent review was followed in 2003-04 by a Treasury led strategic 'Landscape' review of the DMO and its role. This concluded that the overall institutional framework was sound and in keeping with international best practice.

The Government's long term debt management strategy

1.8 The Government's long term approach to debt management stems from the 1995 Report of the Debt Management Review⁷ which examined arrangements around policy setting and debt sales and management of outstanding debt. It concluded that the guiding principles of Government borrowing would be "predictability and transparency" on the grounds that:

- predictability and transparency reduce uncertainty about the debt manager's future actions. Uncertainty, for example, about the timing and amount of borrowing, creates upward pressure on the Government's borrowing costs. Known as 'risk premium', this higher cost reflects investors' natural reaction to uncertainty that causes them to demand a higher return for holding government debt; and
- unpredictability and opportunism (for example, selling gilts without prior notice based on the debt manager's predictions about future movements in interest rates) is unlikely to generate benefits for the Exchequer over the long term. This is because of the existence of risk premia and the likelihood of 'good' and 'bad' borrowing decisions neutralising each other over time.

1.9 There is no recognised way of quantifying whether a strategy based on predictability and transparency or unpredictability and opportunism is the most cost effective

approach to debt management. However, the arguments set out above were reflected in most of the responses we received to our surveys of international debt managers, primary dealers and investors.

The annual financing remit

1.10 The Treasury's Debt and Reserves Management Report⁸ includes the DMO's annual 'financing remit'. The remit is set by Treasury Ministers and specifies the key parameters for borrowing in the year ahead. The DMO is ultimately accountable to the Chancellor of the Exchequer for meeting the terms of the remit.

1.11 Prior to setting the remit, a Treasury Minister (usually the Economic Secretary to the Treasury) chairs annual meetings with major gilt market participants to solicit their views on the gilt issuance plans that should be included in the forthcoming year's remit. These views are taken into account in the formulation of the remit. The DMO publishes summary minutes of the meetings on its website.⁹

1.12 Treasury officials work closely with the DMO on the formulation of the remit and the key stages of the process are as follows:

- the DMO formulates advice on the remit and submits this to the Debt and Reserves Management team in the Treasury ahead of the Budget. The advice sets out the DMO's analysis and recommendations for the forthcoming financial year's remit based on consideration of all factors DMO judges relevant. The advice will include recommendations on the gilt issuance split between different types and maturities of gilt;
- Treasury officials consider the DMO's advice and discuss with the DMO as necessary before making recommendations to Ministers. These include recommendations for the overall quantum of gilt issuance and the split between different maturities and types of gilt for the forthcoming year; and

⁶ Financial Sector Assessment Programme – Technical Note: Public Debt Management in the United Kingdom, May 2003: IMF/World Bank: <http://www.imf.org/external/np/fsap/fsap.asp>

⁷ In 1995, the Treasury and the Bank of England published the Report of the Debt Management Review. This is available at <http://archive.treasury.gov.uk/pub/html/debt95/review.txt>

⁸ The Debt and Reserves Management Report is published annually by the Treasury. Reports are available on the Treasury's website: http://www.hm-treasury.gov.uk/budget/budget_06/other_documents/bud_bud06_oddmo.cfm

⁹ Minutes of the Annual Meetings chaired by the Economic Secretary to the Treasury in 2006 are available on the DMO's website at: <http://www.dmo.gov.uk/documentview.aspx?docName=/gilts/press/sa010206.pdf>

- following Ministerial approval, the remit is published in the Debt and Reserves Management Report alongside the Budget.

1.13 The remit provides clarity to the gilt market about the timing and nature of gilt auctions during the year. The Government's preferences in respect of the split between 'nominal' and 'real' debt, and the 'maturity profile' of its borrowing are key factors that underpin the actions set out in the remit:

- nominal debt: the 'real' value of payments varies inversely with inflation. Conventional gilts are a form of nominal debt because interest and maturity payments are fixed at the time the gilt is first sold. Consequently, the real value of these payments declines during periods of higher than expected inflation and vice versa;
- real debt: the 'real' value of payments remains constant with changes in inflation. Index-linked gilts are a form of real debt because interest payments ('coupons') and final redemption payments vary in line with changes in the Retail Prices Index (RPI) so that their real value is maintained; and
- the maturity profile of government borrowing: with some small exceptions, all gilts have a maturity date, i.e., the date that the Government repays the principal amount borrowed to the investor. Gilts are issued across a range of maturities and the DMO uses three classifications: short dated (one to seven years), medium dated (seven to 15 years) and long dated (over 15 years). Treasury bills are all short dated with maturities of one, three or six months. The make-up of maturities within the Government's borrowing is called the 'maturity profile'.

1.14 The provision of information to investors about the Government's preferences in respect of nominal debt, real debt and maturity profile helps provide the market with longer term confidence about the nature of future Government borrowing. This is consistent with the underlying principles of predictability and transparency and the expected benefits these bring.

1.15 The clearest statement of the Government's borrowing preferences for the composition of its debt portfolio is provided in the DMO's 2003-04 Annual Review.¹⁰ This stated that current policy was 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 practice we assume a preference for maintaining roughly a quarter of the overall debt portfolio in the form of real exposure" (i.e. index-linked gilts and Treasury bills).

1.16 The DMO's Annual Review 2003-04 also explained the starting point for considering gilt sales each year as:

"....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 in considering the planned composition of gilt sales each year the 'default' starting point would be to split fairly evenly between the short, medium and long maturity bands to give a broadly even maturity profile each financial year with consideration given to whether there should be departures from this 'default' issuance strategy in practice (e.g. a greater skew towards long-dated gilt issuance).

