HM TREASURY

Debt and reserves management report 2010-11

March 2010

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ISBN 978-1-84532-697-5
PU933

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Foreword

This is the eighteenth report outlining the Government's debt management activities. It also includes details of the management of the Official Reserves by the Bank of England.

The Government's debt management framework has been strong and flexible throughout the turbulence in global financial markets and economies since 2007. The UK's gilt market is one of the most sophisticated in the world, as evidenced by its depth and liquidity. The market is supported by the debt management objective, to minimise the long-term costs of debt issuance, taking into account risk, whilst ensuring that debt management policy is consistent with the aims of monetary policy. The objective has remained unchanged and has proven to be a clear, appropriate and resilient objective to guide debt management successfully through a challenging period. The Government has consistently adhered to the core principles of transparency and predictability that underpin the framework.

When it has been necessary, the Government has adapted the debt management framework as appropriate. For example, in April 2009, the Government introduced a programme of syndications and mini-tenders for the first time – to enable it to issue more long conventional and index-linked gilts than would have been possible via auctions alone. Further technical changes to the scheduling of operations have been made in this remit to facilitate the use of syndications. In keeping with such innovation, the Debt Management Office (DMO) remains open to enhancements and improvements to its processes.

The Government judges that the resilience and flexibility of the debt management framework has contributed to maintaining lower costs of debt issuance than would otherwise have been the case while appropriately managing risk. It has also benefited from lower exposure to refinancing risk in the short to medium term by extending the maturity of its outstanding debt portfolio. The Government has raised £10.5 billion through sales of 50-year bonds in 2009-10.

2009-10 has been an unprecedented year for debt management. Gross gilt issuance was £227.6 billion and gilt issuance net of redemptions was £211 billion. 58 gilt auctions were held which raised £177.2 billion. A programme of syndications and mini-tenders supplemented the regular gilt auction schedule in 2009-10. £30.5 billion was raised from the sale of gilts by syndication and £10.1 billion was raised by mini-tenders. In addition, £9.8 billion was raised through the post auction top up facility – a new facility for successful bidders at auction to elect to increase their allocation of gilts shortly after the auction has closed.

Gross gilt issuance in 2010-11 is projected to be £187.3 billion and gilt issuance net of redemptions is projected to be £148.3 billion. Our annual consultation with primary dealers and investors in January 2010 showed continued high demand for gilts of all maturities, and particularly for long conventional and index-linked gilts, and support for the supplementary gilt issuance methods introduced as part of the 2009-10 remit. The Government has listened carefully to the feedback from dealers and investors in designing its 2010-11 gilt issuance programme. The percentage of total projected gilt sales in long conventional and index-linked gilts will increase to 45 per cent of total gilt sales and issuance will rise by £2.4 billion to £83.3 billion. This increase has been achieved within a lower total projected gilt sales, enabling the Government to respond to strong structural demand, in particular, from pension funds and insurance companies, and thereby minimising debt interest costs over the long term.

The primary dealers and investors have also indicated that demand for short conventional gilts is high; the Government will sell £59 billion of these gilts in 2010-11.

In accordance with the debt management principles, the Government remains committed to auctions as the primary mechanism to sell gilts, as publication of an auction calendar well in advance allows market participants certainty when planning investment strategies which, in turn, reduces the uncertainty premium in yields to the benefit of the Exchequer. The use of syndication and mini-tenders to issue gilts will continue in 2010-11. In particular, this would enable higher issuance of long conventional and index-linked gilts than would be possible through the use of auctions alone, allow the Government to appropriately manage cost and risk, meet demand for long maturity gilts and align supply closely with demand through book-building.

Following a review of the implementation of the supplementary issuance programme in 2009-10, the Government will also introduce some technical changes to the framework for the scheduling of operations to facilitate the effective implementation of syndication. These are intended to add additional responsiveness to the debt management framework, while adhering to the core principles of transparency and predictability. These changes will be reviewed at the end of 2010-11. I am confident that the DMO will be able successfully to deliver its remit in 2010-11.

For National Savings & Investments (NS&I), following the significant inflows seen in 2007-08 and 2008-09, the main focus for 2009-10 was to retain deposits already held rather than attract new funds. In 2009-10, net financing outturn is projected to be within its target range of zero, plus or minus £2 billion. The target for NS&I in 2010-11 will be to maintain broadly the existing level of stock, while offering reasonable rates to savers and supporting financial stability by maintaining an appropriate competitive position. NS&I remains alert to the intense competition in the retail savings market and will keep its offerings under review to ensure that they appropriately reflect market forces. This position assumes gross sales (including reinvestments and accrued interest) of £15.4 billion in 2010-11.

I would like to add my personal thanks to the DMO and NS&I for working so effectively during the last year.

24 March 2010

Paul Myners

Financial Services Secretary

1 Introduction

1.1 This is the eighteenth report outlining the Government's debt management activities.

1.2 The *Debt and reserves management report* (DRMR) is published in compliance with the *Code for Fiscal Stability*[1] which requires that a debt management report be published every year covering the following areas:

- the overall size of the gilt issuance programme for the coming financial year;
- the planned maturity structure and the proportion of index-linked and conventional gilts;
- the gilt auction calendar; and
- a forecast of net financing through National Savings & Investments (NS&I).

1.3 The Debt Management Office (DMO) publishes detailed information in its Annual Reviews on developments in debt management and the gilt market over the previous year. To avoid duplication, only a summary of developments in the gilt market during 2009-10 is set out in Annex A of this report.

[1] The *Code for Fiscal Stability* can be found on HM Treasury's website at: http://www.hm-treasury.gov.uk/ukecon_fisc_index.htm

2 Size and structure of UK Government debt in 2009-10

Debt stock

2.1 The total nominal outstanding stock of United Kingdom central government sterling debt (excluding official holdings by central government) was £883.4 billion at end-December 2009. This debt comprised £567.2 billion of conventional gilts, £170.2 billion of index-linked gilts (including accrued inflation uplift) and £47.6 billion of Treasury bills (see Table 2.A). In addition, there was £98.4 billion invested in NS&I's (non-marketable) instruments.

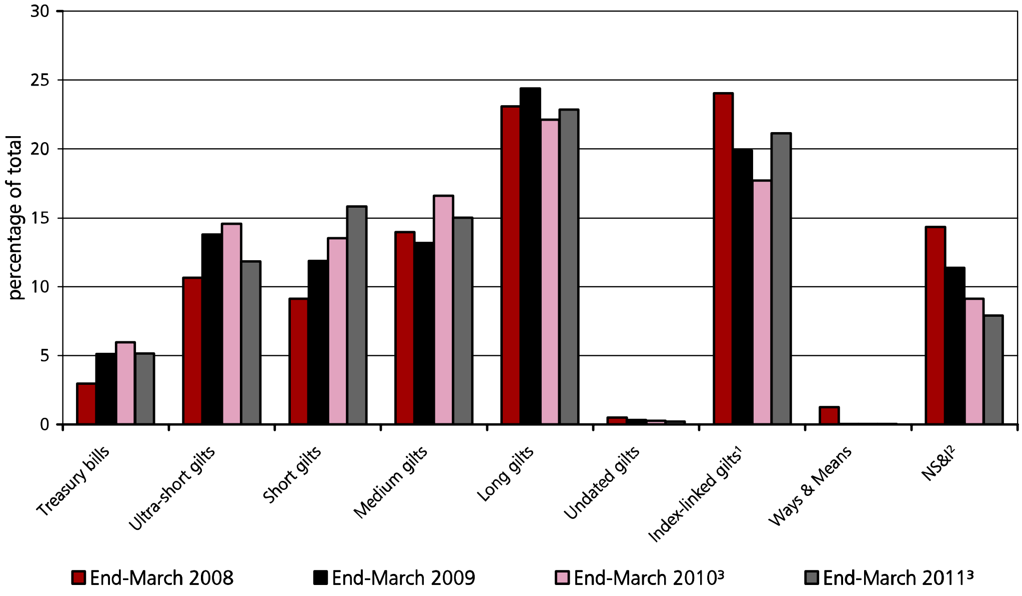
Table 2.A: Composition of UK Central Government sterling debt

	End-March 2009	End-December 2009
(£ billion, nominal value, excluding official holdings)		
Conventional gilts[1]	426.1	567.2
Index-linked gilts[2]	154.0	170.2
Treasury bills[3]	44.0	47.6
Total gilts and Treasury bills	624.1	785.0
National Savings & Investments	97.2	98.4
Total central government sterling debt	721.3	883.4

[1] Includes undated and double-dated gilts.
[2] Includes accrued inflation uplift.
[3] Treasury bill stock in market hands.
Source: Debt Management Office/National Savings & Investments

2.2 Chart 2.A shows a comparison of the Government's debt portfolio at end-March 2008 through to a projected composition at end-March 2011. It assumes that new debt is issued in accordance with the DMO's and NS&I's financing remits. It also takes into account the ageing of existing debt.

Chart 2.A: The composition of UK central government sterling debt



[1] Includes inflation uplift.

[2] Includes accrued interest.

[3] Figures for end March-2010 and end March-2011 are projections.

Source: Debt Management Office/National Savings & Investments

Maturity and duration

2.3 The average maturity of the stock of all dated marketable gilts is projected to decrease from 14.1 years to 13.9 years between end-March 2009 and end-March 2010. Over the same period, the modified duration of the conventional portfolio of marketable gilts is projected to fall from 8.6 years to 8.2 years.[1] The average maturity and duration of the UK Government's marketable domestic debt (gilts and Treasury bills only) continues to be the longest in the OECD. Further details of the maturity structure of the UK's debt portfolio are discussed in Box 2.A.

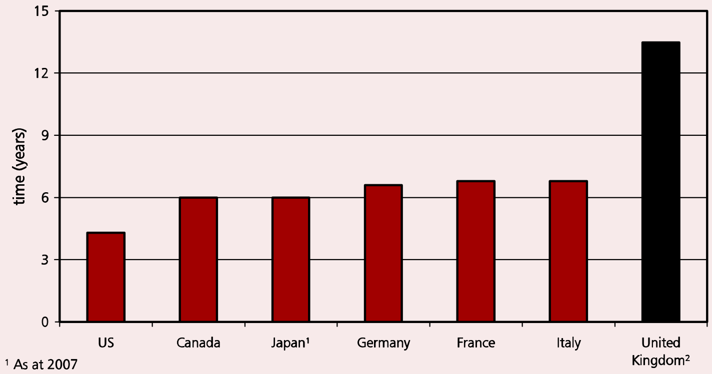
[1] Modified duration is defined in Box 11.1

Box 2.A: Maturity profile of the UK's debt

The maturity profile and relative size of a country's outstanding debt can be an indicator of the refinancing risk to which that country is exposed. Refinancing risk is the risk that a government cannot rollover (i.e. reissue) existing debt effectively as it matures or may have to do so at higher yields. A shorter average maturity of the debt stock can indicate that a government has higher refinancing risk on the basis that it may have to roll its debt over more frequently. Lower refinancing can also reduce volatility in long-term debt interest payments.

Chart A shows a comparison between the average maturity of the UK's outstanding debt and that for G7 countries for which data are reported by the OECD in its *Central Government Debt: Statistical Yearbook* 1999-2008. Chart A shows that, at 13.5 years as at end-December 2009, the average term to maturity of the UK's outstanding debt is the longest of G7 countries. Moreover, the UK is one of only two G7 countries to have issued a 50-year bond in 2009-10 (to date).

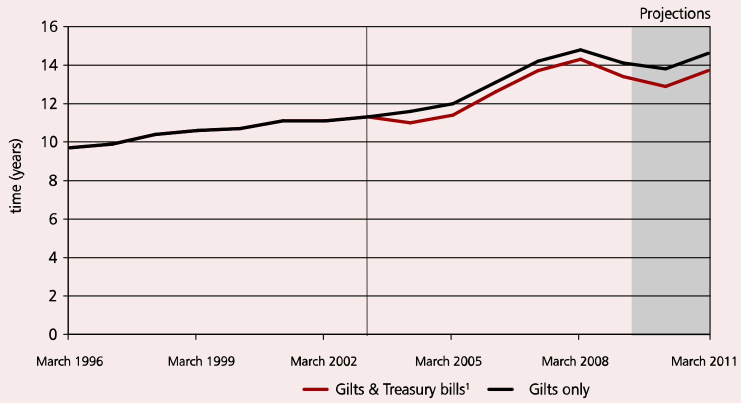
Chart A: Debt maturity in 2008



[1] As at 2007
[2] As at end December 2009
Source: OECD, Debt Management Office

In addition, in recent years, the maturity of the UK's outstanding debt has increased steadily as shown in Chart B. Despite a small decline in 2008-09 and 2009-10, reflecting the need to issue a high volume of short maturity debt to finance the recapitalisation of the banking sector, as announced in October 2008, the average maturity is projected to rise again in 2010-11.

Chart B: UK debt maturity over time



[1] Data for this series are unavailable prior to 12 September 2003, the date when the DMO began publishing Treasury bill reference prices.
Source: Debt Management Office

Interest payments

2.4 Gross central government debt interest payments in 2008-09 were £30.5 billion, equivalent to 4.8 per cent of total managed expenditure (TME). In 2009-10 they are forecast to be £30.8 billion (4.6 per cent of TME) and in 2010-11 are forecast to be £41.6 billion (5.9 per cent of TME).

Gilt issuance and the gilt market

2.5 The DMO was established as part of the Government's reforms to the macroeconomic framework announced in 1997. The DMO took over responsibility for the issuance of gilts from the Bank of England in April 1998. Gross gilt issuance in 2009-10 was £227.6 billion, £81.1 billion more than in 2008-09.[2]

2.6 The central government net cash requirement (CGNCR) measures the cash amount that central government needs to borrow for the financial year and is the key fiscal measure from which the volume of gilt issuance is derived. The CGNCR for each of the years in which the DMO has been responsible for gilt issuance and the volume of gilt sales in each of those years is shown in Table 2.B.

