



HM TREASURY

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**Debt and reserves  
management report**

**2006-07**

March 2006

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# FOREWORD BY THE ECONOMIC SECRETARY TO THE TREASURY

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

£52.3 billion of gross gilt issuance has taken place in 2005-06, a level broadly similar to gross issuance in 2004-05. It is to the credit of the UK Debt Management Office (DMO), the Gilt-edged Market Makers (GEMMs) and the gilt market in general that they have been able successfully to meet the operational demands of this programme in what have sometimes been difficult market conditions.

Two notable innovations in gilt financing have occurred this year:

- following the Chancellor's announcement in his Budget 2005 speech, the DMO has this year issued both conventional and index-linked 'ultra-long' gilts with maturities of approximately 50-years. DMO first issued the conventional 'ultra-long' gilt in May 2005 by auction, followed by the index-linked gilt in September 2005 by a syndicated offering. The 50-year index-linked gilt is the only sovereign bond of this maturity in the world; and
- the DMO has also taken the opportunity to introduce a new three-month lag indexation structure for new index-linked gilts issued from 2005-06 onwards. This new structure reflects the adoption of current international best practice by the DMO.

In the retail sector, National Savings & Investments (NS&I) sold more than £10.9 billion of retail products, bringing its net financing contribution to an estimated £4.8 billion in 2005-06. Of its commitment to achieve £15 billion net financing by 2007-08, NS&I has now achieved a total of £10.3 billion, and is expected to achieve a further £3.0 billion in 2006-07. NS&I has this year also successfully diversified its sales channels both through its website and through its new partnership with Tesco Personal Finance.

Net gilt issuance in 2006-07 is projected to be £33.1 billion and gross issuance £63.0 billion including redemptions. The structure of issuance and the planned gilt auction calendar reflect the Government's commitment to a well-functioning gilt market as well as its aim of being responsive to investor demand and the market environment. Our debt management policy is to minimise financing costs whilst taking account of risk.

The gilt market has experienced very low and sometimes volatile yields at the longest maturities particularly during the final quarter of 2005-06. These unusual conditions may continue next year. To help both the DMO and the gilt market more generally to deal with a potentially challenging environment in 2006-07, the DMO's remit for next year contains temporary changes intended to allow greater responsiveness in gilt issuance by the DMO during 2006-07 whilst retaining the Government's firm commitment to transparency and predictability in debt management policy.

**22 March 2006**



**IVAN LEWIS**

**Economic Secretary to the Treasury**





# INTRODUCTION

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**I.1** This is the thirteenth report outlining the Government's debt management activities.

**I.2** The Debt and Reserves Management Report (DRMR) is published in compliance with the *Code for Fiscal Stability*<sup>1</sup> which requires that a debt management report be published every financial year covering the following areas:

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

**I.3** The UK 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 a summary only of developments in the gilt market during 2005-06 (up to January 2006) is set out in Annex A of this report.

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<sup>1</sup> The *Code for Fiscal Stability* can be found on HM Treasury's website at:  
[http://www.hm-treasury.gov.uk/documents/uk\\_economy/fiscal\\_policy/ukecon\\_fisc\\_code98.cfm](http://www.hm-treasury.gov.uk/documents/uk_economy/fiscal_policy/ukecon_fisc_code98.cfm).



# 2

## SIZE AND STRUCTURE OF UK GOVERNMENT DEBT IN 2005-06

### Debt stock

**2.1** The total nominal outstanding stock of United Kingdom central government marketable sterling debt (including official holdings by central government) was £491.9 billion at end-December 2005. This was comprised of £294.8 billion of conventional gilts, £103.7 billion of index-linked gilts (including accrued inflation uplift) and £21.4 billion of Treasury bills (T-bills) (see Table 2.1). In addition, there was £72.0 billion invested in NS&I's instruments.

**Table 2.1: Composition of UK Central Government sterling debt**

	End-March 2005	End-December 2005
<i>(£ billion, nominal value, including official holdings)</i>		
Conventional gilts <sup>1</sup>	267.3	294.8
Index-linked gilts <sup>2</sup>	88.3	103.7
Treasury bills	20.5	21.4
<b>Total gilts and Treasury bills</b>	<b>376.1</b>	<b>419.9</b>
National Savings & Investments	68.5	72.0
<b>Total central government sterling debt</b>	<b>444.6</b>	<b>491.9</b>

*1. Includes undated and double-dated gilts*

*2. Includes accrued inflation uplift*

*Source: Debt Management Office/National Savings & Investments*

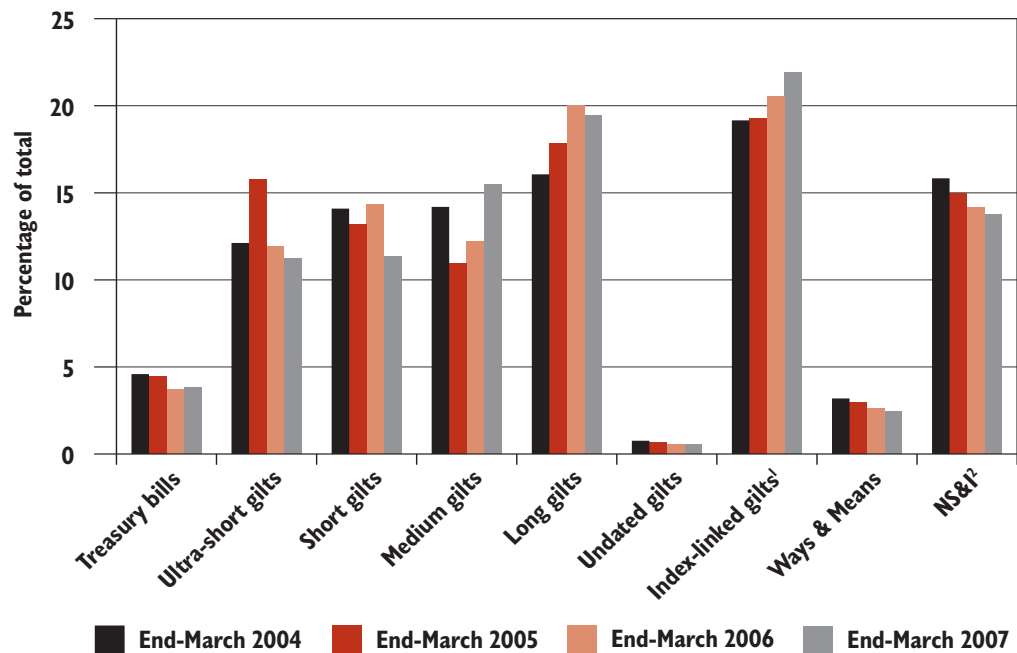
### Maturity and duration

**2.2** The average maturity of the stock of all dated gilts rose from 11.96 years to 13.09 years between end-March 2005 and end-December 2005. Over the same period, the modified duration of the portfolio of conventional marketable gilts rose from 7.45 years to 8.10 years. The maturity and duration of the UK Government's marketable domestic debt continue to be amongst the longest compared with other European countries.

**2.3** Chart 2.1 below shows a comparison of the Government's debt portfolio at end-March 2004 through to a projected composition at end-March 2007<sup>2</sup>. It assumes that new debt is issued in accordance with the DMO's financing remit. It also takes into account the ageing of existing debt. Chart 2.1 includes 8% Treasury Stock 2021 as a long-maturity gilt at end-March 2006. However, the gilt becomes a medium-maturity gilt during 2006-07 when its maturity falls below 15-years and it is, therefore, included as a medium-maturity gilt at end-March 2007. This effect causes a fall in the proportion of long-dated gilts in the debt portfolio between end-March 2006 and end-March 2007 as illustrated in Chart 2.1.

<sup>2</sup> Chart 2.1 assumes that the £7.5 billion unallocated gilt issuance set out in the DMO's financing remit in Chapter 5 is split evenly between maturity baskets and types of gilt (i.e. £1.9 billion to each).

**Chart 2.1: Changes in the percentage composition of UK Government marketable debt (including official holdings)**



Source: Debt Management Office / National Savings & Investments

<sup>1</sup> Includes indexation uplift

<sup>2</sup> Includes accrued interest

## Interest payments

**2.4** Gross central government debt interest payments in 2004-05 were £24.0 billion, equivalent to 4.9 per cent of total managed expenditure (TME). In 2005-06, they are forecast to be £25.7 billion (4.9 per cent of TME) and in 2006-07, £26.3 billion (4.8 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. In 1998-99, gross issuance was only £8.2 billion<sup>3</sup> but this figure has risen substantially since then. Gross gilt issuance in 2005-06 was £52.3 billion, broadly the same as last year.

**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 2.2 below.

<sup>3</sup> Figures in Chapter 2 are in cash terms unless otherwise stated.

**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 is expected to be £37.6 billion in 2005-06 and significant levels of net issuance are projected over the medium-term reflecting the Government's investment programme in the public services. Chart 2.2 below shows the trend in gross and net issuance since 1990-91 with projections to 2010-11.

**2.8** The size of the gilt market reflects these trends: in March 2002 the nominal value of the gilt market (including accrued inflation uplift) was £278.7 billion, by end-January 2006 it had reached £404.8 billion (nominal) – an increase of 45.2 per cent. Chart 2.3 below shows developments in the size of the gilt market since 1990-91.

