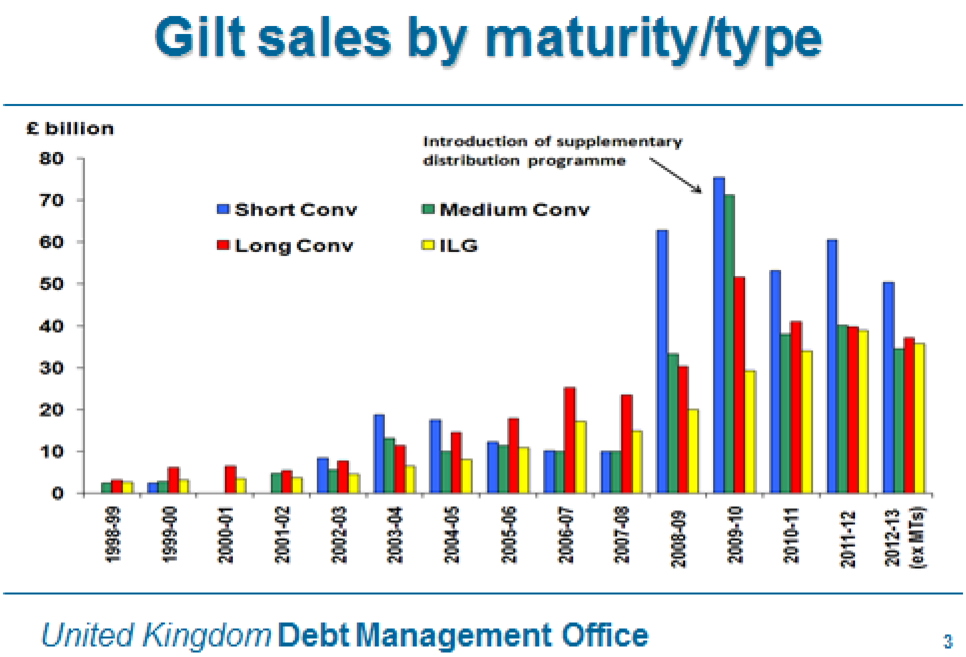
KEYNOTE SPEECH BY ROBERT STHEEMAN (CHIEF EXECUTIVE OF UK DEBT MANAGEMENT OFFICE (DMO)) TO THE EUROMONEY STERLING CONFERENCE ON 26 SEPTEMBER 2012

Ladies and gentlemen.

Firstly I would like to thank Euromoney for inviting me to deliver the keynote address at this year's Sterling Conference. I feel genuinely privileged to have been asked. But I realise that the reason lies in some of the extraordinary changes that the gilt market has witnessed in recent years. It is the DMO's role to try and understand some of the forces behind these changes, and to help devise the appropriate strategy for raising the necessary financing for central government.



