



HM Treasury

Debt management report 2017-18

March 2017



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1 Introduction

1.1 The 'Debt management report' (DMR) is published in accordance with the 'Charter for Budget Responsibility'.¹ The Charter requires the Treasury to "report through a debt management report – published annually – on its plans for borrowing for each financial year" and to set remits for its agents. The Charter requires the report to include:

- the overall size of the debt financing programme for each financial year
- the planned maturity structure of gilt issuance and the proportion of index-linked and conventional gilt issuance
- a target for net financing through NS&I

1.2 The UK Debt Management Office (DMO) publishes detailed information on developments in debt management and the gilt market over the previous year in its 'Annual Review'.

1.3 Chapters 2 and 3 along with annexes A and B contain information on the government's wholesale debt management activities. Information about financing from NS&I is set out in annex C. The Exchequer cash management remit for 2017-18 is contained in annex D.

¹ Available at <https://www.gov.uk/government/publications/charter-for-budget-responsibility-autumn-2016-update>.

2 Debt management policy

2.1 This chapter provides an overview of the government's debt management framework. It also sets out medium-term considerations for debt management policy during the current period of fiscal consolidation. The debt management framework is part of the overall macroeconomic framework, which includes the fiscal, macro prudential and monetary policy frameworks. These are outlined in the Spring Budget 2017 document.¹

Debt management framework

2.2 The debt management framework includes:

- the debt management objective
- the principles that underpin the debt management policy framework
- the roles of the DMO and HM Treasury
- the full funding rule

Debt management objective

2.3 The debt management objective, originally established in 1995 following the 'Debt Management Review', is:

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

2.4 While decisions on debt management policy must be taken with a long-term perspective, specific decisions on funding the government's gross financing requirement are taken annually. Those decisions are announced in advance for the forthcoming year and can be updated during the year.

Components of the debt management objective

2.5 The costs of meeting the government's financing needs arise directly from interest payable on debt (coupon payments and the difference between issuance proceeds and redemption payments) and the costs associated with issuance. "Over the long term" means that the government expects to issue debt beyond the forecast period. This expectation is reflected in the government's choice of debt management strategies.

2.6 A number of risks are taken into account when selecting possible debt management strategies. Five particularly important risks are:

- interest rate risk – interest rate exposure arising when new debt is issued
- refinancing risk – interest rate exposure arising when debt is rolled over, with an increase in refinancing risk if redemptions are concentrated in particular years
- inflation risk – exposure to inflation from the indexation of coupons and principal of index-linked gilts

¹ Available at <https://www.gov.uk/government/topical-events/spring-budget-2017>.

- liquidity risk – the risk that the government may not be able to borrow from a particular part of the market in the required size at a particular time, because that part of the market is insufficiently liquid
- execution risk – the risk that the government is not able to sell the offered amount of debt at a particular time, or must sell it at a large discount to the market price

2.7 These are the major risks that the government has taken into account in recent years and expects to take into account in future years. The weight placed on each risk can change over time. An explanation of how risk is taken into account in determining the DMO's financing remit for 2017-18 is set out in annex B.

Debt management policy principles

2.8 The debt management objective is achieved by:

- meeting the principles of openness, transparency and predictability
- encouraging the development of a liquid and efficient gilt market
- issuing gilts that achieve a benchmark premium
- adjusting the maturity and nature of the government's debt portfolio
- offering cost-effective retail financing through NS&I while balancing the interests of taxpayers, savers and the wider financial sector

2.9 The framework is underpinned by the institutional arrangements for debt management policy established in 1998, in particular the creation of the DMO with responsibility for the implementation and operation of debt management policy.

Roles of HM Treasury and the DMO

2.10 The respective roles of HM Treasury and the DMO are set out in the DMO's 'Executive Agency Framework Document'.² In particular:

- the DMO will conduct its operations in accordance with the principles of openness, predictability and transparency
- HM Treasury and the DMO will explain the basis for their decisions on debt issuance as fully as possible to allow market participants to understand the rationale behind the decisions
- the DMO will advise on and encourage the development of liquid and efficient gilt and Treasury bill markets

2.11 HM Treasury sets the annual financing remit using the projected financing requirement prepared on the basis of the Office for Budget Responsibility's (OBR) forecasts for the fiscal policy aggregates. The DMO has responsibility for pre-announcing the details of its issuance plans to the market, including a planned auction calendar setting out the dates and type of gilt, and details of planned average auction sizes.

The full funding rule

2.12 An overarching requirement of debt management policy is that the government fully finances its projected financing requirement each year through the sale of debt. This is known as

² Available at <http://www.dmo.gov.uk/documentview.aspx?docname=publications/corpgovernance/fwork040405.pdf>.

the 'full funding rule'. The government therefore issues sufficient wholesale and retail debt instruments, through Treasury bills (for debt financing purposes) and gilts and NS&I products respectively, to enable it to meet its projected financing requirement.

2.13 The rationale for the full funding rule is:

- that the government believes that the principles of transparency and predictability are best met by full funding of its financing requirement
- to avoid the perception that financial transactions of the public sector could affect monetary conditions, consistent with the institutional separation between monetary policy and debt management policy³

2.14 The total amount of financing raised in a financial year will in practice differ marginally from the projected financing requirement. This divergence normally occurs towards the end of the financial year and can be explained by a number of different factors. These include:

- the difference between the projected central government net cash requirement (CGNCR) and its outturn
- the difference between the projected net contribution to financing by National Savings and Investments (NS&I) and its outturn
- auction proceeds in the period following the Autumn Statement that are different from those required to meet relevant financing targets⁴
- the implementation of the syndication programme at year-end

2.15 The difference will be reflected in a change in the DMO's cash balance at the end of the financial year. To meet the full funding rule, the government adjusts the projected net financing requirement (NFR) in the following financial year to offset any difference. However, this does not affect the DMO's cash management operations intended to smooth the government's cash flows across the financial year-end. The DMO's flexibility to vary the stock of Treasury bills for cash management purposes is implemented with full adherence to the full funding rule.

Medium-term projections for annual financing requirements

2.16 The government has published projections for financing requirements in the fiscal policy forecast period. The financing requirements include the forecast path for the central government net financing requirement (excluding NRAM plc, Bradford and Bingley and Network Rail) (CGNCR (ex NRAM, B&B and NR)), the gilt redemption profile and planned financing for the Official Reserves.⁵ Table 2.A sets out the financing requirement projections from 2018-19 to 2021-22.

³ The short-term net cash position of the Exchequer will be held with market counterparts, with the exception of any agreed balance on the Debt Management Account held at the Bank of England and the Ways and Means Advance (a government account at the Bank of England). This means that, in practice, financial transactions of the public sector should not affect monetary conditions.

⁴ To meet the financing requirement, which is determined in cash terms, the DMO sizes auctions in nominal terms, taking into account prevailing market prices. Movements in market prices between the announcement of auction sizes and gilt auctions taking place mean that it is not possible to meet these targets precisely.

⁵ This excludes Network Rail's cash requirement but includes HM Treasury's requirement for financing lending to Network Rail.

Table 2.A: Financing requirement projections, 2018-19 to 2021-22

£ billion	2018-19	2019-20	2020-21	2021-22
CGNCR (ex NRAM, B&B and NR)	49.7	28.8	38.6	37.1
Gilt redemptions	67.3	96.2	97.6	79.3
Planned financing for the reserves	6.0	6.0	0.0	0.0
Illustrative gross financing requirement	123.0	130.9	136.3	116.4
Figures may not sum due to rounding.				
Source: OBR, HM Treasury and DMO				

Debt management considerations during the period of fiscal consolidation

2.17 Decisions on debt management policy are taken in advance to achieve the debt management objective. Each year, the government assesses the costs and risks associated with different possible patterns of debt issuance taking into account the most up-to-date information on market conditions and demand for debt instruments.

2.18 At present, annual debt management decisions are also made in the context of an elevated level of debt relative to gross domestic product (GDP), high but falling government borrowing and fiscal consolidation. Consistent with the long-term focus of the debt management objective, the government takes annual decisions that enhance fiscal resilience by:

- mitigating refinancing risk, that is, the need to roll over high levels of debt continuously and to avoid concentrating redemptions in particular years, by taking decisions which spread gilt issuance along the maturity spectrum
- encouraging the development of the liquidity and efficiency of the gilt market
- maintaining a diversity of exposure, both real and nominal, across the maturity spectrum, reflecting its preference for a balanced portfolio

2.19 As a result, subject to cost-effective financing, the government will:

- maintain a relatively high proportion of long average maturity debt in the portfolio to limit exposure to interest rate volatility
- maintain an appropriate proportion of index-linked gilt issuance
- continue to issue conventional and index-linked gilts over a range of maturities, taking account of structural demand and the diversity of the investor base
- maintain the Treasury bill stock at a level that will support market liquidity and the cash management objective

Borrowing by devolved administrations

2.20 The Scottish Government, Welsh Government and Northern Irish Executive have the power to borrow for capital investment, as set out in the Scotland Act 2012, Wales Act 2014 and Northern Ireland (Loans) Act 1975 respectively. Forthcoming changes to Scottish Government and Welsh Government borrowing powers, as agreed in respective fiscal frameworks, are set out below.

2.21 On 23 February 2016 the Scottish Government's new fiscal framework was agreed. This included revised borrowing arrangements. From 1 April 2017, the Scottish Government will be able to borrow up to £450.0 million in any one financial year. This equates to around 15% of the Scottish Government's existing capital expenditure limit, and is an increase of around £150.0

million to the current annual limit. The Scottish Government's total borrowing limit will also increase by £0.8 billion as part of the fiscal framework, to a total limit of £3.0 billion.

2.22 Since 1 April 2015, the Scottish Government has had the power to issue bonds to finance capital investment, in addition to borrowing from the National Loans Fund or commercial lenders. Any borrowing or bond issuance undertaken by the Scottish Government will count towards their overall debt limit of £3.0 billion.

2.23 On 19 December 2016 the Welsh Government's new fiscal framework was agreed. This included revised borrowing arrangements. The level of borrowing for capital investment is currently set at £125.0 million per year, increasing to £150.0 million from 2019-20 as a result of the new framework, within an overall cap of £1.0 billion.

2.24 The Welsh Government has the power to borrow from the National Loans Fund or commercial lenders. From April 2018 the Welsh Government will also have the power to issue bonds, as agreed in the St David's Day agreement between both Governments on 27 February 2015. Any borrowing or bond issuance undertaken by the Welsh Government will count towards their overall debt limit of £1.0 billion.

2.25 The Scottish and Welsh Governments will be solely responsible for meeting their liabilities and the UK government will provide no guarantee on any bonds issued by the Scottish and Welsh Governments. If there is an increase in the Scottish or Welsh Governments' borrowing limits, the UK government will also review devolved administrations powers to issue bonds. In addition, the Scottish and Welsh Governments would need further approval from HM Treasury to issue in any currency other than sterling.