**Table 2.2: Central government net cash requirement and gross gilt sales 1998-99 to 2005-06**

Financial year	CGNCR (£ billion)	Gross gilt sales (£ billion)
1998-99	-4.5	8.2
1999-00	-9.1	14.4
2000-01 <sup>1</sup>	-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 <sup>2</sup>	40.6	52.3

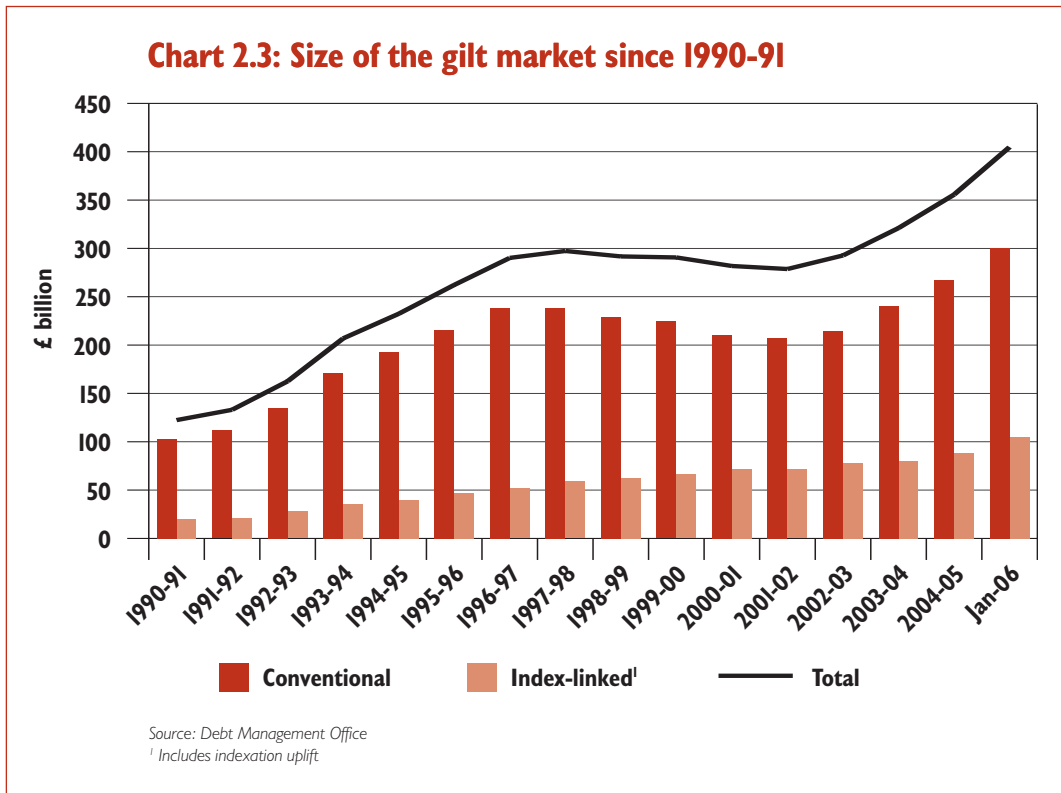
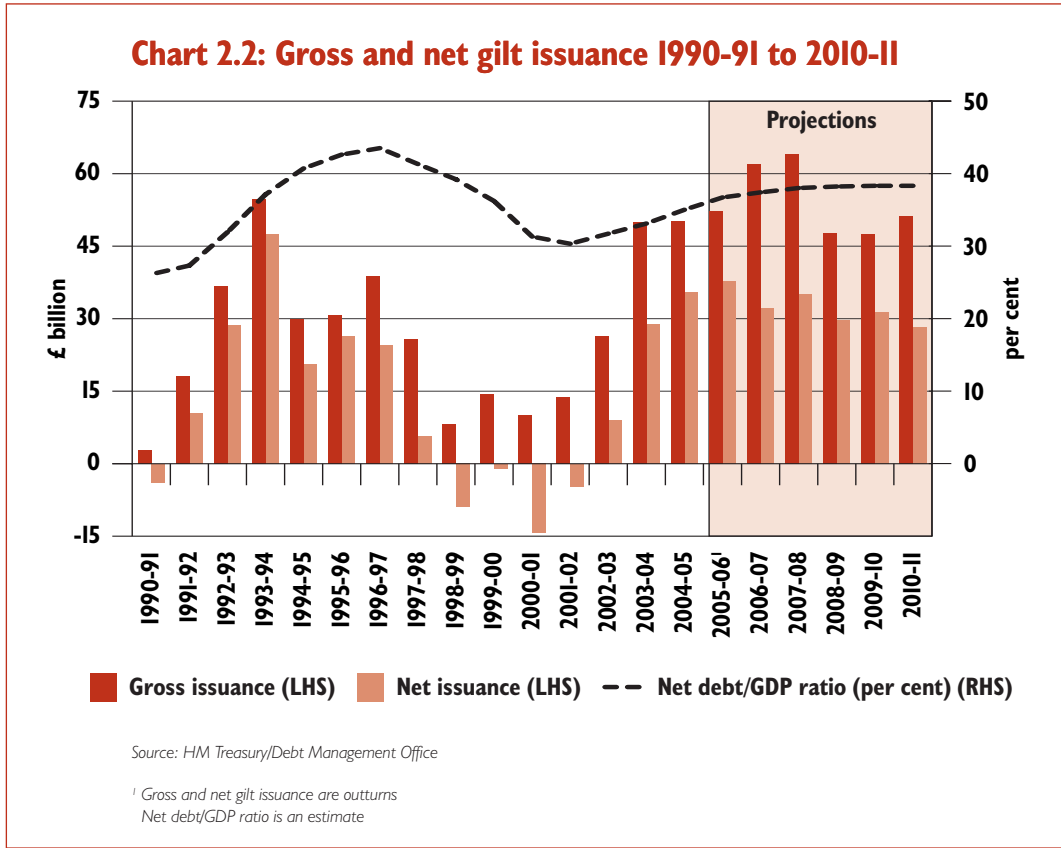
*1. Reflecting the proceeds from the 3G Spectrum auction*

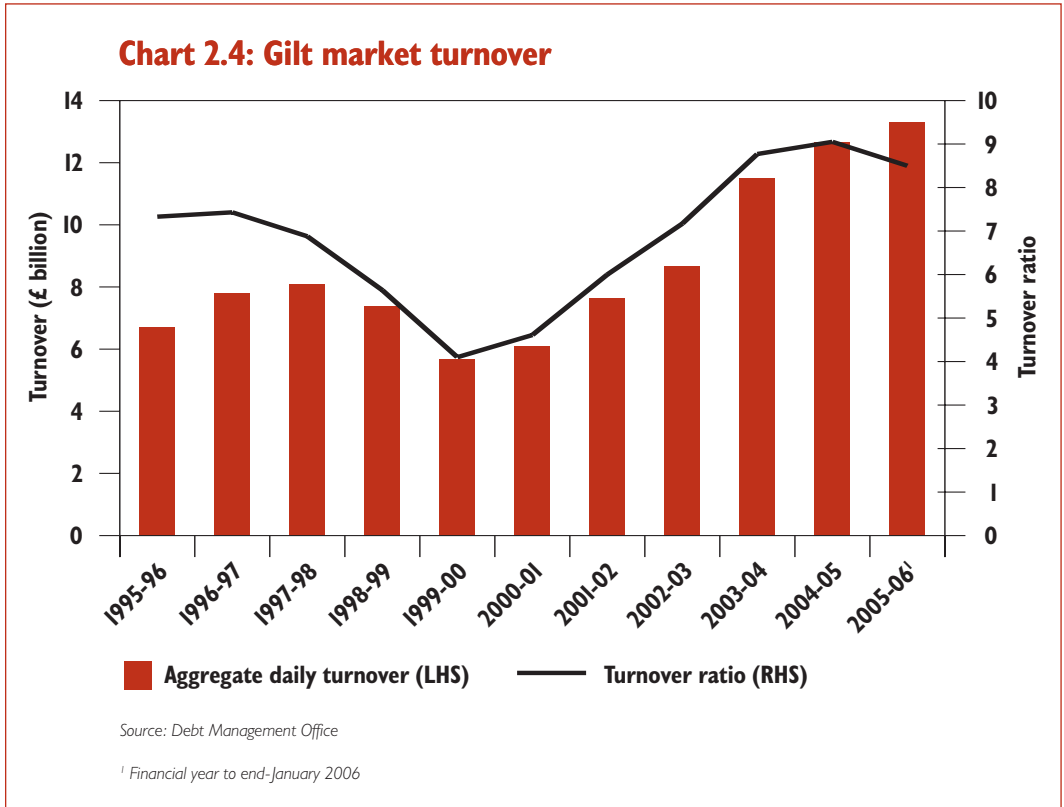
*2. CGNCR estimate at Budget 2006*

*Source: HM Treasury/Debt Management Office*

**2.9** Turnover in the gilt market has been rising since 1999-00. Average daily turnover increased by 124.6 per cent between 1999-00 and 2004-05 (from £5.7 billion to £12.8 billion). So far<sup>4</sup> in 2005-06 this trend has continued, with aggregate daily turnover increasing to £13.3 billion. Trading intensity, as measured by the turnover ratio, increased sharply from 4.1 in 1999-00 to 9.0 in 2004-05. It has fallen back slightly so far in 2005-06 (to 8.5) largely as a result of the marked increase in the size of the underlying portfolio. Chart 2.4 below shows these trends.

<sup>4</sup> Data to end January 2006.







# 3

## UK GOVERNMENT'S DEBT MANAGEMENT POLICY

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### Objectives of debt management

**3.1** The Government's debt management policy objective is:

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

**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 National Savings & Investments.

### Maturity and composition of debt issuance

**3.3** 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.

**Box 3.1: Strategic Debt Analysis model**

The UK Debt Management Office (DMO) has been developing a simulation model (the "Strategic Debt Analysis" (SDA) model) with the aim of analysing quantitatively the trade-off between the long-term expected cost and risk of various debt issuance strategies. There is a growing interest in this type of modelling and a number of other countries have also been developing such models<sup>5</sup>. The SDA model represents work-in-progress and does not currently play any part in the Treasury's decisions about the debt portfolio or the maturity structure and type of gilt issuance set out in the DMO's financing remit each year.