Table 2.B: Central Government Net Cash Requirement and gross gilt sales, 1998-99 to 2009-10

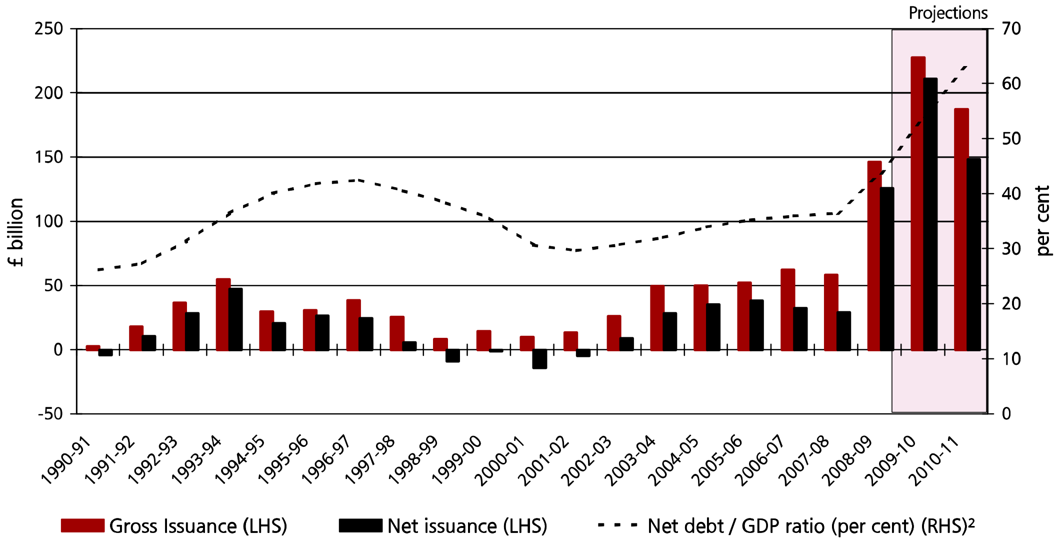
Financial year	CGNCR (£ billion)	Gross gilt sales (£ billion)
1998-99	-4.5	8.2
1999-00	-9.1	14.4
2000-01[1]	-35.6	10.0
2001-02	2.8	13.7
2002-03	21.8	26.3
2003-04	39.4	49.9
2004-05	38.5	50.1
2005-06	40.8	52.3
2006-07	37.1	62.5
2007-08	32.6	58.5
2008-09	162.4	146.5
2009-10[2]	200.9	227.6
2010-11[3]	166.4	187.3

[1] Reflecting the proceeds from the 3G Spectrum auction.
[2] CGNCR projection at Budget 2010.
[3] Projections.
Source: HM Treasury/Debt Management Office

2.7 In the first years of the DMO's operations, the size of the gilt market shrank as net issuance was negative (i.e. gross issuance was exceeded by gilt redemptions). However, net issuance turned positive in 2002-03 as the financing requirement began to rise. Net issuance was £211 billion in 2009-10 and is projected at £148.3 billion in 2010-11. Chart 2.B shows the trend in gross and net issuance since 1990-91 with projections in 2009-10 and 2010-11.

[2] Figures are in cash terms unless otherwise stated.

Chart 2.B: Gross and net gilt issuance 1990-91 to 2010-11[1]



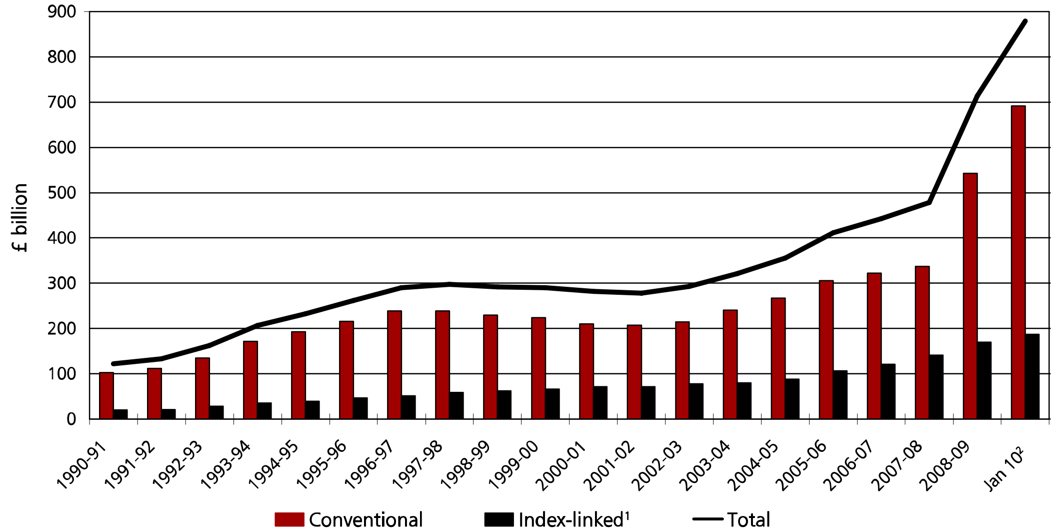
[1] Gross and net issuance are outturns up to and including 2008-09.

[2] Net debt/GDP ratio (excluding liabilities and unrealised losses from government action to support the financial sector) is an estimate.

Source: HM Treasury/Debt Management Office

2.8 Chart 2.C shows the change in the size of the gilt market since 1990-91.

Chart 2.C: Size of the gilt market since 1990-91



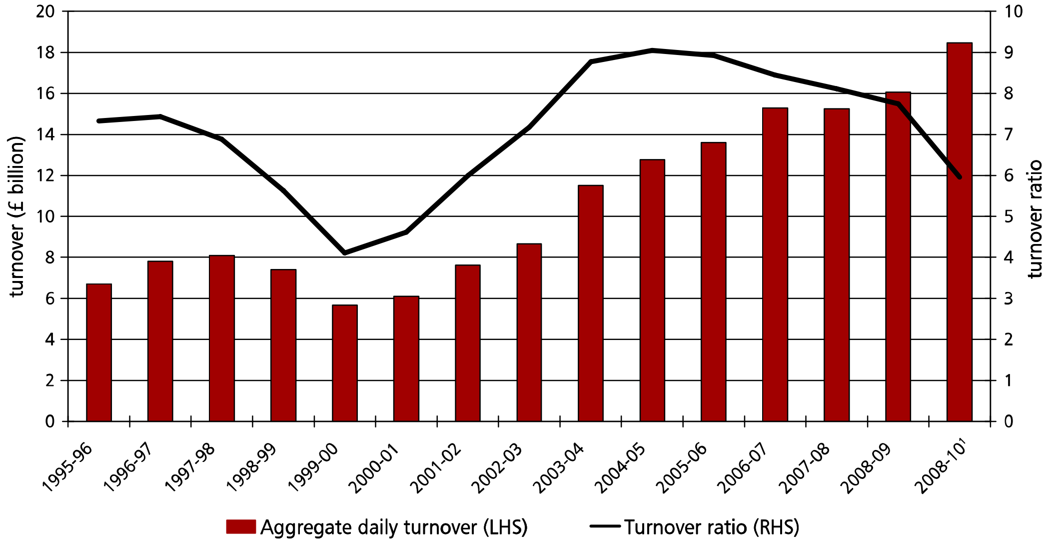
[1] Includes indexation uplift.

[2] As at end January 2010.

Source: Debt Management Office

2.9 Turnover[3] in the gilt market rose steadily from 1999-00 to 2006-07. Average daily turnover increased by 168 per cent between 1999-00 and 2006-07 (from £5.7 billion to £15.3 billion). In 2007-08, average daily turnover remained steady but increased again in 2008-09 and 2009-10, to £18.5 billion. The turnover ratio has fallen for a fifth consecutive year in 2009-10 (to 6), largely as a result of the marked increase in the size of the underlying portfolio. Chart 2.D shows these trends.

Chart 2.D: Gilt market turnover



[1]Financial year to end-January 2010

Source: Debt Management Office

[3] Turnover is a measure of the level of trading activity in the secondary market. The turnover ratio is aggregate turnover relative to the market value of the portfolio at the start of the year.

3 UK Government's debt management policy

Objectives of debt management

3.1 The Government's debt management objective is:

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

3.2 The debt management policy objective is achieved by:

- pursuing an issuance policy that is open, transparent and predictable;
- issuing gilts that achieve a benchmark premium;
- adjusting the maturity and nature of the Government's debt portfolio, primarily by means of the maturity and composition of debt issuance and potentially by other market operations including switch auctions, conversion offers and buy-backs;
- developing a liquid and efficient gilt market; and
- offering cost-effective savings instruments to the retail sector through NS&I.

3.3 HM Treasury has overall responsibility for meeting the debt management policy objective but has delegated operational responsibility for debt management to its agents: the DMO undertakes borrowing in sterling through issuance of government bonds and short-term debt instruments in the wholesale market; NS&I undertakes retail borrowing through sales of retail savings products; and the Bank of England undertakes borrowing in foreign currencies through issuance of foreign currency denominated government bonds.

The role of the Debt Management Office

3.4 HM Treasury has two overarching requirements for the DMO in the conduct of its delegated responsibility for wholesale debt financing operations, namely, that it:

- raises the quantum of financing set out in its annual financing remit. This means that the DMO is expected to achieve the sale of inflation-linked ("index-linked"), nominal ("conventional") gilts and Treasury bills within the operational tolerances specified in the financing and Exchequer cash management remits respectively (see Chapters 4, 5 and 6); and
- conducts its operations in accordance with the principles of openness, predictability and transparency, which underpin the Government's approach to debt management policy more generally. The Government judges that by conducting its operations in accordance with these principles the DMO will effectively contribute to achieving long-term cost minimisation subject to risk.

3.5 In practice, this means that HM Treasury expects the DMO to:

- *adopt a predictable approach to debt issuance*, which includes publishing an annual gilt auction calendar before the beginning of each financial year and holding auctions in accordance with its remit;
- *pre-announce the details of its debt issuance plans* to the market to ensure transparency about its activities; and
- *act in a manner consistent with its remit* and explain the basis for its decisions about debt issuance as fully as possible to the market in order to allow market participants better to understand the rationale behind the DMO's decisions.

3.6 In addition, HM Treasury expects the DMO to:

- *provide advice* in its capacity as the Government's official presence in the gilt market on: (i) the appropriate structure and contents for the financing remit in preparation for publication of the remit each year alongside the Budget; and (ii) how to accommodate revisions to the remit during the course of the year;
- *report during the financial year on progress against the remit*, in particular, progress of gilt sales against the remit targets;
- *monitor developments in the gilt market and the wider economy* and report in a timely manner on changing conditions that might require the terms of the remit to be revisited;
- *maintain open channels of communication with market participants,* both formally and informally, to solicit their views on gilt issuance and other issues affecting the remit and, as far as possible, to explain the rationale for decisions;
- *advise on any operation to manage the maturity and nature of the Government's debt portfolio and conduct any such operation if so directed by HM Treasury*, through gilt issuance decisions and through use of other market management techniques;
- *develop a liquid and efficient gilt market* primarily through regular issuance of benchmark gilts;
- *provide advice on the introduction of any new financing instrument or debt management technique* as deemed appropriate to fulfil the Government's debt management objective; and
- *ensure the continuing and efficient functioning of the gilt market* by undertaking market management operations as necessary.

3.7 This approach to debt management policy, based on principles of openness, predictability and transparency, is recognised internationally as the most effective way to minimise the long-term costs of debt management, although there is no recognised way to measure quantitatively whether long-term costs are minimised through this approach.[1] In order to demonstrate that the DMO is taking decisions aimed at fulfilling the objective of long-term cost minimisation subject to risk, HM Treasury expects the DMO to explain publicly, in its Annual Review, the key factors that motivated its decisions on implementation of the remit during the course of the previous financial year. Quantitative reporting of aspects of the DMO's performance is also undertaken

[1] The key ways in which the DMO seeks to achieve transparency and predictability in its operations are outlined in Box 3.1, ***Debt and reserves management report*** 2007-08.

against a range of measures and indicators wherever that is possible. A number of these measures are set out in the DMO's annual published business plan.[2]

Maturity and composition of debt issuance

3.8 In order to determine the maturity and composition of debt issuance, the Government needs to take account of a number of factors including:

- investors' demand for gilts;
- the Government's own appetite for risk, both nominal and real;
- the shape of both the nominal and real yield curves and the expected effect of issuance policy; and
- changes to the stock of Treasury bills and other short-term instruments.

Medium-term approach to debt issuance

3.9 In the medium term, consistent with the debt management policy objective of minimising long-term costs taking into account risk, the Government's annual decisions about gilt issuance will continue to be informed by a number of factors including: the size of the annual financing requirement; supply-side considerations including the Government's risk preferences; investors' demand for gilts; the shape of the yield curve; and other financial market conditions. In the event that strong demand for long conventional and index-linked gilts persists in the medium term, and continues to influence the shape of the yield curve, the Government's policy of skewing issuance towards long maturities would continue as far as practicable, subject to the operational constraints in doing so.

3.10 Table 3.A shows gilt issuance by maturity since 2004-05.

Table 3.A: Gilt issuance by maturity 2004-05 to 2009-10[1]

	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
£ billion Conventional gilts:						
Short maturity	17.6	12.2	10.1	10.1	62.8	75.4
Medium maturity	10.1	11.4	9.9	10.0	33.4	71.3
Long maturity	14.5	17.9	25.2	23.4	30.3	51.6
Index-linked	8.0	10.8	17.2	15.0	20.0	29.3
Total	50.2	52.3	62.5	58.5	146.5	227.6

[1]Totals may not sum due to rounding.
Source: Debt Management Office

3.11 Table 3.B shows the volume of gilts issued by method, type and maturity in 2009-10.

[2] The DMO's *Business Plan* for 2009-10 is available on the DMO's website at:
http://www.dmo.gov.uk/documentview.aspx?docname=publications/corpgovernance/busplan2009.pdf&page=corporate_governance/Documents

Table 3.B: 2009-10 gilt issuance split by method of issue, type and maturity[1]

	Auction	Syndication	Mini tender	Total
Conventional gilts:				
Short				
£ billion	75.4	-	-	75.4
per cent				33.1
Medium				
£ billion	71.3	-	-	71.3
per cent				31.3
Long				
£ billion	27.9	17.6	6.1	51.6
per cent				22.7
Index-linked				
£ billion	12.4	12.9	4.0	29.3
per cent				12.8
Total	187.0	30.5	10.1	227.6

[1]Totals may not sum due to rounding.

Source: Debt Management Office

Debt management policy in 2009-10

3.12 The considerations underpinning the DMO's financing remit in 2009-10 are set out in Box 3.A.

Box 3.A: Factors underpinning gilt issuance decisions in 2009-10 – cost and risk considerations

The decisions on gilt issuance announced in Budget 2009 were made in accordance with the debt management objective, to minimise the costs of debt issuance over the long term, taking account of risk, while ensuring that debt management policy is consistent with the aims of monetary policy.

