DEBT & RESERVES MANAGEMENT REPORT

2001 - 02

Her Majesty's Treasury

March 2001

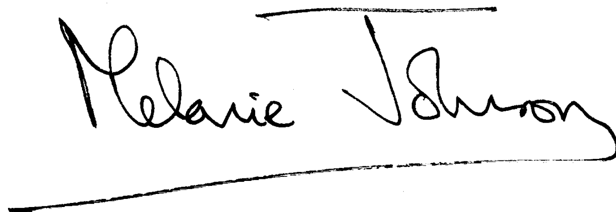
FOREWORD BY THE ECONOMIC SECRETARY TO THE TREASURY

This is the seventh annual report on the Government's debt management activities. It is the first to include details of the management of the UK official reserves by the Bank of England. This section has been included to extend transparency in another area of the Government's financial operations.

2000-01 has been an important year for the gilts market. In a year that was always going to be one of low issuance, the receipts from the 3G Spectrum auctions meant that the Gilts Remit had to be revised. HM Treasury issued a new remit to the Debt Management Office (DMO) on 12 June 2000, which guaranteed gilt sales for the remainder of the financial year. This guarantee was welcomed by market participants and was a further example of how the Government aims for predictability and transparency in policy. The DMO's smooth handling of the receipts in the first year in which they had full responsibility for the Exchequer's cash management duties was widely acknowledged by market operators.

Other developments in debt management in 2000-01 have included a series of reverse auctions. These have helped the Government to maintain market activity despite the limited level of outright issuance and have succeeded in achieving good value for money for the taxpayer. In addition, further switch auctions went some way towards easing very strong institutional demand for long-dated gilts.

The financing plans for 2001-02 continue to be strongly influenced by the Government's successful management of the public finances. This has meant that the overall financing requirement remains low; long-term inflation expectations have fallen to around 2½ per cent and long-term interest rates have remained close to their historic lows.



7 March 2001

MELANIE JOHNSON
Economic Secretary to the Treasury

INTRODUCTION

This is the seventh annual report outlining the Government's debt management activities published by HM Treasury. It has been retitled the "*Debt & Reserves Management Report"* as, for the first time, it outlines details of the management of the official foreign currency reserves. It is designed to review developments in debt and reserves management over the past financial year and sets out the details of the UK government's borrowing programme for the forthcoming financial year.

The Report complements the detailed annual review published each summer by the Debt Management Office (DMO). This report covers the following areas:

- the size and structure of the UK Government's debt;
- UK debt management policy;
- the Government's financing programme in 2000-01;
- developments in the structure of the gilt market and National Savings in 2000-01;
- the management of the official foreign currency reserves by the Bank of England;
- the Government's financing programme for 2001-02; and
- the Remits set by the Treasury to the DMO, National Savings and the Bank of England.

SIZE AND STRUCTURE OF UK GOVERNMENT'S DEBT IN 2001-2002

Debt stock

The total outstanding United Kingdom Central Government marketable sterling debt (including official holdings by Government) was £287.7 billion at end-December 2000. This was comprised of £215.2 billion of conventional gilt-edged stock, £70.3 billion of index-linked gilts (including accrued inflation uplift) and £2.2 billion of Treasury bills (Table 1).

Table 1: Composition of UK Government marketable sterling debt

(£ billion, nominal value, including official holdings)

	End-March 2000	End-Dec 2000
Conventional Gilts[1]	224.5	215.2
Index-linked gilts[2]	66.1	70.3
Treasury Bills[3]	2.8	2.2
	293.4	**287.7**
National Savings	62.6	63.0

1 includes floating rate gilt and undated stocks
2 includes accrued indexation uplift
3 T-bill stock in market hands and net of temporary increase in assets for cash management

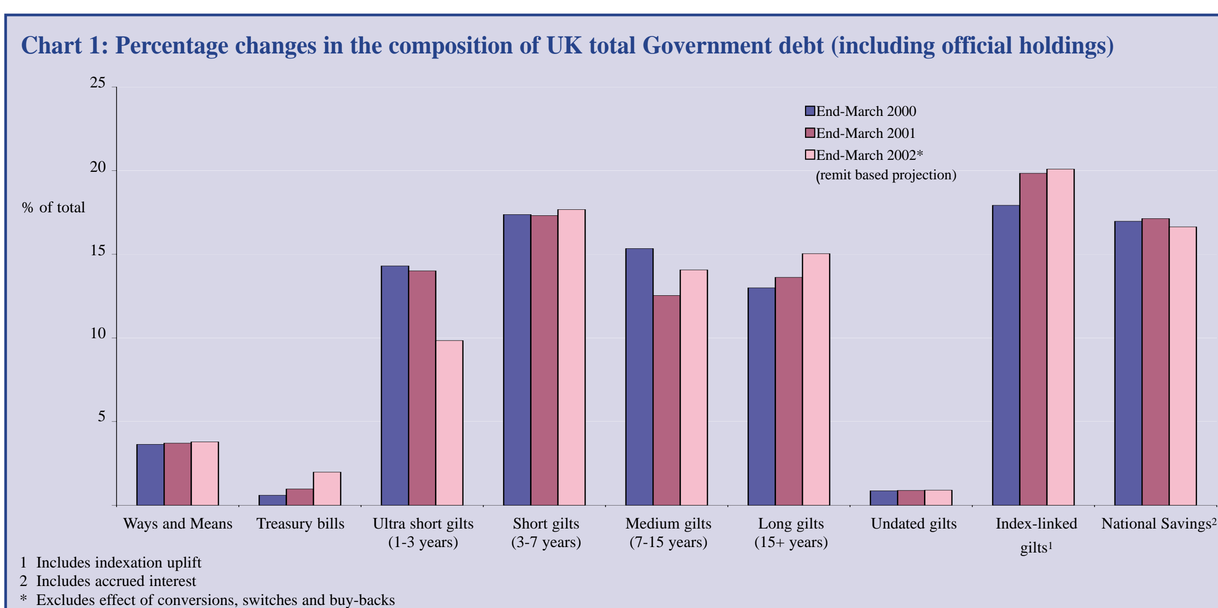
An additional £63.0 billion (including accrued interest) was invested in National Savings instruments.

Chart 1 shows a comparison of the composition of the Government's debt portfolio at end-March 2000 through to the projected composition at end-March 2002. It assumes that new debt is issued in accordance with the forecast financing requirement and issuance remit and takes account of the ageing of existing debt. It does not, however, make assumptions about possible conversion offers, switch and reverse auctions or buy-backs.

Due to the overall strength of the public finances and the unanticipated receipts from the 3G Spectrum auction, it was announced in the Pre-Budget Report (PBR) in November 2000 that the level of the "Ways and Means" facility[1] would be reduced and maintained at the level of £13.4 billion. The balance on the "Ways and Means" facility at end-December 2000 was £13.4 billion.

[1]The net balance on the Governent's general banking account at the Bank of England.

Chart 1: Percentage changes in the composition of UK total Government debt (including official holdings)



1 Includes indexation uplift
2 Includes accrued interest
* Excludes effect of conversions, switches and buy-backs

The stock of Treasury bills at end-December 2000 was £2.2 billion. This is expected to rise to approximately £3.5 billion by end-March 2001.

The DMO has a strategic aim to build up a viable Treasury bill market to aid the efficient execution of Exchequer cash management.

Maturity and duration

The average maturity of the stock of all dated gilts rose from 10.57 years to 11.05 years between end-March 2000 and end-December 2000. The average maturity of conventional gilts alone rose from 9.50 years to 10.38 years. Over the same period, the modified duration of the gilt portfolio as a whole rose from 7.41 years to 7.72 years, and the modified duration of conventional gilts alone rose from 6.37 years to 6.75 years. Compared to other OECD countries, the maturity and duration of the UK Government's marketable domestic debt are among the longest.

Distribution of gilt holdings

Table 2 shows the distribution of gilt holdings by sector at end-March 1999 and end-March 2000. The majority of gilts are still owned by insurance companies and pension funds, with overseas participation remaining stable.

Interest payments

Gross central government debt interest payments in 2000-01 are forecast at £26.6 billion (7.9% of total central government current expenditure). This figure is expected to fall in 2001-02 to £23.1 billion (6.5%), reflecting the lower stock of debt, lower interest rate expectations and issuance at lower coupons than maturing issues. In 2002-03, this figure is expected to rise slightly to £24.2 billion (6.4%) and for 2003-04 fall to £24.0 billion (6.1%).

Table 2: Distribution of gilt holdings at end March 1999 and March 2000 (market values)

	End-March 1999		End-March 2000	
	£ bn	%	£bn	%
Insurance companies and pension funds	214. 6	64.5	207.8	65.3
Banks and building societies	11.3	3.4	9.1	2.9
Other financial institutions	15.0	4.5	15.8	5.0
Households	25.6	7.7	24.0	7.5
Public sector holdings*	3.6	1.1	3.9	1.2
Overseas sector	62.8	18.9	57.7	18.1
Total	**332.9**	**100.0**	**318.3**	**100.0**

**Local authorities and public corporations*

Source: ONS

UK GOVERNMENT DEBT MANAGEMENT POLICY

Objectives of debt management

The debt management policy objective remains:

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

The debt management policy objective is achieved by:

- pursuing an issuance policy that is open, predictable and transparent;
- issuing conventional gilts that achieve a benchmark premium;
- adjusting the maturity and nature of the government debt portfolio, by means of the maturity and composition of debt issuance and other market operations including switch auctions, conversion offers and buy-backs;
- developing a liquid and efficient gilts market; and
- offering cost effective savings instruments through National Savings.

Maturity and composition of debt issuance

In order to determine the maturity and composition of debt issuance, the Government takes account of a number of considerations including:

- investors' demand for gilts;
- the Government's attitude to risks, both real and nominal;
- the shape of both the conventional and real yield curves and the expected effects of issuance; and
- changes to the stock of Treasury bills and other short-term instruments required in 2001-02 for cash management.

The Government keeps its optimal issuance framework under review. When deciding on the volume, composition and maturity of gross issuance, the Government must not only bear in mind the needs of the market (as it did in 2000-01 by biasing issuance towards long-dated gilts) but also its own risk appetite.

As previously noted, the UK gilts portfolio's maturity and duration are markedly higher than the equivalent measures for comparable economies. Historically, the pension funds and life assurance companies have been ready buyers of long maturity gilts in order to meet their own needs and the high levels of Government indebtedness meant that there was a very real need to minimise refinancing risk.

In 2000-01, issuance was biased towards long maturity stocks in response to strong demand for these stocks from the market, particularly from pension funds.

High duration for a portfolio is an indication of vulnerability to interest rate risk. If issuance continued to be biased towards long-dated stocks the Government would not be able to benefit from a possible fall in interest rates, as it would have locked itself into higher interest rates. Conversely, if interest rates rose and the Government had biased issuance towards longs, it would benefit from not having to refinance maturing debt and from financing itself at previously lower rates. The box on page 7 looks at issuance strategy and the make-up of the portfolio in greater detail.

Similar considerations need to be made when deciding on the appropriate level of index-linked issuance. Traditionally, index-linked debt has acted as a hedge against inflation for investors and real rate shocks for the issuer. However, inferring inflation expectations from the real and nominal yield curves, long-term expectations of inflation (as measured by the Retail Price Index (RPI)) have settled at around $2^1/_2$% p.a., consistent with the current long-run target level given to the Monetary Policy Committee by the Government. Consequently, there is no longer a

significant inflation risk premium built into the prices of conventional gilts compared to index-linked. This reduces the expected cost advantages to the Government of issuing index-linked debt. However, there is still good demand from the market for these kinds of securities with limited substitutes available from corporate issuers.