The simulation framework consists of three main building blocks:

- *a macroeconomic model* in which the output gap, the Government's primary net financing requirement, inflation and the short-term interest rate are modelled as separate but inter-related equations;
- *yield curve models* that provide the specification for both the nominal and real term structure of interest rates; and
- *the debt strategy simulation component*, which is used to determine how, under a given debt strategy the Government meets its total financing requirement (central government net cash requirement (CGNCR) plus the refinancing of maturing debt).

It is worth noting that simulation modelling cannot in isolation determine what should be the Government's preferred debt issuance strategy. That can only be determined on the basis of information about the Government's preferences with regard to cost and risk and a consideration of the other factors that the Government examines when choosing a given long-term debt strategy. However, a simulation model can illustrate the medium to long-term conditions under which different possible debt issuance strategies would lead to cheaper and less risky financing for the Government.

A detailed discussion of the modelling work that the DMO has so far undertaken, together with illustrative results from the model will be published in the *DMO Annual Review 2005-06*, which is due to be published in summer 2006.

<sup>5</sup> For example Sweden (see Bergström, P., A. Holmlund and S. Lindberg (2002), *The SNDO's simulation model for government debt analysis*, Swedish National Debt Office); Denmark (see Danmarks Nationalbank (2003), *Danish government borrowing and debt*); and Canada (see Bolder, D. J. (2003), *A stochastic simulation framework for the government of Canada's debt strategy*, Bank of Canada Working Paper 2003-10).

**Box 3.2: Gilts dematerialisation**

During winter 2003 HM Treasury held a public consultation seeking views on a model for a re-engineering of the gilts registration service that proposed changes to how gilts are registered and transferred, including the abolition of paper certificates ("dematerialisation"). Following the consultation, HM Treasury confirmed that the registrar function would be contracted out to the private sector in order to realise cost efficiencies. It considered the legislation required to put these changes into effect and sought views on the costs and benefits to market participants<sup>6</sup>.

Phase One of the modernisation process was completed in December 2004 when Computershare Investor Services plc became the registrar for gilts.

Phase Two of the process aims to achieve dematerialisation of the gilt market. Given the linkages between the cost savings that would be brought about through gilts dematerialisation and those that would arise from equities dematerialisation, HM Treasury has decided that gilts dematerialisation should proceed in line with equities dematerialisation<sup>7</sup>. Therefore the Government will not be taking forward gilts dematerialisation until such time as the process for equities dematerialisation is agreed. A consultation document on the practicalities of equities dematerialisation is currently being prepared, under the stewardship of the Institute of Chartered Secretaries and Administrators (ICSA).

**Box 3.3: Index-linked uplift and redemption of 2% Index-linked Treasury Stock 2006**

The redemption total for 2006-07 of £29.9 billion does not include the full value of the index-linked uplift on 2% Index-linked Treasury Stock 2006. The reason is that under the rules governing the central government net cash requirement (CGNCR) that part of the accrued inflation uplift on any redeeming gilt representing the return to investors is included in the CGNCR in the redemption year, and the remainder is included in the redemption total for the year in which it redeems.

More specifically, in cases where an index-linked gilt is re-opened (following an initial issue) any accrued uplift on that gilt that is accrued before the re-opening occurs will be treated as principal (and therefore part of the redemption total). However, any accrued inflation uplift that occurs after the re-opening of the gilt will be treated as a return to the investor and thus will be included within the CGNCR for the year in which the gilt matures.

Since all cash flows on 2% Index-linked Treasury Stock 2006 are now known, it is possible to calculate the final breakdown between those cash flows that count towards redemptions and those that count towards the CGNCR forecast for 2006-07. The nominal amount of this gilt in issue is £2.11 billion, and the total uplifted amount by the time of redemption will be £5.88 billion, so the total uplift is £3.77 billion.

The nominal amount in issue (less Government holdings at end-March 2006) will count towards redemptions. Of the £3.77 billion of uplift £1.40 billion will count towards redemptions and £2.37 billion will count towards the CGNCR forecast for 2006-07. The uplift on Government holdings, which does not count towards either redemptions or the CGNCR forecast, will be excluded from both.

<sup>6</sup> Details of the model and the Government's response to the consultation can be found on HM Treasury's website at: [www.hm-treasury.gov.uk/consultations\\_and\\_legislation/britgov/consult\\_resp.cfm](http://www.hm-treasury.gov.uk/consultations_and_legislation/britgov/consult_resp.cfm).

<sup>7</sup> Information on the private sector led initiative on equities dematerialisation can be found on the website of CrestCo Ltd at: [www.crestco.co.uk/news/newsletters/newsletter-dec2005.pdf](http://www.crestco.co.uk/news/newsletters/newsletter-dec2005.pdf).



# 4

## UK GOVERNMENT'S FINANCING PROGRAMME FOR 2006-07

### 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 preferred means of issuance for all gilts. In addition, the Government may hold conversion offers, switch auctions, reverse auctions of non-benchmark gilts and syndicated offerings of gilts (although there are no current plans to hold such operations in 2006-07).

**4.2** Temporary changes have been made to the DMO's financing remit for 2006-07 that will allow the DMO greater capacity to respond to a potentially challenging environment. The details of these changes are set out in the DMO's financing remit in Chapter 5 below and are reflected in Tables 4.1 and 4.2 below. The DMO will seek feedback from market participants during the course of 2006-07 on the impact on the gilt market of these temporary changes to the financing remit with a view to informing the Government's decisions about the DMO's financing remit in 2007-08.

### Financing arithmetic

**4.3** The new forecast for the CGNCR in 2006-07 is £41.2 billion, an increase of £1.2 billion from the Pre-Budget Report (PBR) 2005 forecast. Gilt redemptions, excluding official holdings, are expected to be £29.9 billion.

**4.4** Table 4.1 gives details of the financing arithmetic for 2006-07. It outlines the proposed debt instruments that the Government intends to use to meet its financing requirement in 2006-07.

**4.5** Table 4.2 sets out the split of gilt issuance between maturities and types of gilts. Gilt issuance in 2006-07 will be made up of a pre-allocated issuance programme of £53.0 billion<sup>8</sup> and an unallocated tranche of gilt financing of £10.0 billion to be allocated throughout the year. The gilt issuance programme is set out in detail in the DMO's financing remit in Chapter 5 below. Table 4.2 will be updated and published in advance of the start of each quarter to show how the unallocated tranche of financing is being allocated quarter-by-quarter throughout the year. Table 4.2 shows the allocation of the initial tranche of the unallocated gilt issuance programme of £2.5 billion to long conventional gilts in the first quarter of 2006-07. Therefore, the remaining quantum of unallocated financing for 2006-07 to be allocated during the remaining three quarters of the year is £7.5 billion.

### National Savings & Investments

**4.6** NS&I's net contribution to financing (including accrued interest) in 2006-07 is forecast to be £3.0 billion. This assumes gross sales (i.e. sales and deposits including accrued interest) of £13.6 billion. This forecast is not a target but an estimate based on experience in previous years, trends in the retail savings product market during 2005-06 and NS&I's own forecasts and objectives.

<sup>8</sup> Figures in Chapter 4 are in cash terms unless otherwise stated.

**Table 4.1: Financing arithmetic 2006-07**

	£ billion
<b>Central government net cash requirement</b>	<b>41.2</b>
Gilt redemptions	29.9
Financing for the Official Reserves	0.0
Buy-backs	0.0
Planned short-term financing adjustment <sup>1</sup>	-3.1
<b>Gross financing requirement</b>	<b>68.0</b>
<i>less:</i>	
National Savings & Investments	3.0
<b>Net financing requirement</b>	<b>65.0</b>
<i>Financed by:</i>	
<b>1. Debt issuance by the Debt Management Office</b>	
<b>a) Treasury bills</b>	<b>2.0</b>
<b>b) Gilts</b>	<b>63.0</b>
<b>2. Other planned changes in short-term debt<sup>2</sup></b>	
Change in Ways & Means	0.0
<b>3. Unanticipated changes in net short-term cash position<sup>3</sup></b>	<b>0.0</b>
<b>Total financing</b>	<b>65.0</b>
<b>Short-term debt levels at end of financial year</b>	
Treasury bill stock	21.1
Ways & Means	13.4
DMO net cash position	0.2

1. To accommodate changes to the current year's financing requirement resulting from: (i) publication of the previous year's outturn CGNCR and/or (ii) carry over of unanticipated changes to the cash position from the previous year.

2. Total planned changes to short-term debt are the sum of: (i) the planned short-term financing adjustment; (ii) Treasury bill sales; and (iii) changes to the level of the Ways & Means advance.

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

**Table 4.2: Gilt issuance split 2006-07**

£ billion		Quarter I		Quarter I
		Additional gilt issuance allocation		Updated financing programme
<b>Planned gilt sales</b>		<b>63.0</b>		
<b>Pre-allocated gilt issuance</b>		<b>53.0</b>		
<i>of which minimum:</i>				
Conventional	Short	10.0		10.0
	Medium	10.0		10.0
	Long	17.0	2.5	19.5
Index-linked		16.0		16.0
<b>Total pre-allocated gilt issuance</b>		<b>53.0</b>		<b>55.5</b>
<b>Gilt issuance to be allocated</b>		<b>10.0</b>		<b>7.5</b>

## Financing for the Official Reserves

**4.7** 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 2006-07. Any decisions will be taken on the basis of the least cost comparison set out in paragraph 9.6 below.