Borrowing by local authorities

2.26 Under the prudential code, local authorities are fully responsible for meeting their own liabilities, including those they incur by entering into any guarantee commitments. The UK government provides no guarantee on local authority borrowing.

2.27 Local authorities undertake the bulk of their borrowing via the Public Works Loan Board (PWLB). In November 2016, the government published a response to its consultation paper which confirmed its plans to abolish the PWLB and transfer its powers to the Treasury. The government plans to use its powers in the Public Bodies Act 2011 to lay before Parliament a draft Order to implement these changes. This change is about governance only: local authorities will continue to be able to access borrowing from central government.

The Debt Management Office's financing remit for 2017-18

3

Introduction

3.1 The financing arithmetic sets out the components of the government's NFR and the contributions from various sources of financing. The DMO's financing remit sets out how the DMO, acting as the government's agent, will fund the projected NFR.

Financing arithmetic

3.2 The OBR's forecast for the CGNCR (ex NRAM, B&B and NR) in 2017-18 is £47.4 billion. This is the fiscal aggregate that determines gross debt sales and is derived from public sector net borrowing (PSNB). The relationship between PSNB and the CGNCR (ex NRAM, B&B and NR) is set out in the OBR's March 2017 'Economic and fiscal outlook' (EFO).

3.3 The forecast NFR in 2017-18 of £105.6 billion also reflects: projected gilt redemptions of £79.5 billion; a planned short-term financing adjustment of -£14.3 billion resulting from unanticipated overfunding in 2016-17; and additional sterling financing for the Official Reserves of £6.0 billion.

3.4 Proceeds from NS&I are expected to make a £13.0 billion net contribution to financing in 2017-18, following a net contribution of £12.2 billion in 2016-17. This projection assumes gross inflows of £37.0 billion in 2017-18.

3.5 Gilt issuance is the government's primary means of meeting the NFR. Treasury bills may also make a net contribution to meet the NFR.

3.6 In 2017-18, the NFR will be met by gross gilt issuance of £115.1 billion while the net stock of Treasury bills for debt management purposes will be reduced by £9.5 billion to £60.0 billion.

3.7 Table 3.A sets out details of the financing arithmetic for 2016-17 and 2017-18.

Table 3.A: Financing arithmetic in 2016-17 and 2017-18 (£ billion)

	2016-17	2017-18
CGNCR (ex NRAM, B&B and NR) ¹	72.5	47.4
Gilt redemptions	69.9	79.5
Planned financing for the reserves	6.0	6.0
Financing adjustment carried forward from previous financial years	-0.4	-14.3
Gross financing requirement	148.1	118.6
<i>less:</i>		
NS&I net financing	12.2	13.0
Other financing ²	0.2	0.0
Net financing requirement (NFR) for the Debt Management Office (DMO)	135.7	105.6
DMO's NFR will be financed through:		
Gilt sales, through the sales of:		
Short conventional gilts	38.0	27.4
Medium conventional gilts	29.2	22.2
Long conventional gilts	43.3	32.3
Index-linked gilts	36.0	26.6
Unallocated amount of gilts	0.0	6.6
Total gilts sales for debt financing	146.5	115.1
Total net contribution of Treasury bills for debt financing	3.5	-9.5
Total financing	150.0	105.6
DMO net cash position	14.8	0.5
Figures may not sum due to rounding.		
¹ Central government net cash requirement (excluding NRAM plc, Bradford and Bingley and Network Rail).		
² Prior to the publication of the end-year outturn in April each year, this financing item will mainly comprise estimated revenue from coinage.		
<i>Source: DMO, HM Treasury, NS&I, and OBR</i>		

Financing for the Official Reserves¹

3.8 The financing arithmetic provides for £6.0 billion of sterling financing for the Official Reserves in 2017-18. This additional financing, originally announced at Autumn Statement 2014, is intended to meet potential calls on the Official Reserves that may arise, and ensure the level of foreign currency reserves held is sufficient so that the UK remains resilient to possible future shocks.

3.9 For the purposes of the financing arithmetic in table 3.A, it is assumed that sterling will remain the main form of financing for the Official Reserves and no new foreign currency debt will be issued in 2017-18. However, if the government judges that there is a case for doing so, taking into account cost, risk, market conditions and consistency with debt management objectives, consideration would be given to issuing foreign currency securities to finance part of the increase in the Official Reserves in 2017-18.

3.10 If the government were to decide to issue a foreign currency bond later in the year, this would be taken into account in subsequent updates to the DMO's financing remit. The Bank of

¹ The government's official holdings of international reserves, with the exception of some Special Drawing Right (SDR) assets, are held in the Exchange Equalisation Account (EEA).

England will act as HM Treasury's agent in issuing and managing any foreign currency liabilities associated with the Official Reserves.

Other short-term debt

3.11 The projected level of the Ways and Means Advance at the Bank of England at 31 March 2017 will be £0.4 billion. No changes to the level of the Ways and Means Advance are planned in 2017-18.

3.12 The projected level of the DMO's net cash balance at 31 March 2017 is £14.8 billion, £14.3 billion above the level projected at Autumn Statement 2016. The level will be reduced to £0.5 billion during 2017-18, as shown by the planned short-term financing adjustment, and this will in turn reduce the NFR in 2017-18.

Gilt issuance by method, type and maturity

3.13 Auctions will remain the government's primary method of gilt issuance. In addition, the government has decided to continue the use of issuance via syndications. Any type and maturity of gilts can be issued via syndication. However, the current planning assumption is that they will be used for sales of long-dated conventional and index-linked gilts.

3.14 The government may also continue to sell gilts via gilt tenders. These can take place for any type and maturity of gilt, and be sized flexibly in advance of each operation, but will in general be smaller than auctions of comparable gilts. Gilt tenders may also be used at any time during the financial year for market management purposes. Gilt tenders will be used only as a market management instrument in exceptional circumstances.

3.15 The government plans gilt sales via auction of £87.5 billion (or 76.0% of total issuance) which will be split by maturity and type as follows:²

- £27.4 billion of short conventional gilts (23.8% of total issuance)
- £22.2 billion of medium conventional gilts (19.3% of total issuance)
- £23.3 billion of long conventional gilts (20.2% of total issuance)
- £14.6 billion of index-linked gilts (12.7% of total issuance)

3.16 The government is also currently planning to sell a minimum of £21.0 billion of gilts (18.2% of total issuance) via syndication, split as follows:

- a minimum of £9.0 billion of long conventional gilts in 2 transactions
- a minimum of £12.0 billion of index-linked gilts in 3 transactions

3.17 In addition, the DMO's financing remit includes an initially unallocated portion of £6.6 billion (5.7% of total issuance), through which gilts of any type or maturity may be sold, via any issuance method. It is anticipated that such issuance will take place principally via any increases in sales through syndications, and/or auctions. However, the unallocated portion can also be used for sales via gilt tenders, should there be market demand for such operations.

3.18 The deployment of the unallocated amount of gilt sales is designed to facilitate the effective delivery of the gilt issuance programme while remaining consistent with the debt management principles of openness, predictability and transparency.

² Maturities are defined as follows: short (1-7 years), medium (7-15 years), and long (over 15 years).

3.19 To maintain the operational viability of syndicated offerings at the end of each financial year, the overall size of the syndication programmes (conventional and/or index-linked) may be increased by up to 10% at the time of the final syndicated offering of each type. The programmes would only be upsized if, at the time of the final operations, the entire unallocated issuance amount had been exhausted.

3.20 Through its gilt issuance programme, the government aims at regular issuance across the maturity spectrum throughout the financial year and building up benchmarks at key maturities in both conventional and index-linked gilts.

3.21 The planning assumption for gilt issuance in 2017-18 by method of issue, type and maturity is shown in table 3.B.

Table 3.B: Breakdown of planned gilt issuance by type, maturity and issuance method

£ billion	Auction	Syndication	Gilt tender	Unallocated	Total
Short	27.4	-	-	-	27.4 (23.8%)
Medium	22.2	-	-	-	22.2 (19.3%)
Long	23.3	9.0	-	-	32.3 (28.1%)
Index-linked	14.6	12.0	-	-	26.6 (23.1%)
Unallocated	-	-	-	6.6	6.6 (5.7%)
Total	87.5 (76.0%)	21.0 (18.2%)	-	6.6 (5.7%)	115.1

Figures may not sum due to rounding.
Source: DMO

Gilt auction calendar

3.22 On the same day as the publication of the DMR, the DMO will publish a planning assumption for the gilt auction calendar consistent with the remit. The planned auction calendar may be adjusted, at the margin, to accommodate any in-year changes to the planned split of issuance methods. The DMO will explain the parameters for this alongside the publication of the auction calendar.

Post-Auction Option Facility

3.23 In 2017-18, the DMO will continue to offer successful bidders at auction (both primary dealers and investors) the option to purchase additional stock. The details of how this facility works are set out in the DMO operational notices. Any changes to the facility over the course of the year will be communicated by the DMO in its operational notices.³ Any amounts sold via this facility in 2017-18 will count towards the remit sales targets on an auction by auction basis and will, all else equal, be used progressively to reduce the average sizes for the remaining auctions of the maturity/type of gilt in question.

The Standing Repo Facility

3.24 For the purposes of market management, the DMO may create and repo out gilts in accordance with the provisions of its Standing Repo Facility launched on 1 June 2000 and most

³ Available at http://www.dmo.gov.uk/index.aspx?page=Gilts/Operational_Rules.

recently revised on 6 August 2009.⁴ Any such gilts created will not be sold outright to the market and will be cancelled on return.

Other operations

3.25 The DMO has no current plans for a programme of reverse or switch auction or conversion offers in 2017-18.

Coupons

3.26 As far as possible, the DMO will set coupons on new issues to price the gilt close to par at the time of issue.

Purchases of short maturity debt

3.27 The DMO may buy-in gilts close to maturity to help manage Exchequer cash flows.

Treasury bill issuance

3.28 It is currently anticipated that Treasury bills will make a negative net contribution of £9.5 billion to debt financing in 2017-18. The amount Treasury bills have contributed to debt financing up to and including 2016-17 will be reported by the DMO shortly after the end of 2016-17.

New gilt instruments

3.29 There are no current plans to introduce new types of gilt instruments in 2017-18.

Revisions to the remit

3.30 In addition to planned updates to the remit, any aspect of this remit may be revised during the year in light of exceptional circumstances and/or substantial changes in the following:

- the government's forecast for the NFR
- the level and/or shape of the gilt yield curves
- market expectations of future interest and inflation rates
- market volatility

3.31 Any such unplanned revisions will be announced transparently to the market.

⁴ Available at http://www.dmo.gov.uk/index.aspx?page=Gilts/Operational_Rules.

A Debt portfolio

Debt stock

A.1 The total nominal outstanding stock of central government sterling debt excluding official holdings by central government was £1,604.8 billion at end-December 2016.¹ The components of this stock are set out in table A.1.