Additionally, index-linked debt offers the Government an opportunity to hedge against inflation (as measured by the RPI) averaging more or less than $2^{1}/_{2}$%. If inflation is higher than expected, the cost of servicing index-linked debt rises while the real cost of servicing nominal debt falls. Conversely, if inflation is lower than expected, the real cost of servicing nominal debt will rise while the cost of servicing index-linked debt will fall. Thus, index-linked debt can fulfil a useful issuance diversification role and provides more certainty over the real cost and value of debt.

Index-linked debt can also provide fiscal insurance. If deficits are negatively correlated with inflation, index-linked debt should act as a fiscal stabiliser. This is because the rising deficit would mean that although more debt would be issued, the fall in inflation would mean that the nominal costs of servicing index-linked would fall. Conversely, if the deficit fell and inflation rose, the falling borrowing requirement would be offset by the rising nominal costs of servicing index-linked debt.

Treasury Select Sub-Committee report on debt and cash management

The Treasury Select Sub-Committee published their report "*Government's Cash and Debt Management*" on 22 May 2000. The report includes minutes of evidence given by officials, market participants and academics and provides a comprehensive introduction to the work of HM Treasury, the DMO, National Savings and National Investment and Loans Office in this area.

DEBT PORTFOLIO STOCK-FLOW DYNAMICS

HM Treasury continues to pay close attention to the effects of the maturity mix of issuance on the resulting debt portfolio in the long-run.

During 2000-01, low issuance and liquidity needs at the long-end of the maturity spectrum resulted in all conventional issuance being concentrated in this area. This does not signal a change in the Government's long-term optimal issuance strategy.

The following table shows the characteristics after 25 years of the debt portfolio under some illustrative options for issuance in future years. The first assumes that issuance from 2001-02 onwards follows the same pattern as that seen in 2000-01 (65% long-dated conventionals, 35% index-linked). The second assumes that future issuance reverts back to the proportions of the 1997-98 Debt Management Report (35%, 30% and 35% of conventional issuance being short-, medium- and long-dated respectively and 20% of all issuance being index-linked).

Illustrative options for the mix of debt issuance in future years and the resulting debt portfolio

Resulting equilibrium debt portfolios						
	Per cent of conventional gilts			Index-linked	Average Maturity	Duration
Example remit	Short	Medium	Long		(years)	(years)
2000-01 remit pattern	20	21	35	24	13.5	9.3
1997-98 remit pattern	36	20	24	20	10.3	7.4

As in last year's report, for illustrative purposes the calculations assume £5 billion net cash requirement annually and index-linked issuance distributed evenly across the curve. Figures include indexation uplift on index-linked gilts.

The charts show the evolution of the resultant portfolio between 2001-26 under two issuance rules outlined in the table above.

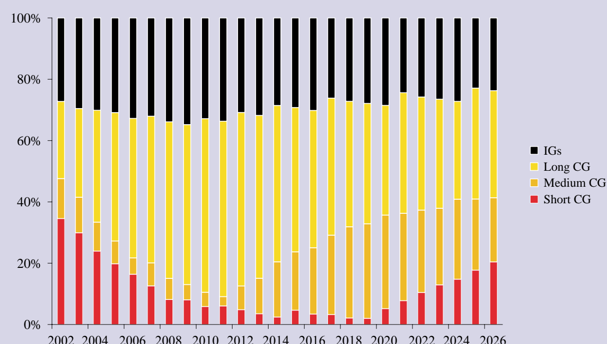


Figure 1: 2000-01 remit pattern

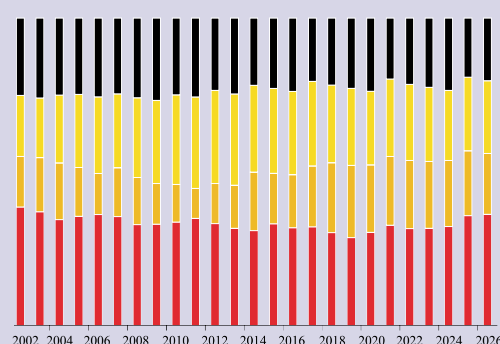


Figure 2: 1997-98 remit pattern

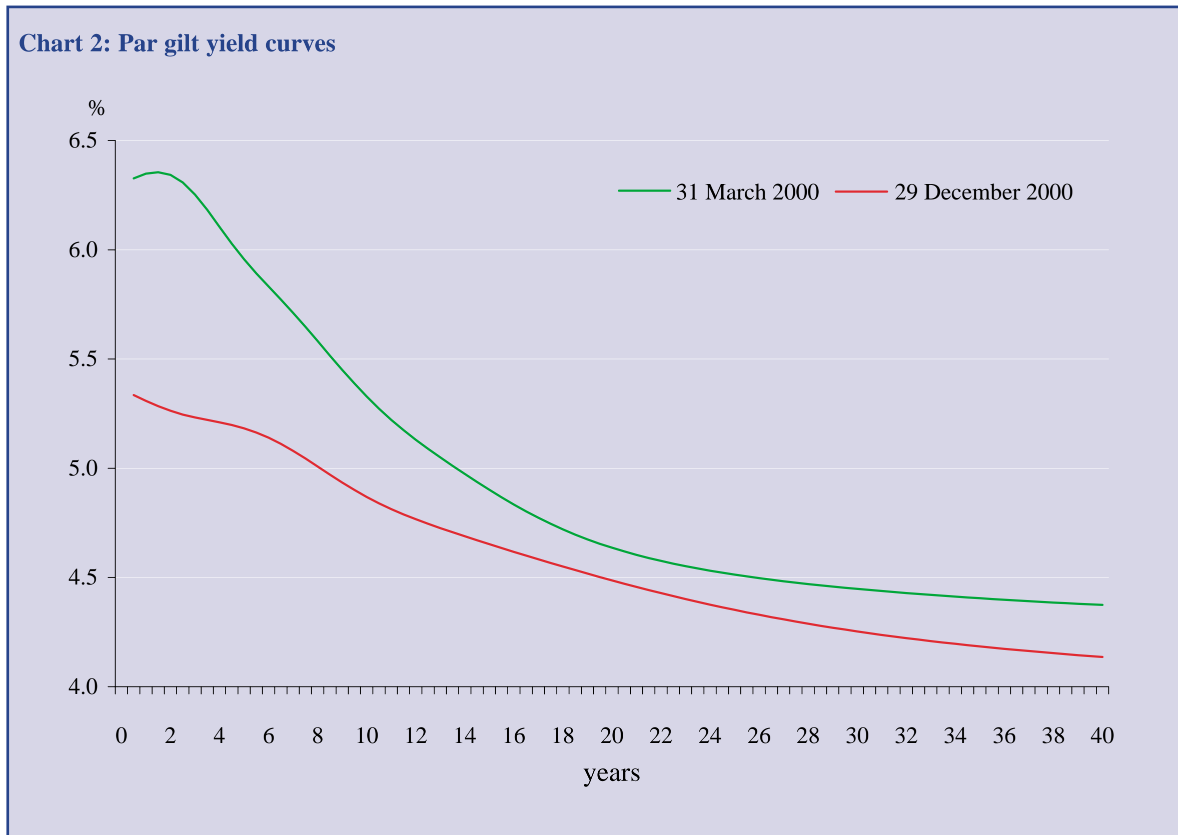
THE GOVERNMENT'S BORROWING PROGRAMME 2000-01

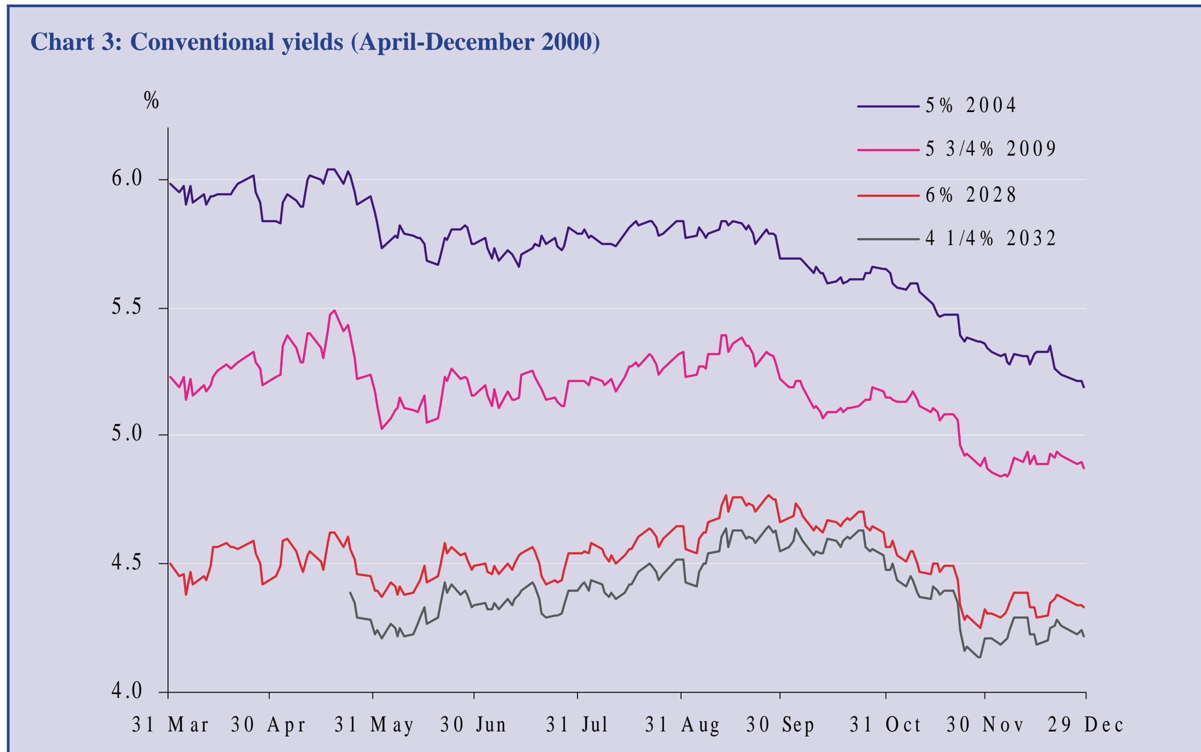
Gilt market review 2000-01

Yields on conventional gilts fell across the curve in the year to December 2000, with the greatest reductions being in ultra-short yields (see Chart 2). In the financial year to end-December, the yield on the 2-year benchmark stock fell over 115 basis points (bp) to 5.28%. Over this period, the yield curve disinverted, particularly at the short-end.

The spread between the 2–year and the 30-year yields narrowed by 84bp to -105bp between April and December 2000. Over the same period, the spread between 10- and 30-year yields narrowed less dramatically, from –73bp at the start of April, to –65bp.