**4.8** If foreign currency bonds are issued in place of swapped sterling liabilities to finance the Official Reserves then the net sterling financing requirement will decline by the sterling value of the bonds issued. Similarly when the foreign currency bonds mature (assuming the level of the borrowed reserves remains unchanged and new foreign currency bonds are not issued) the net sterling financing requirement will rise by the equivalent amount.

**4.9** For the purposes of the financing arithmetic in Table 4.1 it is assumed that swapped sterling will remain the main form of financing the borrowed reserves (as has been the case in recent years) and no new foreign currency debt will be issued in 2006-07. As no Government foreign currency debt matures in 2006-07 the forecast in Table 4.1 shows zero impact due to financing of the Official Reserves. If the Government were to decide to issue a foreign currency bond later in the year, this would be taken into account in subsequent revisions to the DMO's financing remit, either at the Pre-Budget Report in the autumn or in Budget 2007, depending on when the bond was issued.

## Treasury bill sales

**4.10** The financing plans for 2006-07 assume that the outstanding stock of T-bills is increased by £2.0 billion. The planned stock of outstanding T-bills held outside central government is targeted to rise to £21.1 billion.

### **Other short-term debt**

**4.11** The level of the Ways & Means advance from the Bank of England planned for 31 March 2006 is £13.4 billion and is assumed to remain at this level for 2006-07.

**4.12** The DMO will continue to maintain a working balance of £200 million at the Bank of England.

**4.13** It is anticipated that the level of the DMO's net cash position at end-March 2006 will be £3.3 billion. This will be reduced during 2006-07 to £200 million (the working balance at the Bank of England) through a planned reduction in short-term financing of £3.1 billion.

### **Quantity of gilt sales**

**4.14** The DMO will aim to meet the remainder of the financing requirement by selling gilts to the private sector. On the basis of the CGNCR forecast, this means gross gilt sales of approximately £63.0 billion (cash).

### **Benchmark gilts**

**4.15** Through its pre-allocated gilt issuance programme, the Government aims this year at regular issuance across the maturity spectrum throughout the year and at building up benchmarks at key maturities.

# 5

## THE DEBT MANAGEMENT OFFICE'S FINANCING REMIT FOR 2006-07

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### Objectives

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

- to meet the annual remit set by HM Treasury Ministers for the sale of gilts, with 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 to lower the cost of debt financing, liaising as appropriate with the Bank of England, Financial Services Authority, London Stock Exchange, and other bodies and to provide policy advice to HM Treasury Ministers and senior officials accordingly;
- to conduct its market operations, liaising as necessary with regulatory and other bodies, with a view to maintaining orderly and efficient markets and promoting a liquid market for gilts;
- to provide, including in liaison with Computershare Investor Services plc and CRESTCo, a high quality efficient service to investors in government debt, and to deal fairly and professionally with market participants in the gilt and money markets, consistent with achieving low cost issuance;
- to contribute to HM Treasury's work on the development of the 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 lower costs of debt issuance.

### Quantity of gilt sales

**5.2** The DMO, on behalf of the Government, will aim for gilt sales of £63.0 billion (cash)<sup>9</sup> in 2006-07.

### Pre-commitment to gilt issuance

**5.3** Within the total of £63.0 billion a minimum gilt sales programme of £53.0 billion is pre-allocated from the start of the financial year between short (maturity of 1-7 years), medium (maturity of 7 to 15 years), and long (maturity of 15 years and over) conventional gilts, and regular auctions of index-linked gilts. This core issuance programme aims at ensuring regular issuance across the maturity spectrum throughout the year and at building up benchmarks at key maturities (e.g. 5-year and 10-year for conventional gilt issuance).

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<sup>9</sup> Figures in Chapter 5 are in cash terms unless otherwise stated.

**5.4** The remaining unallocated amount of £10.0 billion will be allocated on a quarterly basis throughout the year in a broadly even-flow manner (i.e. approximately £2.5 billion will be allocated each quarter). This is intended to increase the ability of the Government to respond to substantial changes in market conditions and in the pattern of demand for gilts throughout the year. The allocation in the first quarter of the financial year is announced as part of the publication of the DMO's annual remit. From the second quarter of the financial year, decisions on the allocation of these supplementary amounts of issuance will be made following regular consultation meetings with Gilt-edged Market Makers (GEMMs) and representatives of investors (see paragraphs 5.5 and 5.6 below).

**5.5** Supplementary issuance in any one quarter may be achieved by increasing the size of scheduled auctions and/or adding auctions. The dates of any additional auction(s) will be the subject of discussion at the regular quarterly consultation meetings of the DMO with gilt market participants and will be communicated in the quarterly issuance announcement.

**5.6** The March consultation meetings to discuss the calendar for the first quarter of the financial year will continue to take place with the next meeting scheduled for Monday 27 March 2006. In order to improve further the degree of transparency and predictability in the delivery of the remit within the financial year, the quarterly consultation meetings for the remaining quarters of the year will take place in the penultimate month of each quarter and the issuance calendar for the following quarter will be announced at the end of that month. For example, the issuance calendar for July-September 2006 will be announced at 3.30pm on Wednesday 31 May 2006. This, and subsequent quarterly announcements, will also specify that part of the unallocated tranche to be allocated in the forthcoming quarter.

**5.7** The allocation of the £2.5 billion supplementary issuance planned for the first quarter of 2006-07 is as follows:

- £2.5 billion (cash) in long conventional gilts.

This amount has been taken into account in the maturity mix of conventional gilt issuance provided below and in the auction calendar provided in Table 5.1.

### **Minimum amount and maturity mix of conventional gilt issuance**

**5.8** A minimum of 17 auctions of conventional gilts are planned in 2006-07:

- a minimum of 4 in the short (1-7 years) maturity area, aiming to raise at least £10.0 billion cash;
- a minimum of 4 in the medium (7-15 years) maturity area, aiming to raise at least £10.0 billion cash; and
- a minimum of 9 in the long (15 years and over) maturity area, aiming to raise at least £19.5 billion cash.

**5.9** Both the planned total and maturity breakdown of planned conventional gilt issuance, and the number of auctions may be increased in-year as part of the allocation of the supplementary gilt issuance referred to in paragraph 5.4 above.

## Minimum amount and maturity mix of index-linked gilt issuance

**5.10** The Government has an ongoing commitment to the index-linked gilt market. In 2006-07, the DMO aims to sell a minimum of £16.0 billion (cash) in index-linked gilts.

**5.11** A minimum of 16 auctions of index-linked gilts are planned in 2006-07 and it is intended that this will include at least monthly issuance at long maturities.

**5.12** Both the planned total of index-linked gilt issuance and the number of auctions may be increased during the year as part of the allocation of the supplementary gilt issuance referred to in paragraph 5.4 above.

## Sizing of gilt auctions

**5.13** The gilt sales targets in paragraphs 5.2 to 5.10 above are specified in cash terms, but the gilt auctions are sized in nominal terms, typically in £0.25 billion increments for conventional gilts and £0.025 billion increments for index-linked gilts. Therefore all gilt sales targets are expressed in approximate terms.

## Method of issuance of gilts

**5.14** Auctions will constitute the primary means of issuance of all gilts (conventional and index-linked). All auctions will be single auctions held on the day indicated.

**5.15** Each outright auction of conventional gilts is planned to be for between £1.5 billion and £4.0 billion (cash) on a competitive bid-price basis. Each outright auction of index-linked gilts will be for between £0.5 billion and £1.5 billion (cash) on a uniform price basis.

**5.16** The expected timing of gilt sales comprising the £53.0 billion core programme and the £2.5 billion supplementary issuance for Q1 2006-07 is set out in the auction calendar in Table 5.1 below. These dates are subject to revision in the light of decisions by the Chancellor of the Exchequer on the Budgetary timetable and on new information about the publication date of key economic data, in particular RPI release dates.

**5.17** A more detailed auction calendar for the first quarter of the financial year, including the gilts to be auctioned on each date, will be announced by the DMO at 3.30pm on Tuesday 28 March 2006. For the rest of 2006-07 the quarterly calendar announcements will be made at 3.30pm on 31 May, 31 August and 30 November – and these will include the dates of any auctions added as part of the supplementary sales programme. Full details of all auctions will normally be announced at 3.30pm on the Tuesday of the week preceding the auction.

Table 5.1: Gilt auction calendar 2006-07

Date	Type
<b>2006</b>	
4 April	Conventional
11 April	Index-linked
25 April	Index-linked
11 May	Conventional
23 May	Index-linked
25 May	Conventional
7 June	Conventional
22 June	Conventional
27 June	Index-linked
4 July	Conventional
11 July	Index-linked
25 July	Index-linked
1 August	Conventional
23 August	Index-linked
5 September	Conventional
21 September	Conventional
27 September	Index-linked
3 October	Conventional
12 October	Index-linked
24 October	Index-linked
23 November <sup>1</sup>	Conventional
28 November <sup>1</sup>	Index-linked
5 December <sup>1</sup>	Conventional
6 December <sup>1</sup>	Conventional
14 December <sup>1</sup>	Index-linked
<b>2007</b>	
9 January	Conventional
18 January	Index-linked
25 January	Index-linked
20 February <sup>1</sup>	Index-linked
22 February <sup>1</sup>	Conventional
6 March <sup>1</sup>	Conventional
15 March <sup>1</sup>	Conventional
27 March <sup>1</sup>	Index-linked

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

**5.18** The above programme of conventional and index-linked gilt auctions and any others that may be added in-year may be supplemented between auctions by official sales of gilts by the DMO "on tap". Taps of gilts will be used only as a market management instrument in conditions of temporary excess demand in a particular gilt or sector. The DMO would only contemplate taps in exceptional circumstances.