The key risks that the Government sought to mitigate at Budget 2009 were refinancing risk and execution risk. Refinancing risk is the risk associated with re-issuing existing debt as it matures. It has two constituent parts: (i) rollover risk, the risk that the Government cannot refinance its debt smoothly as it rolls over; and (ii) re-fixing risk, the risk that the Government re-fixes the interest payments on its debt at higher rates of interest than previously. A higher volume of gilt redemptions, or concentration of maturing gilts in the short term can, other factors held constant, increase short-term refinancing risk, which can also lead to increased volatility in debt interest payments.

Execution risk is the risk that the Government, as issuer, may not be able to access the gilt market at a particular point in time, without incurring a deep discount. This risk may crystallise as a result of difficult conditions in the market and may result in additional costs in gilt issuance.

The decisions on gilt issuance announced in Budget 2009 were informed by strong demand for conventional and index-linked gilts; from pension funds and insurance companies. Such demand was apparent in the shape of the nominal and real yield curves at Budget 2009 and throughout 2009-10. Charts A and B show the shape of the nominal and real yield curves at Budget 2009 and 17 March 2010. The Government believes that a negative term premium exists in both long conventional and index-linked gilt yields, although it is easier to observe in the shape of the index-linked yield curve which is clearly inverted at long maturities whereas the nominal yield curve is flat at long maturities. The pronounced negative term premium in index-linked gilt yields suggests that issuance of long-dated index-linked gilts is particularly cost effective.

Chart A: Nominal yield curve

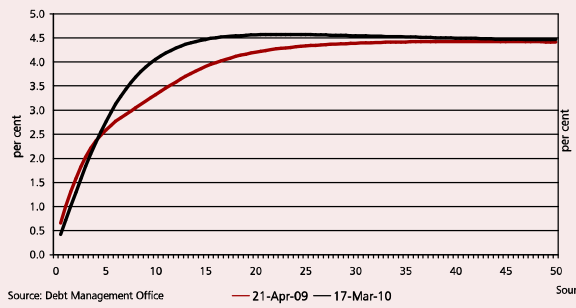
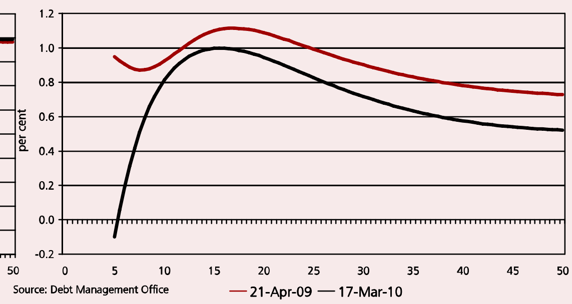


Chart B: Real (index-linked) yield curve



In addition, high absolute issuance of long conventional and index-linked gilts enables the Government to 'lock in' current long-term yields and reduce volatility in debt interest payments.

There are, however, limits to the Government's ability to increase issuance of long conventional and index-linked gilts, namely, the risk and operational constraints associated with doing so. The DMO typically sells, on average, a smaller amount of these gilts at each auction than for other gilts. This is because these types of gilt can be more difficult to hedge, have lower liquidity and a less diversified investor base. In addition, these gilts can be 'riskier' for the market to purchase as their price is more sensitive to changes in yield (duration risk) and demand can be unpredictable on any given day. All of these factors increase risk for both the Government and the gilt market and auctions are sized appropriately to balance cost and risk considerations. Moreover, the frequency of operations also needs to be managed to provide adequate space between sales of similar gilts and to avoid issuing gilts on the same days as significant pre-scheduled market events that might generate volatility in the gilt markets.

The Government also considered that issuance of both short and medium conventional gilts would further aid the execution of the overall financing programme. The short and medium sectors of the conventional gilt market are the most deep and liquid and, as such, facilitate the issuance of a greater amount of gilts at individual auctions than is the case with issuance of long conventional or index-linked gilts, thereby reducing the number of operations needed to raise a given financing requirement over the course of the financial year (which is a particularly important practical consideration during a time of high financing).

In the case of short conventional gilts, the Government believed that it could achieve cost benefits from issuance. This benefit arises from continuing strong demand from international investors and demand for high quality short-dated assets from domestic investors as a result of the ongoing disruption in the financial markets and 'flight to quality', which had exerted downward pressure on yields.

However, the absolute amount of short gilt issuance was limited by the need to manage the profile of gilt redemptions and refinancing risk which can arise if gilt redemptions are concentrated in particular years.

3.13 In March 2009, the Bank of England commenced a programme of asset purchases as part of its implementation of monetary policy including the purchase of gilts in the secondary market. The Bank of England has purchased approximately £200 billion of assets, of which £198.3 billion was in gilts. Debt management and the Bank of England's gilt purchases through the Asset Purchase Facility (APF) are discussed in Box 3.B.

Box 3.B: Debt management and the Bank of England's gilt purchases through the Asset Purchase Facility (APF)

In March 2009, the Bank of England's Monetary Policy Committee (MPC) announced that it would begin its programme of implementation of monetary policy by quantitative means ('quantitative easing') by purchasing £75 billion of assets financed by the creation of central bank reserves. The majority of asset purchases were of conventional gilts. The Bank initially purchased conventional gilts with a minimum residual maturity of five years and a maximum residual maturity of 25 years but retained the option to extend the range of maturities in which it would offer to purchase gilts.

At subsequent meetings in May, August and November 2009, the MPC voted to increase the size of the programme of asset purchases by £50 billion, £50 billion and £25 billion respectively. In August 2009, the Bank of England decided to extend the maturity range of the gilts eligible to be purchased (to all conventional gilts with a residual maturity of more than three years).

At its meeting in February 2010, the MPC announced that the total size of asset purchases financed by central bank reserves would be maintained at £200 billion, that it would continue to monitor the appropriate scale of the asset purchase programme and that further purchases would be made should the outlook for inflation warrant them. The current stock of assets includes £198.3 billion of gilts.

The Governor of the Bank of England stated, on 24 June 2009, at the Treasury Select Committee (TSC) session on the May 2009 *Inflation Report*, that 'It is clear that the operation of asset purchases has to be co-ordinated with the work of the Debt Management Office'. The close cooperation between the DMO and the Bank on operational issues will continue.

Lending of gilts purchased by the Bank

Under an agreement between the Bank of England and the DMO, the Bank made available a significant amount of the gilts it had purchased to the DMO for on-lending to the market through the DMO's repo market activity. The purpose of this arrangement is to alleviate any possible shortage in the secondary market for specific gilts arising from the Bank's purchases. This activity began on 7 August 2009.

The amounts available under this scheme comprise at least 10 per cent of the holdings of each gilt rising to above 10 per cent if the Bank's holding is greater than 50 per cent of the 'free float'[1] of a particular gilt. Table A shows the use of the facility. In addition, the Bank authorised the use of these gilts in the DMO's Standing Repo Facility and in any DMO Special Repo Facility in specific gilts. In exchange for the loan of gilts, the DMO delivers gilts and Treasury bills of equivalent value to the Bank, so that the overall holdings are unaffected and there is no impact on the DMO's cash management operations.

Table A: Lending of gilts purchased by the APF

Quarter ending	Average daily aggregate of gilts lent by the Bank of England's APF to the Debt Management Office (£ billion)
30 September 2009	4.8
31 December 2009	3.3

Source: Bank of England

[1] The 'free float' is the amount of a particular gilt that is available in the secondary market.

4 UK Government's financing programme for 2010-11

Financing framework

4.1 The Government intends to continue to finance the central government net cash requirement (CGNCR) using the framework that was established in the 1995 Debt Management Review. The Government aims to finance its net cash requirement plus maturing debt and any financing required for additional net foreign currency reserves through the issuance of debt. All such debt issuance will take place within a set maturity structure. Auctions remain the primary means of gilt issuance, but will be supported by a supplementary issuance programme comprising syndication and mini-tenders.

4.2 The DMO already has the capability to restate average auction sizes and reschedule auctions around the dates of Pre-Budget Reports and Budgets as part of its delegated operational responsibility. Following a review of the supplementary gilt programme, the Government will introduce, for 2010-11, the ability for the DMO to alter, marginally, the mix of gilt issuance methods it uses to deliver planned gilt issuance set out in the remit. These changes will be reviewed at the end of the year. In particular, to facilitate the optimal timing and/or sizing of syndications the DMO may:

- re-schedule auctions;
- add mini-tenders to the calendar with at least four weeks' notice or remove mini-tenders from the calendar with a minimum of one week's notice; and
- having considered the feasibility of the above, to schedule additional auctions, to the minimum extent necessary, following consultation with the market and with pre-announcement on the normal quarterly timetable.

4.3 This additional flexibility is designed to facilitate the effective delivery of the syndication programme while remaining consistent with the debt management principles of openness, transparency and predictability.

Financing arithmetic

4.4 The new forecast for the CGNCR in 2010-11 is £166.4 billion.

4.5 The forecast net financing requirement of £185.4 billion reflects expected gilt redemptions of £39 billion and the decision to provide an additional £4 billion of sterling finance for the Official Reserves.

4.6 Following the contribution to net financing of £1.5 billion in 2009-10, National Savings & Investments is not expected to make a net contribution to financing in 2010-11, reflecting stabilisation of the high levels of gross financing that underpinned the contribution to net financing in 2008-09. This projection assumes gross inflows of £19 billion in 2009-10.

4.7 The net financing requirement will be met by:

- gross gilt issuance of £187.3 billion; and
- a reduction in the Treasury bill stock of £1.9 billion to £60.8 billion.

4.8 Table 4.A gives details of the financing arithmetic for 2009-10 and 2010-11.

Table 4.A: Financing arithmetic 2009-10 and 2010-11

			2009-10	2010-11
£ billion				
Central Government Net Cash Requirement			200.9	166.4
Gilt redemptions			16.6	39.0
Financing for the Asset Purchase Facility			-1.0	0.0
Financing for the Official Reserves[1]			4.0	4.0
Buy-backs[2]			0.1	0.0
Planned short-term financing adjustment[3]			-0.6	-24.0
Gross financing requirement			220.0	185.4
less:				
National Savings & Investments			1.5	0.0
Net financing requirement			218.5	185.4
Financed by:				
1. Debt issuance by the Debt Management Office				
a) Treasury bills			18.7	-1.9
b) Gilts			227.6	187.3
of which:				
	Conventional	short	75.4	59.0
		medium	71.3	45.0
		long	51.6	45.3
	Index-linked		29.3	38.0
2. Other planned changes in net short-term debt[4]				
Change in Ways and Means[5]			-3.8	0.0
3. Unanticipated changes in net short-term cash position[6]			24.0	0.0
Total financing			242.5	185.4
Short-term debt levels at end of financial year				
Treasury bill stock[7]			62.7	60.8
Ways & Means			0.4	0.4
DMO net cash position			24.5	0.5

Figures may not sum due to rounding

[1] The 2009-10 figure reflects an additional £2 billion of sterling financing for the Official Reserves in addition to the £2 billion announced at Budget 2009.

[2] Purchases of "rump" gilts which are older, small gilts, declared as such by the DMO and in which Gilt-edged Market Makers (GEMMs) are not required to make two-way markets. The Government will not sell further amounts of such gilts to the market but the DMO is prepared, when asked by a GEMM, to make a price to purchase such gilts.

[3] To accommodate changes to the current year's financing requirement resulting from: (i) publication of the previous year's outturn CGNCR; (ii) an increase in the DMO's cash position at the Bank of England; and / or (iii) carry over of unanticipated changes to the cash position from the previous year.

[4] Total planned changes to short-term debt are the sum of: (i) the planned short-term financing adjustment; (ii) net Treasury bill sales; and (iii) changes to the level of the Ways and Means Advance.

[5] Reflects the Government's decision to repay £3.8 billion of the remaining balance of the Ways and Means Advance in 2009-10.

[6] A negative (positive) number indicates an addition to (reduction in) the financing requirement for the following financial year.

[7] The DMO has operational flexibility to vary the end-financial year stock subject to its operational requirements in 2010-11.

Source: HM Treasury/Debt Management Office

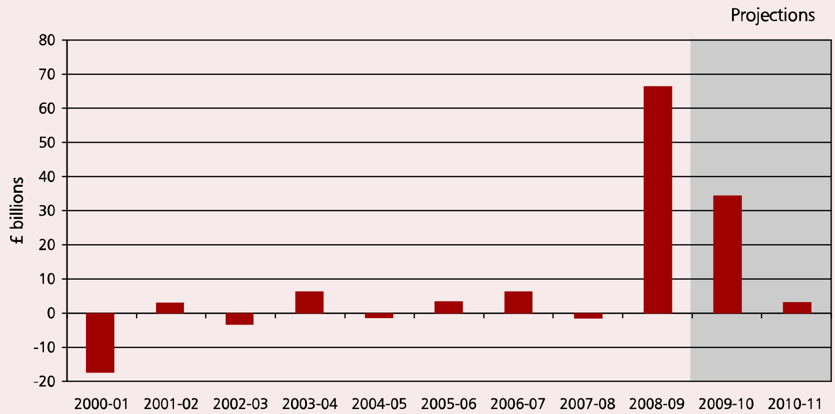
4.9 The CGNCR, which is the fiscal aggregate that determines gross debt sales, is derived from Public Sector Net Borrowing (PSNB). The divergence between CGNCR and PSNB in 2008-09 and 2009-10 is discussed in Box 4.A.

Box 4.A: The relationship between PSNB and CGNCR

The Government publishes a number of fiscal aggregates in each Budget and Pre-Budget Report. The main fiscal aggregate that directly determines the gross financing requirement (and, hence, the volume of gilt sales) is the CGNCR. The CGNCR is, itself, determined by PSNB and a number of adjustments reflecting the impact of financial transactions and borrowing attributable to other parts of the public sector.

The difference between the CGNCR and PSNB is, typically, small and stable. However, as a result of the very significant impact of financial sector interventions, the gap between the CGNCR and PSNB rose sharply in 2008-09 and 2009-10. The gap was £66.3 billion in 2008-09 and is projected to be £34.4 billion in 2009-10. The difference between the CGNCR and PSNB is shown in Chart A. The gap is projected to fall to £3.2 billion in 2010-11, broadly in line with the gap before 2008-09.

Chart A: Difference between CGNCR and PSNB since 2000-01



Source: HM Treasury

The impact of financial transactions on the CGNCR is set out in Table C14 of Budget 2010.

Financing for the Official Reserves[1]

4.10 If the Government judges that there is a value-for-money case for doing so, consideration would be given to issuing foreign currency securities to finance the borrowed reserves in 2010-11. Any decisions will be taken on the basis of the least cost comparison set out in chapter 9.