Chart 2: Par gilt yield curves



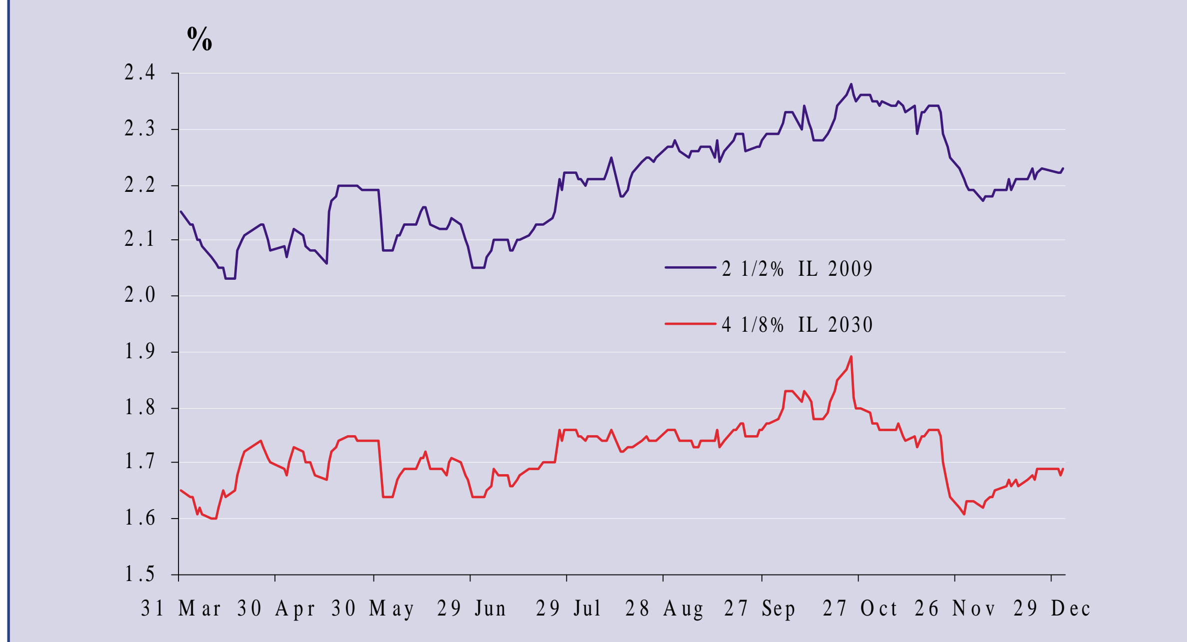


Between the start of the financial year and September, the yield on the 2-year benchmark fell 40bp to 6.00%. The trend intensified in the second half of the period as evidence of slowing growth in the UK appeared to increase market expectations of an early cut in the Bank of England's repo rate.

Further downward pressure on short yields emerged in December as the market became concerned about the impact on the global economy of slowing US growth. Between September and December, the yield on the 2-year benchmark fell by a further 75bp to 5.25%.

At the long end of the curve, investors remained concerned about the likely timing and content of possible changes to the Minimum Funding Requirement (MFR). The yield on long-dated stock increased during the summer months. This was driven by market expectations over the possible changes that might be recommended by the Faculty and Institute of Actuaries. It was believed that the report would signal a loosening of the MFR. Between the beginning of the financial year and 14 September, the yield of the 6% Treasury 2028, the ultra-long benchmark stock, increased by around 37bp to 4.77%.

Chart 4: Index-linked gilt yields (April-December 2000)



The MFR review document was released on 14 September. With the publication of its propals, the DSS and HM Treasury launched a further consultation process. Consequently, expectations that this review would serve to ease some of the domestic institution-led demand for ultra long-dated gilts proved to be premature.

A new ultra-long gilt, $4^{1}/_{4}$% Treasury 2032, was first issued on 24 May 2000. A second auction for this gilt was held on 21 November 2000. Despite there being only two outright auctions to date, the gilt has attained benchmark status aided by three switch auctions. A third outright auction is scheduled for 28 March 2001.

Sales of long-conventional gilts have raised £4.6 billion to date relative to the £6.5 billion remit target. Four index-linked auctions have been held as planned, raising £3.5 billion (cash) as targeted under the remit.

Between 14 September and end-December 2000, long yields fell 54bp to 4.23%. Even at its most extreme, however, this was not a complete retrenchment back to the levels seen towards the end of 1999. The lowest yield for the period reached by the new long-dated benchmark stock, $4^{1}/_{4}$% Treasury 2032, was 4.14% at the close of business on 28 November. This was above the 4.01% yield reached twelve months earlier by 6% Treasury 2028.

By the start of the third quarter of the financial year, with both domestic and international factors influencing both short- and long-dated stocks, medium yields were also able to find direction and trended downwards. From a peak of 5.40% in mid-September the yield on the 10-year benchmark stock had fallen to 4.88% by end-December 2000.

Conventional bond yields overall fell more sharply than index-linked yields (see Charts 3 and 4 on pages 9-10), with the result that across the curve, breakeven inflation rates fell by 40bp in the ten-year sector over the period and around 20bp in the thirty-year area of the curve.

Nominal yields in other major government bond markets also fell during the year. The ten-year spread to Germany was close to zero throughout the period and significant divergences were caused by UK domestic factors. In the ten-year area of the curve gilts reached a maximum of 12bp over Germany on 13 September (the day before the MFR announcement) and fell to reach 20bp below the German equivalent by 23 November in the rally that followed.

The spread of gilts to US Treasuries has narrowed throughout most of the period. It peaked in the 10-year area of the curve at 111bp at the beginning of May but this had fallen to 23bp by end-December 2000. Most of this change can be attributed to falling yields in the US, as the budget surplus restricted issuance of Treasuries and fears mounted of slower economic growth.

Gilt sales and remit contingencies

Planned gilt sales of £12.2 billion were published in the remit for 2000-01 on 21 March 2000: this total was based on a forecast central government net cash requirement (CGNCR) of -£4.9 billion. The planned gilt sales total reflected decisions by Government to increase the financing requirement in 2000-01 by £7.0 billion. This was achieved by:

- pre-financing £3.5 billion worth of foreign currency debt due to mature in 2000-01; and
- buying-back £3.5 billion of debt from the market (including at least £2.5 billion through reverse auctions).

Conventional gilt sales of £8.7 billion (£6.5 billion longs and £2.2 billion mediums) and index-linked sales of £3.5 billion were planned. The planned volume of gilt sales was protected against a rising surplus in 2000-01 by a number of contingencies included in the Gilts Remit:

- a reduction of up to £2.0 billion in the end-year level of the Ways and Means facility at the Bank of England;
- a reduction of up to £2.0 billion in the planned end-year level of the Treasury bill stock; and
- further pre-financing of foreign currency debt - estimated at £5.7 billion.

Following the publication, on 20 April 2000, of the outturn CGNCR for 1999-2000, which showed a surplus of £9.2 billion, £3.4 billion higher than forecast in the March Budget, the implementation of the contingencies began – thereby enabling planned gilt sales to remain unchanged at £12.2 billion. The contingencies implemented on 20 April were:

- a reduction of £2.0 billion in the planned end-year level of the Ways and Means facility (to £15.0 billion); and
- a reduction of £1.3 billion in the planned end-year level of the Treasury bill stock (to £8.7 billion).

Also on 20 April 2000, the Government announced that in light of the proceeds from the 3G Spectrum auction (then still underway), it expected to revise the DMO Remit once the size and timing of the Spectrum receipts was clear.

On 12 June 2000, the Economic Secretary announced that cash receipts in 2000-01 were £19.5 billion more than had been forecast in the Budget, and that consequently gilt sales were being reduced, by £2.2 billion, to £10.0 billion, (with the medium conventional gilt auction being cancelled). Gilt sales were guaranteed at this level for the remainder of the financial year. All the remaining remit contingencies were triggered and the Government announced that debt buy-backs might be increased by a further £1.5 billion (to £5.0 billion) and that this would be decided at the time of the PBR. A residual surplus of £10.7 billion

remained to be used to reduce net short-term debt, but decisions on the composition of this reduction were left for the PBR.

In the PBR on 8 November 2000, a revised CGNCR forecast for 2000-01 of -£28.2 billion was published (a further increase in the forecast surplus of £3.8 billion compared to the position published on 12 June 2000). As foreshadowed in the June revision, planned buy-backs were increased to £5.0 billion. The following further reductions in net short-term debt were announced:

- a reduction of £1.6 billion in the planned end-year level of the Ways and Means facility (to £13.4 billion);
- a reduction of £4.5 billion in the planned end-year level of the Treasury bill stock (to £3.5 billion); and
- a balance of £6.3 billion to be maintained as a short-term cash position to be run down over the next three financial years. The PBR statement indicated that any further variation in the CGNCR for 2000-01 would be accommodated within the cash position.

Table 3: 2000-01 financing requirement (£ billion)

	Original remit March 2000	Revised remit June 2000[1]	PBR Report November 2000	Budget March 2001
Central government net cash requirement forecast (CGNCR)	-4.9	-4.9	-28.2	-33.3
Unanticipated Spectrum receipts		-19.5		
Official financing of net reserves	3.5	9.5	9.3	9.3
Redemptions	18.6	18.6	18.6	18.6
Debt buy-backs	3.5	3.5	5.0	5.5
Residual from 1999-2000	-9.5	-12.8	-12.8	-12.8
Financing requirement	**11.2**	**-5.6**	**-8.1**	**-12.7**
Less				
Assumed National Savings contribution	-0.8	-0.8	-1.5	-0.7
DMO cash deposit	-0.2	-0.2	-0.2	-0.2
Net financing requirement	**12.2**	**-4.6**	**-6.4**	**-11.8**
Contingencies				
Less repayment of Ways and Means	na	-2.0	-3.6	-3.6
Less reduction in planned Treasury bill stock	na	-2.0	-6.5	-6.5
Further reductions in net short term debt	na	-10.7	-6.3	-21.8
Gilt sales planned	**12.2**	**10.0**	**10.0**	**10.0**

Figures may not sum due to rounding

1 Remit revised following outturn of the 1999-2000 CGNCR and outcome of the 3G Spectrum auction

The March 2001 Budget includes a forecast for the 2000-01 CGNCR of -£33.3 billion, with the further increase in the surplus being accommodated by an increase in the net short-term cash position to £11.7 billion. Table 3 outlines the development of the financing requirement over 2000-01.

The 2000-01 Remit included a calendar for four conventional and four index-linked auctions. With the reduction in the level of planned gilt sales announced on 12 June 2000, one conventional auction (the medium maturity) was cancelled.

Switch and reverse auctions

The DMO continued with a programme of switch auctions in 2000-01. These were primarily undertaken to continue to meet the demand for duration in a year of low gross issuance and to address market concerns over index changes in December 2000.

Three operations were held to switch out of 8% Treasury 2015 into the new ultra-long benchmark 4¼% Treasury 2032, reducing 8% Treasury 2015 by £5.0 billion (nominal) to £7.3 billion (nominal). One switch auction was scheduled to take place when the 8% Treasury 2015 fell out of the FTSE Over-15 year gilt index on 8 December 2000. The 4¼% Treasury 2032 was increased in size by £6.8 billion (nominal) by these operations, taking it to £11.6 billion (nominal) in issue by end-December 2000, despite it being auctioned outright only twice.

The DMO carried out six reverse auctions during the year, buying back £4.1 billion (cash) of two baskets of stocks in the 2003-05 and 2006-2008 maturity ranges. In addition, an anticipated £1.4 billion of gilts are expected to be bought back as a result of net purchases in the secondary market. In connection with these purchases, the DMO announced on 14 June 2000 that it would expand the range of stocks for which it would be prepared to make a bid on demand to include shorter-dated index-linked stocks and non-rump double-dated gilts.