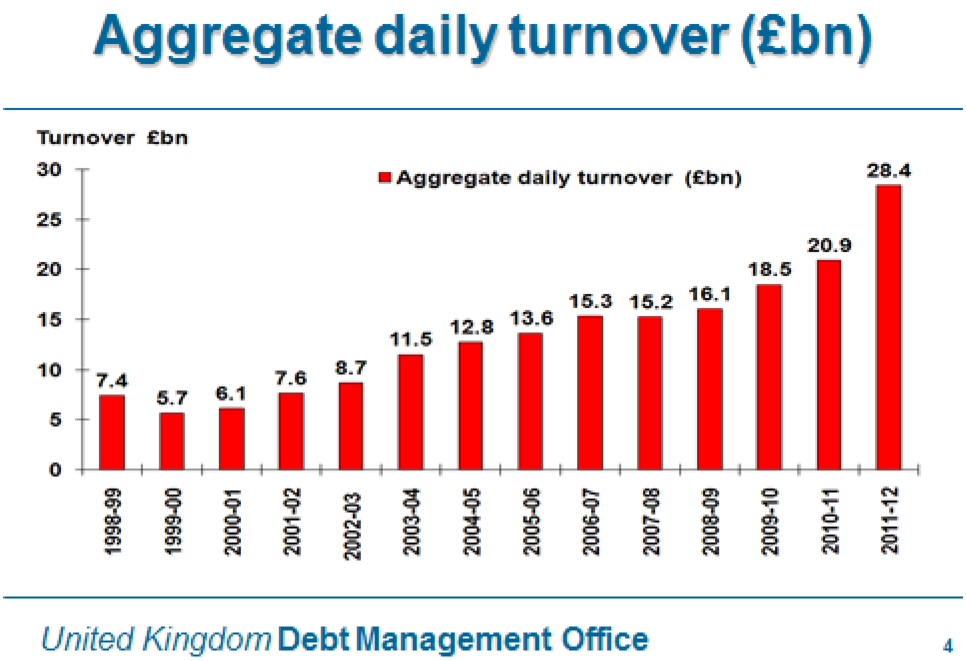
Let's put the scale of the DMO's task in context. In the Financial Year 2007-08 we raised £58.5 billion via gilt sales. A mere two years later the size of the gilt issuance programme nearly quadrupled to £227.6 billion. We have remained at elevated levels since then. This financial year we are tasked with raising £164.4 billion in gilts. The DMO has faced unprecedented challenges since the start of the financial crisis and, according to latest forecast financing projections, the scale of financing over the next few years remains considerable.

Taking into account the increased volume of issuance since the financial crisis, the Government has had to think strategically about how to achieve the issuance split it would like. One of the major changes undertaken post-crisis in the UK has been the introduction of supplementary financing methods to issue gilts, and primarily the use of syndicated offerings. These have enabled the Government to issue larger amounts of longer-dated conventional and index-linked gilts than it judged feasible by auctions alone.

The syndication programme has successfully raised around £110bn in long-dated and index-linked bonds since June 2009. Useful additional funding has been provided through mini-tenders and the Post Auction Option Facility, the PAOF. Fundamentally, the use of supplementary methods adds flexibility to the gilt issuance programme in order to facilitate effective delivery of the programme while remaining consistent with the debt management principles of openness, predictability and transparency.

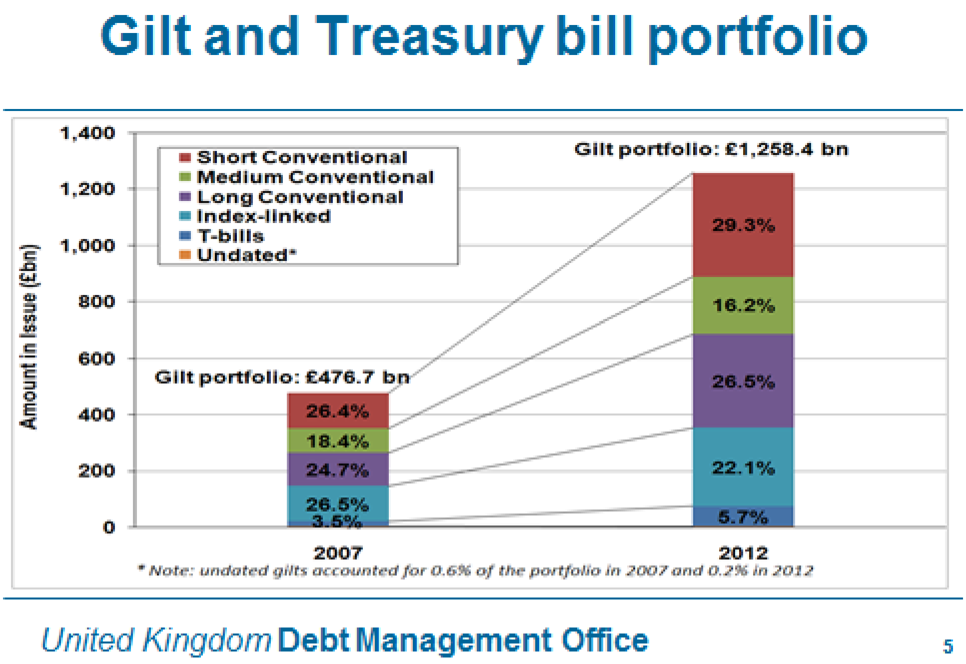
Against a backdrop of very challenging market conditions, and yields falling to historical lows, I have to say that I have been pleasantly surprised by the smoothness with which our financing programmes have been delivered so far – both the core auction programme and the supplementary issuance programme.