**5.19** The DMO has no plans to issue gilts by syndicated offering in 2006-07.

**5.20** After an auction, the DMO will generally refrain from issuing gilts of a similar type or maturity to the auctioned gilt for a reasonable period, unless already pre-announced, or if there is a clear market management case for doing so.

**5.21** 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.

### **Reverse auctions**

**5.22** The DMO has no plans for a programme of reverse auctions in 2006-07.

### **Conversions and switch auctions**

**5.23** The DMO has no plans to conduct conversion offers or switch auctions in 2006-07.

### **Coupons**

**5.24** 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**

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

### **Revisions to the remit**

**5.26** 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.

**5.27** Any revisions to this remit will be announced.



# 6

## THE DEBT MANAGEMENT OFFICE'S EXCHEQUER CASH MANAGEMENT REMIT FOR 2006-07

**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 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 a risk appetite approved by Ministers.

**6.4** The Government's preferences in relation to the different types of risk-taking inherent in cash management will be defined by a set of explicit limits covering four types of risk<sup>10</sup>, which taken together, represent the Government's overall risk appetite. The risk appetite therefore defines objectively the bounds of appropriate Government cash manager behaviour determined 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 goal.

### Exchequer 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 within 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.

### 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<sup>11</sup>. The arrangements for the issuance of T-bills and the management of the T-bill stock in market hands will be set out in and operated according to the DMO's Operational Notice.

<sup>10</sup> 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 4 of the Debt Management Office's Annual Review 2004-05, which is available on the DMO's website at: [www.dmo.gov.uk/gilts/public/annual/gar0405.pdf](http://www.dmo.gov.uk/gilts/public/annual/gar0405.pdf).

<sup>11</sup> The current edition of *Exchequer Cash Management Operational Notice and Treasury Bill Information Memorandum* is available on the DMO's website at: [www.dmo.gov.uk/cash/cashops/10903.pdf](http://www.dmo.gov.uk/cash/cashops/10903.pdf).

**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 T-bills (excluding bills issued solely for collateral purposes). This change is announced as part of the financing remit given by HM Treasury to the DMO (see Chapter 5 above).

**6.8** During the financial year the DMO will manage the level of the T-bill stock and may increase or reduce the stock vis-a-vis the end year target level, in order to support the implementation of Government cash management.

**6.9** As a contingency measure, the DMO may also issue T-bills to the market 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 a request from the Bank, 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. T-bill issues made at the request of the Bank will be identical in all respects to T-bills issued in the normal course of DMO business.

### **DMO collateral pool**

**6.10** To assist the DMO in the efficient execution of its cash management operations a combination of T-bills and 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 2006 and January 2007. 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, DMO will announce that this is the case in advance.

# 7

## NATIONAL SAVINGS & INVESTMENTS' ACTIVITIES IN 2005-06

### 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** In 2005-06, NS&I's overall cost of financing remained an estimated £258 million lower than that of comparable gilts, taking into account management costs and imputed tax foregone. NS&I announced four packages of interest rate changes during 2005-06. For new issues of fixed rate products these reflected changes in gilt yields and for variable rate products these reflected changes in the Bank of England's repo rate as announced by the Bank's Monetary Policy Committee.

**7.3** The net contribution to financing in 2005-06 is estimated to be £4.8 billion with gross sales (including reinvestments and gross accrued interest) of approximately £13.0 billion. Table 7.1 below outlines changes in NS&I's product stock during 2005-06.

**Table 7.1: Change in National Savings & Investments' product stock during 2005-06**

	End-March 2005 £ billion	End-March 2006 <sup>1</sup> £ billion
Variable rate	43.4	47.7
Fixed rate	16.4	15.9
Index-linked	8.7	9.6
<b>Total<sup>2</sup></b>	<b>68.5</b>	<b>73.3</b>

*1. Estimates*

*2. Totals may not sum due to rounding*

*Source: National Savings & Investments*

### Revisions to NS&I's net financing target within the year

**7.4** The original target for NS&I's net contribution to Government financing published at Budget 2005 was £3.5 billion (with a range of +£0.5 to -£1.0 billion around this central target). This target was revised up in the 2005 Pre-Budget Report to an expected outturn of £4.2 billion within a range of between £3.8 billion and £4.8 billion.

### Diversification of product distribution channels

**7.5** In order to reduce the risks of depending on any one distribution channel, NS&I has implemented a strategy to diversify the way in which it sells its products. NS&I's website – www.nsandi.com – has seen rapid growth as a sales channel since it was first launched in February 2005. The website now accounts for over 4% of NS&I's sales and has already contributed over £1 billion to total NS&I sales since its launch. The forecast for Internet sales in 2006-07 is for continued growth with estimated sales of £1.3 billion.

**7.6** In addition, NS&I signed a five-year marketing partnership agreement with Tesco Personal Finance to support the promotion of Premium Bonds and Savings Certificates. The pilot of this partnership took place between November 2005 and February 2006 at 50 Tesco stores, with the roll-out to over 700 stores taking place in March 2006.

### **Television advertising**

**7.7** NS&I also started a television advertising campaign in August 2005, featuring Sir Alan Sugar. The campaign generated new sales and helped to retain existing customers. NS&I is planning a further television advertising campaign in 2006-07.

### **Conclusion**

**7.8** NS&I had a year of strong sales. In addition, it has been taking steps to build its capacity in terms of customer awareness and distribution channels in order to ensure it is able to continue to deliver its targets in the future.

# 8

## NATIONAL SAVINGS & INVESTMENTS' FINANCING REMIT FOR 2006-07

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### Introduction

**8.1** National Savings & Investments' (NS&I's) aim is to help 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** Key business objectives for NS&I to deliver its strategic objective are:

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

**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 Treasury 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, Treasury Ministers would expect to endorse them.

### Volume of financing in 2006-07

**8.6** Gross sales (including gross accrued interest) of NS&I products are assumed to be around £13.6 billion in 2006-07. After meeting expected maturities and withdrawals, NS&I is expected to make a net contribution to Government financing of £3.0 billion.

### Cost of financing

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

**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.

## Review of the remit

**8.9** HM Treasury or NS&I may initiate a review of this remit during the course of 2006-07 in the light of any relevant factors.

# 9

## MANAGEMENT OF THE OFFICIAL RESERVES IN 2005-06

### Introduction

**9.1** The UK Government's official holdings of international reserves<sup>12</sup> comprise gold, foreign currency assets and International Monetary Fund (IMF) Special Drawing Rights (SDRs)<sup>13</sup>. With the exception of the SDR assets that constitute the UK's reserve tranche position (RTP) at 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 for "checking undue fluctuations in the exchange value of sterling". Subsequent legislation (including the Exchange Equalisation Account Act 1979) has extended the possible uses of the fund to include making payments abroad on behalf of the Government and for certain transactions associated with the UK's membership of the IMF. The 1979 Act permits the EEA to invest in assets denominated in the currency of any country and to hold gold or SDRs.

### Management of the Exchange Equalisation Account

**9.3** The EEA is under the control of HM Treasury, which appoints the Bank of England ('the Bank') 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 specifies the parameters under which the reserves are managed. This SLA includes investment benchmarks and limits for controlling credit, market and other risks. A summary of the current SLA is set out in Chapter 10.

### Financing of the reserves

**9.4** Reserve assets can be acquired primarily in two ways; either sterling can be sold for foreign currency or foreign currency can be borrowed (see below). Reserves financed by foreign currency borrowing are known as 'the borrowed reserves'. The borrowed reserves are hedged so that the interest rate and currency exposures of the reserve assets match those on the foreign currency borrowing. Reserves that are not funded by foreign currency borrowing are known as the 'net reserves'. Net reserves are in effect the Government's net asset position in foreign currency and gold, and have been generated over time by sales of sterling for foreign currency or through retained earnings. Interest rate and currency exposures are not hedged on the net reserves.

<sup>12</sup> 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 May 1997 which is available on HM Treasury's website at: [http://www.hm-treasury.gov.uk./media/ED3/C6/foi\\_boeindep\\_nremonetarypolicy\\_40205.pdf](http://www.hm-treasury.gov.uk./media/ED3/C6/foi_boeindep_nremonetarypolicy_40205.pdf).

<sup>13</sup> 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 on the IMF's website at: <http://www.imf.org/external/np/exr/facts/sdr.HTM>.

**9.5** Foreign currency can be borrowed directly by issuing Government securities denominated in foreign currency. In this event the Bank acts as HM Treasury's agent for the issue<sup>14</sup>. Alternatively, sterling financing may be raised (by the Debt Management Office) and the proceeds 'swapped' into foreign currency, which also gives rise to a foreign currency liability. This second method, which can be described as 'synthetic' foreign currency borrowing, entails using the proceeds from issuing sterling gilts to acquire foreign currency assets and using a currency swap to hedge foreign currency and interest rate exposures that arise.

**9.6** 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.

### Composition and size of the UK Reserves

**9.7** EEA assets 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 (other than gold) 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, and in the debt instruments of highly-rated banks.

**9.8** Table 9.1 below sets out developments in UK official holdings of international reserves. The value of the gross foreign exchange reserves fell over the year, from US\$ 49.4 billion at end-December 2004 to US\$ 46.2 billion at end-December 2005. This was mainly because of valuation effects resulting from the strengthening of the dollar, which appreciated by 15% against the euro and the yen in 2005. There was also a compositional shift from SDR-denominated assets to foreign currency assets, reflecting repayments from countries that had borrowed from the IMF. The level of the UK's net reserves fell slightly over the year, from US\$ 19.1 billion at end-December 2004 to US\$ 18.9 billion at end-December 2005, also because of revaluation effects from the stronger dollar.