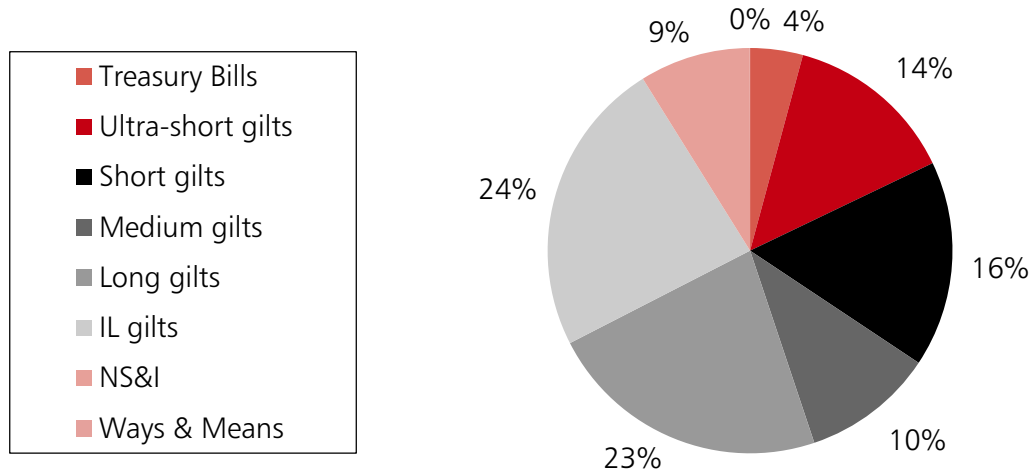
Table A.1: Composition of central government wholesale and retail debt

£ billion nominal value, excluding official holdings	End-December 2015	End-December 2016
Wholesale		
Conventional gilts	1,090.0	1,124.8
<i>less official holdings</i>	106.5	110.2
	983.5	1,014.5
Index-linked gilts	287.5	304.1
<i>less government holdings</i>	5.0	4.0
<i>plus accrued inflation uplift</i>	87.1	79.4
	369.7	379.4
Treasury bills	82.8	95.4
<i>less bills for cash management</i>	0.3	27.9
	82.5	67.5
Total wholesale debt	1,435.7	1,461.5
Retail		
NS&I	134.1	143.0
Other		
Balance on Ways and Means Advance	0.4	0.4
Total central government sterling debt	1,570.1	1,604.8
Statistics: Wholesale debt		
Wholesale debt to GDP ¹ (%)	82.5%	81.7%
Average time to maturity (years) ²	14.4	14.9
Debt maturing in one year (%)	11.5%	10.2%
Figures may not sum due to rounding.		
¹ GDP centred on end-December.		
² Calculated on a nominal weighted basis, excluding official holdings, including accrued inflation uplift.		
Source: DMO, OBR, ONS, & NS&I		

A.2 Chart A.1 shows the composition of the government's debt portfolio at end-December 2016. Conventional and index-linked gilts made up the largest proportion of government debt at 87%.

¹ Official holdings of gilts comprise holdings by the DMO of gilts created for use as collateral in the conduct of its Exchequer Cash Management operations (such gilts are not available for outright sale to the market). It does not include gilts held by the Bank of England's Asset Purchase Facility.

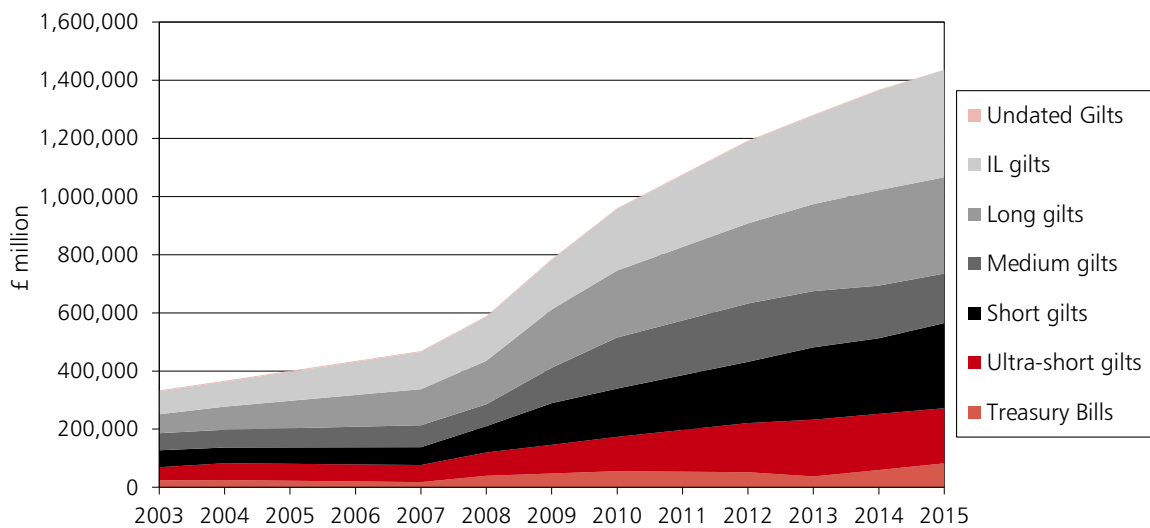
Chart A.1: Composition of central government sterling debt (end-December 2016)¹



¹Figures may not sum due to rounding.
Source: DMO and NS&I

A.3 Chart A.2 shows the composition of gilt stock over time. Conventional gilts continue to make up the largest share of gilt stock. The proportion between different maturities and index-linked gilts has remained relatively stable over the past decade.

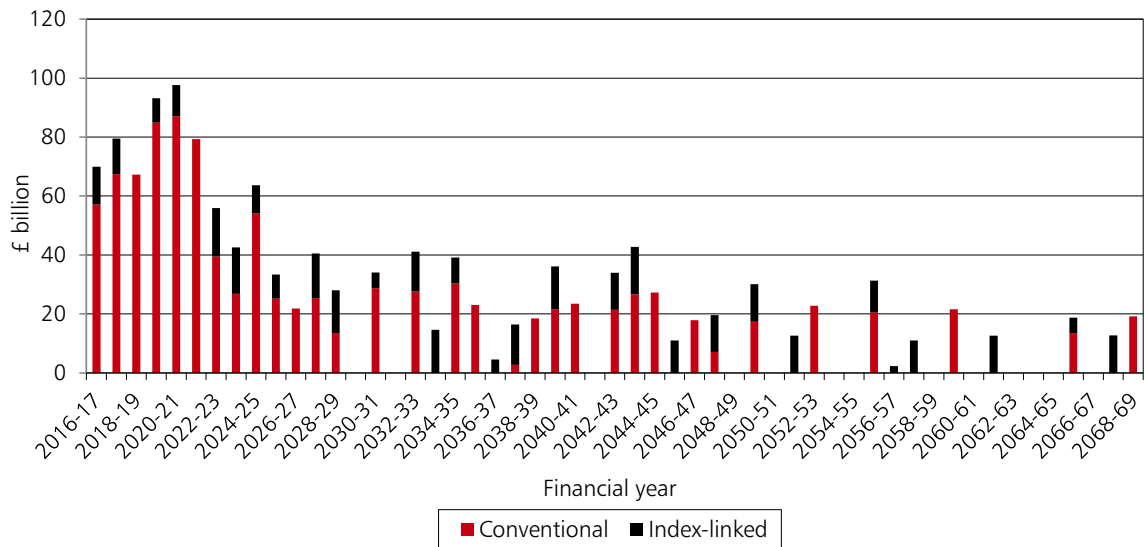
Chart A.2: Composition of central government gilt stock (end-December values)



Source: DMO

A.4 Chart A.3 shows the government's gilt redemption profile as of end-December 2016. The longest maturity gilt in issuance is due to redeem in 2068-69. While the majority of gilts in issue are conventional, the split between conventional and index-linked gilts becomes more even at higher maturities.

Chart A.3: Gilt redemption profile (end-December 2016)

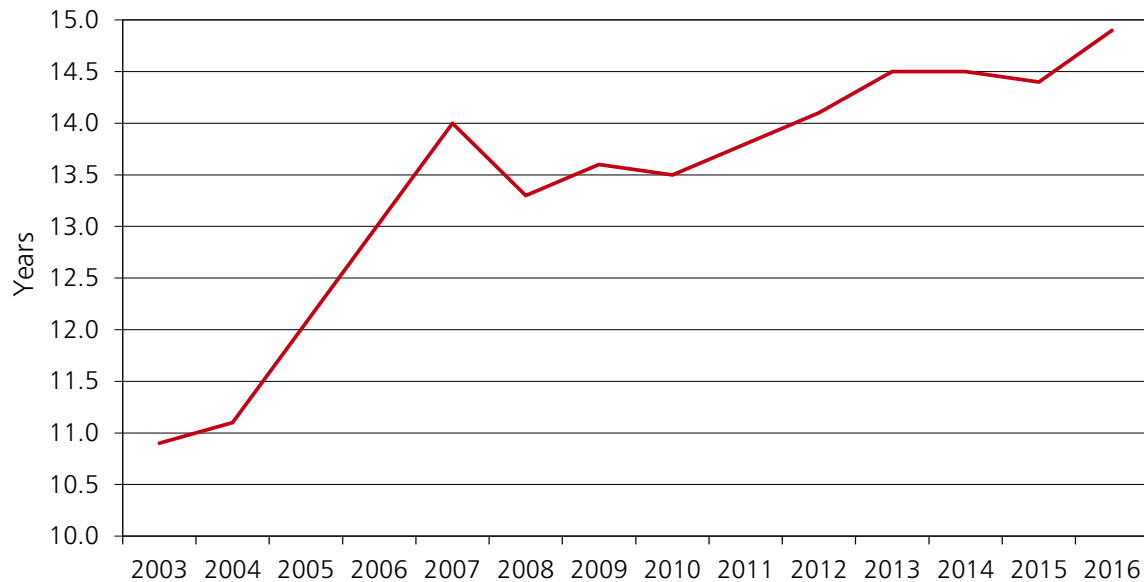


Source: DMO

Maturity and duration of the debt stock

A.5 By end-December 2016, the average maturity of the stock of wholesale marketable debt had risen to 14.9 years. The average maturity of the stock of conventional gilts had risen to 13.5 years, with index-linked gilts continuing to be above 22 years.² The average maturity of the government’s wholesale debt has been consistently longer than the average across the G7 group of advanced economies, as shown in chart A.5.