4.11 For the purposes of the financing arithmetic in Table 4.A, it is assumed that swapped sterling will remain the main form of financing of the borrowed reserves (as has been the case in recent years) and no new foreign currency debt will be issued in 2010-11. The financing arithmetic provides for an additional £4 billion of sterling finance for this purpose in 2010-11. There is no Government foreign currency debt that matures in 2010-11. If the Government were to decide to issue a foreign currency bond later in the year, this may be taken into account in subsequent revisions to the DMO's financing remit, for example at the 2010 Pre-Budget Report or at Budget 2011, depending on when the bond was issued.

[1] The Government's official holdings of international reserves, with the exception of the Special Drawing Rights (SDR) assets, are held in the Exchange Equalisation Account (EEA).

Treasury bill sales

4.12 The financing plans for 2010-11 show that the outstanding stock of Treasury bills is expected to fall by £1.9 billion to 60.8 billion. In addition to the scheduled weekly tenders, the DMO may continue to re-open, on request, existing issues of Treasury bills for sale on a bilateral basis, to raise funds for cash management. Consequently, the DMO will continue to have operational flexibility to vary the end-financial year stock subject to its operational requirements (see paragraph 6.8). The 2009-10 outturn for the Treasury bill stock will be reported alongside CGNCR outturn in April 2010; similarly, the outturn for 2010-11 will be reported in April 2011 alongside the outturn for the 2010-11 CGNCR.

Other short-term debt

4.13 The projected level of the Ways & Means Advance at the Bank of England at 31 March 2010 is £0.4 billion. No changes to the level of the Ways & Means Advance are planned in 2010-11.

4.14 The projected level of the DMO's cash balance at the Bank of England at the end-March 2010 is £24.5 billion, £24 billion above the level of the projected cash balance in the 2009 Pre-Budget Report. The level will be reduced during 2010-11 from £24.5 billion to £0.5 billion (as shown by the planned short-term financing adjustment) that will, in turn, reduce the net financing requirement in 2010-11. Further details are set out in Box 4.B.

Box 4.B: Changes in the DMO's net short-term cash position in 2009-10 since the 2009 Pre-Budget Report

As at 31 March 2010, the DMO's net cash position is projected to be £24.5 billion – an increase of £24 billion over the level projected at the Pre-Budget Report (of £0.5 billion). The increase in the DMO's net cash position predominantly reflects a reduction in the Central Government Net Cash Requirement (CGNCR) of £22.4 billion since the Pre-Budget Report. The reduction in the CGNCR partly reflects a reduction in Public Sector Net Borrowing and a reduction in financial transactions. An unanticipated increase in the DMO's net cash position late in the financial year means that the Government has over-funded its net financing requirement by the amount of the increase in the short-term cash position.

Consistent with the principles of predictability and transparency that underpin the debt management framework, and the practicality of implementation, the Government has elected not to use the decrease in the CGNCR to either reduce sales of gilts or significantly reduce the stock of Treasury bills in 2009-10. In accordance with previous practice, the Government has decided to reflect the impact of the reduction in the CGNCR in the DMO's net cash position as at 31 March 2010.

The DMO's net cash position is planned to be reduced in 2010-11 to £0.5 billion which, other factors held constant, reduces the net financing requirement in 2010-11 by £24 billion.

Quantity of gilt sales

4.15 The DMO will aim to meet the remainder of the financing requirement by selling gilts to the private sector. It will aim to sell gilts on a broadly even-flow basis throughout the financial year. On the basis of the forecast for the CGNCR, there will be projected gross gilt sales of approximately £187.3 billion (cash) in 2010-11.

Benchmark gilts

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

5 The Debt Management Office's financing remit for 2010-11

Objectives

5.1 The 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 due 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 better to meet the debt management objective, liaising as appropriate with the Bank of England, Financial Services Authority, London Stock Exchange and other bodies and to provide policy advice to Ministers on the DMO's performance against its remit, objectives and targets;
- 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 Computershare Investor Services plc and Euroclear UK and Ireland, 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 medium-term 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 lowers the costs of debt issuance.

Quantity of gilt sales

5.2 The DMO, on behalf of the Government, will aim to deliver gilt sales of £187.3 billion (cash)[1] in 2010-11. Auctions will remain the Government's primary method by which to issue gilts. In addition, the Government has decided to continue the use of supplementary methods to issue gilts in 2010-11.

[1] Figures in Chapter 5 are in cash terms unless otherwise stated.

5.3 It is anticipated that:

- £148.1 billion (79.1 per cent of total issuance) will be issued through pre-announced auctions;
- £29.2 billion (15.6 per cent of total issuance) will be issued by syndication; and
- £10.0 billion (5.3 per cent of total issuance) will be issued through mini-tenders.

5.4 The planned amount of issuance and maturity mix in 2010-11 is:

- £59.0 billion of short conventional gilts (31.5 per cent of total issuance);
- £45.0 billion of medium conventional gilts (24.0 per cent of total issuance);
- £45.3 billion of long conventional gilts (24.2 per cent of total issuance); and
- £38.0 billion of index-linked gilts (20.3 per cent of total issuance).

5.5 The planning assumption for gilt issuance in 2010-11 by method of issue, type and maturity is shown in Table 5.A.

Table 5.A: Planned gilt issuance split by method of issue, type and maturity 2010-11[1]

	Auction	Syndication	Mini tender	Total
Short				
£ billion	59.0	-	-	59.0
per cent				31.5
Medium				
£ billion	45.0	-	-	45.0
per cent				24.0
Long				
£ billion	26.7	12.8	5.8	45.3
per cent				24.2
Index-linked				
£ billion	17.4	16.4	4.2	38.0
per cent				20.3
Total[2]	148.1	29.2	10.0	187.3

[1]As a planning assumption the DMO will use the supplementary issuance programme to sell long-dated and index-linked gilts .

[2]Totals may not sum due to rounding

Amount and maturity of conventional gilt issuance at auction

5.6 The planned amount of issuance and maturity mix of conventional gilts in 37 auctions in 2010-11 is:

- 13 auctions in the short (1-7 years) maturity area, aiming to raise £59 billion cash;
- 12 auctions in the medium (7-15 years) maturity area, aiming to raise £45 billion cash; and
- 12 auctions in the long (15 years and over) maturity area, aiming to raise £26.7 billion cash.

Amount of index-linked gilt issuance at auction

5.7 In 2010-11, the DMO aims to sell £17.4 billion (cash) in index-linked gilts in 15 auctions. These auctions will include frequent issuance at long maturities.

Size of gilt auctions

5.8 Each outright auction of conventional gilts is planned to be between £1.5 billion and £6.0 billion (cash) on a competitive bid-price basis. Each outright auction of index-linked gilts will be between £0.5 billion and £2.0 billion (cash) on a uniform price basis.

5.9 The planned gilt sales above are specified in cash terms, but gilt auctions are sized in nominal terms, typically in £250 million increments for conventional gilts and £25 million increments for index-linked gilts. Therefore, all gilt sales plans are expressed in approximate terms.

Gilt auction calendar

5.10 Auctions will constitute the primary means of issuance of all gilts (conventional and index-linked).

5.11 The expected timing of gilt sales at auction is set out in the calendar in Table 5.B below. A more detailed calendar for the first quarter of the financial year, including the gilts to be auctioned at each date, will be announced by the DMO at 3.30pm on Wednesday 31 March 2010. For the rest of 2010-11 the quarterly calendar announcements will be made at 3.30pm on 28 May, 31 August and 30 November 2010.[2] Full details of all auctions will normally be announced at 3.30pm on the Tuesday of the week preceding the auction.

5.12 As set out in paragraph 4.2, the calendar may be updated during the year and altered marginally to accommodate the optimal timing and/or sizing of a syndication by:

- rescheduling existing auctions;[3] and
- scheduling additional auctions, to the minimum extent necessary, following consultation with the market and with pre-announcement on the normal quarterly timetable.

5.13 The DMO may also alter the date of an auction:

- following confirmation of the date of a General Election; and/or
- following confirmation of the Chancellor's decisions on the timing of the Budget and the Pre-Budget Report.

5.14 After an auction, the DMO will generally refrain from issuing the same gilt for a reasonable period, unless already pre-announced, or if there is a clear market management case for doing so.

Post auction top up facility

5.15 In 2010-11, the DMO will continue to offer to successful bidders at auctions (both primary dealers and investors) an option to top up gilt purchases by up to 10 per cent of the amount allocated to them at auction, at the average accepted price at conventional auctions and the clearing (or strike) price at index-linked auctions. Further details of this facility are available in the DMO's gilt market operational notice.

5.16 Any additional amounts sold via this facility will count towards the remit sales targets and may be used to reduce the required average sizes for the remaining auctions of the maturity/type of gilt in question. If exercised consistently, the option may allow the cancellation of future auctions, but any such cancellation would be announced well in advance as part of the regular issuance calendar announcements and/or at the 2010 Pre-Budget Report.

[2] The announcement in November is subject to change depending on the date of the Pre-Budget Report.

[3] To be announced alongside an announcement about the likely timing of a syndication with a minimum of one week's notice of the rescheduled operation.

Table 5.B: Gilt auction calendar 2010-11

Date	Type
2010	
7 April	Conventional
13 April	Conventional
15 April	Index-linked
22 April	Conventional
27 April	Index-linked
5 May	Conventional
11 May	Conventional
13 May	Index-linked
20 May	Conventional
2 June	Conventional
3 June	Conventional
8 June	Index-linked
9 June	Conventional
17 June	Conventional
1 July	Index-linked
6 July	Conventional
14 July	Conventional
15 July	Index-linked
20 July	Conventional
3 August	Conventional
10 August	Conventional
12 August	Conventional
19 August	Index-linked
2 September	Conventional
7 September	Index-linked
15 September	Conventional
16 September	Conventional
5 October	Index-linked
13 October	Conventional
14 October	Conventional
19 October	Index-linked
21 October	Conventional
2 November	Conventional
9 November	Index-linked
11 November	Conventional
18 November	Conventional
2 December	Conventional
7 December	Conventional
15 December	Conventional
16 December	Index-linked
2011	
6 January	Conventional
11 January	Index-linked
19 January	Conventional
20 January	Conventional
1 February	Conventional
3 February	Conventional
8 February	Index-linked
17 February	Conventional
1 March	Conventional
3 March	Conventional
8 March	Index-linked
17 March	Conventional

[1] Auctions are subject to confirmation depending on the dates of the General Election, the 2010 Pre-Budget Report and Budget 2011.

Supplementary gilt issuance programme

5.17 The Government will continue to use supplementary methods to issue gilts in 2010-11. The planning assumption is that £39.2 billion of gilts will be issued via supplementary methods and that supplementary issuance methods will be used to sell long-dated conventional and index-linked gilts.

Syndication

5.18 The Government plans to sell £29.2 billion of gilts in up to ten syndications in 2010-11. The planning assumption is that £12.8 billion of long conventional and £16.4 billion of index-linked gilts will be issued by syndication (including new issues). The DMO will consult, with market participants, on plans for syndications in the quarterly consultation meetings throughout the year and will announce its intention to hold such operations, subject to market conditions, in its quarterly issuance announcements. Further details of any planned syndications will be announced around two weeks in advance of each operation.

Mini-tenders

5.19 The Government plans to issue £10.0 billion (cash) of gilts via a series of mini-tenders in 2010-11. The planning assumption is that this issuance will be split between long conventional and index-linked gilts. The DMO envisages holding at least one mini-tender per month and will announce the weeks in which tenders are planned in its quarterly issuance calendar announcements. The DMO may subsequently add mini-tenders to the calendar with at least four weeks' notice or remove mini-tenders from the calendar with a minimum of one week's notice. Mini-tenders will generally be around half the size of outright auctions of the same maturity/type.

5.20 The use of syndications and mini-tenders in 2009-10 is discussed in Box 5.A.

Box 5.A: The use of supplementary gilt distribution methods – syndication, mini-tenders and the post auction top up facility – in 2009-10

In 2009-10, the Government used syndication to complement auctions and facilitate the primary gilt distribution process. For the first time, a programme of syndications enabled the Government to issue more long maturity conventional and index-linked gilts than would have been possible via the auction process alone. The use of syndication in 2009-10 also:

- enabled the sale of new gilts in larger size than would have been possible via auctions, hence building new bonds to benchmark size more quickly;
- enabled a reduction in the number of auctions in a crowded calendar given that proceeds from syndication are higher than at an auction of equivalent maturity/type;
- increased the likelihood that supply would be aligned with demand because the exact timing of syndications is decided closer to the event;
- increased participation in the issuance process. Domestic demand (which accounted for on average around 95 per cent of each issue) has been mainly from investors, primarily fund managers, pension funds and insurance companies, reflecting strong structural demand for long-dated fixed income assets; and
- facilitated 'price discovery', in particular, for points on the curve for which pricing references did not already exist.

The costs to the Exchequer of using syndication in 2009-10 – fees and issuance concessions – are judged to have been proportionate compared with the cost of issuance using the auction mechanism. Unlike auctions, fees are paid on each syndicated gilt sale and reflect the value-add from the primary market dealers in facilitating the transaction. Issuance concessions, which are essentially price movements in the secondary market attributable to the sale of gilts, can occur using both the auction format and the syndication process. The details and results of the syndication programme, which raised £30.5 billion (cash), are set out in Table A.

Table A: Syndications in 2009-10

Syndication date	Gilt	Amount sold (£ billion nominal)	Issue yield (per cent)
16 June 2009	$4^1/_2$% Treasury Gilt 2034	7.0	4.65
23 July 2009	$0^5/_8$% Index-linked Treasury Gilt 2042	5.0	0.89
24 September 2009	$0^1/_2$% Index-linked Treasury Gilt 2050	5.0	0.54
21 October 2009	4% Treasury Gilt 2060	7.0	4.18
27 January 2010	$0^5/_8$% Index-linked Treasury Gilt 2040	3.5	0.71
23 February 2010	4% Treasury Gilt 2060	4.5	4.57
Total		32.0	

Source: Debt Management Office

Mini-tenders were also used in 2009-10 to supplement auctions and their use enabled the Government to access 'pockets of demand' in specific gilts as they emerged. 12 mini-tenders[1] were held which raised £10.1 billion (£6.1billion and £4 billion in long maturity and index-linked gilts respectively). In 2009-10, the Government also introduced the post auction top up option facility to encourage bidding at auctions. The facility also enabled the Government to raise additional proceeds by allowing successful bidders at auctions (both primary dealers and investors) the option to top up gilt purchases by up to 10 per cent of the amount allocated to them at the auction. The proceeds raised before the 2009 Pre-Budget Report were largely used to reduce the size of auctions after the PBR. Total proceeds raised by the facility were £9.8 billion.