1.17 For example, the DMO researches the market to identify significant medium or long term demand factors ('preferred habitats') which may offer potential cost savings to the Government. The 2003-04 Annual Review states:

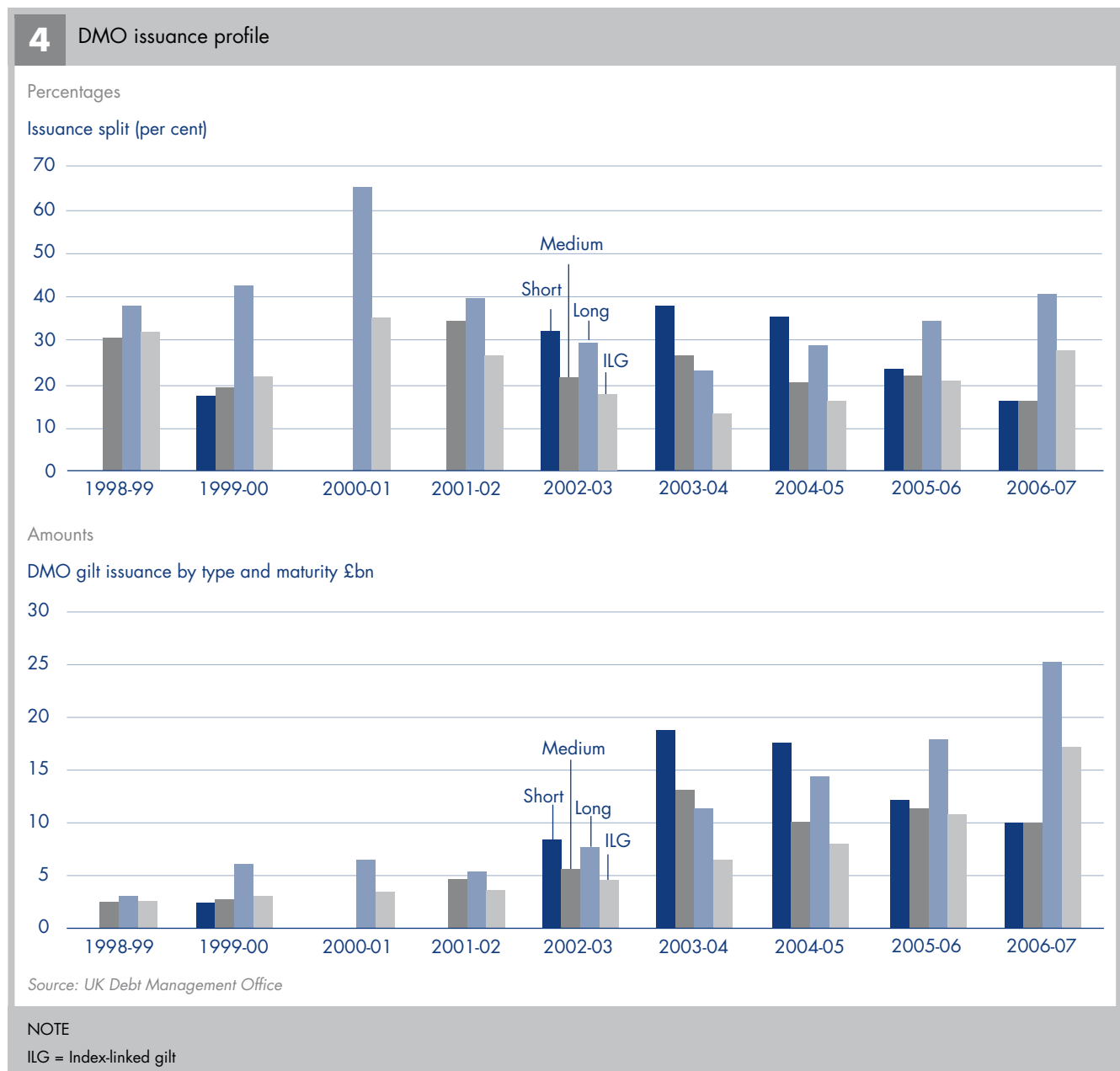
"A preferred habitat is said to exist where a distinct group of investors strongly prefers to hold bonds within a specific maturity range, or a specific instrument type, to hedge its liabilities or to comply with regulatory requirements....."

¹⁰ Available on the DMO's website: <http://www.dmo.gov.uk>

1.18 In recent years, the preferred habitat phenomenon has resulted in a shift towards issuance of long maturity gilts. This reflects strong demand for these instruments from investors. For example, in 2005-06 the DMO introduced ‘ultra-long’ gilts (both nominal and real) with initial maturities of approximately 50 years. In the final quarter of the financial year, demand for long dated gilts (partly due to demand from pension funds seeking to match assets with liabilities) helped to reduce yields (borrowing costs) on long-dated conventional gilts to their

lowest levels in around 50 years (below 3.5 per cent) and the real yield on the 50-year index-linked gilt fell to an intra-day low of 0.38 per cent (18 January 2006).

1.19 The Government’s preferences in respect of the split between nominal and real debt and the maturity profile as expressed in the DMO’s Annual Review for 2003-04 are reflected in **Figure 4**. This illustrates the move in recent years towards greater issuance of long maturity gilts and rising volumes of index-linked gilt sales.



THE DMO'S CONTRIBUTION TO THE ACHIEVEMENT OF THE PRIMARY DEBT MANAGEMENT OBJECTIVE

The primary debt management objective

2.1 The UK's primary debt management objective is:

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

This objective is consistent with International Monetary Fund/World Bank guidelines for debt management¹¹ and is similar to those adopted by many other countries.

2.2 Overall responsibility for achieving the debt management objective lies with the Treasury as 'principal' but, in order to meet the Government's borrowing needs, the Treasury operates through its 'agents', the DMO, National Savings & Investments (NS&I) and, for foreign currency denominated debt issuance, the Bank of England. In pursuit of its overall responsibility the Treasury formulates the Government's financing programme, in particular: (i) the planned proportions of financing to be obtained from gilt and Treasury bill issuance by the DMO; (ii) the contribution to financing to be achieved through retail savings products issued by NS&I; and (iii) any foreign currency debt issuance by the Bank of England to finance the official foreign exchange reserves.