Chart A.4: Average maturity of UK debt stock (end-December values)¹

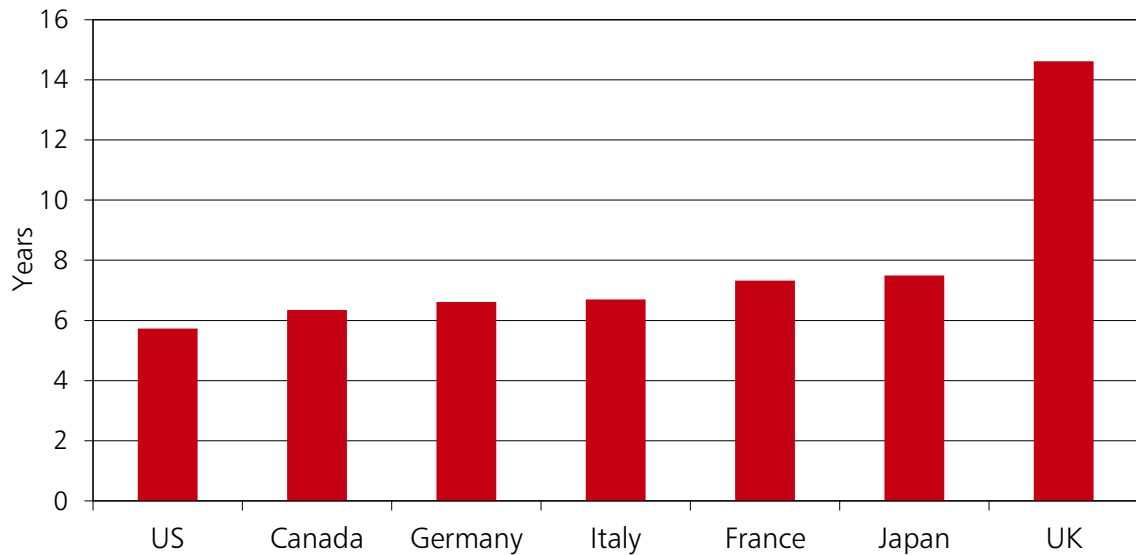


¹Calculated on a nominal weighted basis, excluding official holdings, including accrued inflation uplift.

Source: DMO

² Calculated on a nominal weighted basis, excluding official holdings, including accrued inflation uplift.

Chart A.5: Average maturity in years of the debt stock by country (end-December 2016)¹



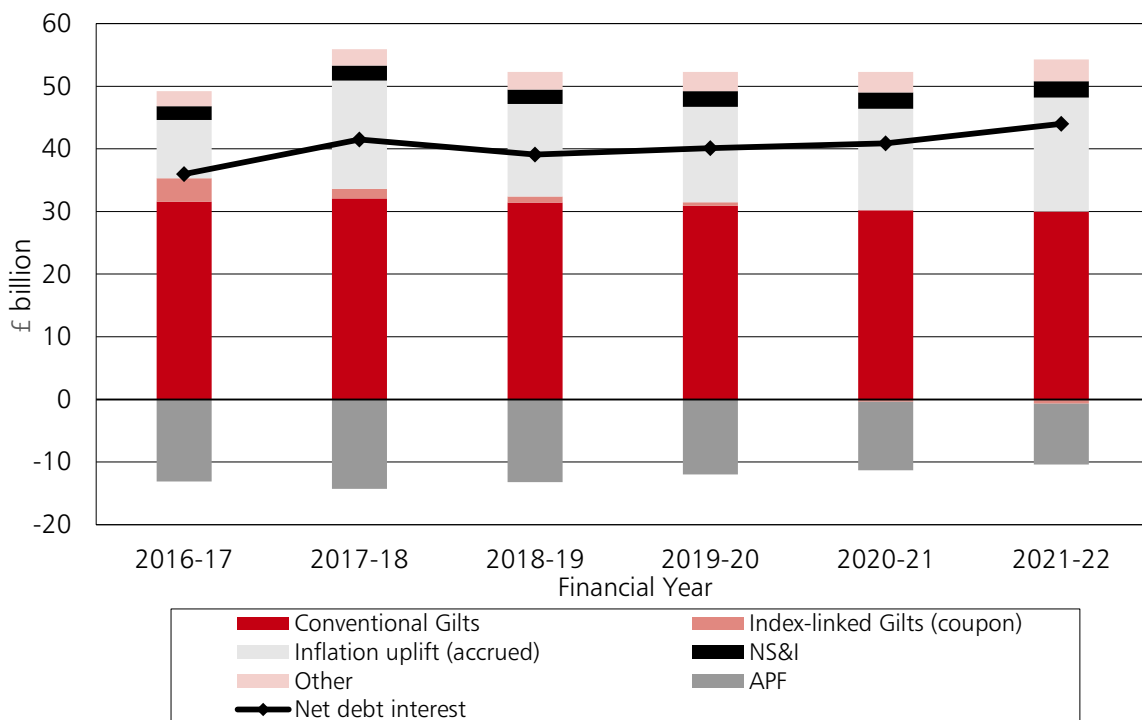
¹ Calculated on a nominal weighted basis, excluding inflation uplift.

Source: Bloomberg L.P.

Debt interest

A.6 While debt interest on conventional gilts is forecast to fall in nominal terms over the 5 year period, an increase in forecast inflation pushes up total debt interest costs in future financial years.

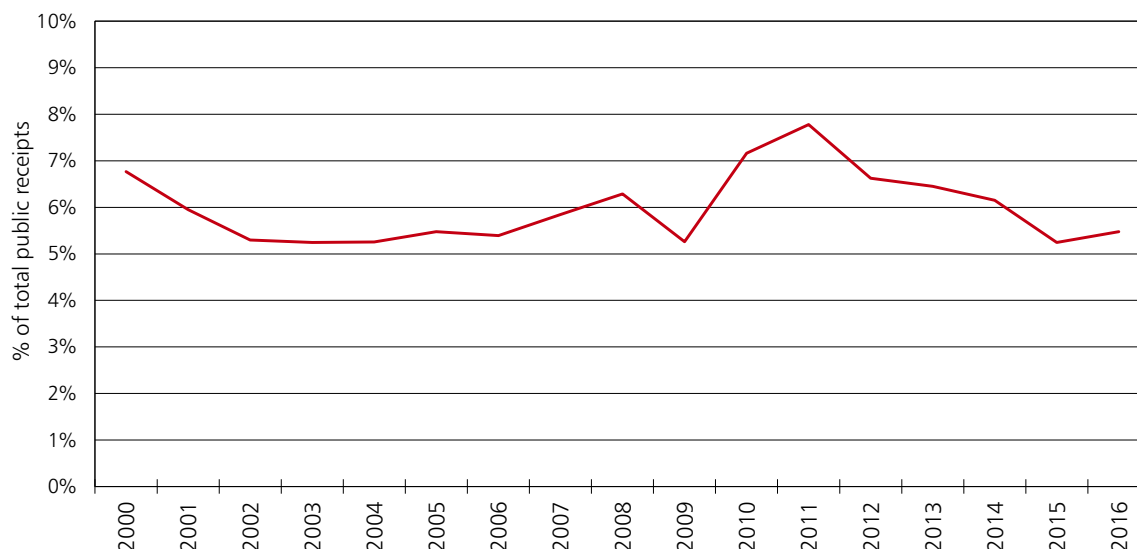
Chart A.6: Breakdown of debt interest forecast



Source: OBR

A.7 While net debt interest is forecast to rise in cash terms, chart A.7 shows that debt interest as a percentage of public sector receipts has fallen since 2011. It reached its lowest ever figure since official records begin (1940) in 2015.

Chart A.7: Debt interest as % of public sector receipts¹



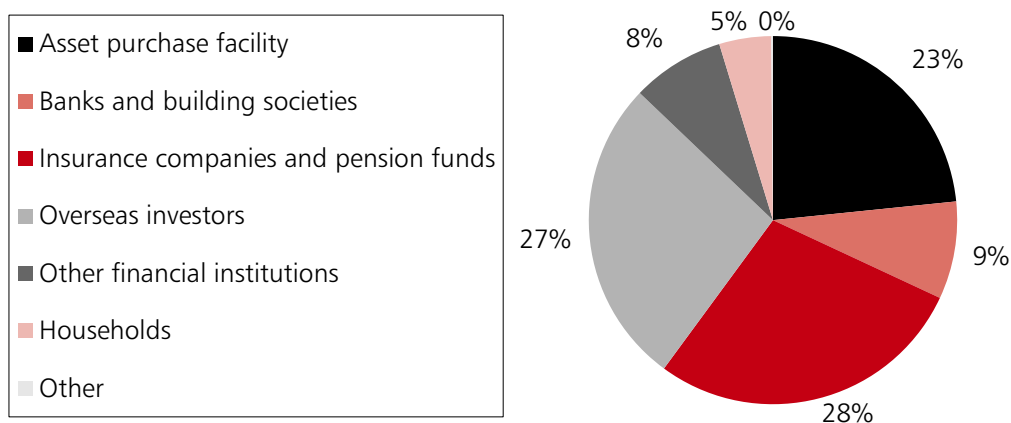
¹ 2016 figures only include January-September.

Source: ONS

Gilt holdings by sector

A.8 Chart A.8 shows gilt holdings by sector using data published by the Office for National Statistics (ONS) and Bank of England. At end-September 2016, the 3 largest investor groups were insurance companies and pension funds (28%), overseas investors (27%) and the Bank of England Asset Purchase Facility Fund Ltd (23%).

Chart A.8: Gilt holdings by sector – (end-September 2016) (market value)¹



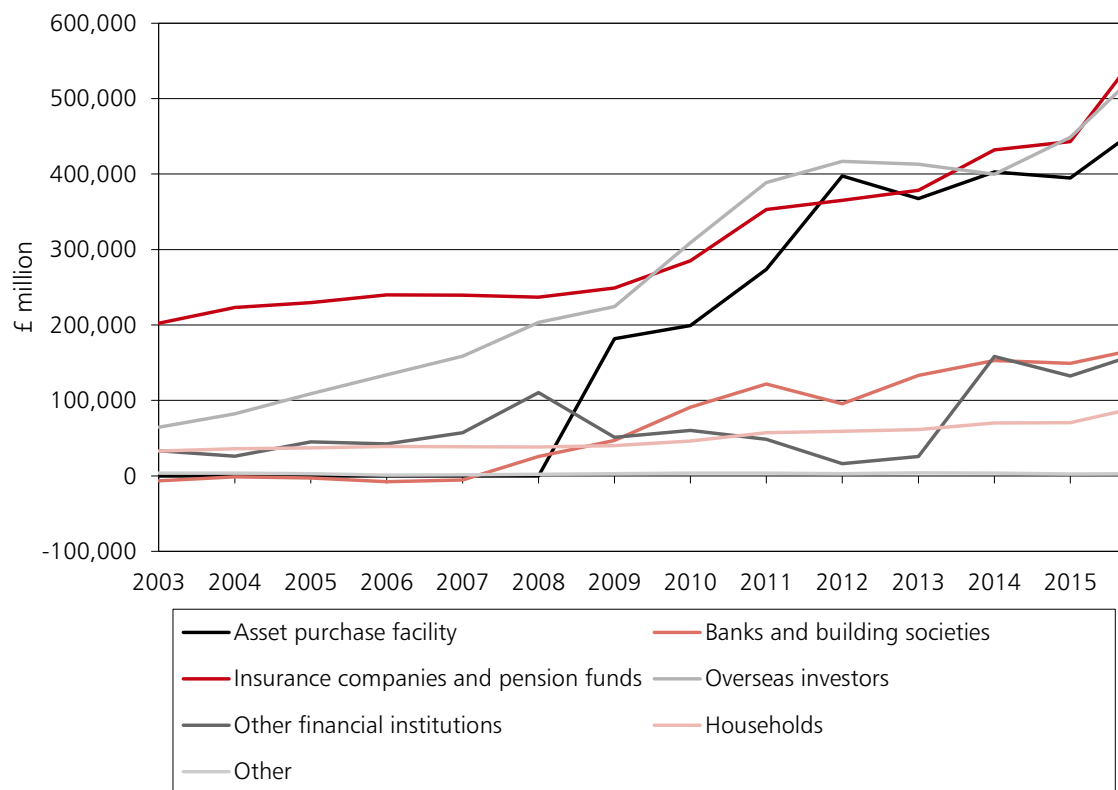
¹ Figures may not sum due to rounding.