[1] An additional tender was held in April 2009 of the residual stock from the uncovered auction of 4 ¼ % 2049 Treasury gilt (which took place in March 2009).

Tap sales of gilts

5.21 The above programme of conventional and index-linked gilt auctions (and any others that may be added during the year) and mini-tenders and syndicated offerings may be supplemented by official sales of gilts by the DMO "on tap". Taps of gilts will be used only as a market management instrument in exceptional circumstances.

The Standing Repo Facility

5.22 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 recently revised on 6 August 2009.[4] Any gilts so created will not be sold outright to the market and will be cancelled on return.

Reverse auctions

5.23 The DMO has no current plans for a programme of reverse auctions in 2010-11.

Conversions and switch auctions

5.24 The DMO has no current plans for a programme of conversion or switch auctions in 2010-11.

Coupons

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

Buy-ins of short-maturity debt

5.26 The DMO will have responsibility for buying in gilts close to maturity to help manage Exchequer cash flows.

New gilt instruments and issuance techniques

5.27 There are no plans to introduce new types of gilt instrument or issuance techniques. Before introducing any new instruments or issuance techniques, the DMO would consult market participants and seek HM Treasury's approval prior to their introduction.

Revisions to the remit

5.28 Any aspect of this remit may be revised during the year, in the light of exceptional circumstances and/or 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.

5.29 Any revisions to the remit will be announced.

[4] The announcement of 6 August 2009 is available on the DMO website at: http://www.dmo.gov.uk/documentview.aspx?docname=publications/operationalrules/RepoTC060809B.pdf&page=operational_rules/Document

6 The Debt Management Office's Exchequer cash management remit for 2010-11

Exchequer cash management objective

6.1 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 that this is used to best advantage. HM Treasury and the DMO work together to achieve this.

6.2 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.

6.3 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.

6.4 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

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

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

[1] The four types of risk 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

6.6 The range of instruments and operations that the DMO may use for cash management purposes is set out in its Operational Notice.[2] The arrangements for the issuance of Treasury bills, and the management of the Treasury bill stock in market hands, is set out in, and operated according to, the DMO's Operational Notice.

6.7 One component of the debt sales planned to meet the Government's annual financing requirement is the year-on-year change in the outstanding stock of Treasury bills (excluding bills issued solely for collateral purposes).

6.8 During the financial year, the DMO will manage the level of the Treasury bill stock and may increase or reduce the stock *vis à vis* the end year target level, in order to support the implementation of Government cash management. The DMO will announce the dates of Treasury bill tenders on a quarterly basis. The precise details of the maturity and the amount of the Treasury bills on offer at specific tenders will be announced one week in advance. In addition to the bills issued at weekly and ad hoc tenders, the DMO is able to reopen, on request from its counterparties, existing issues of Treasury bills on a bilateral basis to raise funds for cash management.

6.9 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 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

6.10 To assist the DMO in the efficient execution of its cash management operations an amount of gilts, which shall be chosen to have a negligible effect on relevant indices, may be issued to the DMO on the third Wednesday of April, July and October 2010 and January 2011. Any such issues to the DMO will only be used as collateral in the DMO's cash management operations and will not be available for outright sale. The precise details of any such issues to the DMO will be announced in advance. If no issue is to take place in a particular quarter, the DMO will announce that this is the case in advance.

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

6.12 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).[3] 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.

[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/documentview.aspx?docname=publications/moneymarkets/cmopnot180210.pdf&page=money_markets/publication

[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/discount/index.htm

Active cash management

6.13 The combination of HM Treasury's cash flow forecasts and the DMO's market operations characterises the active approach to Exchequer cash management. In 2007-08, a new 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 – was introduced. These include quantifying excess returns to active management by measuring the net cost of cash management, after deducting an interest charge, equivalent to the Government's marginal cost of funds. Performance against key indicators, including quantitative and qualitative measures, is reported in the DMO's *Annual Review*.[4]

[4] See Appendix D of the DMO Annual Review 2008-09, which can be found on the DMO's website at: http://dmo.gov.uk/documentview.aspx?docname=publications/annualreviews/gar0809.pdf&page=Annual_Review

7 National Savings & Investments' activities in 2009-10

Introduction

7.1 National Savings & Investments (NS&I) is both a government department and an executive agency of the Chancellor of the Exchequer. It is one of the largest savings institutions in the UK and is an integral part of the Government's debt management strategy. NS&I contributes to reducing the cost of Government borrowing by raising cost-effective financing from the retail sector. NS&I meets this primary objective by offering customers secure savings and investment products that are both attractive and competitive.

7.2 2009-10 was the third year of NS&I's five year strategy "adding value", which does not aim to achieve market growth but aims to deliver sustainable long-term value to stakeholders by simplifying, modernising and diversifying the business. Originally, the intent for "adding value" was to increase net financing by around £13 billion over five years. However, as a result of the flight to safety, NS&I delivered £18.5 billion of net financing in the first two years of its strategy. In 2009-10, the focus was on preserving rather than increasing net financing, continuing to offer a fair rate of interest to customers and supporting financial stability by maintaining an appropriate competitive position.

7.3 The net contribution to financing in 2009-10 is projected to be £1.5 billion with gross inflows (including reinvestments and gross accrued interest) of approximately £19 billion. Table 7.A shows changes in NS&I's product stock during 2009-10.

Table 7.A: Changes in National Savings & Investments' product stock in 2009-10

	End-March 2009 (£ billion)	End-March 2010[1] (£ billion)
Variable Rate	63.5	61.2
Fixed Rate	17.4	20.8
Index-linked	16.3	16.7
Total[2]	**97.2**	**98.7**

[1] Projections
[2] Total may not sum due to rounding

Source: National Savings & Investments

NS&I's net financing target

7.4 Following significant inflows in 2007-08 and 2008-09, the main focus for 2009-10 was to retain deposits rather than attract new funds: the target for NS&I's net contribution to financing the Government's financing requirement published at Budget 2009 was for no contribution to net finance, within a range of +/– £2 billion either side. The estimated outturn of £1.5 billion for the year falls within the target range.

7.5 As a result of continued low interest rates, the value added target remained suspended in 2009-10. NS&I remains committed to its long-term strategy and generating value for the Government through the provision of cost effective finance when compared to the cost of wholesale funds. To this end, it has been monitoring the value it adds in a slightly different way adapted for the current exceptional interest rate environment. This is called the Value Indicator (see table 7.B for method of calculation). At the end of the year this measure is projected to stand at around £1.3 billion.

Table 7.B: Method of calculation of Value Indicator

	Comparator Cost[1]
less	Capitalised and accrued interest paid on total NS&I stock
less	Management costs of NS&I products
less	Tax foregone on total stock of 'tax free' products
Equals	**Value Indicator**

[1] This 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, and for variable rate products it is the average length of time the product is held by the customer. This differs from Value Add in respect of variable rate products for which the comparator was linked to Base Rate.

Source: National Savings & Investments

Modernisation programme

7.6 NS&I's long-term strategy is the simplification, modernisation and diversification of its business, supported by updated IT infrastructure. The launch of its new Direct Saver account using this infrastructure – available from March 2010 – offers savers easy access to their money either online or by telephone.

7.7 In October 2009, NS&I announced that its Guaranteed Income Bonds and Guaranteed Growth Bonds would be available directly from NS&I only and no longer available through the Post Office. NS&I and the Post Office jointly agreed to this change which is, in part, a reflection of the development of the Post Office's own brand of savings products.

Marketing activities

7.8 NS&I's core customer communications programme has an increasing focus on online activity and promotion of NS&I's direct sales channels.

7.9 In November 2009, NS&I expanded its 'You and your money' financial information website onto the high street with the rollout of a series of free personal finance guides available through its marketing partnership with WHSmith. The guides are now available in over 300 stores across the UK. Topics covered include: 'Kids and money', 'Retirement', 'Later life' and 'Bereavement'.

7.10 Using the 'My Lost Account' website – a facility set up and run by NS&I, the British Bankers' Association and the Building Societies Association to help reunite consumers with lost deposits – NS&I has now reunited its customers with over £189 million in lost assets via the site.

Conclusion

7.11 NS&I aimed to achieve the levels of sales and repayments to deliver neutral net financing for the year, which is forecast to be achieved within the tolerance agreed with HM Treasury. In line with the 'adding value' strategy, it has taken further steps to simplify and modernise its business and product range to the benefit of customers and to help ensure that it continues to deliver its strategic intent in the future. It has maintained its values of offering a secure, straightforward and trusted service to its customers.

8 National Savings & Investments' financing remit for 2010-11

Introduction

8.1 NS&I's aim is to reduce the cost to the taxpayer of government borrowing now and in the future. To achieve this, NS&I's strategic objective is to provide retail funds for the Government that are cost-effective in relation to funds raised on the wholesale market.

8.2 The key business objectives for NS&I to deliver its strategic objective are to:

- ensure levels of customer service which meet standards of best practice in the retail financial services sector;
- develop a more flexible and responsive business that can deliver a range of net financing requirements to HM Treasury; and
- begin to leverage their capabilities to reduce future cost to the taxpayer.

8.3 In pursuit of its strategic objectives, NS&I will operate fairly, transparently and competitively, engendering customer loyalty and securing new business by offering attractive products on fair terms.

Responsibility for setting product terms

8.4 HM Treasury is ultimately responsible, under the *National Loans Act* 1968, for setting the terms of NS&I's products.

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

Volume of financing in 2010-11

8.6 Gross inflows (including reinvestments and gross accrued interest) of NS&I products are projected to be around £15.4 billion in 2010-11. The target for NS&I in 2009-10 was to broadly maintain the existing level of stock, while offering reasonable rates to savers, and supporting financial stability by maintaining an appropriate competitive position. This target will continue in 2010-11. After meeting expected maturities and withdrawals, NS&I is not expected to make a net contribution to government financing (within an agreed range of +/– £2 billion).

Cost of financing

8.7 The average cost of NS&I products should lie, on average, below the cost of equivalent gilts or other short-term comparators. NS&I monitors the value it adds to the government debt programme through the Value Indicator, a measure of the cost of sales planned to deliver the net financing target, compared with the cost of raising finance by selling equivalent maturity gilts. For 2010-11, the cost of these sales is forecast to be £750 million less than equivalent gilt sales, demonstrating that raising finance through NS&I is cost effective for the taxpayer. The final outturn will depend on the actual sales volumes for the year and retail and wholesale market conditions.

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

9 Management of the Official Reserves in 2009-10

Introduction

9.1 The Government's official holdings of international reserves comprise gold, foreign currency assets and International Monetary Fund (IMF) Special Drawing Rights (SDRs).[1] With the exception of the SDR assets that constitute the UK's Reserve Tranche Position (RTP) at the IMF and other loans to the IMF, these assets are held in the Exchange Equalisation Account (EEA).

Origin and purpose

9.2 The EEA was established in 1932 to provide a fund that could be used, when necessary, to regulate the exchange value of sterling and, therefore, is the mechanism through which any Government exchange rate intervention would be conducted.

9.3 The Government's macroeconomic framework is designed to maintain long-term economic stability. This is achieved by maintaining low inflation, sustainable economic growth and sound public finances. The framework does not entail management of the exchange rate and the Government has not intervened for the purposes of influencing the sterling exchange rate since 1992. Against this background, foreign exchange reserves are held on a precautionary basis – to meet any change in exchange rate policy in the future, if required, or in the event of any unexpected shocks. The reserves are also used to provide foreign currency services for government departments and agencies to provide foreign exchange for making payments abroad and to buy, sell and hold Special Drawing Rights (SDRs) as required by the UK's membership of the IMF. The way the reserve assets are invested, financed and managed is primarily designed to meet these policy objectives.

9.4 The Bank of England may also hold foreign currency reserves on its own balance sheet, including for intervention purposes, in pursuit of the Monetary Policy Committee's monetary policy objective. This is set out in the Chancellor's letter to the Governor of the Bank of England of May 1997.[2]

Management of the Exchange Equalisation Account

9.5 The EEA is under the control of HM Treasury, which appoints the Bank of England as its agent to carry out the day-to-day management of the international reserves ('the reserves'). An annual Service Level Agreement (SLA) between HM Treasury and the Bank of England specifies the parameters under which the reserves are managed. This SLA includes investment benchmarks and limits for controlling credit, market and other risks. The SLA specifies:

- benchmarks[3] for investing the reserves, with limits to the Bank of England's discretion to take currency or interest rate positions relative to these benchmarks;

[1] The SDR is an international reserve asset created by the IMF. Its value is defined in terms of a basket of the US dollar, the euro, the yen and sterling. More information on the SDR can be found at: http://www.imf.org/external/np/exr/facts/sdr.HTM

[2] This letter is available on HM Treasury's website at: http://www.hm-treasury.gov.uk/newsroom_and_speeches/press/1997/press_40_97letter.cfm

[3] The benchmark is the neutral or passive investment strategy for the reserves portfolio. Active management performance is measured against a target return over the benchmark.

- the framework for controlling credit, market, liquidity and other risks;
- a target return for active management compared to benchmark positions; and
- the programme for financing the reserves, covering the EEA's foreign currency borrowing and currency swaps out of sterling.

9.6 A summary of the current SLA which excludes market-sensitive risk limits is set out in Chapter 10.

Financing of the Reserves

9.7 The reserve assets are partly financed either by issuing securities denominated in foreign currency or, alternatively, sterling financing from issuing gilts; these funds are used to acquire foreign currency assets. The Government retains a flexible approach to determining which method to adopt depending upon least cost. Least cost can be determined by comparing, on a swapped basis, the cost of issuing bonds in foreign currency of a given maturity and nominal amount with the cost of issuing in sterling. The Government previously issued a US$3 billion five year Eurobond in 2003 (which has since matured). The remaining part of the reserves are financed by retained earnings, historic sales of sterling for foreign currency and the EEA's net SDR position.

9.8 The reserve assets are divided between those that are currency-hedged and those that are unhedged for currency risk. The currency-hedged reserves are also largely hedged against interest rate risk, through the use of swaps. The unhedged reserves are, in effect, the net asset position in foreign currency (because the rest of the reserves are hedged with matching foreign currency liabilities): they comprise dollar and euro-denominated bonds, gold, the Reserve Tranche Position (which is part of the National Loans Fund) and yen exposure obtained largely through forward yen purchases. Movements in the value of the reserves largely arise from changes in the value of these assets.