I should also say that the reliance on the GEMMs as the primary distribution channel for gilt issuance via auctions has also remained a cornerstone of our issuance strategy. The UK gilt market (like many other sovereign bond markets) operates with a primary dealer system. The government believes that the presence of competing market makers who undertake to make, on demand and in all market conditions, effective two way prices is key to its ability to be able to distribute cost effectively the supply we bring. Many of you will have heard me and my colleagues speak frequently about the critical importance of a deep and liquid market in order for us fulfil our mandate successfully. Continuous liquidity bolsters market confidence; it avoids price discontinuity. It encourages widespread demand for and investment in gilts, which in turn reduces the Government's financing costs. It remains of critical importance to us that the market continues smoothly and efficiently to find the right price equilibrium at which to take down gilt supply. The primary dealer model supports this process and has stood the test of time. It provides a strong base for the effective functioning of the gilt market.



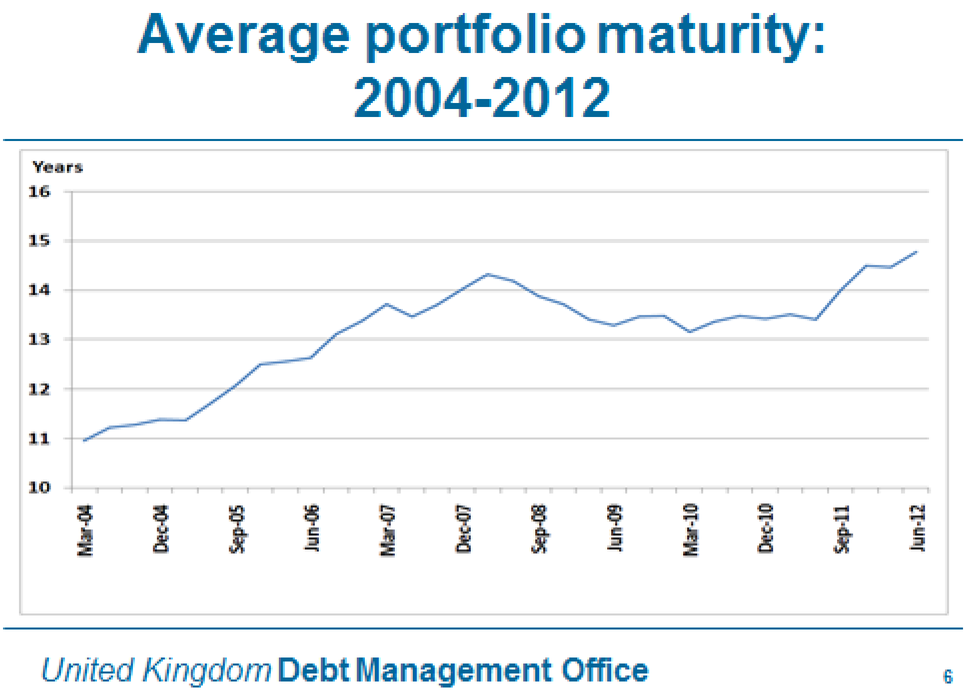
One indicator of how liquidity has increased can be seen in this chart. The liquidity of a debt market can be observed directly through bid-ask spreads, turnover ratios and traded volumes, i.e. the number and frequency of transactions. It can also be proxied, or to some extent inferred, by indirect measures such as total annual debt issuance and the total amount of debt outstanding. A larger debt stock is *generally* associated with better market liquidity due to the larger volume and higher frequency of transactions, as well as the larger size of those transactions. It is our belief that investors have valued the increase in the depth and liquidity of the gilt market during these times of market stress. They value the ability to enter and exit the market with ease and minimal price disruption.