2.3 As shown in Part 1, the major part of the Government's annual financing needs is met through gilt and Treasury bill issuance by the DMO. The DMO's financing remit sets out the quantum of financing that the DMO is required by Treasury to achieve through the sale of gilts and Treasury bills, together with the planned split between index-linked and conventional gilts.

Operational responsibility for delivery of the financing remit

2.4 The DMO is an executive agency of the Treasury and is, therefore, legally and constitutionally part of the Treasury. However, it operates at arms length from Ministers, which is an arrangement designed to allow the DMO to concentrate on delivery of the remit within broad guidelines set by Ministers (and published in the Debt and Reserves Management Report) but without day-to-day interference in the Chief Executive's responsibilities for operational decisions and the running of the Office.

2.5 The DMO has operational responsibility for delivery of the financing remit. The key ways in which the DMO achieves operational delivery of the remit are through: (i) execution of market operations (primarily gilt and Treasury bill sales); (ii) monitoring progress against delivery of the remit and reporting to the Treasury on progress; and (iii) monitoring market developments and advising the Treasury in a timely manner of any changes that could necessitate a revision to the remit, providing analysis and evidence as necessary to support its assessment.

Treasury monitoring of the DMO's performance

2.6 Once the remit is set, the Treasury's two key ongoing responsibilities are to ensure that:

- the DMO meets the Government's net financing requirement through successful delivery of the remit. Most fundamentally, the Treasury monitors DMO's gilt and Treasury bill sales programmes to ensure that the DMO raises the quantum of financing specified in the remit. In particular, the Treasury scrutinises the result of each gilt auction and analyses monthly and quarterly (unpublished) reports from the DMO that report progress against the remit; and
- in delivering the remit, the DMO contributes to achievement of the debt management objective. The means by which this is achieved are considered further below.

¹¹ “The main objective of public debt management is to ensure that the government's financing needs and its payment obligations are met at the lowest possible cost over the medium to long run, consistent with a prudent degree of risk” - International Monetary Fund/World Bank Guidelines for Public Debt Management: 9 December 2003.

The DMO's contribution to the primary debt management objective

2.7 At present there is no single indicator that can demonstrate the DMO's contribution to the primary debt management objective. However, the Debt and Reserves Management Report 2006-07 states that the primary objective is achieved by:

- pursuing an issuance policy that is open, transparent and predictable;
- managing the maturity and nature of the Government's borrowing;
- selling gilts that achieve a benchmark premium; and
- developing a liquid and efficient gilt market.

Pursuing an open, transparent and predictable issuance strategy

Clarity around debt issuance plans

2.8 The financing remit circumscribes the DMO's behaviour to ensure that, in delivering the remit, the DMO will conduct its operations in a predictable and transparent way. In particular, the remit includes: (i) publication of an auction calendar up to one-year in advance; (ii) a commitment to hold quarterly consultation meetings with major gilt market participants to solicit views on the forthcoming quarter's gilt issuance; (iii) advance quarterly publication of the gilt auction calendar; and (iv) advance publication of the size of each auction. The Treasury monitors the DMO's performance against these aspects of the remit.

Regular contact with market participants

2.9 The DMO undertakes borrowing using a 'primary dealer' system. In practice this means that investment firms registered with the DMO (Gilt Edged Market Makers – GEMMs¹²) provide a ready market for the DMO's sales of gilts. The DMO hosts quarterly meetings with the GEMMs to seek their views on market issues and future gilt sales.

2.10 While the GEMMs buy gilts for themselves, they also purchase on behalf of clients and transact in the secondary market. The DMO also holds quarterly meetings with representatives of 'end-investors' i.e. the wider gilt market (on the same day as the meeting with the GEMMs). The DMO publishes the minutes of its quarterly meetings with GEMMs and end-investors on its website on the morning after the meetings.

2.11 As part of our review we surveyed GEMMs and end-investors for their views on a range of aspects of the DMO's debt management activities. Our survey raised issues to which the DMO responded as shown in **Figure 5**.

Managing the maturity and nature of the Government's borrowing

2.12 In consultation with the Treasury, the DMO can use market management techniques¹³ to influence the maturity profile and composition of Government debt. The aim is to concentrate borrowing into benchmark gilts. These are gilts with large amounts in issue that pay interest in line with prevailing rates for the relevant maturity. They are the 'benchmark' that the financial markets use to help price other instruments of similar maturity. **Figure 6** illustrates how the DMO has used gilt sales and market management steadily to increase benchmark gilts as a proportion of the Government's borrowing.

2.13 Benchmark gilts are generally more liquid than other gilts i.e. because of the large amounts in issue they are relatively easy to buy and sell. This makes benchmark gilts more attractive to investors and helps to minimise borrowing costs.

¹² There are 17 investment firms recognised as GEMMs covering both conventional and index-linked gilts.

¹³ Various techniques are available to the DMO including: buy-backs, reverse auctions, conversions and switch auctions.

5 GEMMs/end-investors: feedback from NAO survey

Issue arising

1. Wider consultation base – the DMO should build the level of contact with the underlying investor base, such as pension funds themselves rather than just their fund managers. This may give a more complete view of the underlying market demand for gilts.

2. Availability for bi-lateral meetings – the DMO should ensure that market participants are aware that it is available for bi-lateral meetings where they can give feedback.

3. Explanations of decisions – the DMO should assess the scope to explain to market participants more fully and promptly the factors underlying decisions it makes with the Treasury, and consider the most appropriate mechanisms to provide such information.

4. Consultation meetings – the DMO should review the format and attendees mix of the quarterly consultation meetings with investors so that investors are willing and able to contribute.