Composition and size of the Reserves

9.9 The Government's official holdings of international reserves comprise gold, foreign currency assets and the two main components of the UK's financial relationship with the International Monetary Fund (IMF); the UK both finances IMF lending operations and holds an allocation of SDRs.

9.10 Every country that is a member of the IMF is allocated a quota subscription. Quota subscriptions traditionally determine both the amount that a member country can be asked to lend to the IMF, and the amount that it can borrow, and also determine a country's voting share at the IMF. The UK's Reserve Tranche Position (RTP) at the IMF describes the amount of the UK's quota that the IMF has drawn upon. The RTP and other loans made to the IMF are assets of the National Loans Fund (NLF) but are part of the Official Reserves. SDR assets are held in the EEA.

9.11 Foreign currency assets held in the EEA need to be highly liquid so that they can be made available quickly for intervention purposes (or other permitted uses) if necessary. Inevitably, these assets carry some element of credit risk. In order to keep this risk at a low level, and to ensure a high level of liquidity, the funds of the EEA are predominantly invested in securities issued, or guaranteed, by the national governments of the United States, euro-area countries and Japan.

9.12 Table 9.A sets out developments in UK official holdings of international reserves. The value of the gross foreign exchange reserves increased over the year, from US$53.9 billion at end-December 2008 to US$66.4 billion at end-December 2009, reflecting an increase in SDR denominated assets. The increase in SDR denominated assets was due to the receipt of US$12.8 billion of SDR assets as part of the IMF SDR allocations and borrowing from the IMF by some countries (see Box 9.A below). The level of the UK's unhedged reserves rose over the year, from US$28 billion at end-December 2008 to US$32.9 billion at end-December 2009, mainly because of valuation effects resulting from an increase in the dollar value of gold.

Table 9.A: UK official holdings of international reserves

Currency breakdown Assets	**US$ million – Market Value**	
	End-December 2008	**End-December 2009**
$US	13,398	14,356
Euro	23,985	22,207
Yen	5,090	1,098
Other currencies	6	7
SDR	2,798	17,676
Gold	8,628	11,012
Total Assets[1]	53,906	66,357
Liabilities	**End-December 2008**	**End-December 2009**
$US	-5,536	-6,295
Euro	-16,210	-14,165
Yen	-1,187	2,916
Other currencies	-4	-1
SDR	-2,947	-15,887
Gold	-	-
Total Liabilities	-25,884	-33,432
Net Reserves (Asset – Liabilities)	28,022	32,925

[1] Totals and net figures may not sum due to rounding.
Source: HM Treasury/Bank of England

Box 9.A: Commitments to the International Monetary Fund in 2009-10

£4 billion of sterling financing was provided for the Official Reserves in 2009-10 and it is anticipated that a further £4 billion will provided in 2010-11. This additional financing is intended to meet potential calls on the Official Reserves arising from the commitments made at the G20 London Summit. At the London Summit, the G20 leaders agreed to triple the resources available to the IMF to US $750 billion. This agreement has two stages:

- countries are providing over US $250 billion in immediate support, in the form of bilateral loan agreements. The UK has an agreement to provide up to US $15 billion[1] (SDR 9.92 billion); and
- the bilateral loans serve as a bridge to what will be an expanded and more flexible New Arrangements to Borrow (NAB),[2] which countries agreed to increase by up to US $500 billion. The UK has committed to providing up to an additional US $11 billion above the US $15 billion contributed through the bilateral loan.

In addition, the UK has expanded its role in the SDR market. The IMF acts as a broker to enable countries to exchange their SDRs for currency with other IMF members. For more than two decades, the SDR market has functioned through voluntary trading arrangements, with the UK and other key IMF members cooperating with the Fund to buy and sell SDRs. In view of the expected increase in the number of transactions following the 2009 SDR allocations called for at the London Summit, the number and capacity of these voluntary arrangements has been expanded to ensure continued liquidity in the SDR market.[3]

Further information on the UK's financial relationship with the IMF is available in the Government's latest report to Parliament on the UK and the IMF, published in June 2009.[4]

[1] A copy of the loan agreement is available at: http://www.imf.org/external/np/pp/eng/2009/090109.pdf

[2] The NAB is a multilateral credit arrangement between the IMF and a group of member countries and institutions to provide supplementary resources to the IMF.

[3] Information on SDR holdings is available on the IMF's website at: http://www.imf.org/external/np/fin/tad/extsdr1.aspx

[4] Available at: http://www.hm-treasury.gov.uk/d/ukimf200708_300609.pdf

Performance evaluation

9.13 In accordance with the SLA, the Bank of England manages the Official Reserves consistently with the Government's policy aims. A key objective in that context is to maintain their liquidity and security and, subject to that, to minimise the cost of holding the reserves. HM Treasury sets a target active management return as part of the annual SLA. This target, along with other aspects of the management of the reserves, makes up the basket of indicators that were agreed for 2009-10 between HM Treasury and the Bank of England. These key performance indicators are explained further alongside the SLA in chapter 10. HM Treasury will report formally against these measures in the 2009-10 EEA accounts.

Disclosure of financial data

9.14 Since April 2000, the UK has published reserves data in accordance with the IMF/G10's Special Data Dissemination Standard (SDDS). These monthly releases set out the value and composition of the UK's foreign currency and gold assets, liabilities and derivatives on a marked-to-market basis (that is, using current market valuations).[4]

[4] Reserves data from July 1999 onwards are available on the Bank of England's website at: http://www.bankofengland.co.uk/statistics/reserves/index.htm

9.15 HM Treasury publishes the financial accounts for the EEA as part of the statutory obligations set out in the *Exchange Equalisation Account Act* 1979 (as amended by the *Finance Act* 2000). The financial accounts for 2008-09, audited by the National Audit Office, were published and laid before both Houses of Parliament on 20 July 2009.

Intervention

9.16 The Government announced in September 1997, as part of its commitment to openness and transparency with respect to the reserves, that it would publish details of any intervention undertaken to influence exchange rates in the subsequent monthly press release. Since September 1997, the UK authorities have only intervened on one occasion, when the Government joined a concerted intervention by the G7 to support the euro in September 2000.

10 The Bank of England's Service Level Agreement for the management of the Official Reserves

Introduction

10.1 The Service Level Agreement ('SLA') sets out the arrangements for the Bank of England acting as HM Treasury's agent in managing the Exchange Equalisation Account (EEA). It will remain in force indefinitely and be reviewed annually.

10.2 The SLA provides both parties with an understanding of what constitutes an acceptable level of service in managing the EEA.

10.3 The SLA should be read in conjunction with all relevant legislation, particularly the *Exchange Equalisation Account Act* 1979, as amended by the *Finance Act* 2000, which provides that the EEA shall be used:

- for checking undue fluctuations in the exchange value of sterling;
- for securing the conservation or disposition in the national interest of the means of making payments abroad;
- for the purpose specified in Section 1(3) of the *International Monetary Fund Act* 1979 (payment of charges under Section 8 of Article V of the *Articles of Agreement of the International Monetary Fund*); and
- for carrying out any of the functions of the Government of the United Kingdom under those of the said *Articles of Agreement* which relate to Special Drawing Rights (SDRs).

Objectives

10.4 The Bank of England will at all times:

- carry out efficiently and cost effectively, in a legal and proper form, foreign currency and gold transactions on behalf of HM Treasury and other government departments, including the issuance of foreign currency debt on behalf of HM Treasury;
- manage the reserves so as to maintain their liquidity and security within limits agreed with HM Treasury and ensure that the public funds entrusted to the Bank of England in the EEA are properly and well managed and safeguarded. Subject to these limits, the Bank of England will manage the reserves to maximise their return;
- advise HM Treasury on the financing of the reserves including, as necessary, the management of foreign currency borrowing (covering new borrowing, hedging and repayments);
- monitor and report to HM Treasury on the level of risk and return on holding the reserves and provide accurate and timely accounting and management information and statistical analysis pertaining to the reserves as requested by HM Treasury;

- ensure that effective management systems, including financial monitoring and control systems, are in operation and 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 prescribed for the published accounts; and
- advise HM Treasury as to how to ensure that the EEA assets have the fullest possible protection of sovereign immunity and that the EEA enters into appropriate legal agreements with counterparties, nominees, delegates and agents that provide the fullest possible protection for EEA assets, subject to commercial feasibility.

10.5 To help gauge the effectiveness of the Bank of England's management of the reserves, HM Treasury and the Bank of England use a set of key performance indicators. Performance against these indicators will be published in the EEA accounts for 2009-10. These performance measures are explained in Box 10.A.

Box 10.A: Key performance indicators in 2009-10

HM Treasury and the Bank of England agreed a set of performance measures that have been monitored throughout 2009-10. The intent of the performance measures is to provide a basket of indicators that can be used to assess the effectiveness of the management of the EEA.

The Government's prime objective in managing the EEA is to ensure that the reserves are fit for purpose in order to meet current policy objectives and any potential future changes in policy. In support of that, the Government's objective is to preserve the liquidity and security of the reserves and to ensure that the Government maintains its capability to intervene in the foreign exchange market if required. Subject to this, the aim is to minimise the overall cost of holding the reserves, while ensuring exposure to financial risk is limited through the appropriate choice of portfolio and risk management practices.

HM Treasury's role is to:

- ensure that its choice for the strategic composition for the benchmark asset allocation of the reserves, including gold, meets the policy objectives set out above. Subject to meeting those objectives, HM Treasury will make that benchmark asset allocation choice to trade off risk, return and liquidity in line with its risk preferences. The performance of the reserves, including financial outturns, will be reported in the annual accounts; and
- set an active management return target for the Bank in managing the reserves against the benchmark, subject to the limits detailed in the Service Level Agreement. This target will be set to at least cover the costs of the Bank in managing the EEA.

The foreign currency reserves will be invested in assets that are liquid and secure. Specifically;

- a minimum of 90 per cent will be held in tradable debt securities and cash;
- a minimum of 90 per cent will be invested in assets that are rated at least AA-; and
- all assets must be investment grade.

The Bank will observe the limits as set out in the SLA. In line with the SLA, any substantive breaches of the limits and/or any operational errors will be reported to HM Treasury as soon as possible, along with advice, if necessary, as to how best to deal with them. Any significant breach will be reported publicly (e.g. in the annual accounts).

In order to aim to at least cover costs, and to ensure that the Bank maintains its capability to intervene in the foreign exchange market, if required, the Bank will actively manage the EEA portfolio against the benchmark to meet the active management return target set by HM Treasury, whilst ensuring compliance with the limits as detailed in the SLA.

The Bank will ensure that all transactions that relate to the Government and the IMF shall be handled efficiently, accurately and in a timely fashion. In carrying out its services, the Bank will, as far as possible, ensure that:

- its management and staff are of high repute and integrity;
- staff training and experience are appropriate for the tasks that they are expected to undertake and consistent with the amount of risk that they are authorised to take;
- its internal systems and controls are adequate for the size, nature and complexity of EEA operations and comply with best market practice so far as possible; and
- appropriate preparations are made for possible policy deployment of the reserves (e.g. foreign exchange intervention).

These performance measures have been monitored throughout 2009-10 and HM Treasury and the Bank will report formally against them in the 2009-10 EEA financial accounts.

Authorised financial instruments

10.6 The reserves can be invested in a specified range of financial instruments:

- conventional bonds, bills, discount notes and floating rate notes of any maturity and commercial paper issued by other national governments, supranational organisations and selected official sector agencies;
- foreign currency spot, forward and swap transactions;
- interest rate and currency swaps;
- bond and interest rate futures, swap notes and swap futures;
- sale and repurchase, and buy-sell back, agreements;
- gold deposits;
- forward rate agreements;
- SDRs;
- deposits with the Bank of England;
- bank certificates of deposit and commercial paper;
- Pfandbriefe;[1]
- bank conventional bonds of any maturity explicitly guaranteed by a national government or official sector agency whose own obligations are authorised investments; and
- corporate commercial paper and bonds.

Active management

10.7 The Bank of England will actively manage the reserves against a number of benchmarks. The benchmarks will be reviewed regularly and constructed so that they are replicable and represent HM Treasury's long-term investment strategy. They are split into benchmarks for the currency-hedged reserves (on which currency and interest rate exposures are hedged) and the unhedged reserves which are not hedged against exchange rate and interest rate risk. The Bank of England's scope to deviate from the benchmarks through active management will be constrained by agreed risk limits.

Risk management

10.8 The Bank of England will:

- ensure that the risks associated with its management of the EEA are properly identified, evaluated and mitigated and that exposures comply with the detailed credit risk, market risk and operational risk framework and limits agreed with HM Treasury at the start of the year;
- monitor the EEA's credit exposures on a daily basis, applying the credit risk framework agreed with HM Treasury. The Bank of England will review this framework and the credit limits it provides in the light of market or institutional developments, and

[1] A Pfandbrief is a form of covered bond, common in Germany. Pfandbriefe are collateralised by long-term assets such as property mortgages or public sector loans as stipulated in the Pfandbrief Act.

changes in the nature of the EEA's activities. The Bank of England will assess the credit rating of each counterparty, issuer and banking sector;

- monitor the exposure of the EEA to market risk and ensure that it complies with the limits agreed with HM Treasury using Value at Risk (VaR) which provides a means of aggregating risk consistently across the components of the portfolio, and stress tests to quantify the potential loss from particular scenarios; and
- confirm to HM Treasury, on a quarterly basis, that sufficient controls were in place to mitigate the operational risks affecting the EEA during that quarter, that appropriate mechanisms were in place to identify and address new risks and that the processes and framework in place adequately meet the "Turnbull" requirements[2] relating to the Bank of England's management of the EEA. If appropriate, exceptions to such confirmation will be listed.

Audit arrangements and accounting requirements

10.9 The Bank of England will agree the annual programme of work of the Bank of England's Internal Audit Division pertaining to the EEA with HM Treasury by the beginning of the year. The Bank of England's internal audit arrangements will follow the standards set by the Institute of Internal Auditors UK and Ireland and will accord with the objectives, standards and practices set out in HM Treasury's *Government Internal Audit Standards*. The Bank of England will maintain the EEA's accounts drawn up in accordance with UK GAAP as far as appropriate and in accordance with the relevant Accounts Directions.

National Audit Office access

10.10 For the purposes of:

- the examination and certification of the EEA accounts; or
- any examination pursuant to Section 6(1) of the *National Audit Act* 1983 or any re-enactment thereof of the economy, efficiency and effectiveness with which the Bank of England has managed the EEA;

the National Audit Office (NAO) may examine such documents as it may reasonably require which are owned, held, or are otherwise within the control of the Bank of England, have access to Bank of England buildings, and may require the Bank of England to produce such oral or written factual explanations as it considers necessary. However, the NAO will address substantive questions on the management of the reserves to HM Treasury and not the Bank of England.