A full record of the DMO’s market activities is listed in Table 4.

Table 4: Results of gilts auctions held in 2000-01

Results of outright gilt auctions

Date	Stock	Nominal Amount Auctioned (£mn)	Cover	Average accepted price (AAP) (£)	Yield at AAP (%)
3 May 2000	2 1/2% IL 2020	375	2.30	219.00	1.92
24 May 2000	4 1/4% 2032	2,500	1.63	96.21	4.47
26 Jul 2000	2 1/2% IL 2013	425	1.94	195.45	2.18
25 Oct 2000	4 1/8% IL 2030	450	2.07	189.00	1.87
21 Nov 2000	4 1/4% 2032	2,250	2.21	97.27	4.41
24 Jan 2001	2 1/2% IL 2016	450	3.16	218.75	2.08
24 Jan 2001	2 1/2% IL 2016	450	3.16	218.75	2.08
28 Mar 2001	4 1/4% 2032	-		-	-

Results of reverse gilt auctions

Date	Maximum value of stocks sought	Stocks sought	Stock bought nominal value (£mn)	Average price paid (£)	Average yield (%)
20 Jul 2000	£800mn cash	8% 2003	381.2	105.40	5.93
		10% 2003	357.0	111.53	5.91
		6 3/4% 2004	0	na	na
		9 1/2% 2005	0	na	na
21 Sep 2000	£900mn cash	7 3/4% 2006	130.0	110.13	5.72
		8 1/2% 2007	463.7	115.83	5.66
		9% 2008	180.0	122.04	5.57
11 Oct 00	£700mn cash	8% 2003	220.7	105.41	5.77
		10% 2003	381.0	111.17	5.76
		6 3/4% 2004	0	na	na
		9 1/2% 2005	38.0	115.42	5.59
23 Nov 2000	£700mn cash	7 3/4% 2006	0	na	na
		8 1/2% 2007	592.2	118.20	5.22
		9% 2008	0	na	na
18 Jan 2001	£500mn cash	8% 2003	0	na	na
		10% 2003	0	na	na
		6 3/4% 2004	0	na	na
		9 1/2% 2005	430.6	116.17	5.20
22 Feb 2001	£500mn cash	7 3/4% 2006	13.3	112.23	5.18
		8 1/2% 2007	411.0	118.03	5.15
		9% 2008	0	na	na

Results of gilt switch auctions

Date	Source stock	Nominal Switched (£mn)	Destination stock	Nominal created (£mn)	Average Dirty Price ratio
22 Jun 2000	8% 2015	1,500	4 1/4% 2032	2,046	1.3641
27 Sep 2000	8% 2015	1,500	4 1/4% 2032	2,098	1.3985
6 Dec 2000	8% 2015	2,000	4 1/4% 2032	2,686	1.3435

National Savings

The outstanding balance of National Savings' instruments at the start of the financial year was £62.6 billion. During 2000-01, National Savings are expected to make a net financing contribution of -£0.7 billion. Gross sales of National Savings' products for 2000-01 are expected to be £12.0 billion (including accrued interest).

National Savings' overall cost of financing remained lower than that of comparable gilts throughout the year after taking into account management costs and imputed tax foregone.

National Savings announced five packages of rate changes during the year. For variable rate products, the changes reflected movements by their competitors and short-term market interest rates. New issues of fixed rate products were introduced during the year to reflect movements in medium-term market rates. With shorter-term interest rates remaining higher than 5-year rates, demand for 5–year products remained relatively modest. However, this was partly offset by continued demand for Premium Bonds and other shorter-maturity products.

Table 5: Change in National Savings' products outstanding (2000-01)

(including accrued interest)

	End-March 2000		End-March 2001*	
	£ bn	%	£ bn	%
Variable Rate	33.6	53.7	34.5	55.8
Fixed Rate	19.2	30.7	17.9	29.1
Index-linked	9.8	15.6	9.5	15.4
Total	**62.6**	**100.0**	**61.9**	**100.0**

*estimates

NATIONAL SAVINGS FIVE YEARLY REVIEW

The Government's five yearly review of National Savings (NS) was announced on 11 January 2000. The review took a fundamental look at the strategic purpose of the functions carried out by the agency in the light of developing circumstances and government policy. It then considered what organisational structure might best deliver the Government's policy objectives. In doing so it looked at all options on their merits, with the aim of identifying whether NS remains the most suitable way of delivering policy.

The review recognised the importance of recent innovations in NS in making the agency more efficient and more flexible. This includes the role played by outsourcing its operations. It is now better placed to build on this achievement to modernise and adapt to the changing market in which it operates. It now has the potential to match the best in the financial services market, providing choice and good value products for savers and investors in the very competitive savings market.

The review sees these developments as central to NS continuing to make a valuable contribution to the cost-effectiveness of financing the national debt by offering attractive products and services to members of the public. As a result of the review, NS has been set a clear and overarching objective to achieve cost-effective government debt management. NS, which will remain a government agency, funds a significant amount–almost £62 billion- of the national debt. Taxpayers will continue to see the benefit of National Savings' contribution, which is more cost-effective than comparable gilt-edged securities.

Existing NS savers and future customers will also benefit. NS will be working to give its current and new customers more attractive and more up-to-date products and services. People will also get more choice on how they access those products. In addition to being able procure NS products through the Post Office and by post as they do now, customers will in future be able to choose from a wide range of channels.

In taking forward the review's recommendations, NS will continue to modernise its activities to make and keep it relevant, efficient and cost-effective. This will involve focussing on developing those aspects of the business that can operate competitively and cost-effectively, and continuing to develop new products as well as embracing innovations and new ideas.

The outcome of the review has been developed into a new business strategy, and has been reflected in a new framework document which governs the relationship between NS, HM Treasury and Ministers.

DEVELOPMENTS IN THE GILTS AND STERLING MONEY MARKETS

Exchequer cash management

On 3 April 2000, the DMO assumed full responsibility for Exchequer cash management. This was the final part of the transfer of Exchequer cash management responsibilities from the Bank of England. The rising Exchequer cash surplus (largely due to receipts from the sale of 3G Spectrum licences) posed major challenges for the DMO early in its first year of cash management responsibility. One consequence of this involved the DMO announcing on 9 November 2000 (after the PBR) the expansion of the range of financial instruments in which it may transact on a bilateral basis for cash management purposes (the full range of instruments are listed in the DMO's Cash Management Remit, on pages 31-32).

Gilt-edged market makers

The Royal Bank of Canada (RBC) became a Gilt-edged Market-Maker (GEMM) in November 2000. The DMO also recognised RBC as a specialist Index-Linked Market-Maker (IGGEMM), increasing the number of IGGEMMs to ten. Later in November 2000 the DMO also recognised UBS Warburg as an IGGEMM taking the number of IGGEMMs to eleven. Société Générale ceased to be a GEMM in October 2000.

Reverse gilt auctions

The DMO published proposals on the conduct of reverse gilt auctions and details of a proposed extension to the scope of its secondary market purchase operations on 26 April 2000. These new operations were part of the Government's strategy to buy back debt from the market debt totalling £3.5 billion (cash) in 2000-01 (the target was increased to £5.0 billion on 8 November 2000).

Following consultation with the market, the DMO published its response on 14 June 2000 and the first reverse gilt auction was successfully held on 20 July 2000. Six reverse auctions have been held in total this financial year (see Table 4 on page 14 for further details).

Strippable gilts

One stock was added to the list of strippable gilts in 2000-01. The new ultra-long benchmark $4^{1}/_{4}$% Treasury 2032 took the total number of strippable stocks to twelve; however, the total reverted to eleven when 8% Treasury 2000 redeemed on 7 December 2000. The total nominal strippable stock in issue was £101.6 billion at the end-December 2000 (of which £2.4 billion, or 2.4%, was held in stripped form).

Operation of the DMO's Standing Repo facility

On 29 December 2000, in response to requests by a number of its dealing counterparties, the DMO created an additional £1,146.5 million of $5^{3}/_{4}$% Treasury 2009 under the terms of the Standing Repo facility that was introduced on 1 June 2000. The stock was cancelled on 2 January 2001. There were three subsequent operations on 3 January, 5 January and 11 January 2001, all of which involved the $5^{3}/_{4}$% Treasury 2009. On each occasion the stock created was cancelled on the following business day.

Gilt price information

In order to promote further transparency in the gilts market, the DMO introduced a real-time benchmark gilt price screen on its wire services in September 2000. This screen displays indicative mid-prices for a series of gilts, derived from GEMM's published quotes.

Transfer of gilt settlement system to the CREST settlement system

Gilt settlement transferred from the CGO system to the CREST settlement system over the weekend of 1-2 July 2000. Responsibility for the operation of the CGO had transferred from the Bank of England to CRESTCo on 24 May 1999.

Table 6: Strippable stocks outstanding

Gilt	Nominal amount in issue at end-December 2000 (£mn)	Nominal amount held in stripped form at end-December 2000 (£mn)	Percentage held in stripped form at end-December 2000 (£mn)
7% Treasury 2002	9000	176	2.0
6 1/2% Treasury 2003	7987	41	0.5
5% Treasury 2004	7408	119	1.6
8 1/2% Treasury 2005	10373	277	2.7
7 1/2% Treasury 2006	11700	206	1.8
7 1/4% Treasury 2007	11000	267	2.4
5 3/4% Treasury 2009	8827	237	2.7
8% Treasury 2015	7288	491	6.7
8% Treasury 2021	16500	372	2.3
6% Treasury 2028	11512	249	2.2
4 1/4% Treasury 2032	11580	0	0
Total	**101595**	**2435**	**2.4**

Gilt market turnover

Total turnover in the gilt market recorded on the London Stock Exchange reached £1,100 billion in the period between the beginning of the financial year 2000-01 and end-December 2000. The GEMMs reported a similar figure to the DMO. This suggests that, if turnover continues at the same rate, average daily turnover in the market will be around £5.8 billion for the financial year 2000-01, a decrease of 8% on last year.

Turnover was concentrated in the long (i.e. gilts with in excess of 15 years residual maturity) and medium (i.e. gilts with between 7 and 15 years residual maturity) sectors of the gilt market. Twenty-eight percent of total turnover was recorded in each sector. Turnover in index-linked stocks accounted for only 4% of total turnover. Chart 5 shows the weekly turnover reported by the GEMMs categorised as either professional or customer. Professional turnover captures all trades executed between GEMMs, either directly, or indirectly through the inter-dealer brokers, plus transactions involving the DMO (including auction participation). Customer turnover captures everything else. Unsurprisingly, the market was particularly active in weeks of DMO operations. Note that activity seems to be on a rising trend. In the first quarter of the financial year, turnover was £361 billion. This rose marginally to £362 billion in the second quarter but increased significantly to £453 billion in the third quarter. This probably reflected increased activity as the market adjusted to changes in FTSE gilt indices.

In the period from the beginning of the financial year 2000-01 to end-December 2000, the average daily turnover in the long gilt futures contract traded on LIFFE was 20,711 contracts. This represents a 33% decline on the same period last year. Chart 6 shows the average daily turnover on a monthly basis with the level of open interest in the contract at the end of each month.