² The Bank of England's holdings of gilts not related to the Asset Purchase Facility are included in the 'Banks and building societies' category.

Source: ONS and Bank of England

A.9 The introduction of quantitative easing through the Asset Purchase Facility (APF) has caused the largest change to gilt holdings by sector over time, as shown in chart A.9. The value of holdings in the APF has increased to just over £450,000 million (as of end-September 2016) since its introduction in 2008. Domestic insurance companies and pension funds have frequently been the largest holders of gilts, though the share of gilts held by overseas investors has increased over time to make up a similar share of the investor base.

Chart A.9: Gilt holdings by sector over time (end-September 2016) (market value)



Source: ONS and Bank of England

Gilt issuance

A.10 The CGNCR (ex NRAM, B&B and NR), gilt redemptions, and the volume of gilt sales for each of the last 10 years is shown in table A.2. 2017-18 will be the first year since 2001-02 when CGNCR (ex NRAM, B&B and NR) has been lower than redemptions.

Table A.2: CGNCR and gross gilt sales

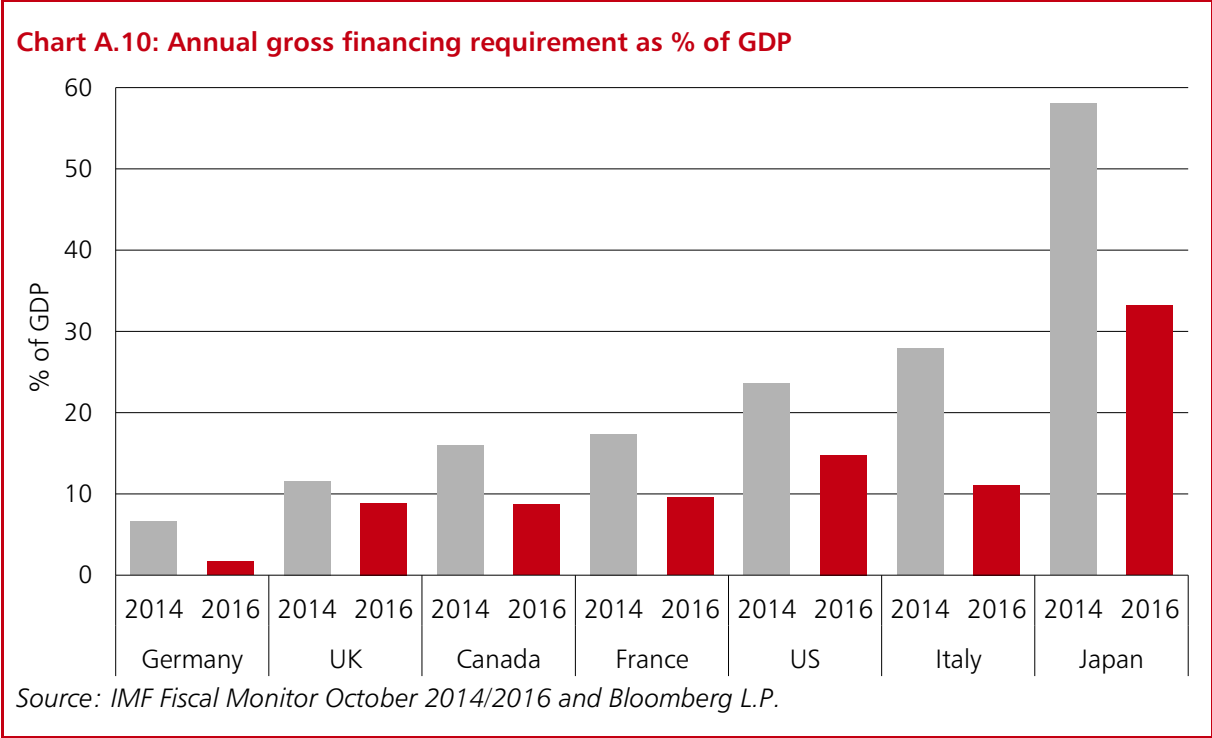
£ billion	CGNCR (ex NRAM, B&B and NR)	Redemptions	Gross gilt sales ¹
2007-08	32.6	29.2	58.5
2008-09	162.4	18.3	146.5
2009-10	198.8	16.6	227.6
2010-11	139.6	38.6	166.4
2011-12	126.5	49.0	179.4
2012-13	98.6	52.9	165.1
2013-14	79.3	51.5	153.4
2014-15	92.3	64.5	126.4
2015-16	78.5	70.2	127.7
2016-17 ²	72.5	69.9	146.5
2017-18 ²	47.4	79.5	115.1

¹ Figures are in cash terms.

² Spring Budget 2017 projections.

Source: DMO, HM Treasury, ONS and OBR

A.11 Chart A.10 shows the expected gross financing requirement as a percentage of GDP for all G7 countries. This illustrates the supportive impact the UK's long average debt stock maturity has on the UK's gross financing requirement, lowering our refinancing risk.



Context for decisions on the Debt Management Office's financing remit

B

Introduction

B.1 This annex provides the context for the government's decisions on gilt and Treasury bill issuance in 2017-18, setting out the qualitative and quantitative considerations that have influenced them.

B.2 The government's decisions on the structure of the financing remit, which are taken annually, are made in accordance with the debt management objective, the debt management framework and wider policy considerations during the period of fiscal consolidation (see chapter 2).

B.3 In determining the overall structure of the financing remit, the government assesses the costs and risks of debt issuance by maturity and type of instrument. Decisions on the composition of debt issuance are also informed by an assessment of investor demand for debt instruments by maturity and type as reported by stakeholders, and as manifested in the shape of the nominal and real yield curves, as well as the government's appetite for risk.

B.4 Alongside these considerations, the government takes into account the practical implications of issuance (for example, the scheduling of operations during the course of the year and the appropriate use of different issuance methods).

Demand

B.5 Both Gilt-Edged Market Makers (GEMMs) and end-investors have reported ongoing demand for conventional and index-linked gilts that is well diversified across the maturity spectrum and by investor type.

B.6 At the annual consultation meetings in January 2017 attendees anticipated continued demand for UK government debt from domestic pension funds in 2016-17, with a particular focus on index-linked gilts.¹

B.7 Market participants also expected ongoing demand for gilts from a range of international investors, including central banks and reserve managers.

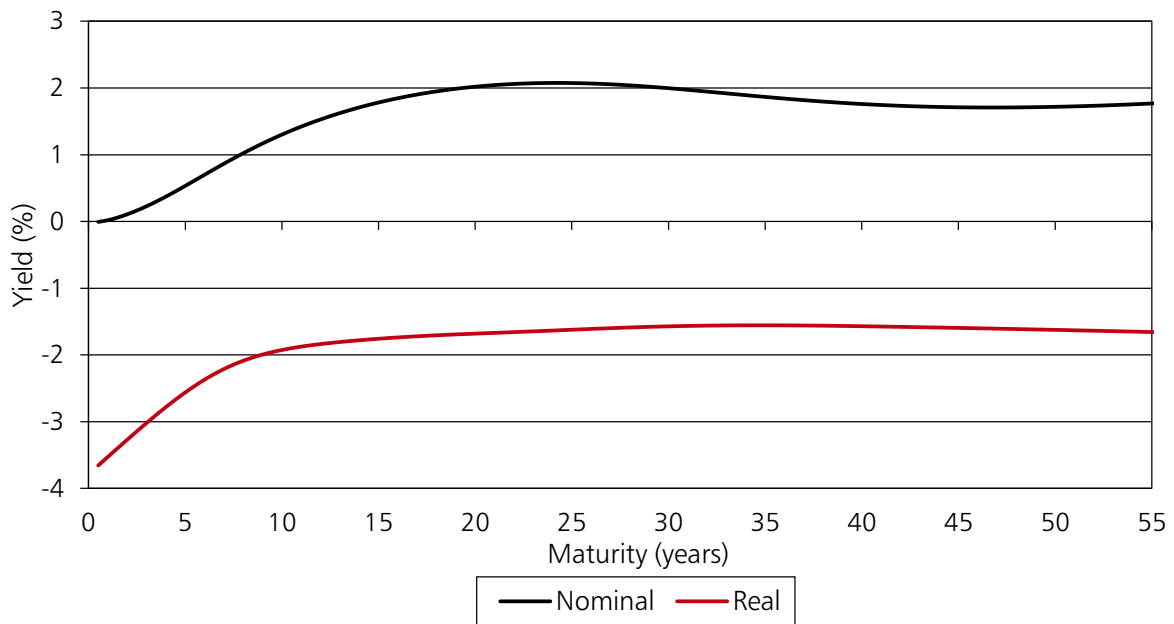
B.8 Domestic banks and building societies have become significant holders of gilts in recent years for regulatory purposes. No major changes in gilt investment by domestic financial institutions are expected in the coming year.

Cost

B.9 In assessing the cost of different types of debt issuance by maturity and type, the government undertakes an analysis of the nominal and real yield curves. Chart B.1 shows the shape of the nominal and real spot curves at 20 February 2017.

¹ Minutes of the meetings are available at: <http://www.dmo.gov.uk/documentview.aspx?docName=/gilts/press/sa240117.pdf>.