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<sup>14</sup> The most recent example is the Government's US dollar bond issued in July 2003 (for more information see the Debt and Reserves Management Report 2004-05, page 36, which can be found on HM Treasury's website at: [http://www.hm-treasury.gov.uk/media/92B/27/debt\\_res.pdf](http://www.hm-treasury.gov.uk/media/92B/27/debt_res.pdf)). The Bank of England may also issue foreign currency securities in its own name.

**Table 9.1: UK Official Holdings of International Reserves**

Currency breakdown		US\$ million – market value	
Assets	End-December 2004	End-December 2005	
US\$	11,802	11,941	
Euro	21,636	23,077	
Yen	5,691	4,039	
Other currencies	2	11	
SDR	5,861	2,051	
Gold	4,397	5,126	
<b>Total Assets</b>	<b>49,389</b>	<b>46,246</b>	
Liabilities	End-December 2004	End-December 2005	
US\$	–7,801	–6,167	
Euro	–16,913	–17,301	
Yen	–3,326	–1,155	
Other currencies	–2	–9	
SDR	–2,958	–2,734	
Gold	—	—	
<b>Total Liabilities</b>	<b>–30,281</b>	<b>–27,367</b>	
<b>Net Reserves (Assets – Liabilities)</b>	<b>19,108</b>	<b>18,879</b>	

Source: HM Treasury/Bank of England

## Performance evaluation

**9.9** HM Treasury undertakes: “to minimise the cost of holding the Government’s foreign currency reserves, while managing risk within limits agreed between the Bank and HM Treasury” within a three-year cycle. Details of this Service Delivery Agreement target are reported in detail in HM Treasury’s annual report on the expenditure plans of the Chancellor of the Exchequer’s Departments.

## Disclosure of financial data

**9.10** Since April 2000, the UK has published reserves data in accordance with the IMF/ Group of Ten Countries<sup>15</sup> (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)<sup>16</sup>.

<sup>15</sup> The G10 countries are Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, United Kingdom and United States.

<sup>16</sup> Reserves data from July 1999 onwards are available on the Bank of England’s website at: [www.bankofengland.co.uk/statistics/reserves/index.htm](http://www.bankofengland.co.uk/statistics/reserves/index.htm).

**9.11** 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 2004-05, audited by the National Audit Office, were accordingly published and laid before both Houses of Parliament on 6 July 2005<sup>17</sup>.

## **Intervention**

**9.12** 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 Group of Seven Countries<sup>18</sup> (G7) to support the Euro in September 2000.

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<sup>17</sup> The Financial Accounts for the EEA are available on HM Treasury's website at:

[http://www.hm-treasury.gov.uk/media/ECA/3D/eea\\_account\\_report0405\\_060705.pdf](http://www.hm-treasury.gov.uk/media/ECA/3D/eea_account_report0405_060705.pdf).

<sup>18</sup> The G7 countries are Canada, France, Germany, Italy, Japan, United Kingdom and United States.

## Introduction

**10.1** The Service Level Agreement ('SLA') sets out the arrangements for the Bank 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 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 in the EEA are properly and well managed and safeguarded. Subject to these limits manage the reserves to maximise their return and assist the Treasury in meeting the published Service Delivery Agreement target.
- 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.
- Advise the Treasury as to how to ensure 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.

## **Authorised financial instruments**

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

- bonds 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;
- sales and repurchase, and buy-sell back agreements;
- gold deposits, gold loco and gold quality swaps;
- forward rate agreements;
- Special Drawing Rights (SDRs);
- bank deposits; and
- certificates of deposit and corporate commercial paper.

## **Active management**

**10.6** The Bank 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 borrowed reserves, on which currency and interest rate exposures are hedged; and the net reserves which are not hedged against exchange rate and interest rate risk. The Bank's scope to deviate from the benchmarks through active management will be constrained by agreed risk limits.

## Risk management

### 10.7 The Bank 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 will review this framework and the credit limits it provides in the light of market or institutional developments, and changes in the nature of the EEA's activities. The Bank's Credit Ratings Advisory Committee (CRAC) will normally undertake credit assessments at least once a year of each issuer whose securities may be held in the EEA; of counterparties; of banking sectors; of futures clearing brokers; and of commercial global custodians and correspondent banks utilised by the EEA.
- 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.
- 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 relating to the Bank's management of the EEA. If appropriate, exceptions to such confirmation will be listed.

## Audit arrangements and accounting requirements

**10.8** The Bank will agree the annual programme of work of the Bank's Internal Audit Division pertaining to the EEA with HM Treasury by the beginning of the year. The Bank'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 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

### 10.9 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 has managed the EEA,

**10.10** 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, have access to Bank buildings, and may require the Bank 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.

## **HM Treasury's responsibilities**

**10.11** HM Treasury is responsible for monitoring the risk environment and performance of the Bank in managing the reserves. To support this process, the Bank 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'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's role in identifying, assessing, managing and monitoring the risks relating to its management of the EEA.
- Quarterly reports from the Bank's Internal Audit Division on the internal audit programme agreed for the EEA.
- Bank and Treasury officials meet at monthly 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's Executive Director for Markets meet twice each year to discuss overall strategy and governance issues.

## **Financing the reserves**

**10.12** The Bank 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 'borrowed reserves' will be agreed between the Bank and HM Treasury at the beginning of the financial year. The Bank 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 will act as HM Treasury's agent in issuing and managing any foreign currency liabilities associated with the reserves. The Bank 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 will liaise closely with the Debt Management Office (DMO) with respect to managing sterling flows relating to EEA operations. The Bank will, so far as is possible, aim to manage the EEA so as to avoid conflict with the DMO's sterling cash management operations while in no way disadvantaging the EEA.

## Publication requirements

**10.15** The Bank 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 website. 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 will subsequently report on the extent to which any such authority was used, and to what effect, by letter.



# CENTRAL GOVERNMENT'S FINANCIAL ASSET AND LIABILITY RISK MONITOR

## Introduction

**II.1** The central government's asset and liability risk monitor ('the monitor') is being 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 un-audited.

**II.2** The monitor is a precursor to the publication of 'Whole of Government Accounts'<sup>19</sup> from 2006-07 onwards and is in accordance with the transparency and accountability recommendations published in the International Monetary Fund's 'Guidelines on Public Debt Management' 2003<sup>20</sup>.

**II.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. 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 2005 long-term public finance report<sup>21</sup>, which provides a comprehensive assessment of the sustainability of the public finances, for example by taking account of future government revenues and expenditures.

## Description of Table II.1

**II.4** Table 11.1 below breaks up total assets and liabilities by type and by managing institutions. 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. Box 11.1 explains these key variables.

<sup>19</sup> The Government announced in 2003 that it will publish Whole of Government Accounts (WGA) for the 2006-07 financial year onwards, once the methodological issues that have been raised by the development work have been addressed through the dry-run processes. If the first two WGA dry-runs are progressively achieved, and if local authority and public corporation accounting practices are – over the same time frame – brought into line with those in central government, it is then hoped that the first WGA balance sheet information can be made available for the year ending 31 March 2007.

<sup>20</sup> 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>.

<sup>21</sup> 2005 *Long-term public finance report: an analysis of fiscal sustainability*, HM Treasury, December 2005 can be found on HM Treasury's website at: [http://www.hm-treasury.gov.uk/media/F59/32/pbr05\\_longterm\\_513.pdf](http://www.hm-treasury.gov.uk/media/F59/32/pbr05_longterm_513.pdf). See also the 2003 Long-term public finance report, HM Treasury, December 2003, which provides a discussion of the different approaches to assessing long-term fiscal sustainability and can be found on HM Treasury's website at: [http://www.hm-treasury.gov.uk/media/8F5/85/pbr04long-term\\_473.pdf](http://www.hm-treasury.gov.uk/media/8F5/85/pbr04long-term_473.pdf).

## Key facts – central government's financial assets

**11.5** The nominal value of central government's total financial assets was £143.0 billion at end-December 2005. This compares with £104.3 billion at end-December 2004. This change was primarily due to an increase of £17.8 billion in DMO's holdings of gilts and the omission from last year's table Deposits given to DMO by the Commissioners for the Reduction of the National Debt (CRND) (which now stands at £15.1 billion).

**11.6** The market value of central government's total financial assets was £158.5 billion at end-December 2005 compared with £115.6 billion at end-December 2004, an increase of £43.0 billion.

**11.7** The average modified duration, which excludes the gold volatility measure and duration for index-linked gilts, remained unchanged from end-December 2004 at 6.2 years, whilst average maturity over the period fell to 10.9 years from 11.1 years.

**11.8** The largest single contributor to central government's financial assets reported in Table 11.1 is loans to local authorities (£45.3 billion) from the Public Works Loans Board, which make up nearly 32 per cent of the total nominal value. Other significant contributors include marketable conventional gilts held by the DMO (£18.2 billion), foreign currency bonds (£17.1 billion) managed by the Bank of England, deposits given to the DMO by CRND (£15.1 billion), and non-marketable conventional gilts held in central government funds by CRND (£14.7 billion).

### Box 11.1 Description of variables in the Central government asset and liability risk monitor

- **Nominal value and market value<sup>22</sup>** – 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 1 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 monitor, duration offers some indication of how great an impact small interest rate changes might have on the present value of central government's balance sheet. Other things equal, longer duration suggests a greater degree of sensitivity to small interest rates 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.

<sup>22</sup> Nominal value of index-linked gilts includes inflation uplift.