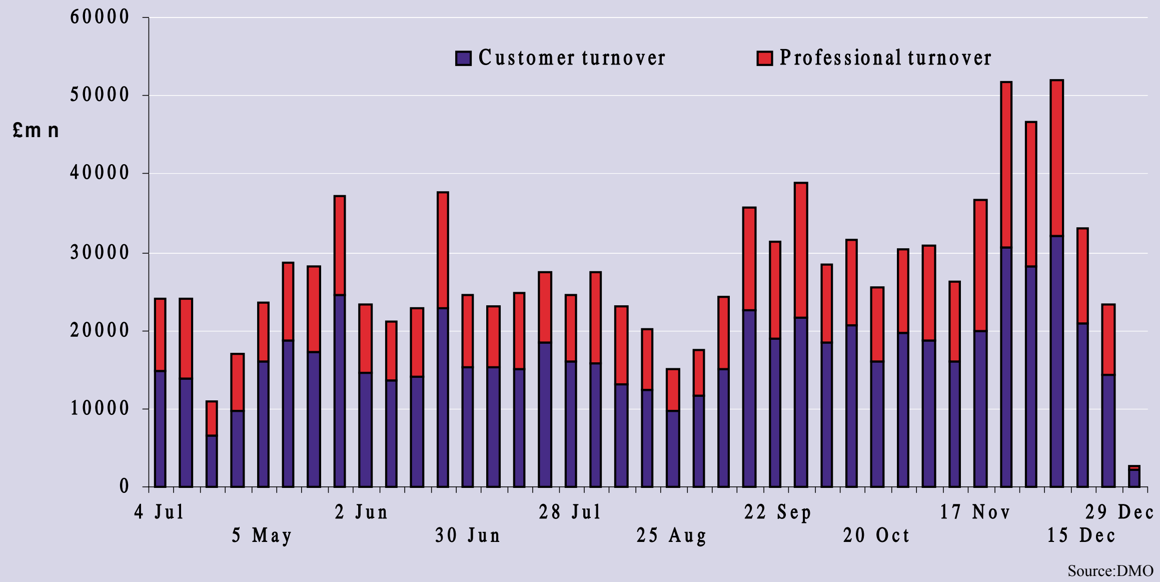


Chart 5: Gilt market turnover (April-December 2000)
£mn
60000
50000
40000
30000
20000
10000
0
Customer turnover
Professional turnover
4 Jul
5 May
2 Jun
30 Jun
28 Jul
25 Aug
22 Sep
20 Oct
17 Nov
15 Dec
29 Dec
Source:DMO

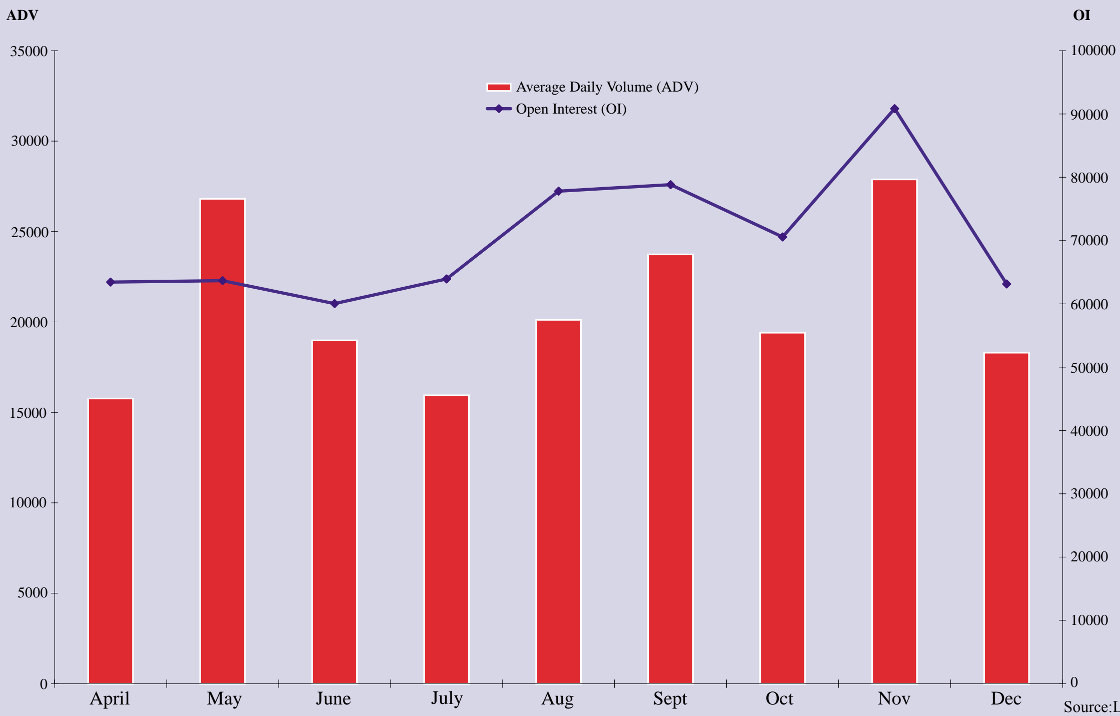


Chart 6: Average daily turnover of the long gilt futures contract and open interest (April-December 2000)
ADV
OI
35000
30000
25000
20000
15000
10000
5000
0
100000
90000
80000
70000
60000
50000
40000
30000
20000
10000
0
Average Daily Volume (ADV)
Open Interest (OI)
April
May
June
July
Aug
Sept
Oct
Nov
Dec
Source:LIFFE

Proposed changes to the structure of the secondary market for gilts

In January 2000, the DMO issued a consultation document on the implications on the secondary market for gilts of developments in electronic trading of fixed income instruments on the secondary market for gilts. The consultation document questioned whether the DMO needed to change its relationship with the GEMMs as a result of these new developments.

The DMO received many considered responses to the document and in June 2000 published proposals to develop an inter-GEMM market with mandatory quote obligations. This is an extension of the existing relationship between GEMMs that is facilitated through the gilt-edged inter-dealer brokers (IDBs). Under the proposals, GEMMs would be required to make firm two-way quotes in a selection of benchmark bonds to each other on a near-continuous basis. It is hoped that this would maintain and improve the liquidity available to all GEMMs. Competition between the GEMMs should ensure that any improvement in liquidity that results is reflected in the provision of liquidity to end-investors.

The Gilt-edged Market-Makers Association (GEMMA) and the DMO established a working group in August to take forward the question of how this inter-GEMM market should be delivered. In September, the group issued an invitation to interested platform providers that identified three possible options that the group wished to explore. The group is continuing to work towards identifying a solution that can be adopted by the whole GEMMA community.

DMO website and publications

The DMO has also expanded and restructured its website (www.dmo.gov.uk), on which all its publications appear. New areas covering retail involvement in the gilts market, index-linked gilts and the DMO's cash management operations have been added to the site. The DMO is committed to making all non-commercial information relating to its activities available on its website.

The DMO published its regular annual review of developments in the gilt market: "*The Gilt Review 1999-2000*" on 4 August 2000; this included for the first time references to the DMO's emerging cash management role. The DMO has also continued to publish and refine its quarterly review. A comprehensive redesign occurred in the first quarter of 2001.

The DMO and the Bank of England Registrar's Department produced a second edition of the booklet: "*Investing in Gilts: the private investor's guide to British Government Stock*" in February 2001.

THE MANAGEMENT OF THE OFFICIAL RESERVES IN 2000-01

For the first time, the Government is publishing in this document information concerning the management of the official reserves by the Bank of England. This has been included as it is in keeping with the Government's international role in promoting transparency in financing and reserves management policy.

Introduction

The United Kingdom holds official reserves of gold, foreign currency assets and International Monetary Fund (IMF) Special Drawing Rights (SDRs). Apart from those SDR assets which constitute the UK's reserve tranche position at the IMF, these reserves are held in the Exchange Equalisation Account (EEA). The EEA is under the control of HM Treasury but the Bank of England, acting as HM Treasury's agent, manages the EEA by carrying out day-to-day tasks such as foreign exchange dealing and portfolio investment, within the framework of an annual remit set by HM Treasury (see the summary remit on pages 33-35).

Origins and purpose

The EEA was established in 1932 as a fund for stabilising the exchange value of sterling. Its uses were later extended to cover the financing of payments abroad (the EEA continues to provide extensive foreign currency dealing services to government) and also aspects of the UK's membership of the IMF.

The EEA is closely linked to the National Loans Fund (NLF), which finances nearly all of the EEA's investments through a combination of sterling and foreign currency borrowing. Any NLF foreign currency exposures are managed alongside those of the EEA by the Bank of England, which also acts as HM Treasury's agent for foreign currency liabilities management.

Disclosure of financial data

The presentation of data on the reserves and its accounting basis has changed radically since 1997, in line with the Government's leading international role in promoting openness and transparency in reserves data. Beginning with the April 2000 figures, data on the official reserves has been compiled in line with the IMF/G10's Special Data Dissemination Standard and published in a monthly HM Treasury press release, with more detail given on the Bank of England's website. This data discloses the value and composition of the UK's gold and foreign currency assets, liabilities and derivatives on a "marked-to-market" basis (that is, using current market valuations). The press release also reports the size(s) and date(s) of any intervention in the foreign exchange markets, either by HM Treasury or by the Bank of England, and gives an explanation of any intervention carried out.

In addition, financial accounts for the EEA are being published for years since 1997-98. These give a measure of the EEA's turnover for the year and a statement of its assets and liabilities at historic cost. However, from the financial year 2000-01 onwards, the annual accounts will follow accounting methodology as set out in UK Generally Agreed Accounting Practice (UK GAAP), which will bring them in line with monthly published data, and will be published to a statutory timetable.

Evaluation of performance in reserves management

The Government has a Public Service Agreement (PSA) target to minimise the cost of holding the foreign currency reserves while reducing risk. Performance is reported on in detail in HM Treasury's annual report on the expenditure plans of the Chancellor of the Exchequer's Departments. The most recently reported figures, those for 1998-99 show an overall cost of £395 million in that year.

Review of activities during 2000-01

There were three noteworthy areas of operational activity during the year.

Gold sales

The UK's gold sales programme announced on 7 May 1999 continued. A further 125 tonnes of gold have been sold at five auctions to date in 2000-01, with another auction of approximately 25 tonnes scheduled for 14 March 2001.

A total of $1.1 billion has been raised by these sales and re-invested in interest-bearing foreign currency assets in broadly the same proportions as the existing net foreign currency reserves, continuing the restructuring of the reserves.

The net foreign currency reserves are held in the proportions 40% US dollars, 40% euros and 20% yen, with some limited scope for deviations from this benchmark.

During 2001-02, HM Treasury plans to sell a further 120 tonnes of gold through auctions conducted by the Bank of England. It is intended that there will be 6 auctions of approximately 20 tonnes. These auctions will continue to be conducted on a single, uniform-price basis, and will complete the UK's gold sales programme.

An NAO report on the gold sales programme published in January concluded that: "the Treasury has met successfully its objectives to sell in a transparent and fair manner while achieving value for money."[2]

Sterling swaps

The Bank has also undertaken a major programme of swapping out of sterling in order to obtain better value for money in the financing of the reserves than the alternative of foreign currency borrowing, given the premium on gilts. Some £8.5 billion of such swaps will have been completed by the end of the year. An additional £0.8 billion of sterling was used to finance the replacement of forward contracts to purchase foreign currency with spot foreign currency reserves. The resulting temporary rise in the gross reserves has not increased the UK's net foreign currency exposures because all transactions have been hedged. The mechanics of the swaps programme are explained in the box on pages 23 and 24.