Chart B.1: Nominal and real spot yield curves (20 February 2017)



Source: DMO

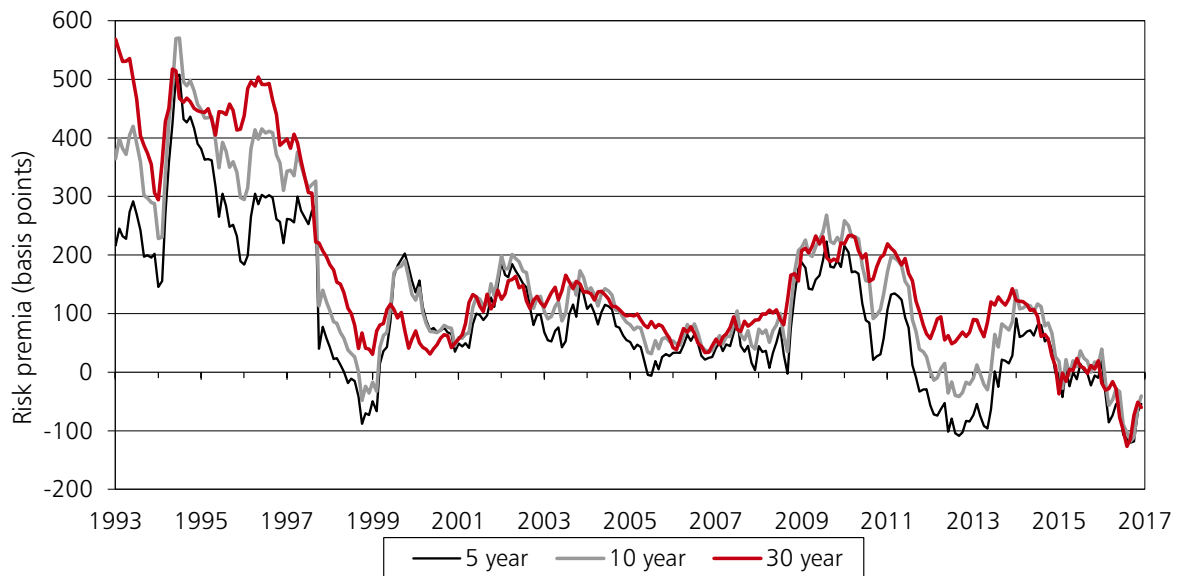
B.10 Conventional asset pricing theory suggests the observed yield on a bond can be decomposed into two components: a 'risk neutral' yield and a risk premium. The risk neutral yield is the interest rate under 'pure expectations'. In practice, forward yields follow a different path, as markets demand higher yields in order to protect investments against a variety of risks.² This gives rise to the risk premium. The variability and trends in risk premia reflect investors' risk preferences over time. It is cost-effective for a government to issue at maturities where the risk premium demanded by the investor is lowest relative to other maturities.

B.11 Chart B.2 shows risk premia in the nominal yield curve between 1992 and end-December 2016. Results indicate the existence of a time-varying risk premium in the conventional gilt market which is usually positive and, as a general rule, increases with maturity, although this appears to have reversed in the last year.³ In 2016-17, risk premia remained close to historically low levels at all key benchmark maturities. Premia for different maturities are now within a very narrow range. This suggests that, on this measure, conventional gilts across the maturity spectrum are broadly equal in terms of cost-effectiveness.

² The risk premia has several components, including, but not limited to: (i) a premium which compensates investors for duration risk that increases for longer maturity investments; (ii) a credit and default risk premium; (iii) a liquidity premium owing to the lower level of liquidity in some bonds or maturities, which restricts investors' ability to hedge; and (iv) an inflation risk premium to compensate investors in nominal bonds for uncertainty owing to inflation. In general, the premium is the extra return investors expect to obtain from holding long-term bonds as opposed to holding and rolling over a sequence of short-term securities over the same period. The risk premium estimated by the DMO's model also includes a 'convexity premium' component – this increases with maturity and yield volatility and it offsets to some degree the other risk premium components as it represents a charge that the investor pays the issuer.

³ This analysis is based on academic research by Christensen, Diebold and Rudebusch. The model has not been adjusted to account for 'zero bound effects'.

Chart B.2: Risk premia



Source: DMO

B.12 Alongside this analysis of the relative cost-effectiveness of conventional gilts across different maturity sectors, the government undertakes an evaluation of index-linked gilt cost-effectiveness, using conventional gilts as a benchmark for comparison, by examining breakeven inflation rates, the difference between nominal and real yields.⁴

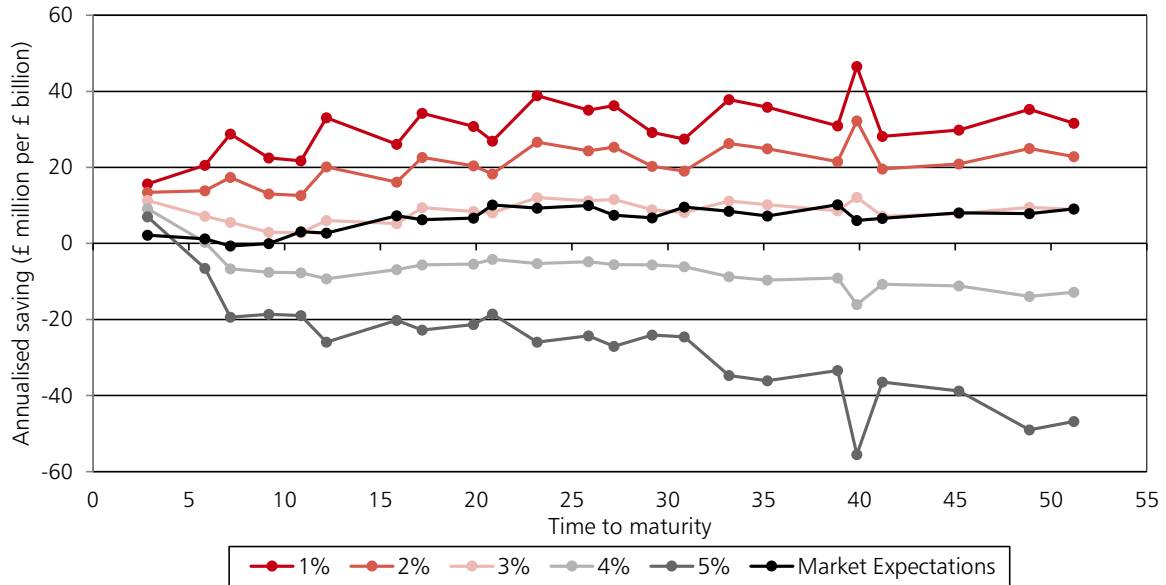
B.13 Similar to nominal yields, breakeven rates can also be decomposed into two components: a 'risk neutral' inflation rate, which is the pure market implied expectation of future inflation embedded in nominal yields, and a risk premium, which includes the premium for inflation risk in conventional gilt yields.⁵ The government can choose either to pay the inflation risk premium and the level of inflation priced in the conventional gilt yield, which is 'fixed' at issue for the life of the bond, or it can issue an inflation-linked gilt, pay future realised inflation at a later time and bear the inflation risk. The two strategies are cost-equivalent if future realised inflation turns out to be equal to the level implied in the breakeven rate at issue. Chart B.3 shows the cost-effectiveness of issuance of index-linked gilts, relative to conventional gilts, under a range of paths for future inflation, which also includes market-implied pure expectations.

B.14 As at end-January 2017 the model shows that for an assumption that RPI remains constant at 3% over the life of the bond, index-linked gilts are generally more cost effective than equivalent maturity conventional gilts. Results using the market implied inflation forecast are very similar, although there is some divergence at shorter maturities reflecting the market's expectations around the path of near-term inflation. Compared to a year ago, the majority of index-linked gilts are marginally more cost effective across the curve.

⁴ A more detailed explanation of the methodology used in this analysis can be found in the following documents: http://www.oecd-ilibrary.org/finance-and-investment/assessing-the-cost-effectiveness-of-index-linked-bond-issuance_5k481881kjwh-en and <http://www.bankofengland.co.uk/research/Pages/workingpapers/2015/swp551.aspx>.

⁵ There is an additional risk due to liquidity conditions in the two markets. This is in relation with the cost to finance the purchase of the bond in the money market and to transact in the secondary market. A more detailed explanation of the methodology to estimate breakeven inflation risk premia can be found in the following document: <http://www.bankofengland.co.uk/research/Pages/workingpapers/2015/swp551.aspx>.

Chart B.3: The cost effectiveness of index-linked gilts under different RPI assumptions (end-January 2017)



Source: DMO

Risk

B.15 In the context of the long-term focus of the debt management objective, the other key determinant in the government's decisions on debt issuance by maturity and type of instrument is its assessment of risk. In reaching a decision on the overall structure of the remit, the government considers the risks to which the Exchequer is exposed through its debt issuance decisions and assesses the relative importance of each risk in accordance with its risk appetite.

B.16 The government places a high weight on minimising near-term exposure to refinancing risk. The government can partly manage this exposure by maintaining a sizeable proportion of long-dated debt in its portfolio, which reduces the need to refinance debt frequently. The government places importance on avoiding, when practicable, large concentrations of redemptions in any one year. To achieve this, the government will issue debt across a range of maturities, smoothing the profile of gilt redemptions.

B.17 Prudent debt management is also served by promoting sustainable market access, which the remit is designed to support. The government places significant importance on encouraging a deep, liquid and efficient gilt market and a diverse investor base in order to maintain continuous access to cost-effective financing in all market conditions.

B.18 Promoting these features of the gilt market will also serve to minimise debt costs to the government because investors reward an issuer for providing a continuous and ready market and a globally recognised benchmark product.

Modelling of cost, interest rate and refinancing risk

B.19 The analysis underpinning the government's decisions on its issuance strategy includes an exercise in which debt interest cost and risk simulations are generated to illustrate the cost-risk trade-off associated with different issuance strategies.⁶ This allows the government to investigate

⁶ The government does not use this simulation tool to determine a single optimal debt issuance strategy.

the medium-term implications of different possible future issuance skews relative to the current annual issuance strategy.

B.20 Debt interest cost is defined as the cost of the coupon payments and redemptions associated with government debt, accrued over the life of each bond, measured in terms of the relevant yield.⁷ Risk is defined as the standard deviation of debt interest cost or debt interest cost volatility, reflecting potential variation in the relevant yield. This can be seen as a measure combining both interest rate risk and refinancing risk.⁸

B.21 As in previous years the exercise has been carried out over a 15-year horizon, close to the average maturity of the gilt portfolio, and therefore captures a rollover of approximately half of it.⁹ The metrics resulting from this analysis combine the impact from alternative issuance strategies for financing new government debt (to meet the CGNCR and the refinancing of redemptions) with the existing characteristics of the debt portfolio inherited from previous financial years.¹⁰

B.22 The DMO’s Portfolio Simulation Tool (PST), which calculates debt interest cost, is used in conjunction with a macroeconomic-based Vector Autoregressive (VAR) model, which provides two alternative distribution assumptions for simulating the yield curve, to depict risk in cost terms.¹¹ In this way, the PST maps the projected yield curve distributions to a debt interest cost distribution so that simulated cost and risk metrics can be analysed.

B.23 As an example, table B.1 shows the issuance skew planned by the DMO at the start of 2016-17, which was well diversified across maturity ranges.