## Key facts – central government's financial liabilities

**II.9** The nominal value of central government's total financial liabilities was £586.0 billion at end-December 2005. This is an increase of £52.3 billion compared with end-December 2004 (£533.6 billion). This large change is attributable primarily to a £55.3 billion increase in gross gilts in issue by the Debt Management Office to £418.1 billion, a £4.2 billion increase in National Savings & Investments products to £72.0 billion and other short-term liabilities (particularly outstanding repos) to £17.3 billion from £13.4 billion. These were partially offset by a decrease in Treasury bill liabilities of £17.2 billion to £22.8 billion.

**II.10** The market value of central government's total financial liabilities at end-December 2005 was £640.1 billion compared with £571.4 billion at end-December 2004.

**II.11** The average modified duration of the liabilities at end-December 2005 was 6.0 years, an increase of 1.6 years from December 2004 (4.5 years) and the average maturity of the liabilities was also higher at 10.3 years compared with 8.8 years at end-December 2004, reflecting significant increases in gross conventional gilts in issue and gross gilts in issue, respectively. There was a marginal increase in the nominal value of liabilities with a maturity of less than one year of £1.4 billion to £102.0 billion.

**II.12** Gross gilts in issue represent the highest proportion of central government financial liabilities (£418.1 billion), accounting for 71 per cent of the nominal value of total liabilities. Other significant liabilities include those managed by National Savings & Investments (£72.0 billion) accounting for 12 per cent of the nominal value of total liabilities, DMO holdings of Treasury bills (£22.8 billion), other short-term bills (£19.5 billion), repos-outstanding (£16.2 billion), and the Ways and Means advance (£13.4 billion).

**Table 11.1: Central government's asset and liability risk monitor at 31 December 2005**

Central government financial assets	Nominal Value <sup>1</sup> (£ billion)	Market Value (£ billion)	Maturities of less than 1 year (£ billion)	Modified duration <sup>2</sup> (years)	Average maturity (years)	Floating rate composition (£ billion)
<i>Managed by:</i>						
<b>Public Works Loan Board (loans to local authorities)</b>	45.3	55.6	1.0	11.7	21.1	0.3
<b>Debt Management Office</b>						
<i>Gilts held by DMO</i>						
Marketable conventionals	18.2	20.8	1.4	7.4	11.4	—
Marketable index-linked	7.6	8.7	0.3	10.7	12.9	—
<b>Total</b>	<b>25.8</b>	<b>29.6</b>	<b>1.7</b>	<b>—</b>	<b>11.8</b>	<b>—</b>
<i>Gilts held in Central Government funds by the Commissioners for the Reduction of the National Debt (CRND)</i>						
Marketable conventionals	0.0	0.0	0.0	4.8	9.1	—
Non-marketable conventionals	14.7	15.6	2.6	2.9	2.9	—
Non-marketable index-linked	0.9	0.9	0.2	7.2	7.2	—
<b>Total</b>	<b>15.6</b>	<b>16.5</b>	<b>2.8</b>	<b>—</b>	<b>3.2</b>	<b>—</b>
<i>CRND loans to local authorities</i>	0.0	0.0	0.0	0.0	0.0	—
<i>Other short-term bills held by CRND in Central Government funds</i>						
Treasury bills <sup>3</sup>	0.3	0.3	0.3	0.0	0.0	—
Deposits given to DMO by CRND	15.1	15.1	15.1	0.1	0.1	—
<b>Total</b>	<b>15.4</b>	<b>15.4</b>	<b>15.4</b>	<b>0.1</b>	<b>0.1</b>	<b>—</b>
<i>Other short-term assets</i>						
Reverse repos – outstanding	0.1	0.1	0.1	0.0	0.0	—
Deposits at commercial banks	0.8	0.8	0.8	0.0	0.0	—
Cash deposits at the Bank of England	0.2	0.2	0.2	0.0	0.0	—
Sterling Certificates of Deposit	0.0	0.0	0.0	0.0	0.0	—
Sterling Commercial Paper	0.0	0.0	0.0	0.0	0.0	—
FX Commercial Paper	0.0	0.0	0.0	0.0	0.0	—
<b>Total</b>	<b>1.1</b>	<b>1.1</b>	<b>1.1</b>	<b>0.0</b>	<b>0.0</b>	<b>—</b>
<b>Bank of England</b>						
<i>Sterling assets</i>						
Sterling leg of swaps and FX liabilities <sup>4</sup>	10.0	10.1	2.8	0.2	1.7	10.0
<i>Foreign currency assets</i>						
Bonds	17.1	17.5	2.1	2.3	2.4	0.0
Money Market Instruments	2.7	2.7	2.7	0.2	0.2	—
Short-term assets <sup>5</sup>	3.0	3.0	3.0	0.1	0.1	—
Gold <sup>6</sup>	3.0	3.0	—	18.0	—	—
IMF Special Drawing Rights	0.2	0.2	—	0.0	—	0.2
<b>Total</b>	<b>26.0</b>	<b>26.4</b>	<b>7.8</b>	<b>1.6</b>	<b>1.8</b>	<b>0.2</b>
<b>HM Treasury</b>						
<i>Sterling assets</i>						
National Loans Fund loans <sup>7</sup>	2.9	2.9	0.1	8.9	14.8	—
<i>Foreign currency assets</i>						
IMF Reserve Tranche Position	1.0	1.0	—	0.0	—	1.0
<b>Total<sup>8,9</sup></b>	<b>143.0</b>	<b>158.5</b>	<b>32.6</b>	<b>6.2</b>	<b>10.9</b>	<b>11.5</b>

**Table 11.1: Central government's asset and liability risk monitor at 31 December 2005 (continued)**

Central government financial liabilities	Nominal Value <sup>1</sup> (£ billion)	Market Value (£ billion)	Maturities of less than 1 year (£ billion)	Modified duration <sup>2</sup> (years)	Average maturity (years)	Floating rate composition (£ billion)
<i>Managed by:</i>						
<b>National Savings and Investments</b>	72.0	72.0	10.0	5.1	5.3	46.6
<b>Debt Management Office</b>						
<i>Gross gilts in issue</i>						
Marketable conventionals <sup>10</sup>	300.7	336.5	22.3	8.1	12.6	—
Non-marketable conventionals <sup>11</sup>	18.7	19.9	3.8	2.7	3.5	—
Marketable index-linked <sup>12</sup>	97.8	114.5	0.0	11.9	14.6	—
Non-marketable index-linked <sup>11</sup>	0.9	0.9	0.2	5.5	6.2	—
<b>Total</b>	<b>418.1</b>	<b>471.7</b>	<b>26.3</b>	<b>—</b>	<b>12.7</b>	<b>—</b>
<i>Treasury bills<sup>13</sup></i>						
Treasury bills <sup>13</sup>	22.8	22.7	22.8	0.1	0.1	—
Other short-term bills	19.5	19.5	19.5	0.1	0.1	—
<b>Total</b>	<b>42.3</b>	<b>42.2</b>	<b>42.3</b>	<b>0.1</b>	<b>0.1</b>	<b>—</b>
<i>Other short-term liabilities</i>						
Repos – outstanding	16.2	16.3	16.2	0.1	0.1	—
Deposits made by local authorities and commercial banks	1.1	1.1	1.1	0.1	0.1	—
<b>Total</b>	<b>17.3</b>	<b>17.4</b>	<b>17.3</b>	<b>0.1</b>	<b>0.1</b>	<b>—</b>
<b>Bank of England</b>						
<i>Sterling liabilities</i>						
Ways and Means advance	13.4	13.4	—	0.0	—	13.4
<i>Foreign currency liabilities</i>						
HMG Bonds	1.7	1.7	0.0	2.4	2.5	—
Loans <sup>14</sup>	0.1	0.1	0.0	0.9	1.0	—
Repos	3.2	3.2	3.2	0.1	0.1	—
Swaps & FX Liabilities (excludes £ leg) <sup>15</sup>	9.0	9.5	2.9	1.6	1.1	9.0
IMF Special Drawing Rights allocation	1.6	1.6	—	0.0	—	1.6
<b>Total</b>	<b>15.6</b>	<b>16.0</b>	<b>6.1</b>	<b>1.2</b>	<b>0.9</b>	<b>10.6</b>
<b>HM Treasury</b>						
<i>Sterling assets</i>						
IMF non-interest bearing securities	7.2	7.2	-	0.0	-	7.2
<b>Total<sup>8,9</sup></b>	<b>586.0</b>	<b>640.1</b>	<b>102.0</b>	<b>6.0</b>	<b>10.3</b>	<b>77.9</b>

Figures may not sum due to rounding

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

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 £0.33 million of Treasury Bills held for repo collateral purposes matured on 16 January 2006.

4 Modified duration covers swaps only.

5 Short term assets = deposits + reverse repos.

6 Modified duration gold = 30-day moving average volatility of spot gold prices.

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. Gold volatility measure and duration for index-linked gilts are excluded from this calculation.

9 Total for average maturity is weighed by market value.

10 Nominal value is different from Table 2.1 because for the purpose of measuring risk, which is the primary aim of Table 11.1, 2% Index-linked Treasury Stock 2006 is included in the nominal value of conventional gilts in this table.

At end-December 2005, 2% Index-linked Treasury 2006 is treated as a conventional gilt because the final cash flows have already been determined.

11 Non-marketable gilts are held by the Commissioners for the Reduction of the National Debt (CRND).

12 See Footnote 10.

13 Nominal value is different from Table 2.1 because Table 11.1 includes transactions made prior to end-December 2005 that are due to settle in the first quarter of 2006.