Intervention

Intervention in the foreign exchange markets was undertaken on one occasion, on 22 September 2000, when the Bank purchased €85 million against sterling. This was part of a concerted intervention by the G7 monetary authorities because of the shared concern about the potential implications of movements in the euro for the world economy.

Size of the UK's reserves

Over the year to the end-February 2001, the UK's reserves had changed very little at $13.7 billion in dollar terms although they had risen by nearly £800 million, or around 10%, in sterling terms, reflecting the depreciation of sterling against the dollar over the period.

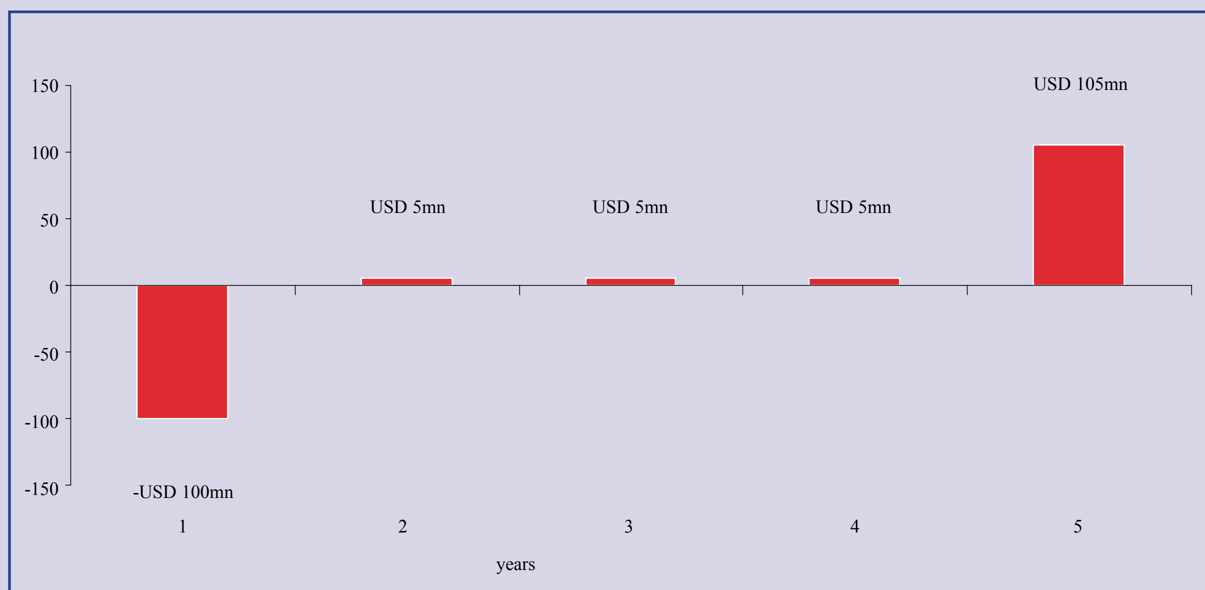
[2]Source: The Sale of Part of the UK Gold Reserves, HC 86 Session 2000-01, January 2001, National Audit Office

EEA SWAPS PROGRAMME EXPLAINED

During the course of 2000-01 the Bank of England, as HM Treasury's agent, will have undertaken around £8.4bn of swaps out of sterling into foreign currency assets, in regular weekly operations. The basic structure of the swaps used is set out below.

Typically, in each transaction a foreign currency-denominated fixed rate bond was bought, and at the same time both the currency and interest rate risks on the bond were hedged in the swaps market. Depending on which structure offered the best value for money, the Bank undertook either a single transaction, or conducted separate currency and interest rate swaps. The cash flows generated are set out in more detail in the example given below. These operations are conducted in US dollars (USD), euros and yen.

Diagram 1: Cash flows of 5% USD par bond

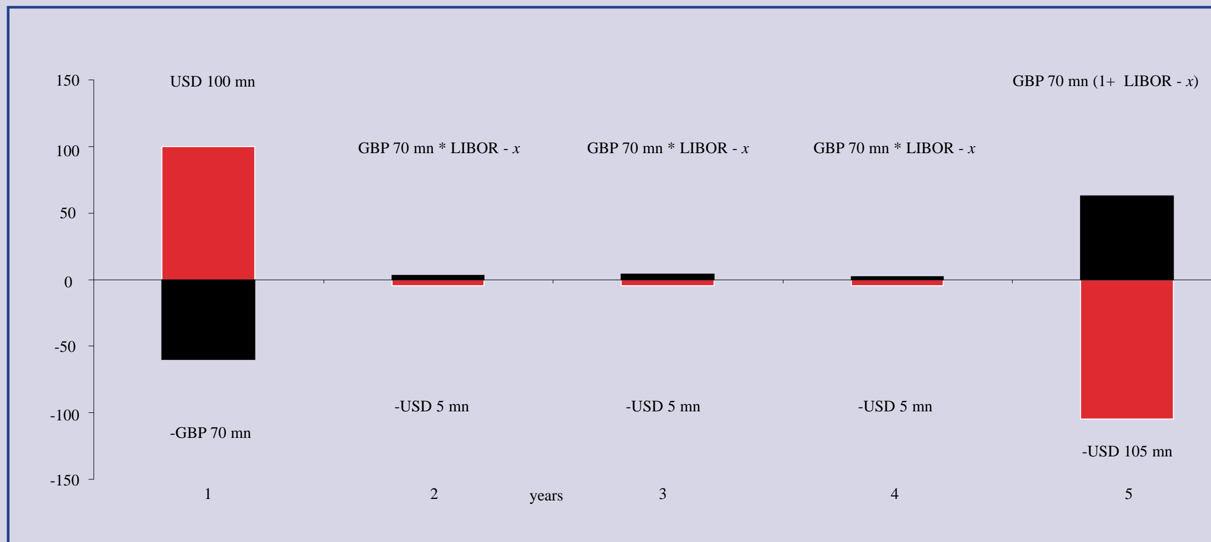


In the above example, the Bank makes an initial payment to the swap counterparty of £70 million in exchange for USD 100 million, converted at the prevailing spot rate. At the maturity of the swap the Bank will repay USD 100 million to the counterparty in exchange for the return of £70 million. Over the life of this "basis swap", which hedges the exchange rate risk, the Bank will remunerate the counterparty for the dollars at a dollar LIBOR rate, and will receive interest on the sterling exchanged at sterling LIBOR. A basis point spread between the two rates may be negotiated to reflect the price of the basis swap.

The USD100 million will be used to purchase USD-denominated assets, such as the 5-year 5% par bond selected in the above example. The interest rate exposure of this bond will be eliminated through an interest rate swap, where the fixed dollar cash flows will be paid to the swap counter-party in return for floating dollar LIBOR receipts, plus or minus a basis point spread. These receipts are used to pay the interest on the initial dollar exchange.

The USD-denominated cash flows in this transaction will cancel and so the only net cash flows for the EEA will be the sterling principal payment, remunerated over the life of the swap at sterling LIBOR plus or minus *x* (where *x* is the total basis point spread on the currency swap), which is then returned to the Bank at maturity. The foreign currency-denominated fixed rate asset thus generates a stream of floating rate sterling receipts, which are immune to both changes in the sterling exchange rate and to changes in USD interest rates.

Diagram 2: Currency cash flow swaps



THE GOVERNMENT'S FINANCING PROGRAMME FOR 2001-02

Financing framework

The Government intends to continue to finance the central government net cash requirement using the framework which was established in the 1995 Debt Management Review. The Government aims to finance its net cash requirement plus maturing debt and any finance required for additional net foreign exchange reserves through the issuance of debt. All such debt issuance will take place within a set maturity structure, which will be determined each year and published before the start of the year in the Debt & Reserves Management Report. In addition, the Government may hold conversion offers, switch and reverse auctions of non-benchmark stocks.

The financing requirement for 2001-02 also takes into account the DMO's net cash surplus accumulated over 2001-01. This was a result of the strength of the public finances and the unanticipated receipts from the 3G Spectrum auction. It is anticipated that this net cash position will be run down over the next three financial years, consistent with the policy commitment given by Ministers at the time of the PBR.

Financing arithmetic

Table 7 gives full details of the structure and composition of debt instruments that the Government intends to use to finance the central government net cash requirement in 2001-02.

The central government net cash requirement for 2001-02 is forecast to be £0.3 billion. Gilt redemptions excluding official holdings are expected to be £16.7 billion (see Table 8). In line with the assumption for 2000-01, the level of the net official foreign currency reserves is assumed to be unchanged between end-March 2001 and end-March 2002.

The Government has decided to pre-finance its 2003 €2 billion note (£1.3 billion at current exchange rates) by additional gilts issuance. This represents no addition to the net official foreign currency reserves.

This transaction should provide better value for money for the taxpayer compared to further foreign currency borrowing.

Table 7: 2001-02 financing requirement (£ billion)

Central government net cash requirement forecast		0.3
Accrued uplift on maturing index-linked gilt		1.1
Pre-financing foreign currency debt		1.3
Gilt redemptions		16.7
Gilt buy-backs		1.0
Gross Financing Requirement		**20.4**
Less		
National Savings		-3.0
Net Financing Requirement		**23.4**
Financed by		
Gilt Sales		
Conventional	Short	0.0
	Medium	4.75
	Long	5.0
Index-linked		3.75
Total		**13.5**
Changes in Net Short-Term Debt		
Changes in the Ways & Means		0.0
Changes in T-bill stock		5.0
Change in DMO net cash position		4.9
Total		**9.9**
Forecast Net Short-Term Debt Levels (end-March 2002)		
Ways & Means		13.4
T-bill stock		8.5
DMO net cash position		6.8

National Savings

National Savings' net contribution to financing (including accrued interest) in 2001-02 is forecast to be -£3.0 billion. This assumes gross sales (i.e. sales and deposits including accrued interest) of around £11 billion. This forecast is not a target but an estimate based on experience in previous years, trends in 2000-01 and National Savings' own forecasts and objectives. It also reflects the large amount of maturities falling due on National Savings' products during 2001-02.

Short-term net debt position

It is forecast that the short-term net debt position will change by £9.9 billion in 2001-02. This is driven by two main factors:

- the forecast increase in the planned end-year Treasury bill stock; and
- a run down of the DMO's accumulated cash position.

The level of the Ways and Means planned for 31 March 2001 is £13.4 billion and in the central forecast is assumed to remain at this level.

The financing plans for 2001-02 assume a build up in the Treasury bill stock of £5.0 billion. The planned stock of Treasury bills held outside central government is targeted to rise to £8.5 billion by the end of 2001-02. The DMO has a strategic aim to build up the Treasury bill market in order to facilitate efficient cash management.

It is assumed the DMO will partially unwind its accumulated net cash position by £4.9 billion over 2001-02. This is consistent with the policy commitment given in the November 2000 PBR, which stated that the accumulated net cash position would be run down over the next three financial years.

Quantity of gilt sales

The DMO, under instruction from HM Treasury and on behalf of the Government, will aim to meet the remainder of the financing requirement by selling gilts to the private sector. On the basis of the Budget 2001 central government net cash requirement forecast, this means gross gilt sales of approximately £13$^{1}/_{2}$ billion (cash).

Nature of stocks

The Government will continue to have available the full range of financing instruments and market operations, including conversion offers and switch and reverse auctions, to maintain large liquid issues across the maturity spectrum. There are no current plans for a new floating rate gilt or issuance of gilts of less than 5-years maturity. Index-linked issuance will be concentrated in the medium and long maturities although the option to issue shorter maturity stocks remains open.