DMO response

As part of the DMO’s consultation on issuance of ultra-long gilts, the DMO engaged directly not only with fund managers, but also trustees, investment consultants and academics, to form a more complete view on medium-term demand for gilts. Going forward, the DMO intends to maintain such contacts with a diversified set of stakeholders, including overseas investors, whose share in gilt holdings has been rising steadily.

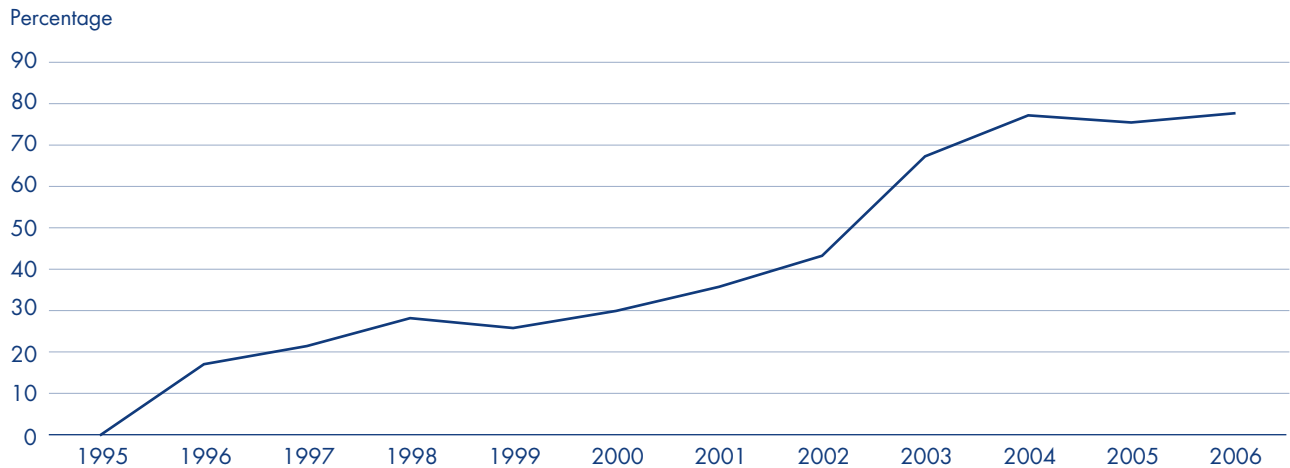
The DMO has an open-door policy and all requests for bi-lateral meetings by stakeholders have been accommodated. The DMO has been actively encouraging stakeholders to visit and in some cases has initiated contact itself. Resources allowing, the DMO intends to maintain and expand its open-door policy, while paying particular attention to ensuring that no stakeholder benefits from privileged information in the context of bi-lateral contacts with the DMO.

From 2006-07, the publication of the quarterly gilt issuance calendar has been accompanied by a statement by the DMO’s Chief Executive explaining the main factors behind the decisions. The agendas for the DMO’s quarterly consultation meetings with major gilt market participants now also include some explanation of the choices faced by the DMO in the quarter ahead. Going forward, the DMO will consider whether other means are warranted to explain more transparently the rationale behind its decisions.

The DMO now issues an open invitation to the meetings to up to 20 investors, on a first-come-first-served basis in order to encourage broader participation by investors. As a result attendance at the consultation meetings is now more diversified. The DMO has also encouraged investors who cannot participate at the consultation meetings (e.g. those located outside London or overseas) to contribute views by telephone or email. The DMO has also reiterated that meetings are held under the ‘Chatham House’ Rule so as to encourage more active participation.

Source: National Audit Office survey of GEMMS/end-investors

6 Benchmark gilts as a percentage of total gilts in issue



Source: UK Debt Management Office

Selling gilts that achieve a benchmark premium

2.14 An estimate of the impact that creating individual benchmark gilts can have on borrowing costs can be made by measuring ‘benchmark premium’. This occurs where the greater secondary market liquidity of the benchmark gilt (i.e., how easily it can be bought and sold) results in lower borrowing costs when compared with existing non-benchmark gilts of a similar maturity.

2.15 Since 2000-01 the DMO has published information on the different premia achieved by individual benchmark gilts. Outcomes vary and, while it is still possible to demonstrate the continued existence of a benchmark premium, it is becoming increasingly difficult to measure benchmark premia as the growing volume of benchmark gilts (as Figure 6 illustrates) means the number of suitable non-benchmark comparators has inevitably declined.

Developing a liquid and efficient gilt market

2.16 A liquid investment is one that can be bought and sold easily – i.e. it has a ready market. Many investors prefer to hold liquid investments as they know they can change their holdings relatively easily. Consequently, investors will generally pay more for a liquid than an illiquid investment. From the Government’s perspective as a borrower, a liquid and efficient gilt market helps to minimise borrowing costs.

2.17 The build up of benchmark gilts is a key element in the DMO’s approach to the development of a liquid and efficient gilt market. Also important are the operational practices adopted by the DMO. The preferred method used by the DMO (and many other sovereign debt managers) for the sale of gilts is by auction. There are detailed procedures in place in support of gilt auctions but essentially GEMMs bid for the gilts available.

2.18 Where uncertainty exists about the ability of an auction to ensure a successful sale, the DMO (in agreement with the Treasury) can adopt an alternative approach. In September 2005, the DMO used a syndicated offering¹⁴ to issue successfully a new 50-year index-linked gilt. It was judged that a syndicated offering would help avoid: (i) poor value for money being achieved at auction – this could have arisen if uncertainty about the appropriate price caused investors to place bids at very conservative levels; and (ii) reputational damage from an unsuccessful auction, with possible negative consequences for future sales of the new index-linked gilt.