Table B.1: Gilt issuance strategy composition

	Short conventional (0-7 years)	Medium conventional (7-15 years)	Long conventional (over 15 years)	Index-linked	Unallocated
Issuance skew 2016-17	23.5%	19.2%	28.0%	23.2%	6.2%

Figures may not sum due to rounding.
Source: Budget 2016

B.24 The resulting probability distributions of debt interest cost (if issuance continued to follow the current issuance maturity skew for the next 15 years) are shown in charts B.4 and B.5.¹² It is worth noting that the choice of distribution has a significant impact on the resulting projected yields and that neither distribution used generates short and long-run yields that are in line with current market expectations. This supports the view that there are negative risk premia priced in the yield curve currently.

⁷ There are small differences in the methods used to calculate debt interest cost here from those used by the Office of Budget Responsibility (OBR), which publishes the official debt interest forecast. These include differences in coverage, on the RPI inflation assumption used and some simplifying assumptions with respect to the debt management operational details.

⁸ Interest rate risk is defined as the risk associated with new issuance while refinancing risk is the risk associated with the roll-over of maturing debt.

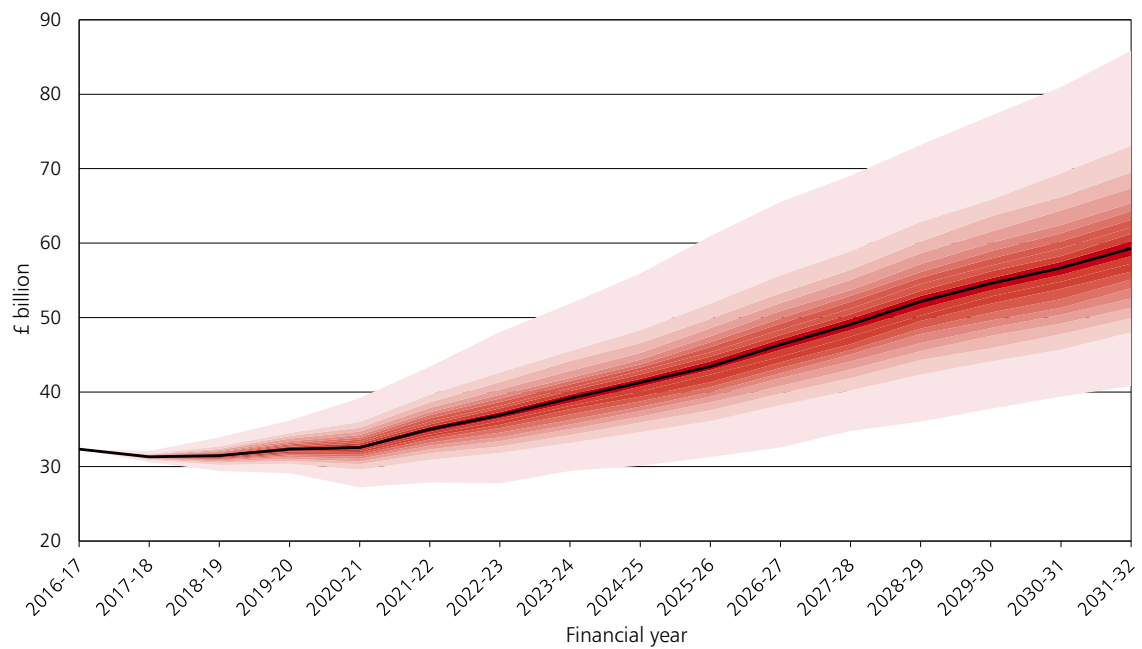
⁹ It is worth noting that the index-linked part of the debt portfolio has a longer average maturity of around 22 years.

¹⁰ The financing assumptions used in this exercise are based on Autumn Statement 2016 numbers.

¹¹ The VAR is estimated using data from October 1992 to December 2016, making use of the OBR EFO November 2016 forecasts for the macroeconomic variables. For each year of the 15-year horizon, a yield curve forecast is produced. In order to generate a distribution of yield curve forecasts for each year, simulations around the central forecast are made by drawing from a distribution of errors, one thousand times. Two alternative yield curve distributions are analysed, normal and bootstrapped distributions. Nominal yields’ forecasts are not restricted to positive values. Bootstrapping is an econometric technique that does not make an assumption about the parametric form of the distribution of errors from estimation, such as the normal distribution. Instead, resampling techniques are applied to actual estimation errors in order to deduce the underlying distribution of the data sample. The VAR currently only forecasts nominal yields; the break-even inflation rate from the Variable Roughness Penalty (VRP) yield curve model is used to derive the real yield curve.

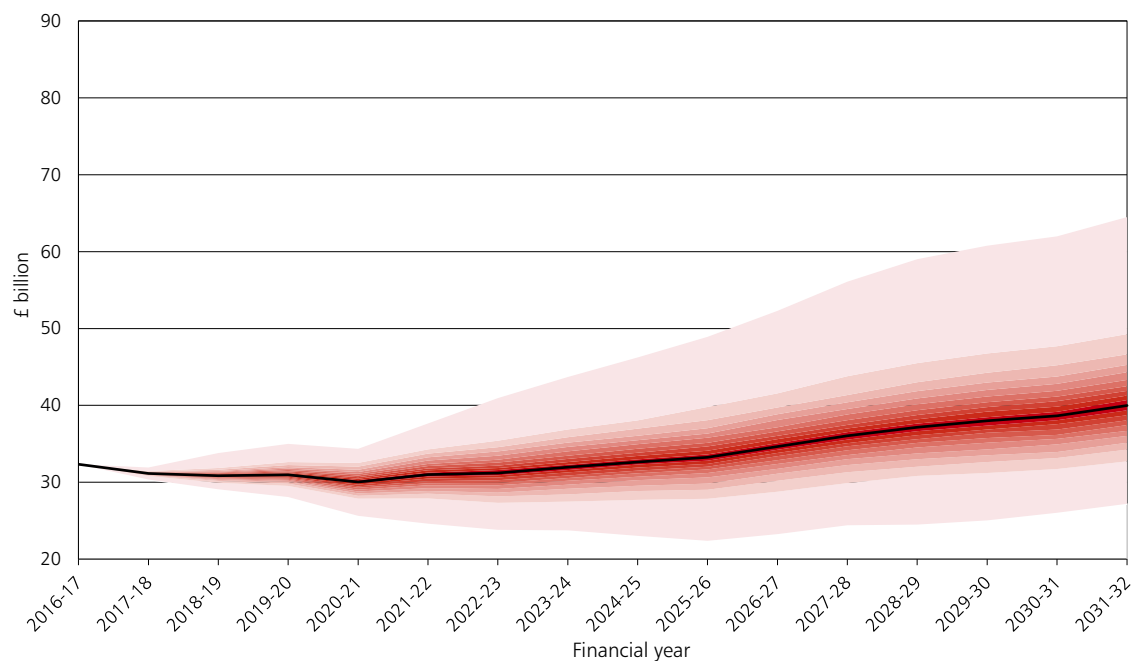
¹² Debt interest from APF holdings is netted out here, in line with the OBR’s debt interest forecast.

Chart B.4: Probability distribution of debt service cost (normal distribution)



Source: DMO

Chart B.5: Probability distribution of debt interest costs (bootstrapped distribution)



Source: DMO

B.25 The central line of each fan chart represents the median debt interest cost after 1,000 simulations using the PST model (each simulation has an alternative yield curve) for each financial year. The shaded red areas (from darker to lighter red respectively) around the median debt interest cost projection represent the percentiles of the probability distribution, with each colour area representing an additional 5% probability. The debt interest values in the lightest shades of red at the top and at the bottom of the fan chart represent the 'tails' of the distribution, with only 5% probability associated with them. For example, debt interest values on the upper tail of the distribution would not be expected to be reached with a 95% probability.

Forecast uncertainty increases further into the future and, therefore, the 'fan' widens over the horizon. Overall, at the 15-year horizon, under a normal distribution it can be said with 90% certainty (i.e. excluding the top and bottom 'tails' of the distribution) that debt interest costs will be between £48 billion and £73 billion, with a median value of around £59 billion. Under a bootstrapped distribution there is a 90% probability that debt interest costs will be between £33 billion and £49 billion, with a median value of around £40 billion.

B.26 It is important to note that debt interest simulations in charts B.4 and B.5 reflect the combination of simulated future yields and projected debt issuance together with the unfolding of existing portfolio dynamics. As a consequence, debt interest appears to pick up in the later part of the horizon. This reflects the redemption profile of the debt portfolio, with a higher volume of redemptions that will mature and be refinanced at new rates of financing, amongst other factors. Given the long average maturity of the UK's debt, which creates 'stickiness' in the evolution of the portfolio, any impact from debt issuance is slow to take effect. In the 2016-17 issuance skew example, only about half of the entire debt interest cost bill would have been refinanced at new yield levels after 15 years.

Gilt distribution

B.27 Auctions will remain the primary method of issuance.

B.28 The government will continue the syndication programme in 2017-18. Gilts of any type and maturity can be sold via syndication. However, the current planning assumption is that:

- syndications will be used to launch new gilts or to re-open high duration conventional and index-linked gilts
- the size of transactions will be determined in response to the size and quality of market demand for the gilt being sold

B.29 Reflecting the lower financing requirement in 2017-18 relative to recent years, the government expects to hold five syndicated offerings in 2017-18.

B.30 Gilt tenders will be made available in 2017-18 for the issuance of conventional and index-linked gilts across maturities. The purpose of gilt tenders is to allow the government to respond more flexibly to changing market and demand conditions.

B.31 The government remains committed to the GEMM model to distribute gilts through auctions, syndications and tenders and the government recognises that GEMMs play an important role in helping to facilitate liquidity in the secondary market.

B.32 At the government's annual consultation meeting with the GEMMs and end-investors in January, many attendees reported that the package of measures introduced at Budget 2016 had been valuable in supporting gilt distribution and smooth delivery of the DMO's financing remit in 2016-17. The package of measures introduced at Budget 2016 will be retained in 2017-18.

Gilt issuance by maturity and type in 2016-17

B.33 In determining the split of gilt issuance, the government has considered its analysis of the relative cost-effectiveness of the different gilt types and maturities, its risk preferences including for the portfolio as well as the issuance programme, and the market feedback it has received.

B.34 Continuing demand for short conventional gilts is anticipated, including from overseas investors. However, the relatively high weight that the government places on managing its near-term exposure to refinancing risk has also continued to influence its decision on the amount of short-dated conventional gilt issuance.

B.35 In deciding the proportion of medium conventional gilts to issue, the government recognises the important role that medium conventional gilts (particularly in the 10-year maturity) play in facilitating the hedging of a wide range of gilt market exposures through the futures market, which helps underpin liquidity in the sector.