Against this backdrop, the gilt market has also become increasingly something of a *globally* important market. Gilts now represent some 7.5% of global government bond indices, up by roughly 2 percentage points since 2007. The gilt market also continues to be very well supported by overseas investors across the globe. To a certain extent I think it is true that we have become a safe haven. But I am also wary of too much reliance on a characteristic of the market that is not always within our control. Safe havens are needed when problems exist elsewhere. They may not exist for ever and a resolution of some of those problems must be in all our interests.



Moving on it is worth reminding ourselves of the scale of the changes to the debt portfolio.

The chart above clearly shows in absolute terms the growth in outstanding long-dated conventional and index-linked bonds alongside the significant issuance of shorts and mediums. One of the side benefits of having large issuance programmes has been the opportunity to issue bonds at all maturities along the curve to meet with demand from a diverse set of investors.



The consequence of regular issuance at long and ultra-long maturities has been to see the average maturity of UK debt increase over time to 14.8 years. At a time of increased focus, including by credit rating agencies, on the ability of sovereigns to refinance their existing debt effectively and efficiently, having a high average debt maturity has been seen as a strength of the gilt market.

You will be aware of the DMO's recent consultation on the case for issuing gilts with maturities significantly longer than those currently in issue and/or perpetual gilts. The consultation exercise was designed to establish the likely strength and sustainability of demand of any new issuance in excess of 50 years. We also wished to determine the cost-effectiveness of any such issuance, the impact on market liquidity and the good functioning of the wider gilt market.

The consultation period closed on 17th August and I would like to take this opportunity to pass on my thanks to all those who offered their views and who submitted a response. It is perhaps worth reiterating the reasons for consulting at this time. The UK's debt portfolio has a number of characteristics that are unusual amongst OECD countries. I have mentioned the long average maturity, but we also have an element – albeit very small – of perpetual debt in our portfolio. At a time when demand for UK debt remains strong with long-dated yields close to historically low levels, it seems entirely appropriate for the Government at the very least to explore some of the potential costs and benefits of instruments of this nature. We have received good feedback that will continue to help inform our thinking and discussions with Treasury colleagues about the policy recommendations that are put to Treasury Ministers. We will publish a response document in due course, but no timing has been set at this stage.

As you will all be aware, one of the most significant structural changes to the gilt market has been the growth of the Bank of England's holdings of gilts arising from its asset purchase facility being conducted as part of its monetary policy responsibilities. These purchases, which began in March 2009, will have expanded to a total value of up to £375 billion by the end of the current round, which would be the equivalent of nearly 30% of the entire gilt market and almost 38% of the conventional gilt market. Again, I think it's an extraordinary testimony to the strength and resilience of the gilt market that it has coped with the entrance of a single new buyer on such a large scale in such a smooth fashion. As I am sure you'll recall some people may have felt that the independence of debt management and monetary policy has been blurred by the Bank's purchases of gilts in the secondary market as part of its quantitative easing programme. However, I would argue that the distinction between debt management and monetary policy (and their independence from each other) would have been significantly more difficult if the two functions were to have been housed under one roof and primary and secondary market activities potentially confused.

The DMO and the Bank of England have also undertaken practical steps to reduce the impact of the APF's purchases on the liquidity of the gilt market. Since August 2009, there has been a gilt lending facility in place under which the Bank can, if required, make available to the DMO gilts it had bought via the APF, for on-lending to the market through the DMO's usual repo activities.

The Bank itself has also taken steps to avoid purchases having too much of an effect on the liquidity of the market. They intend to restrict their QE purchases to no more than 70% of the free float (the amount in issue minus Government holdings).

Before I finish there are two areas of topical discussion that I would like to address. The first relates to the possibility of change by the Office for National Statistics to the methodology for the calculation of the Retail Prices Index – the RPI. This has led to some concerns about the impact on index-linked gilt cash flows and the practical implications for holders of certain older eight-month lag index-linked gilts. It might be helpful if I make a few comments, in particular around the issue of process. I'll come to that shortly.