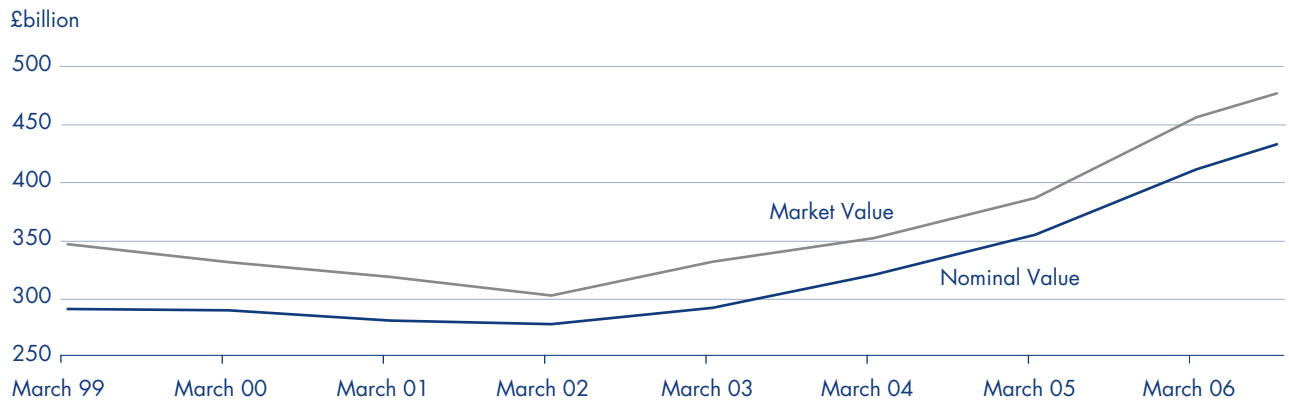
2.19 Figure 7 shows the steady increase in the size of the gilt market since the DMO’s creation. This is driven by the size of gilt issuance, which is a function of the Government’s public finance forecasts; in particular, central Government’s annual net cash requirement.

2.20 The growth of the gilt market over the past four years has also contributed to a significant increase in gilt market turnover and, by implication, market liquidity. Figure 8 shows that average daily turnover has increased from £8.7 billion in 2002-03 to £13.6 billion in 2005-06 and to £14.7 billion in the first half of 2006-07. Figure 9 on page 14 shows that as the size and value of the gilt market has increased, so has the level of gilts owned by overseas investors, though at a faster rate, which has resulted in overseas holdings rising as a proportion of the outstanding gilt portfolio.

2.21 Our survey of investors indicated that the level of liquidity in the index-linked gilt market is lower than for conventional gilts. The DMO stated that this reflected the nature of UK investors who tended to be ‘buy and hold’ investors, particularly in index-linked gilts (long term investors that hold gilts until they mature). However, the DMO considers that this issue merits further research to identify whether scope exists to increase liquidity in index-linked gilts – for example, by targeting maturity gaps and selling new gilts to fill them.

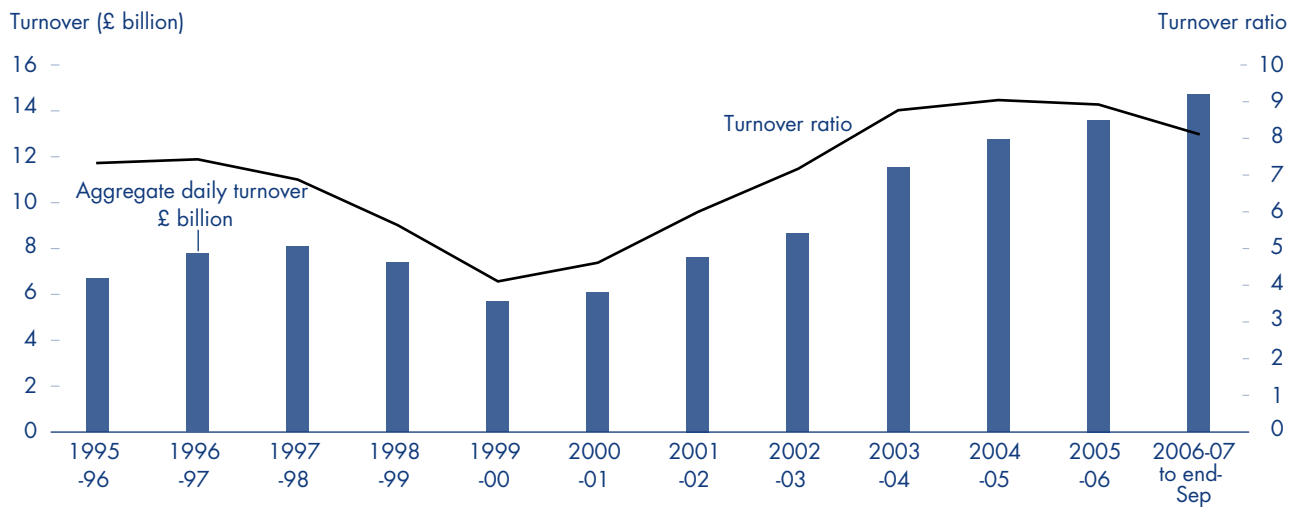
¹⁴ The syndicated offering involved the appointment of four book-runners (drawn from the Gilt-Edged Market Makers (GEMMs)) and was formed for the purpose of jointly managing the initial offering of the new gilt. The book-runners acted as lead managers of the syndicate and built a ‘book’ of orders for the gilt prior to the sale taking place.