HM Treasury's responsibilities

10.11 HM Treasury is responsible for monitoring the risk environment and performance of the Bank of England in managing the reserves. To support this process, the Bank of England provides the following management information:

- monthly financial reporting, detailing the returns made with respect to the management of the EEA and the market and credit risks incurred;
- quarterly management reports on operational risk issues and the Bank of England's compliance with the guidance issued by the Turnbull Report (*Internal Control: Guidance for Directors on the Combined Code* issued by the Institute of Chartered Accountants in England and Wales). These reports highlight the Bank of England's

[2] *Internal Control: Guidance for Directors on the Combined Code* issued by the Institute of Chartered Accountants in England and Wales.

role in identifying, assessing, managing and monitoring the risks relating to its management of the EEA;

- quarterly reports from the Bank of England's Internal Audit Division on the internal audit programme agreed for the EEA; and
- Bank of England and HM Treasury officials meet at regular reserves meetings to review the performance against the parameters set out in the SLA and to consider wider operational and policy issues. The EEA Accounting Officer and the Bank of England's Executive Director for Markets meet twice each year to discuss overall strategy and governance issues.

Financing the reserves

10.12 The Bank of England will provide HM Treasury with relevant market intelligence and advice on options for financing the reserves with a view to minimising the costs and risks to the Government. An annual financing programme for the currency-hedged reserves will be agreed between the Bank of England and HM Treasury at the beginning of the financial year. The Bank of England will undertake this programme in accordance with the timetable and guidelines agreed, as well as any changes subsequently agreed with HM Treasury.

10.13 The Bank of England will act as HM Treasury's agent in issuing and managing any foreign currency liabilities associated with the reserves. The Bank of England will provide regular information on the pricing of foreign currency debt and, if agreed with HM Treasury, will appoint managers to undertake an issuance in accordance with HM Treasury's instructions.

Sterling cash management

10.14 The Bank of England will liaise closely with the DMO with respect to managing sterling flows relating to EEA operations. The Bank of England will, so far as is possible, aim to manage the EEA so as to avoid conflict with the DMO's sterling cash management operations while in no way disadvantaging the EEA.

Publication requirements

10.15 The Bank of England will provide the figures for the United Kingdom's official holdings of international reserves monthly Press Notice, by no later than 2pm on the second working day of every month, to be published on the third working day of every month. The format for this Press Notice will be in accordance 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 on the Bank of England's web site. The monthly Press Notice will provide details of the amount and date of any official intervention during the month and an explanation of why it was undertaken.

Intervention

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

11 Central Government's financial asset and liability risk monitor

Introduction

11.1 The central government's asset and liability monitor ('the monitor') is produced in order to aid quantification of the risks faced by central government on its balance sheet and forms part of an ongoing HM Treasury work programme. It should be regarded as a 'work in progress' because it records only current financial assets and liabilities of central government and some of the calculations involve approximating assumptions. Therefore, it cannot be reconciled with other central government accounting publications and is not subject to audit.

11.2 The monitor is a precursor to the publication of 'Whole of Government Accounts'[1] and is in accordance with the transparency and accountability recommendations published in the International Monetary Fund's *Guidelines on Public Debt Management* 2003.[2]

11.3 It should be noted that the monitor records only one aspect of the Government's wider financial position as it currently covers only financial assets and liabilities of central government managed by the executive agencies that are responsible for debt and reserves management. For example, it does not take account of other significant public sector assets and liabilities such as local authorities' assets or non-financial assets and liabilities such as contingent liabilities or future tax revenue streams. Information covering the Government's wider fiscal position and prospects going forward can be found in the 2009 *Long-term public finance report*,[3] which provides a comprehensive assessment of the sustainability of the public finances.

Description of Table 11.A

11.4 Table 11.A below shows total assets and liabilities by type and by managing institution. In addition to nominal and market values of the assets and liabilities, some other key variables are reported, which help to provide greater insight into the characteristics of central government's balance sheet thereby facilitating a better evaluation of the risks that the balance sheet is exposed to. These key variables are explained in Box 11.A.

[1] From 2009-10 onwards, *Government Accounts* will be prepared using International Financial Reporting Standards, as adapted in the public sector context. The *Whole of Government Accounts* will be presented on the same basis from 2009-10.

[2] The latest version of the *Guidelines on Public Debt Management* can be found on the IMF website at: http://www.imf.org/external/np/mfd/pdebt/2003/eng/am/index.htm

[3] 2009 *Long-term public finance report*, HM Treasury, December 2009, can be found on HM Treasury's website at: http://www.hm-treasury.gov.uk/prebud_pbr09_longtermfinances.htm

Box 11.A: Description of variables in the Central Government Financial Asset and Liability Risk Monitor

- Nominal value and market value[1] – the nominal value of assets or liabilities is the value at which they would be repaid. The market value is the value of assets or liabilities if they were purchased in the market. For example, the nominal value of central government's gilt liabilities represents the amount that the Government would pay on redemption of these liabilities whereas the market value of the gilt liabilities is their tradable value in the secondary market.
- Maturities of less than one year – the nominal value of the assets or liabilities that have less than one year before they are redeemed.
- Average modified duration – this is a measure of the sensitivity of the value of assets or liabilities to interest rate movements. In the context of the asset and liability monitor, duration offers some indication of how great an impact small interest rate changes might have on the present value of the central government's balance sheet. Other things equal, longer duration suggests a greater degree of sensitivity to small interest rate changes.
- Average maturity – indicates the market value weighted average length of time (in years) before assets and liabilities are due to be redeemed.
- Floating rate composition – the value of those assets and liabilities that are indexed to a short-term money market interest rate.

[1] Nominal value of index-linked gilts includes inflation uplift.

Key facts – central government's financial assets

11.5 The nominal value of the central government's total financial assets was £498.2 billion at end-December 2009. This compares with £555.7 billion at end-December 2008.

11.6 The market value of central government's total financial assets was £523.6 billion at end-December 2009 compared with £591.4 billion at end-December 2008, a decrease of £67.8 billion.

11.7 The average modified duration, which excludes the duration for index linked gilts, increased to 3.9 years at end-December 2009 from 3.5 years at end-December 2008. The average maturity over the period decreased to 6.2 years from 6.3 years.

11.8 The largest contribution to central government's financial assets is Treasury bills held on the Debt Management Account (£185 billion), which account for 37 per cent of the total nominal value. Other significant contributors include gilt collateral (£126.3 billion or 25 per cent), loans to local authorities from the Public Works Loans Board (£50.8 billion or 10 per cent of total) and foreign currency assets managed by the Bank of England (£38 billion or 8 per cent of total).

Key facts – central government's financial liabilities

11.9 The nominal value of central government's total financial liabilities was £1081.7 billion at end-December 2009. This is an increase of £236.8 billion compared with end-December 2008 (£844.9 billion). This change is attributable primarily to an increase of £226.8 billion in gross gilts in issue by the DMO to £863.9 billion, an increase in Treasury bills managed by the DMO of £21 billion to £61.1 billion and an increase of £3.5 billion in NS&I products to £98.4 billion.

11.10 The market value of the central government's total financial liabilities at end-December 2009 was £1144.4 billion compared with £927.9 billion at end-December 2008, an increase of £216.5 billion.

11.11 The average modified duration of the financial liabilities at end-December 2009 was 8.1 years, a decrease of 2.2 years from December 2008 (at 10.3 years) and the average maturity of the financial liabilities rose to 11.7 years from 11.5 years at end-December 2008, reflecting an increase in the size of marketable gilts in issue. There was an increase of £24.5 billion in the nominal value of liabilities with a maturity of less than one year from £117.3 billion to £141.8 billion.

11.12 Gross gilts issued represent the highest proportion of central government financial liabilities (£863.9 billion), accounting for 80 per cent of the nominal value of total financial liabilities. Other significant liabilities include those managed by NS&I (£98.4 billion) accounting for 9 per cent of the nominal value of total liabilities, Treasury bills (£61.1billion), and foreign currency liabilities managed buy the Bank of England (£20.3 billion).

Table 11.A: Central Government's financial asset and liability risk monitor at 31 December 2009

Central Government financial assets	Nominal Value[1] (£ billion)	Market Value (£ billion)	Maturities of less than 1 year (£ billion)	Modified duration[2] (years)	Average Maturity (years)	Floating rate composition (£ billion)
Managed by						
Public Works Loan Board (loans to local authorities)	50.8	61.1	1.7	14.7	16.8	0.2
Debt Management Office						
Gilts held by DMO						
Marketable conventionals	113.9	124.0	7.5	8.4	13.6	-
Marketable index-linked	12.3	14.6	-	10.1	11.9	-
Total	126.3	138.6	7.5	8.6	13.4	
Gilts held in Central Government funds by the Commissioners for the Reduction of the National Debt (CRND)						
Marketable conventionals	0.1	0.1	-	13.3	21.0	-
Non-marketable conventionals	0.1	0.2	0.0	1.3	1.4	-
Non-marketable index-linked	-	-	-	-	-	-
Total	0.2	0.3	0.0	6.3	9.4	-
CRND loans to authorities						
Other short-term bills held by CRND in Central Government funds						
Treasury bills	-	-	-	-	-	-
Deposits given to DMO by CRND	52.5	52.5	52.5	0.0	0.1	-
Total	52.5	52.5	52.5	0.0	0.1	-
Other short-term assets						
Reverse repos - outstanding	30.7	31.3	30.7	0.1	0.1	-
Deposits at commercial banks	0.2	0.2	0.2	0.0	0.0	-
Cash deposits at the Bank of England	0.5	0.5	0.5	0.0	0.0	-
Bonds[3]	0.2	0.2	0.2	0.0	0.1	-
Sterling Certificates of Deposit	0.4	0.4	0.4	0.0	0.1	-
Bank of England bills	-	-	-	-	-	-
Treasury bills[4]	185	185	186	0.0	0.4	-
Sterling Commercial Paper	0.9	0.9	0.9	0.0	0.3	-
FX Commercial Paper	-	-	-	-	-	-
Total	217.9	218.5	217.9	0.0	0.4	-
Bank of England						
Sterling assets						
Sterling leg of swaps and FX liabilities[5]	7.5	7.5	2.9	0.3	1.4	7.5
Foreign currency assets						
Bonds	19.8	21.5	3.2	2.3	2.4	19.8
Money Market Instruments	0.7	0.7	0.7	0.2	0.2	-
Short-term assets[6]	1.8	1.8	1.8	0.0	0.0	-
Gold	6.8	6.8	-	-	-	-
IMF Special Drawing Rights	8.9	8.9	-	0.0	-	8.9
Total	38	39.7	5.7	1.2	1.3	28.7
HM Treasury						
Sterling assets						
National Loans Fund loans[7]	2.9	3.3	0.1	14.2	8.64	-
Foreign currency assets						
IMF Reserve Tranche Position	2.1	2.1	0.0	0.0	-	2.1
Total[8, 9]	498.2	523.6	286.9	3.9	6.2	38.5

Table 11.A: Central Government's financial asset and liability risk monitor at 31 December 2009

Central Government financial liabilities	Nominal Value[1] (£ billion)	Market Value (£ billion)	Maturities of less than 1 year (£ billion)	Modified duration[2] (years)	Average Maturity (years)	Floating rate composition (£ billion)
Managed by:						
National Savings & investments	98.4	98.4	18.3	4.19	4.25	61.6
Debt Management Office						
Gross gilts in use						
Marketable conventionals	681.2	723.9	28.0	8.4	13.3	-
Non-marketable conventionals	0.1	0.2	0.05	1.3	1.4	-
Marketable index-linked	182.5	211.2	0.0	14.5	16.8	-
Non-marketable index-linked	-	-	-	-	-	-
Total	863.9	935.2	28.1	9.7	14.1	-
Treasury bills	61.1	61.1	61.1	0.0	0.2	-
Other short-term bills	4.6	4.6	4.6	0.0	0.1	-
Total	65.7	65.7	65.7	0.0	0.2	-
Other short-term liabilities						-
Repos – outstanding	20.0	20.0	20.0	0.0	0.0	-
Deposits made by local authorities and commercial banks	4.1	4.1	4.1	0.0	0.1	-
Total	24.1	24.1	24.1	0.0	0.1	
Bank of England						
Sterling liabilities						
Ways and Means Advance	0.4	0.4	-	0.0	-	0.4
Foreign currency liabilities						
HMG Bonds	0.0	0.0	0.0	0.0	0.0	-
Loans	0.0	0.0	0.0	0.0	0.0	-
Repos	2.0	2.0	2.0	0.1	0.1	-
Swaps & FX liabilities (excludes £ leg)	8.5	8.8	3.6	0.3	1.0	8.5
IMF Special Drawing Rights allocation	9.8	9.8	-	-	-	9.8
Total	20.3	20.6	5.6	0.2	0.8	18.3
HM Treasury						
Sterling liabilities						
IMF non- interest bearing securities	8.9	-	-	0.0	-	8.9
Total	1081.7	1144.4	141.8	8.1	11.7	89.2

1 Nominal value of index-linked gilts includes inflation uplift.
2 Modified duration of index-linked gilts is calculated with respect to changes in real yield.
3 Sterling denominated supranational bonds.
4 This represents the amount of Treasury bills issued for use in the Special Liquidity Scheme as at 30 January 2009 when the scheme drawdown came to an end.
5 Modified duration covers swaps only.
6 Short-term assets equals deposits plus repos.
7 NLF loans are composed of loans to nationalised industries and public corporations. Market value is approximated by the nominal value.
8 Totals for modified duration are weighted by market value. Duration for index-linked gilts are excluded from this calculation.
9 Total for average maturity are weighted by market value.
10 Non-marketable gilts are held by the Commissioners for the Reduction of the National Debt (CRND).
11 Nominal value is different from Table 2.A because Table 2.A gives Treasury bill stock in market hands.
12 Modified duration covers swaps only.