B.36 Market feedback suggests ongoing demand for long-dated conventional gilts from domestic investors in particular. Additionally, in determining the amount of long-dated conventional gilts to issue, the government has taken into account the role of long conventional issuance in mitigating its near-term exposure to refinancing risk.

B.37 For conventional gilts, the risk premia analysis suggests that issuance across the maturity spectrum is broadly equivalent in terms of cost-effectiveness. Under market implied inflation expectations, index-linked gilts are expected to be more cost effective to issue than equivalent maturity conventional gilts, particularly at longer maturities. In relation to risk, the government is aware the significant volume of index-linked issuance in recent years has consequences for the overall amount of inflation exposure in its debt portfolio. Accordingly, the cost-effectiveness of index-linked gilts has been weighed against the need to retain a balance in the debt portfolio as well as in the annual issuance programmes.

B.38 Taking these considerations into account, the government's intention is to deliver in 2017-18 a gilt issuance programme that is well-diversified amongst different types and maturities of gilts, but with a slight bias towards longer maturities.

B.39 A slightly smaller portion of issuance will be held in initially unallocated form in 2017-18 compared to last year. The main purpose of the unallocated portion of issuance is to give increased flexibility to the DMO to issue any type or maturity of gilt by any issuance method in response to in-year evolution in demand and market conditions, while remaining consistent with the principles of predictability and transparency.

Treasury bill issuance in 2016-17

B.40 Treasury bills are used for both debt and cash management purposes. With regards to the former, changes to the Treasury bill stock have historically offered an efficient way to accommodate in-year changes to the financing requirement.

B.41 As in 2016-17, the government will not target a planned end-year Treasury bill stock in 2017-18. Information on the outstanding stock of Treasury bills will continue to be published monthly in arrears on the DMO's website.

B.42 It is expected that the net contribution from Treasury bills to debt financing in 2017-18 will be -£9.5 billion.

C NS&I's financing remit for 2017-18

C.1 This annex sets out information on the activities of NS&I in 2016-17 and 2017-18. NS&I is both a government department and an executive agency of the Chancellor of the Exchequer. Its activities are conducted in accordance with its remit, which is to provide cost-effective finance now and in the future for the government. It does this by raising deposits and investments from retail customers. This will remain the case in 2017-18.

C.2 NS&I's contribution to financing is agreed with HM Treasury each year, and is based on the government's gross financing requirement, conditions in the retail financial services market and NS&I's ability to raise the funding without distorting the market.

C.3 Spring Budget 2017 confirms the rate on the NS&I Investment Bond announced at Autumn Statement 2016. The Investment Bond will pay a rate of 2.2% over a term of 3 years and will be available from April 2017. The bond is designed to support savers who have been affected by low interest rates. The cost of raising financing through this bond, rather than gilts, was set out at Autumn Statement 2016. This policy has been re-costed in table 2.2 of the Spring Budget 2017 document.

Volume of financing in 2016-17

C.4 NS&I's contribution to financing in 2016-17 is projected to be £12.2 billion with gross inflows (including reinvestments and gross accrued interest) of approximately £35.9 billion. This is above NS&I's target range of £7.0 billion to £11.0 billion. The government has judged that the risk of exceeding the target is acceptable to strike the right balance between the interest of savers, taxpayers and the wider financial sector during a period of change in the savings and wider financial markets. Table C.1 shows changes in NS&I's product stock during 2016-17.

Table C.1: Changes in NS&I's product stock in 2016-17 (£ billion)

	End-March 2016	End-March 2017 ¹
Variable rate	90.5	106.8
Fixed rate	21.3	20.5
Index-linked	23.3	20.0
Total	135.1	147.3

Figures may not sum due to rounding.
¹ Projections.
Source: NS&I

C.5 NS&I calculates the value it creates for the government using the Value Indicator, which compares the cost of funds raised to comparable gilt yields (see table C.2). These comparator rates have been at or close to historic lows over the course of the year. On this basis, NS&I projects a Value Indicator return of £87.6 million in 2016-17. This is in line with the target set by HM Treasury at Budget 2016; which was for NS&I to deliver positive value.

Table C.2: Calculator of Value Indicator

Comparator cost¹	
<i>Less</i>	Interest and prizes earned by investors
<i>Less</i>	Management costs of NS&I products (net equivalent of DMO costs & leveraging revenue)
<i>Less</i>	Tax foregone on total stock of 'tax-free' products
Equals	Value Indicator

¹This is the cost of raising funds in the wholesale market of an equivalent term. For fixed-rate products it is the term of the product while, for variable rate products, it is the average length of time the product is held by the customer.

Source: NS&I

Volume of financing in 2017-18

C.6 Gross inflows (including reinvestments and gross accrued interest) of NS&I’s products are projected to be around £37.0 billion in 2017-18. After allowing for expected maturities and withdrawals, NS&I will have a 2017-18 net financing target of £13.0 billion, within a range of £10.0 billion to £16.0 billion. NS&I’s 2017-18 net financing target includes financing raised through the new Investment Bond.

C.7 Based on current market expectations for comparator gilt yields, the cost to government of NS&I’s stock is expected to be lower than wholesale funding costs for the year. NS&I’s expected Value Indicator outturn for 2017-18 is £510 million.

C.8 The cost of the Investment Bond which NS&I will launch in April 2017 was set out at Autumn Statement 2016 and so will not be reflected in NS&I’s 2017 Value Indicator calculation.

C.9 Further details of NS&I’s activities in 2017-18 will be included in its Annual Report and Accounts, which is scheduled to be laid in Parliament in 2017 and will be available in print form and at www.nsandi.com.

The Exchequer cash management remit for 2017-18

D

Exchequer cash management objective

D.1 The government's cash management objective is to ensure that sufficient funds are always available to meet any net daily central government cash shortfall and, on any day when there is a net cash surplus, to ensure this is used to best advantage. HM Treasury and the DMO work together to achieve this.

D.2 HM Treasury's role in this regard is to make arrangements for a forecast of the daily net flows into or out of the National Loans Fund (NLF); and its objective in so doing is to provide the DMO with timely and accurate forecasts of the expected net cash position over time.

D.3 The DMO's role is to make arrangements for funding and for placing the net cash positions, primarily by carrying out market transactions in the light of the forecast; and its objective in so doing is to minimise the costs of cash management while operating within the risk appetite approved by ministers.

D.4 The government's preferences in relation to the different types of risk taking inherent in cash management are defined by a set of explicit limits covering four types of risk which, taken together, represent the government's overall risk appetite.¹ The risk appetite defines objectively the bounds of appropriate government cash management in accordance with the government's ethos for cash management as a cost minimising, rather than profit maximising, activity and playing no role in the determination of interest rates. The DMO may not exceed this boundary, but, within it, the DMO will have discretion to take the actions it judges will best achieve the cost minimisation objective.

The DMO's cash management objective

D.5 The DMO's cash management objective is to minimise the cost of offsetting the government's net cash flows over time, while operating to the government's risk appetite. In so doing, the DMO will seek to avoid actions or arrangements that would:

- undermine the efficient functioning of the sterling money markets
- conflict with the operational requirements of the Bank of England for monetary policy implementation

¹ The four types of risk for cash management are liquidity risk, interest rate risk, foreign exchange risk and credit risk. An explanation of these risks and the government's cash management operations more generally is set out in chapter 5 of the DMO's Annual Review 2004-05, which is available on the DMO's website: http://www.dmo.gov.uk/documentview.aspx?docname=publications/annualreviews/gar0405.pdf&page=Annual_Review.

Instruments and operations used in Exchequer cash management

D.6 The range of instruments and operations that the DMO may use for cash management purposes, including the arrangements for the issuance of Treasury bills, is set out in its Operational Notice.²

D.7 Treasury bills can be used for both cash and debt management purposes. In relation to the latter, any positive or negative net contribution to the government's debt financing plans which is attributable to changes in the stock of Treasury bills is set out in the financing arithmetic table (table 3.A).

D.8 For cash management, the DMO uses Treasury bills to help manage fluctuations in the government's cash flow profile throughout the year and does so by varying the amount raised through Treasury bills by reference to the forecast net cash position. In order to provide flexibility to the DMO to use Treasury bills across financial year-end for cash management, no end-year target stock of Treasury bills is set. Information on the total stock of Treasury bills is published monthly on the DMO's website.

D.9 As a contingency measure, the DMO may issue Treasury bills to the market at the request of the Bank of England and, in agreement with HM Treasury, to assist the Bank of England's operations in the sterling money market for the purpose of implementing monetary policy while meeting the liquidity needs of the banking sector as a whole. In response to such a request, the DMO may add a specified amount to the size(s) of the next 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 Treasury bill tender announcement. Treasury bills may also be issued bilaterally to the Bank of England to support intervention schemes. Treasury bill issues made at the request of the Bank will be identical in all respects to Treasury bills issued in the normal course of DMO business. The DMO may also raise funds to finance advances to the Bank of England and would, in conjunction with HM Treasury, determine the appropriate instruments through which to raise those funds.

DMO collateral pool

D.10 Gilts and/or Treasury bills may be issued to the DMO to help in the efficient execution of its cash management operations. The amounts will be chosen to have a negligible effect on any relevant indices. This will normally be on the third Tuesday of April, July and October 2017 and January 2018. Any such issues to the DMO will be used as collateral and will not be available for outright sale. The precise details of any such issues to the DMO will be announced at least two full working days in advance of the creation date. If no issue is planned to take place in a particular quarter, the DMO will announce that this is the case in advance.

D.11 In the event that the DMO requires collateral to manage short-term requirements, the DMO may create additional Treasury bill collateral at other times. Any such issues to the DMO will only be used as collateral and will not be available for outright sale by the DMO.

D.12 The DMO's collateral pool may also be used to support HM Treasury's agreement to provide gilt collateral for the purpose of the Bank of England's Discount Window Facility (DWF).

² The current edition of Exchequer Cash Management Operational Notice and Treasury Bill Information Memorandum is available on the DMO's website at: http://www.dmo.gov.uk/index.aspx?page=publications/money_markets.

The gilt collateral will be held by the DMO and lent to the Bank of England on an 'as needed' basis; gilts created for this purpose will not be sold or issued outright into the market.³

Active cash management

D.13 The combination of HM Treasury's cash flow forecasts and the DMO's market operations characterises an active approach to Exchequer cash management. Since 2007-08, a performance measurement framework for active cash management – in which discretionary decisions that are informed by forecast cash flows are evaluated against a range of indicators – has been in place. These include qualitative measures as well as measures quantifying returns to active management, after deducting an interest charge representing the government's cost of funds. Performance against these key indicators is reported in the DMO's Annual Review.⁴

³ More information about the Discount Window Facility can be found on the Bank of England's website at: <http://www.bankofengland.co.uk/markets/money/dwf/index.htm>.

⁴ For the latest report See annex B of the DMO Annual Review which can be found on the DMO's website at: http://www.dmo.gov.uk/index.aspx?page=publications/Annual_Reviews.

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