Maturity structure of issuance

Gross issuance is again expected to be relatively low in 2001-02. Issuance is to be split between medium and long conventionals and index-linked stocks.

The Gilts Remit for 2001-02 assumes four outright auctions for conventionals, two each for medium and long maturities.

It is assumed that just under one third of total gross issuance (£3.75 billion cash) will be of index-linked debt via four outright auctions. This reflects the Government's continuing commitment to the index-linked market against a background of sustained low inflation.

Table 8: Stocks maturing in 2001-02 (£ million)

Redemption Date	Stock	Nominal amount outstanding	Official holdings (end-January 2001)	Nominal value of stocks outside central government (end-January 2001)
10 Jul 2001	Floating rate 2001	3,000	20	2,980
12 Jul 2001	9 1/2% Conversion 2001	3	3	0
10 Aug 2001	9 3/4% Conversion 2001	35	28	7
24 Sept 2001	2 1/2% IL Treasury 2001	2,150	123	2,027
6 Nov 2001	7% Treasury 2001	12,750	1,039	11,711
Total Outstanding		**17,938**	**1,213**	**16,725**

Index-linked gilt switch auctions

The 2% Index-linked Treasury 2006 drops out of the FTSE over 5-year index-linked gilt index in July 2001. In order to facilitate switching longer by index-linked tracking funds the DMO may consider switching to stock by auction out of 2% Index-linked Treasury 2006 (and possibly others) into longer-dated index-linked gilts. The DMO will consult with the market on how to extend the current switch auction policy and methodology to index-linked gilts and will publish its conclusions in advance of any such operations.

Potential redesign of index-linked gilts

The Government has not issued a new index-linked gilt since 1992. Since then, there have been several international innovations in the design of such bonds, which offer potential advantages over the current UK design. The DMO will consult the market during 2001-02 on whether to adopt a new design for new index-linked gilts; however, it is not envisaged that any new index-linked gilt will be issued prior to 2002-03.

Contingencies

If the forecast for the central government net cash requirement is revised down (i.e. a surplus), HM Treasury would consider accommodating such a revision by: a programme of debt buy-backs including reverse auctions (up to £1.5 billion); accommodating the surplus in the DMO's net cash position; reducing the planned increase in Treasury bill stock; reducing gilt supply; or some repayment of the Ways and Means facility at the Bank of England (up to £1 billion).

If the financing requirement were to be revised upwards, HM Treasury would consider: increasing gilts issuance; running down further the DMO's net cash position; or increasing the planned outstanding stock of Treasury bills.

Specific decisions on the exercising of contingencies would be made in light of circumstances.

THE DEBT MANAGEMENT OFFICE REMIT FOR 2001-02

A) Gilt remit

Objectives

1. The Debt Management Office (DMO), an Executive Agency of HM Treasury, has been given the following objectives in respect of Government debt management:

- to meet the annual remit set by HM Treasury Ministers for the sale of gilts with high regard to long-term cost minimisation taking account of risk;
- to advise Ministers on setting the remit to meet the Government's debt management objectives, and to report to Ministers on the DMO's performance against its remit, objectives and targets;
- to develop policy on, and promote advances in, new instruments, issuance techniques and structural changes to the debt markets that will help to lower the cost of debt management, liaising as appropriate with the Bank of England, Financial Services Authority, London Stock Exchange, and other bodies; and to provide policy advice to HM Treasury Ministers and senior officials accordingly;
- to conduct its market operations, liaising as necessary with regulatory and other bodies, with a view to maintaining orderly and efficient markets and promoting a liquid market for gilts;
- to provide, including in liaison with the Bank of England and CRESTCo, a high quality efficient service to investors in government debt, and to deal fairly and professionally with market participants in the gilt and money markets, consistent with achieving low cost issuance;
- to contribute to HM Treasury's work on the development of the strategy for the debt portfolio; and
- to make information publicly available on the debt markets and DMO policies where that contributes through openness and predictability to efficient markets and lower costs of debt issuance.

Quantity of gilt sales

2. The DMO, on behalf of the Government, will aim for gilt sales of approximately £13 1/2 billion (cash) in 2001-02.

Pace of gilt sales

3. The DMO will aim to sell gilts at a broadly even pace through the year. Within-year seasonal fluctuations in the pattern of central government expenditure and revenue will be met by other financing means governed by the Exchequer Cash Management Remit.

Amount and maturity mix of index-linked gilt issuance

4. Over 2001-02, the DMO plans to sell £3.75 billion (cash), just under 30 per cent of its gilts sales, in index-linked stocks.

5. Four auctions of index-linked stocks are planned in 2001-02. Issuance will be directed at medium- and longer-dated maturities (i.e. stocks dated 2009 and longer).

6. To ensure the medium-term viability of the index-linked auction programme, the authorities remain committed to a minimum annual supply of £2.5 billion (cash) of index-linked stocks for the foreseeable future.

Amount and maturity mix of conventional gilt issuance

7. Four auctions of conventional stocks are planned in 2001-02; two in the long (15 years and over) maturity area and two in the medium (7-15 years) area.

8. HM Treasury will consider accommodating reductions in the forecast 2001-02 financing requirement by: a programme of debt buy-backs including reverse auctions (up to £1.5 billion); accommodating the surplus in the DMO's net cash position; reducing gilt supply; reducing the planned increase in Treasury bills; or some repayment of the Ways and Means facility at the Bank of England (up to £1 billion).

9. Increases in the financing requirement will be accommodated by a combination of: increasing gilts issuance; running down the DMO's net cash position; or increasing the planned outstanding stock of Treasury bills.

10. Specific decisions would be made in the light of circumstances.

Buy-backs of debt

11. The DMO may accept offers of stock from the market up to a total of £1.0 billion (cash) net of gilts in 2001-02. This will initially be through secondary market purchases rather than via a programme of reverse auctions.

Method of issuance of gilts

12. Auctions will constitute the primary means of issuance of all gilts (conventional and index-linked). The DMO plans to hold four outright auctions of conventional gilts and four outright auctions of index-linked gilts. All auctions will be single auctions held on the day indicated.

13. Each outright auction of conventional gilts is planned to be for between £1 1/2 billion and £3 billion (cash) of stock on a competitive bid-price basis. Each auction of index-linked gilts will be for between £1/2 billion and £1 1/4 billion (cash) on a uniform price basis.

Gilt Auction Calendar 2001-02

Date	Type
Wednesday 25 April 2001	Index-linked
Thursday 24 May 2001	Conventional
Wednesday 25 July 2001	Index-linked
Wednesday 26 September 2001	Conventional
Wednesday 24 October 2001*	Index-linked
Wednesday 28 November 2001*	Conventional
Thursday 24 January 2002	Index-linked
Wednesday 27 March 2002*	Conventional

** Subject to confirmation following the Chancellor's decisions on the Budgetary timetable.*

14. The programme of conventional and index-linked gilt auctions may be supplemented between auctions by official sales of stock by the DMO "on tap". Taps of stocks will be used only as a market management instrument in conditions of temporary excess demand in a particular stock or sector. The DMO would only contemplate taps of stocks in exceptional circumstances.

15. After an auction, the DMO will generally refrain from issuing stocks of a similar type or maturity to the auction stock for a reasonable period. Such stock will only be issued if there is a clear market management case.

16. For the purposes of market management, the DMO may create and repo out stock in accordance with the provisions of its Standing Repo facility launched on 1 June 2000.

In-year consultation and announcements on auctions

17. Towards the end of each calendar quarter, the DMO will publish, with the agenda for the consultation meetings with gilt market participants, details of progress to date with the gilt issuance programme, including any changes to the Government's financing requirement and any changes to the gilts auction programme. The DMO will then consult Gilt-edged Market-Makers and representatives of end-investors on the auction programme for the following quarter and any other issues that may arise. Following that consultation, at the end of the quarter, the DMO will announce plans for the auctions scheduled for the coming quarter. For each auction, this will indicate the stock to be auctioned or, where relevant, the approximate maturity of a new stock.

18. The auction plan for the first quarter of 2001-02 will be announced at 3:30 p.m. on Friday 30 March 2001.

19. Full details of these, and subsequent, auctions will be announced at 3:30 p.m. on the Tuesday of the week preceding the auction.

Coupons

20. As far as possible, coupons on new issues of gilts will be set to price the stock close to par at the time of issue. The DMO may consider establishing a new set of coupon dates on any stock issued in 2001-02.

Buy-ins of short maturity debt

21. The DMO will have responsibility for buying-in stocks close to maturity to manage Exchequer cash flows.

Conversions and switch auctions

22. In order to build up the pool of benchmark stocks further, the DMO may in future make offers for the conversion of unstrippable stocks into benchmarks of similar maturity during 2001-02. The DMO may consider converting out of stocks with up to £5.5 billion (nominal) in issue. Such offers may be supplemented by switch auctions into benchmark stocks during 2001-02. Subject to the conclusions of a consultation exercise with the market on the introduction of index-linked switch auctions, the DMO may launch such auctions in 2001-02. Details of any future switch auction stocks will be announced at the same time as the end-quarter announcements of forthcoming outright auctions.

Revisions to the remit

23. This remit, and in particular the number of auctions and the allocation between conventional maturity bonds and index-linked gilts, may be varied during the year in the light of substantial changes in the following:

- the Government's forecast of the gilt sales requirement;
- the level and shape of the gilt yield curve;
- market expectations of future interest and inflation rates; and
- market volatility.

24. Any revisions to this remit will be announced.

B) Exchequer cash management remit

Objective

1. The DMO's primary objective in carrying out its Exchequer cash management operations will be to offset, through its market operations, the expected cash flow into or out of the National Loans Funds on every business day; and to do so in a cost-effective manner. In doing so the DMO should:

- balance cost and risk in its choice of strategies; and
- manage cash flows without influencing the level of short-term interest rates.

2. The DMO should also take account of:

- the operational requirements for the Bank of England for implementation of its monetary policy objectives; and
- its impact on the efficiency of the sterling money market.

3. The DMO will carry out its objective primarily by a combination of:

- structured weekly Treasury bill tenders;
- bilateral market operations with DMO counterparties; and
- ad hoc tenders of Treasury bills (and repo or reverse repo transactions).

4. The DMO and the Bank of England will work together to avoid clashes in the delivery of their respective objectives in the money markets. The DMO will not take speculative positions on interest rate decisions by the Bank nor hold operations which by their nature or timing in the day could be perceived to clash with the Bank's open market operations.

I) Structured Treasury bill tenders

Timing and schedule of announcements

5. The DMO will hold structured Treasury bill tenders on the last business day of each week. When announcing the results, the DMO will also announce the quantity and maturity of Treasury bills on offer in the structured tender in the following week and may give the maturity and indicative size of any ad hoc tenders in the following week.

6. Following the final structured tender at the end of each quarter, the DMO will issue a notice outlining the maturities of Treasury bills likely to be available via structured tenders over the following quarter.

Maturities

7. The DMO's structured Treasury bill tenders in 2001-02 may be of the following maturities:

- one month (approximately 28 days);
- three months (approximately 91 days);
- six months (approximately 182 days); and
- twelve months (approximately 364 days).

8. The DMO expects to give priority to establishing fully the shorter maturities before introducing the longer maturity instruments.