7 Nominal and market values of the gilt portfolio



Source: UK Debt Management Office

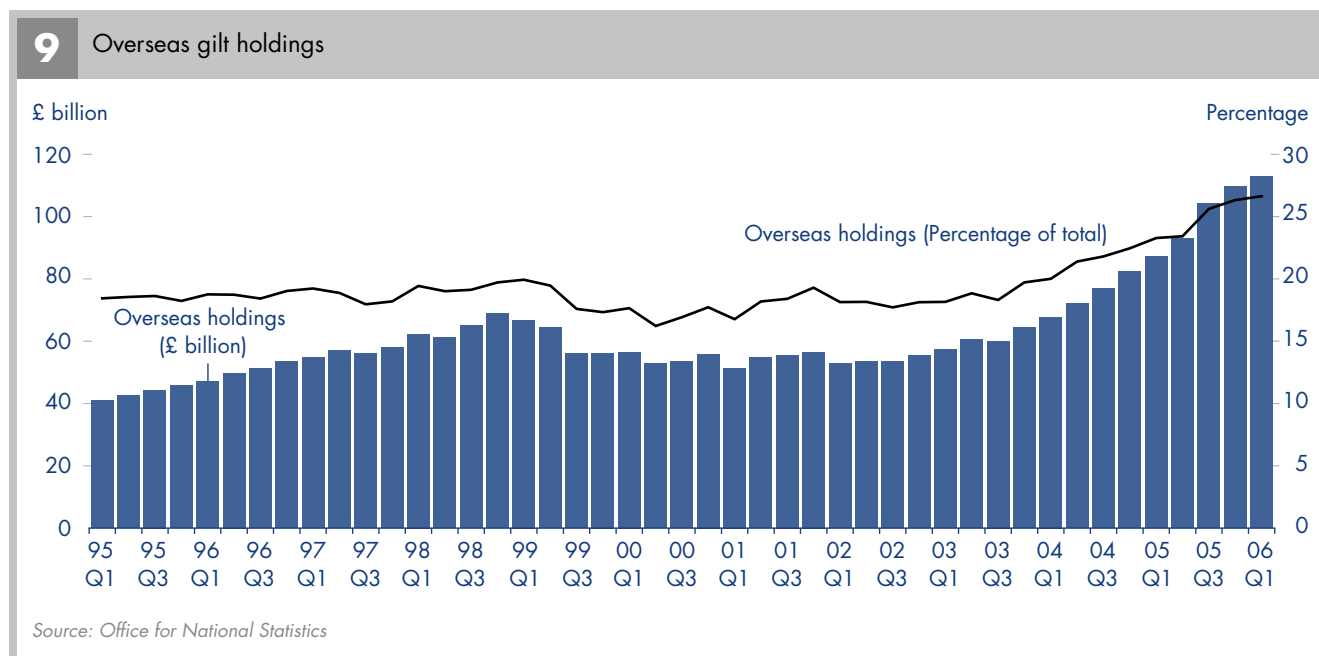
8 Daily turnover and turnover ratio¹



Source: UK Debt Management Office (using data received from Gilt Edged Market Makers)

NOTE

¹ Aggregate daily turnover = the average value of daily gilt transactions during the financial year. Turnover ratio (a measure of trading intensity) = aggregate daily turnover/value of total gilt portfolio



2.22 The DMO has a target set by the Treasury to publish the results of gilt and Treasury bill sales within 40 and 30 minutes respectively. The rapid release of results is significant because it reduces market uncertainty, i.e., investors know quickly how much stock they receive. The DMO achieves its targets comfortably. For example, in 2004-05 average publication times were 19 minutes for the results of gilt auctions and 10 minutes for the results of Treasury bill tenders.

2.23 Our survey of overseas debt managers indicated the publication times achieved by the DMO are longer than those in most respondent countries including: USA (two minutes), Ireland (two minutes), Germany (two to three minutes) and France (less than five minutes). These faster times are possible because these countries use ‘e-bidding’ (electronic bidding) systems, rather than a telephone based system as used by the DMO. The DMO intends to introduce an e-bidding system in the first quarter of 2007.

Consistency with the aims of monetary policy

2.24 The primary debt management objective contains a commitment to ensure that debt management policy is consistent with the aims of monetary policy. The key way in which the Government ensures debt management policy is consistent with monetary policy is through the separation of responsibility for the implementation of monetary policy (which resides with the Bank of England) from debt management operations (which are the responsibility of the DMO). This arrangement is designed to ensure that the DMO is not party to ‘inside information’ about monetary policy decisions and thereby ensures that DMO’s actions do not represent a signal to the market about the path of future interest rates. If the Bank has any concerns that the DMO’s operations are conflicting with monetary policy it must relay these concerns to the Treasury, which will then discuss them with the DMO.

THE DMO'S PERFORMANCE REPORTING

Published information

3.1 Figure 10 summarises the wide range of information published by the DMO (and the Treasury) about debt management activities.

Operational targets

3.2 The Treasury sets and monitors the DMO's performance against a range of detailed operational targets that are published by the DMO in its annual Business Plan and on its website. Performance against these targets is quantified, but this does not measure how the DMO contributes to the government's overall debt management objective. Performance against specific aspects of the DMO's behaviour (e.g. the speed with which auction results are released by the DMO) can be quantified far more easily than attempting to place a number on the DMO's contribution to the primary debt management objective.

3.3 In the private sector, fund managers often use targets to assess their performance relative to an operational benchmark. For example, an equity based investment fund might look to earn three per cent above the annual movement in the FTSE100 share index. However, we accept the DMO's view that it would not be appropriate to use such an operational benchmark as a way of measuring the performance of the debt management authorities for the following key reasons:

- operational benchmarks can encourage short term thinking and opportunistic behaviour to meet current targets, for example, by taking advantage of short term market conditions to make a quick gain. This would run counter to the principles of transparency and predictability and could increase borrowing costs in the longer term;