Let me say upfront that the discussions around potential changes to the RPI are driven purely by the ONS's remit to produce the highest quality national statistics. This is a process initiated and led by them, independent of Ministers. The UK Statistics Authority, which oversees the work of the ONS, is an independent body operating at arm's length from Government. It is a non-ministerial department, with an objective to promote and safeguard the quality and comprehensiveness of official statistics, and ensure good practice in relation to their calculation. Under these institutional arrangements, Ministers have no role in driving forward any change to the inflation index, and the Chancellor's only potential involvement might be in the latter stages of the process. I'll come to that shortly.

The ONS is advised by the Consumer Prices Advisory Committee – CPAC. CPAC met on 13 September and discussed its work to identify the differences between the RPI and CPI's estimates of inflation. As a result of this work, the National Statistician will publish a consultation document on 8 October 2012 to invite users' views on a range of options for the way RPI is calculated. The consultation will ask users to indicate which of the options developed by the National Statistician they feel are most appropriate.

The CPAC, chaired by the National Statistician, will then meet to consider the responses. The National Statistician may then put forward recommendations, which the UK Statistics Authority would be asked to consider. Any recommendations for change would be published in January 2013.

Any changes to the RPI are required by law to follow governance arrangements set out in Section 21 of the Statistics and Registration Service Act 2007. Consequently, the Bank of England will be consulted on whether any proposal would be a fundamental change to the basic calculation of the RPI that would be materially detrimental to the holders of certain 8-month lag index-linked gilts. The agreement of the Chancellor of the Exchequer to any proposed change to the RPI is *only* required if the Bank considers that this would constitute a fundamental change that is materially detrimental to the holders of these index-linked gilts. The reason for requiring the Chancellor's consent is that, depending on the nature of the change to the RPI and on market circumstances at the time, the triggering of the section could have a significant impact on financial markets and potentially on the public finances.

In the event that a change to the RPI is recommended and the Chancellor's consent is required, the Treasury has informed the ONS that it will provide advance notice of the date that his decision would be published. The DMO will circulate this notice among market participants by way of a screen announcement.

If any change were proposed, and subject to my earlier comments on the process, the Office for National Statistics (ONS) would introduce any change with the annual update of the RPI when it is published on 19 March 2013.

As you can see any announcements or updates are driven by the ONS and UKSA processes which reinforces the independent nature of this work-stream. The consideration of change is part of a programme of work to maintain the quality of the statistics. Should a change be proposed, there is a clear procedure that will be followed where the gilt market implications will be taken into account.

The second major issue is that of regulation. In the post-financial crisis world there have been a number of regulatory initiatives and proposals emerging from the European Commission and internationally. Some of these clearly have the potential to impact sovereign bond markets, be they in the primary or secondary markets. The DMO is very mindful of regulatory developments and their potential impact on the gilt market. We recognise the need to provide advice and analysis to the Treasury and to colleagues at the FSA, especially if some proposals have unintended consequences that could adversely affect liquidity. I would like to assure you that the DMO, Treasury and FSA retain an ongoing dialogue with respect to regulatory issues.

On the subject of the relationship between official institutions in the UK, the Government has a robust institutional framework in place to ensure that key institutions maintain their autonomy to avoid the potential for any conflict of interest. A key example of this is the explicit separation in the responsibility for and conduct of debt management and monetary policy, the latter being the preserve of the Monetary Policy Committee of the Bank of England. Nevertheless, I would like to reinforce to you all that there are a number of formal arrangements and policies in place that shape the relationships between the DMO, the Treasury and the Bank of England. Alongside these formal arrangements, working relationships are maintained across all of these bodies at all levels in respect of matters of mutual interest.

Many thanks for your attention. I would also like to take this opportunity to express my gratitude to you all for supporting the gilt market during these challenging and unpredictable times.

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