Source: HM Treasury/Debt Management Office/National Savings & Investments/Bank of England

A

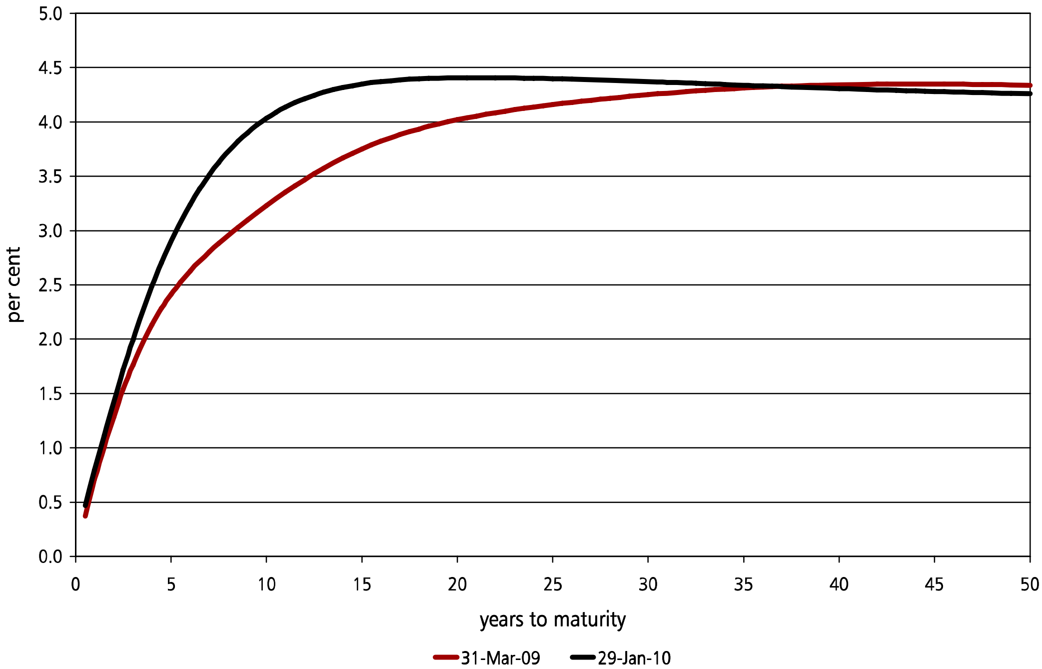
Key developments in the gilt market in 2009-10

A.1 This annex summarises the key developments in the UK gilt market in 2009-10 (to end-January 2010). A more comprehensive review of the year as a whole, in the context of developments in other major international bond markets, will be published in the DMO *Annual Review* 2009-10.

Nominal gilt par yield curves

A.2 The nominal gilt par curve ended the period relatively unchanged at both the ultra-short and long ends of the curve but shifted upwards over the period (by an average of 46 basis points) in the 5- to 30- year range as shown in Chart A.1 below. At the 5-year point of the curve, yields rose by 49 basis points while yields rose by 80 and 39 basis points at the 10- and 20-year points of the curve between end-March 2009 and end-January 2010.

Chart A.1: Par gilt yield curves



Source: Debt Management Office

Developments in the gilt market

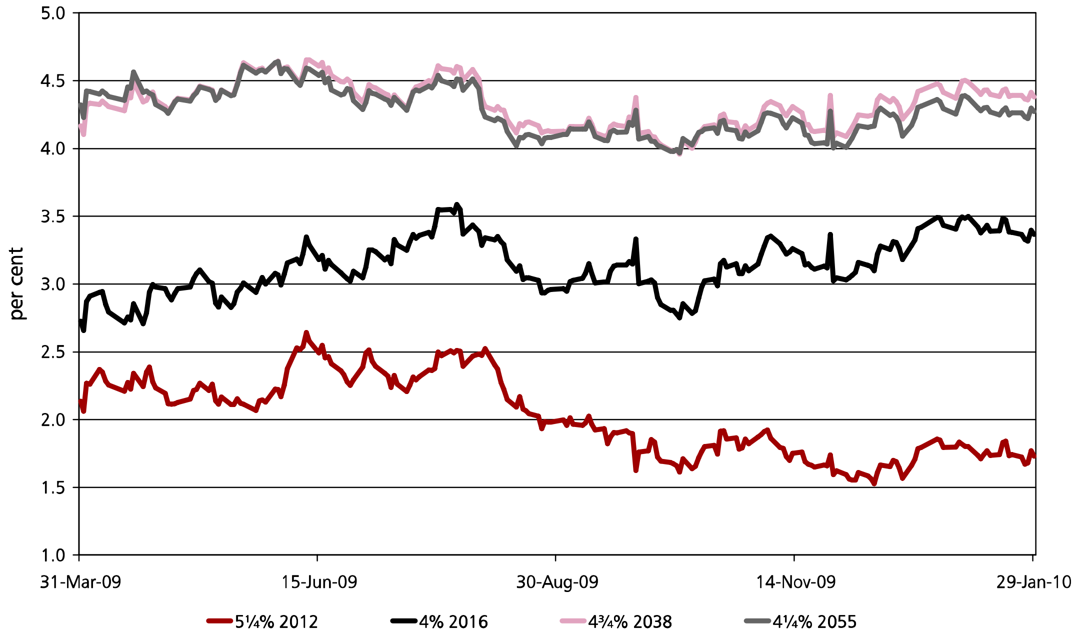
A.3 The year 2009-10 was characterised by volatility in gilt yields ascribed to the uncertain macroeconomic outlook. The Bank of England made a number of announcements relating to the use of its Asset Purchase Facility in 2009 (see Box 3.B): in March 2009, it announced it would purchase up to £75 billion of assets financed by the creation of central bank reserves; on 7 May 2009, it announced that it would purchase an additional £50 billion of assets over the following three months (taking total purchases to £125 billion); on 6 August 2009, it announced that it was increasing asset purchases by £50 billion (taking total purchases to £175 billion); and on 5 November 2009, it announced that asset purchases would increase by £25 billion (taking the total to £200 billion). In addition, the Government announced, in the Budget on 22 April 2009, its plans for increased gilt sales for 2009-10 compared to that in the 2008 Pre-Budget Report.

A.4 Volatility in short-term yields continued in the second quarter of 2009-10. At the long end of the nominal curve gilt yields fell.

A.5 There was further volatility in the third quarter of 2009-10. Gilt yields rose in December 2009.

A.6 The path of nominal yields over the last year is shown in Chart A.2.

Chart A.2: Conventional benchmark gilt yields



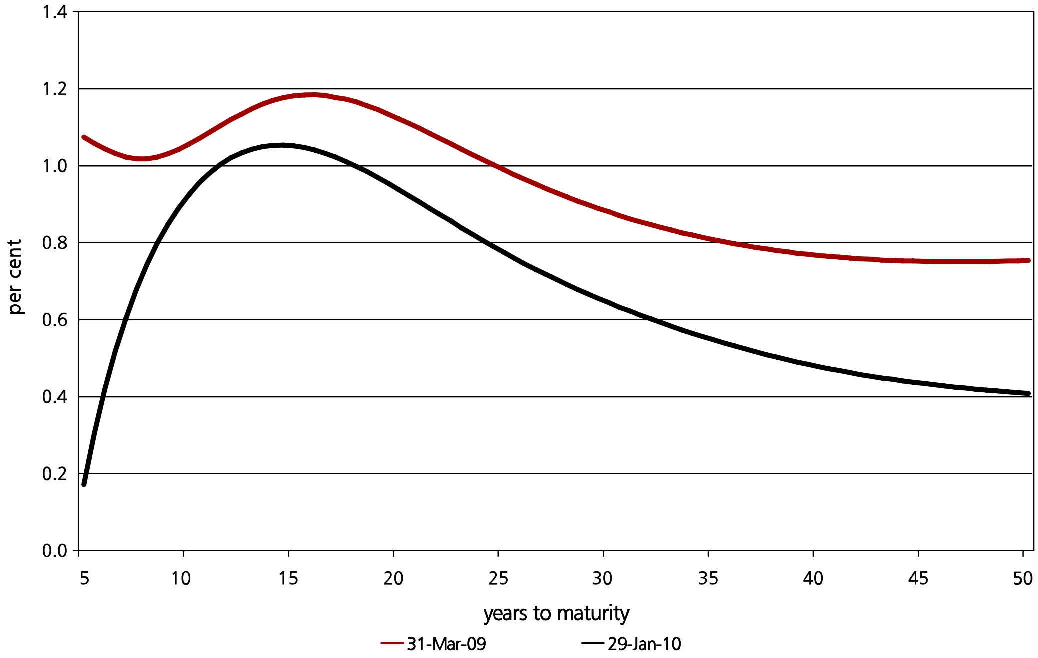
Source: Debt Management Office

Real gilt par yield curves

A.7 In contrast to nominal yields, the real gilt par yield curve shifted downward. In 2009-10 (until January 2010), the 10-year real gilt par yield fell by 13 basis points to 0.93 per cent and the 50-year real gilt par yield fell by 34 basis points to 0.41 per cent as shown in Chart A.3.

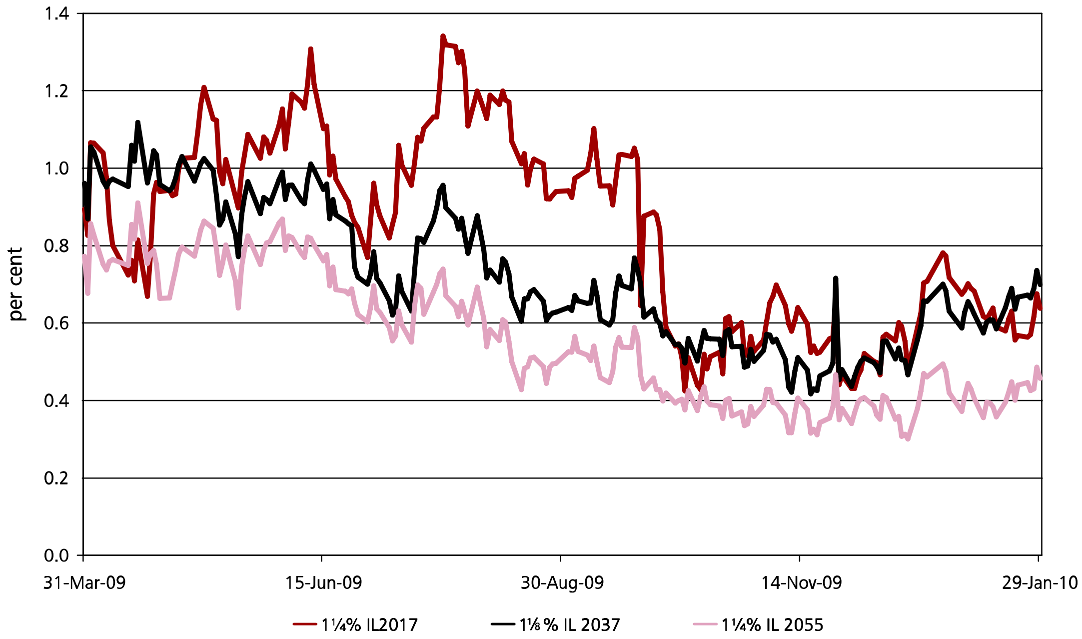
A.8 Chart A.4 shows the real yields on selected benchmark index-linked gilts over the same period. The yield on the 1¼ % Index-linked Treasury Gilt 2017 fell by 25 basis points to 0.63 per cent. The yields on the 1⅛ % Index-linked Treasury Gilt 2037 and 1¼ % Index-linked Treasury Gilt 2055 fell by 26 and 31 basis points respectively. The yield on the 1⅛ % Index-linked Treasury Gilt 2037 was 0.70 per cent on 29 January 2010. The 1¼ % Index-linked Treasury Gilt 2055 yielded 0.45 per cent on the same day.

Chart A.3: Real par gilt yield curves



Source: Debt Management Office

Chart A.4: Index-linked gilt yields

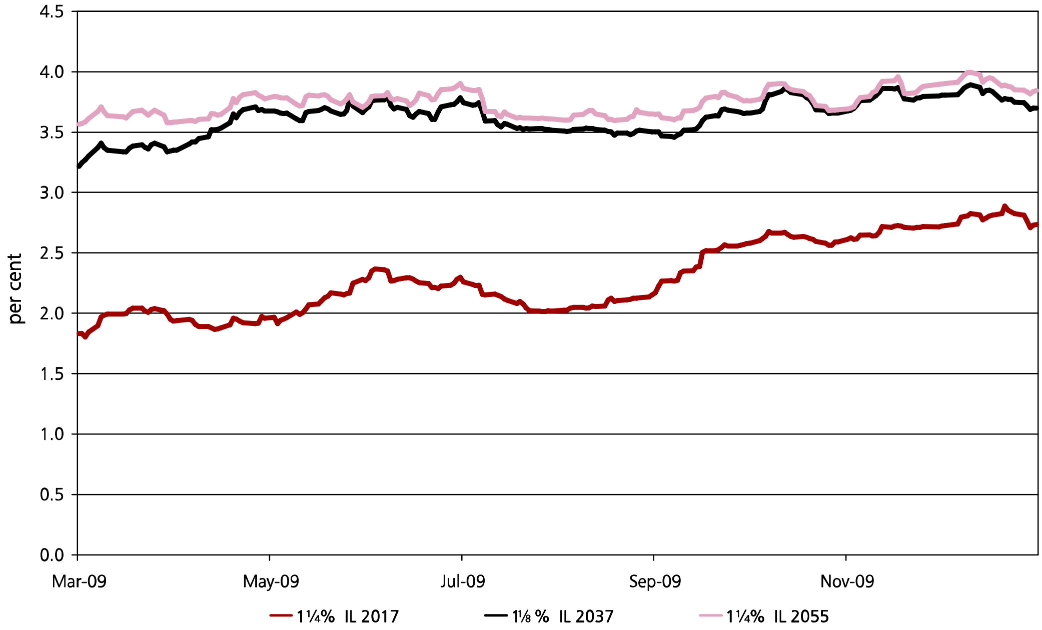


Source: Debt Management Office

Breakeven inflation rates[1]

A.9 Over the financial year to January 2010, the price of index-linked gilts generally increased relative to that for conventional gilts, partly due to expectations of higher future inflation and also, reportedly, continued strong demand for index-linked gilts from the domestic pension fund and insurance sectors. Breakeven inflation rates on 1¼% Index-linked Treasury Gilt 2017, 1⅛% Index-linked Treasury Gilt 2037 and 1¼% Index-linked Treasury Gilt 2055 rose by 90 basis points (to 2.73 per cent), 48 basis points (to 3.69 per cent) and 27 basis points (to 3.84 per cent) respectively (see Chart A.5).

Chart A.5: Breakeven inflation rates



Source: Debt Management Office

[1] The breakeven inflation rate is the difference between the yield on a conventional gilt of a particular maturity and the yield on an index-linked gilt of the same maturity.

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This document can be found in full on our website at:
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ISBN 978-1-84532-697-5

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