10 Published information about debt management activities

Information source	Areas covered
Agency Framework Document	Provides details of the status and aims of the DMO, together with reporting and accountability requirements.
DMO Annual Business Plan	Contains details of the DMO's aims, objectives, responsibilities and operational targets, a brief review of the previous year, and key planning themes for the three years ahead.
DMO Annual Review	Gives information about the DMO's activity and economic and market developments during the previous financial year. It includes some quantitative indicators about aspects of debt management.
Debt Management Account Report and Accounts and the DMO Annual Report and Accounts	Provide financial information about the DMO's operations and performance information organised by objective and operational target as expressed in the Business Plan.
Published guidance/information	The DMO's website contains a large amount of material on its debt management activities. In addition to the documents identified above, this includes: <ul style="list-style-type: none"> ■ gilt market information – press releases, auction results, GEMM details, Annual Remit progress, gilt indices, retail access to gilt market, common questions and answers, gilt prices, gilt prospectuses; ■ publications – quarterly reviews, market consultation documents and responses (for example, ultra-long gilt instruments); ■ technical and research papers (for example, GEMM Guidebook, Gilt Stripping and Reconstitution, 'Smoothing the way for Ultra-Long Bonds'); and ■ international guidance – for example, World Bank/IMF guidance on debt management.
Debt and Reserves Management Report	Published annually by the Treasury alongside the Budget, it includes the DMO's Financing Remit for the year ahead. It provides details of the size, structure and key developments in the gilt market and information on the Government's debt management policy.

Source: National Audit Office analysis

- operational benchmarks might encourage inappropriate risk taking. For example, a debt manager might minimise in-year costs by issuing very short term debt. However, this could expose the Government to a greater degree of refinancing ('roll-over') risk than it would want;
- a debt manager is likely to have limited control over performance against an operational benchmark as borrowing costs are influenced by economic and market conditions;
- a suitable operational benchmark cannot be readily identified. In the UK, gilts are the benchmark used by others to measure relative borrowing costs; and
- the primary debt management objective requires borrowing costs to be minimised over the long term. In the context of assessing performance against an operational benchmark, there is no agreed period of time that represents the 'long term'.

Average gilt yields

3.4 From the Government's perspective a gilt's 'yield' is a measure of cost. Essentially, higher gilt yields at issuance equate to higher borrowing costs for the Government. In its Annual Review, the DMO publishes a range of quantitative performance indicators including a comparison between the actual average yield of gilt issuance and a range of counterfactual yields (the average predicted yields that would have been achieved if a different issuance pattern had been followed). This is a similar approach to that used by Government debt managers in other countries.

3.5 Drawing on published information, it is apparent that there has been a general downward trend in average gilt issuance yields since the creation of the DMO i.e., the Government has generally borrowed more cheaply since 1998. This reflects the wider macroeconomic environment in which the DMO has been operating and is illustrated in **Figure 11**.

Current developments

3.6 In its 2005-06 Annual Review, the DMO reported progress on the development of a 'Strategic Debt Analysis' (SDA) model. Details about the model and the potential benefits to accountability that it may provide are set out in the panel below.

Strategic debt analysis model

The DMO is developing a 'Strategic Debt Analysis' (SDA) model that has the principle objective of quantifying the trade-off between the costs and risks associated with different borrowing strategies. The SDA model does this by evaluating the cost of different gilt issuance strategies in a simulation framework that replicates the "typical" or stylised behaviour of the UK economy over the business cycle. The aim of the model is to provide the Treasury with quantitative illustrations of the possible long-run or average costs per period of different debt issuance strategies and their associated risks. The model does this by capturing how the:

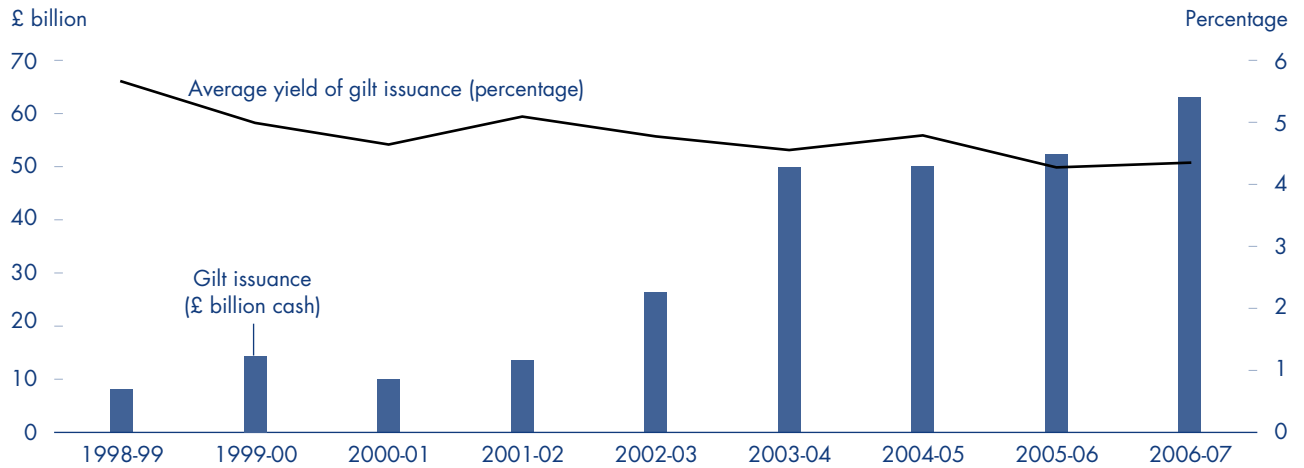
- size and composition of the debt portfolio;
- state of the real economy;
- term structure of interest rates;
- inflation; and
- the government's financing requirement

interact to determine the cost of servicing the government's debt in a given period of time. The illustrative outputs of the SDA model also have the potential to provide a point of reference for explaining the assumptions about the yield curves that underpin the Treasury's decisions on the composition of debt issuance and its approach to managing the debt portfolio.