Level of stocks

9. The DMO will manage Treasury bill transactions with a view to running down the stock of bills in months of positive cash flows and increasing it in months of higher net expenditure. The DMO will aim to build up the stock of Treasury bills in market hands to £8.5 billion by the end of March 2002.

Interaction with Bank of England's money market operations

10. The DMO may also issue Treasury bills to the market to assist the Bank of England in its management of the sterling money markets. In response to a request from the Bank, the DMO will add a specified amount to the size(s) of the next structured bill tender(s) and deposit the proceeds with the Bank, remunerated at the weighted average yield(s) of the respective tenders. The amount being offered to accommodate the Bank's

request will be identified in the DMO's weekly structured bill tender announcement. Treasury bill issues at the request of the Bank will be identical in most respects with the rest of the stock of Treasury bills outstanding.

Ad hoc tenders

11. The DMO may also issue short maturity Treasury bills (up to 28 days) at ad hoc tenders. The objective of such tenders will be to provide additional flexibility for the DMO in smoothing Exchequer cash flows. Treasury bills issued in ad hoc tenders will be identical in every respect with those issued by structural tenders.

12. In addition to issuing Treasury bills, the DMO may also execute repo or reverse repo transactions at ad hoc tenders. For such transactions, collateral used would either be gilts or Treasury bills.

13. The DMO may also hold ad hoc tenders for buying in gilts (or gilt strips) with a residual maturity of less than six months.

Timing of ad hoc tenders

14. The DMO will usually announce its intention to hold ad hoc tenders in the weekly announcement of the structured tender result. Such announcements will indicate the day(s) of the following week on which ad hoc tender(s) are expected to be held, together with a guide to the expected maturity and size.

15. The precise details of the maturity and nominal amount on offer will be announced at the opening of the offer on the morning of the tender (usually at either 8:30 a.m. or 10:00 a.m.).

II) Bilateral operations with the market

16. In pursuit of its cash management objectives, the DMO expects to continue to trade on a daily basis with its counterparties across a range of instruments.

17. The DMO's bilateral operations may comprise of:

- purchase from the market for future resale (reverse repo);
- sale to the market for future repurchase (repo);
- outright sale and purchase of gilts, Treasury bills and eligible bank bills, certificates of deposit, commercial paper, selected bank bills and other short-term debt issued by high quality issuers, including supranationals and foreign governments;
- unsecured cash borrowing and lending with its counterparties; and
- short-term foreign currency swaps, Forward Rate Agreements (FRAs) and interest rate futures may also be used to manage foreign currency and interest rate exposures. All foreign currency exposure will be hedged back into sterling.

18. The DMO would give prior notice to the market if it planned to introduce additional instruments for use in its bilateral operations.

19. Other than gilts and Treasury bills, collateral used in the repo and reverse repo transactions may include selected euro-denominated government securities, eligible bank bills, and supranational sterling and euro-denominated securities. In carrying out these transactions, the DMO may make use of those of its own holdings of marketable gilts, and of funds managed by the National Investment and Loans Office (NILO), for collateral purposes. If required, in exceptional circumstances, HM Treasury may issue gilts or Treasury bills, to the DMO for collateral purposes.

BANK OF ENGLAND'S REMIT FOR THE MANAGEMENT OF THE OFFICIAL RESERVES

Introduction

1. This remit sets out the objectives and strategy which the Bank of England (the Bank) is to pursue in managing the Exchange Equalisation Account (EEA) as agent for HM Treasury. The EEA is subject to the provisions of the Exchange Equalisation Account Act 1979, which sets out the purposes for which it is to be used. In addition, HM Treasury has published a Public Service Agreement (PSA) objective under which it undertakes to minimise the cost of holding the Government's foreign currency reserves, while reducing risk.

Objectives

2. In order to fulfil the functions laid down in the EEA Act 1979, and meet the published PSA objective, HM Treasury and the Bank have agreed that the Bank will:

i carry out in a legal and proper form foreign currency and gold transactions on behalf of HM Treasury and other Government departments efficiently and cost effectively;

ii manage the official reserves so as to maintain their liquidity and security within the limits agreed with HM Treasury, and that the public funds entrusted to the Bank in the EEA are properly and well managed and safe-guarded;

iii subject to ii above, manage the official reserves so as to maximise their return;

iv monitor and report on the level of risk and return on holding reserves;

v ensure that effective management systems, including financial monitoring and control systems, have been put in place;

vi ensure that proper financial procedures are followed and that accounting records are maintained in a form suited to the requirements of management as well as in the form of prescribed for the published accounts;

vii provide accurate and timely accounting and statistical information and analysis as requested by HM Treasury;

viii advise HM Treasury on foreign exchange market conditions; and

ix advise HM Treasury on the management of foreign currency borrowing (covering both new borrowing, hedging and repayments) and implement agreed strategy in these areas.

Composition of the reserves and discretionary management

3. The reserves will be invested in a specified range of instruments and relative to currency and other benchmarks as agreed with HM Treasury, with limited scope to deviate from these constraints in order to enhance the return on the reserves.

Operational standards

4. In carrying out these tasks the Bank will so far as possible ensure that its internal systems and controls are adequate for the size, nature and complexity of operations on the EEA and compare well with best market practice.

Monitoring and controlling risk

5. The Bank will measure the exposure of the EEA portfolio to market risk in three main ways: using a Value at Risk (VAR) measure to aggregate risk consistently across the components of the portfolio; using sensitivity measures for a more detailed analysis of risk; and using stress tests that quantify the potential loss from worst case scenarios.

6. The Bank will continue to measure and manage the EEA's exposures to banks, securities houses and issuers using the existing credit system. This system and the credit limits which it provides will be kept under review in the light of market or institutional developments affecting the position of counterparties. The Bank will also provide HM Treasury with a monthly report of limit excesses or management overrides, and a full statement of credit limits every six months.

Audit arrangements

7. The Bank agrees to provide regular written reassurance to the EEA Accounting Officer that Bank management of the EEA is regular and proper and in particular that the Bank's management of the EEA is properly controlled, the systems that generate the EEA's annual accounts are properly controlled, and the Bank has complied with this remit. The Bank's internal audit arrangements will accord with the objectives, standards and practices set out in HM Treasury's *"Government Internal Audit Manual"* and the guidance provided in the *"Government Information Systems Audit Manual"*.

Accounting and NAO access

8. The Bank will maintain accounts based on UK Generally Accepted Accounting Practice (UK GAAP) in accordance with the relevant Accounts Direction and will prepare draft accounts for the EEA for 2001-02 by the end of July 2002 for immediate submission to the National Audit Office.

9. For the purposes of the examination and certification of the EEA accounts, or for any examination pursuant to Section 6(1) of the National Audit Act 1983 concerning the economy, efficiency and effectiveness with which the Bank has managed the EEA, the Comptroller and Auditor General may require access to such documents, Bank buildings, and factual explanations as he considers necessary.

Review of reserves management

10. To enable HM Treasury to monitor the management of the reserves, the Bank will provide HM Treasury with accurate and timely accounting and statistical information. In particular, a monthly management information report, which will be discussed at a monthly meeting chaired by the Debt and Reserves Management team leader, and a quarterly report on performance which should enable the Accounting Officer to check progress in meeting HM Treasury's PSA target on reserves management.

11. The Accounting Officer for the EEA will also meet the Bank every six months in order to review strategy and to agree on analysis to be commissioned from the Bank for the next six-monthly meeting. Changes to this remit in 2001-02 and meetings to discuss individual issues may be proposed at any time by HM Treasury or by the Bank, and in such cases the Bank will provide relevant information as requested by HM Treasury.

Publications policy

12. Figures on the United Kingdom's net reserves and the Bank's net holdings of foreign currency and gold will be published in a Press Notice at 9:30 a.m. on the third working day of every month. This will disclose the amounts, currencies and dates of any intervention operations undertaken during the period, with explanations as to why the intervention was undertaken. The format of this monthly Press Notice will be in line with the requirements of the IMF's Special Data Dissemination Standard and will be aligned with the conventions of the G10/IMF reserves template published simultaneously on the Bank of England's website.

Cash management

13. Subject to meeting its objectives under this remit, the Bank will so far as is possible aim to manage the EEA so as to avoid conflict with the DMO's sterling cash management operations.

Intervention

14. Specific prior authority from HM Treasury Ministers is required for intervention designed to influence sterling's exchange rate using the EEA, or for EEA participation in concerted intervention in support of any other currency. The Bank will subsequently report on the extent to which any such authority was used, and to what effect, by letter.

Gold sales

15. During 2001-02, HM Treasury plans to sell a further 120 tonnes of gold through auctions conducted by the Bank of England. It is intended that there will be 6 auctions of approximately 20 tonnes. These auctions will continue to be conducted on a single, uniform-price basis, and will complete the UK's gold sales programme.

NATIONAL SAVINGS' FINANCING REMIT 2001-02

1. National Savings (NS) is an Executive Agency of the Chancellor of the Exchequer. Its role is to act as an integral part of the UK's debt management arrangements and its aim is to help reduce the cost to the taxpayer of Government borrowing now and in the future. To achieve this NS' strategic objective is to:

- provide retail funds for the Government that are cost-effective in relation to funds raised on the wholesale market.

2. Key business objectives for NS to deliver its strategic objective are:

- to improve the competitiveness of the overall offer to customers;
- to ensure levels of customer service which meet standards of best practice in the retail financial services sector; and
- to develop a more flexible and responsive business that can deliver a range of net financing requirements to HM Treasury.

3. In pursuit of its cost-effectiveness strategy, NS will operate fairly, transparently and pro-competitively, engendering customer loyalty and securing new business by offering attractive products on fair terms.

Responsibility for setting product terms

4. HM Treasury are ultimately responsible, under the National Loans Act 1968, for setting the terms of NS products.

5. NS will normally take the lead in bringing forward proposals to HM Treasury Ministers on product development (including proposals for new products) or on product terms (including interest rates). If the proposals are consistent with NS' objectives and this remit, HM Treasury Ministers would expect to endorse them.

Volume of financing in 2001-2002

6. Sales and deposits (including accrued interest) of NS products are assumed to be around £11.0 billion in 2001-02. After meeting expected maturities and withdrawals there is expected to be a net contribution to government financing of around -£3.0 billion.

Cost of financing

7. The average cost of NS products should lie within a reasonable range of the cost of equivalent gilts or other short-term comparators.

8. NS or HM Treasury can initiate a review of product terms at any time. NS will carry out each review. Any proposed changes will take account of the cost of NS financing, the achievement of this remit and the need for NS to retain the capability and market presence to contribute to government financing over the medium-term.

Review of remit

9. HM Treasury or NS may initiate a review of this remit in the course 2001-02 in the light of any relevant factors.

Any enquiries about this document should be addressed to:

HM Treasury

Moyeen Islam, Tel (44) 20 7270 5471

Address : Debt and Reserves Management Team, 3rd Floor, HM Treasury, Parliament Street, London SW1P 3AG.
E-mail : moyeen.islam@hm-treasury.gov.uk

UK Debt Management Office

Allison Holland, Tel (44) 20 7862 6534

Address : UK Debt Management Office, 1st Floor, Cheapside House, 138 Cheapside, London EC2V 6BB.
E-mail : allison.holland@dmo.gov.uk

Further copies of this document are available from:

The Public Enquiry Unit, HM Treasury, Parliment Street, London, SW1P 3AG.
Tel: (44) 20 7270 4558

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