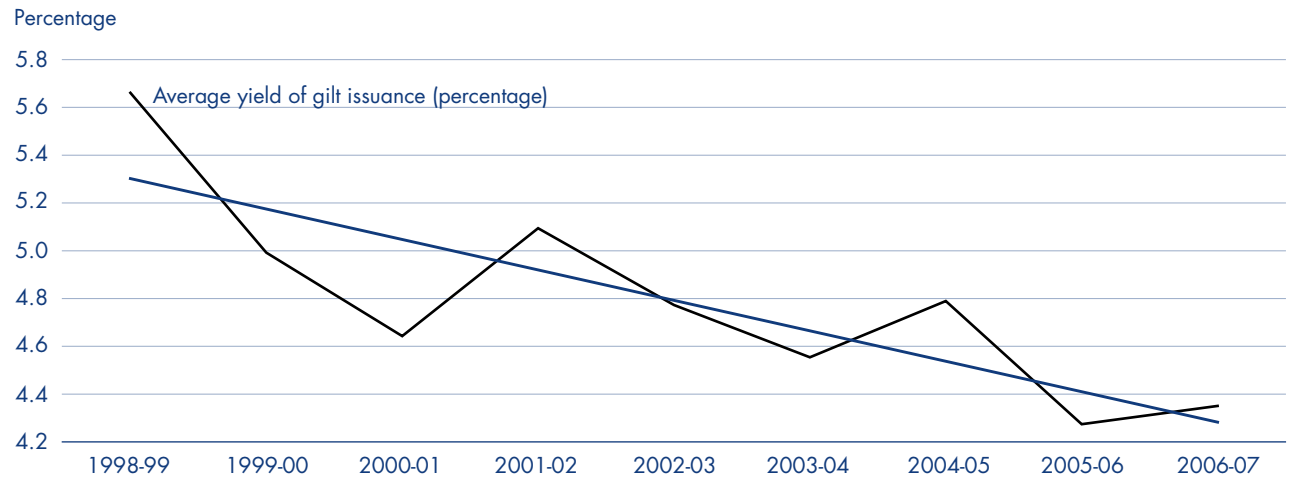
Although the model captures the key risks (i.e., the volatility of debt servicing costs) inherent in debt management it does not (and cannot) capture all the risks faced by the debt management authorities (e.g. the risk that the gilt market does not remain liquid or that the customer base for gilts is not sufficiently diversified). Outputs from the SDA model have the potential to enhance the accountability of the debt management authorities for decisions on debt issuance strategies by providing a quantitative way of explaining the consequences of some of the key assumptions that lie behind the issuance strategies the government pursues. Such a quantitative explanation would complement the qualitative analysis that underpins recommendations on the remit.

Source: UK Debt Management Office

11 Average gilt issuance yields and amount issued



Average gilt issuance yields trend-line



Source: UK Debt Management Office

Looking ahead

3.7 There is a large amount of information about debt management available, including details of performance against the DMO's objectives and targets as set out in its Business Plan. The range of publications in which DMO reports on its debt management activities is partly a function of statutory requirements. However, bearing in mind these statutory constraints, the DMO's performance information could be presented in a way that facilitates a better understanding of its performance in delivering the full range of its debt management functions. To this end, the Treasury should publish a statement setting out what it requires from the DMO in the conduct of its debt management operations, both in terms of delivery of the Remit and in terms of the DMO's contribution to the achievement of the primary debt management objective.

3.8 The Strategic Debt Analysis model may provide further improvements to accountability. However, the DMO has recognised that there is scope to make better use of and build on existing information to provide a more comprehensive view of its performance. In considering arrangements for reporting performance the DMO should explore fully the following options:

- the DMO's reporting of its contribution to achieving the primary debt management objective should encompass key initiatives and developments supporting achievement of that objective (for example, the implementation of e-bidding);
- rationalisation of current arrangements: the DMO's aims, objectives and targets are set out in different documents (Agency Framework Document, DMO Business Plan and the Financing Remit) while performance information is also published in a variety of documents (DMO Annual Review, Debt Management Account Report and Accounts, DMO Agency Accounts). The DMO should seek to minimise within legislative constraints, the number of different documents that need to be examined when considering its performance; and
- publication of a comprehensive list of the sources in which information on its performance is presented, together with information on where this information can be accessed.

OUR APPROACH TO THIS REVIEW

The main elements of our work were:

- a survey of overseas debt managers;
- a survey of all Gilt Edged Market Makers and Representatives of End Investors;
- meetings with DMO and Treasury staff;
- work-shadowing within the DMO; and
- attendance at key events.

Survey of overseas debt managers

We sent a questionnaire to a range of overseas debt managers. The countries were members of the OECD debt management working group and active in the development and enhancement of global debt management practice. The following countries responded to our questionnaire – Canada, Denmark, France, Germany, Republic of Ireland, Netherlands, New Zealand, Portugal, Sweden, USA.

The questionnaire sought information across a range of issues:

- institutional framework and responsibilities;
- debt management objectives and strategy setting; and
- debt management operations.

The questionnaire served two main purposes:

- to help develop our knowledge of the subject area and the different potential approaches to debt management; and
- to highlight significant differences of approach that merited inclusion in this briefing.

Survey of all Gilt Edged Market Makers and Representatives of End Investors

We sent a questionnaire to all 16 Gilt Edged Market Makers operating in the market at that time and 20 Representatives of End Investors. We received responses from 9 Gilt Edged Market Makers and 9 Representatives of End Investors.

The questionnaire sought views on the impact on borrowing costs of the long term debt management strategy and the effectiveness of contact with the DMO.

Meetings with DMO and Treasury staff

We held meetings with key staff at the DMO and the Treasury during the life of the project. The meetings provided much of the source material for the briefing and facilitated the development of issues and the preparation of an agreed final document.

Work-shadowing within the DMO

NAO staff spent time at the DMO to gain a first-hand insight into operational activities. This included observing management meetings on future issuance and attending a gilt auction and Treasury bill tender.

Attendance at key events

NAO staff attended key debt management related events during the life of the project:

- Treasury/DMO debt management workshop;
- consultation meetings with Gilt Edged Market Makers and Representatives of End Investors; and
- meeting of the OECD debt manager working party on public debt management.

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