14 Composed of Canadian and US war loans.

15 Modified duration covers swaps only.



# A

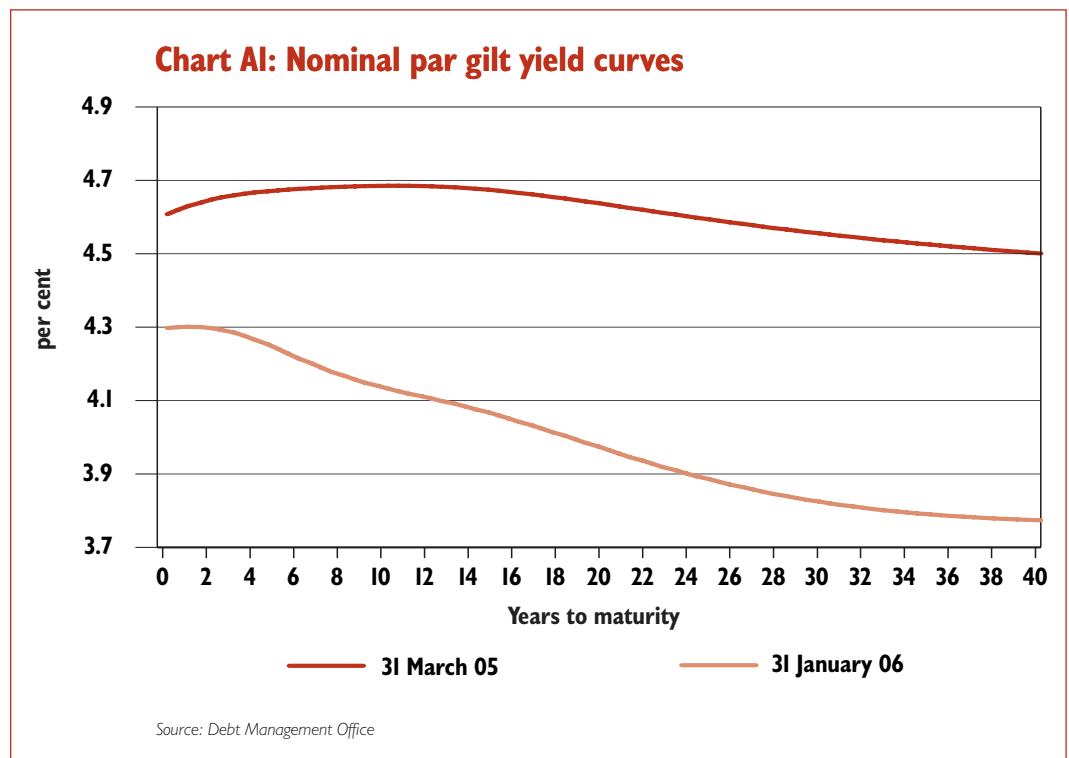
## KEY DEVELOPMENTS IN THE GILT MARKET APRIL 2005 TO JANUARY 2006

### Introduction

**A.1** This annex summarises key developments in the gilt market in 2005-06 (to end-January 2006). A more comprehensive review of the financial year as a whole, in the context of developments in other major international government bond markets, will be published in the DMO Annual Review 2005-06.

### Par gilt yield curves

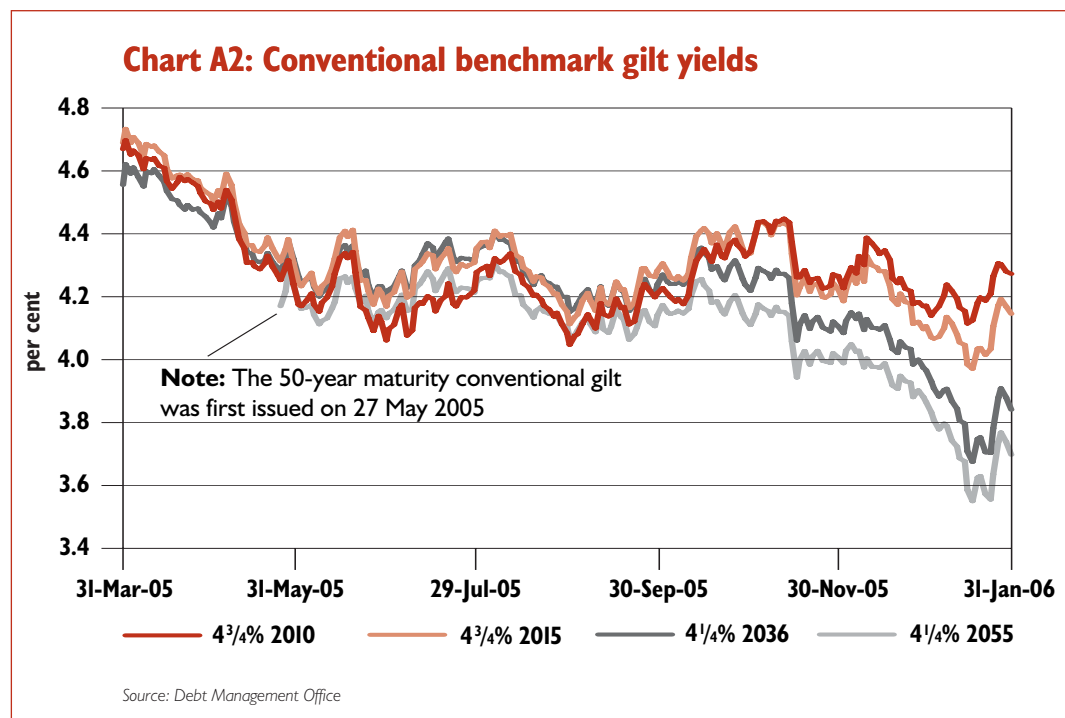
**A.2** The significant fall in the par gilt yield curve between end-March 2005 and end-January 2006 is shown in Chart A1 below. Yields fell at all maturities, but the long-end outperformed other maturities. 5-year par yields fell 42 basis points (bps) to 4.25%, 10-year par yields fell by 55 bps, to 4.14% but 30-year yields fell by 73bps, to 3.82%.



## Conventional benchmark gilts

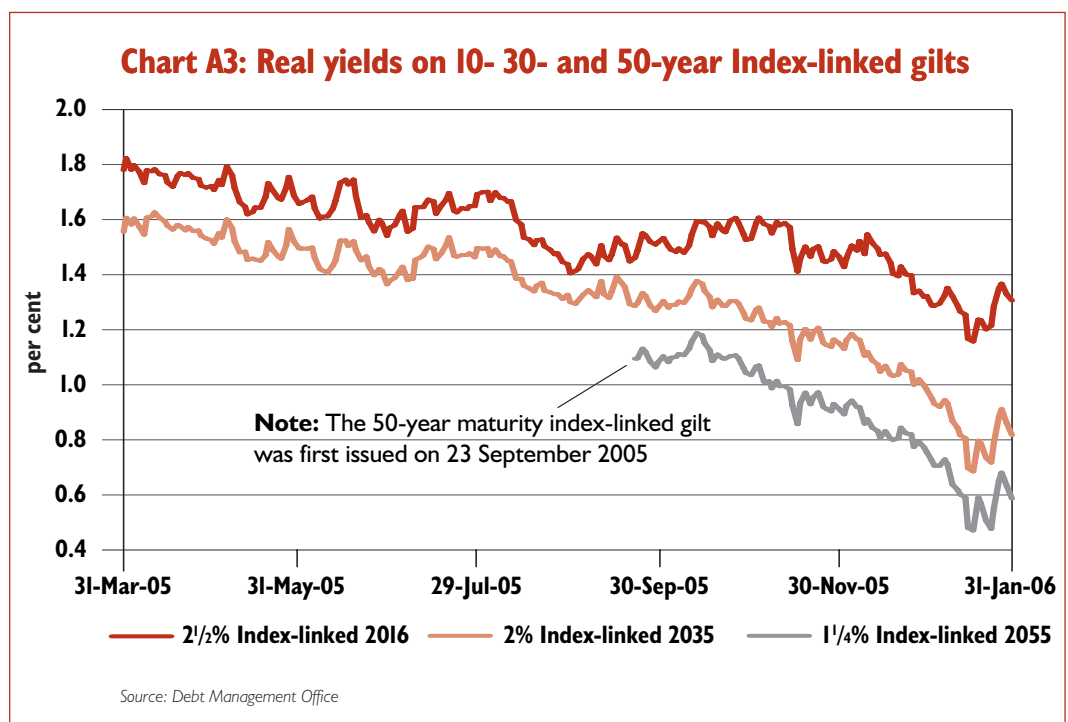
**A.3** Gilts began the financial year strongly with yields falling steadily over the first quarter, boosted by weak economic data (GDP growth, house prices and retail sales) and some flight-to-quality flows from weaker equities. Weak economic data were reflected in falling interest rate expectations during the first quarter of the financial year and by the end of the first quarter gilt yields were at two-year lows and the market was anticipating a cut in the Bank of England's repo rate in August. The second quarter saw a halt in the downward direction of yields influenced by generally stronger than expected economic data in July (despite a short-term flight-to-quality around the terrorist attacks in London on 7 July).

**A.4** There was some recovery in the gilt market in August as the Bank of England's Monetary Policy Committee (MPC) cut the repo rate on 4 August (as expected) but yields started to rise again at most points along the curve in September with the exception of yields at long-maturities which began to outperform. This was a trend that continued into the final quarter of 2005 when the whole gilt market rallied strongly (causing yields to continue to fall), helped by weaker data (in particular weaker inflation data in November and a dovish Inflation Report). At the long-maturity sector of the gilt market (particularly 30- to 50-year maturities), sustained demand by pension funds seeking to match assets with liabilities helped drive long yields to lows not seen since the 1950s – as long conventional yields fell below 4 per cent. This trend accelerated in early January with the yield on the 2055 conventional gilt reaching a low of 3.49 per cent on 18 January 2006.



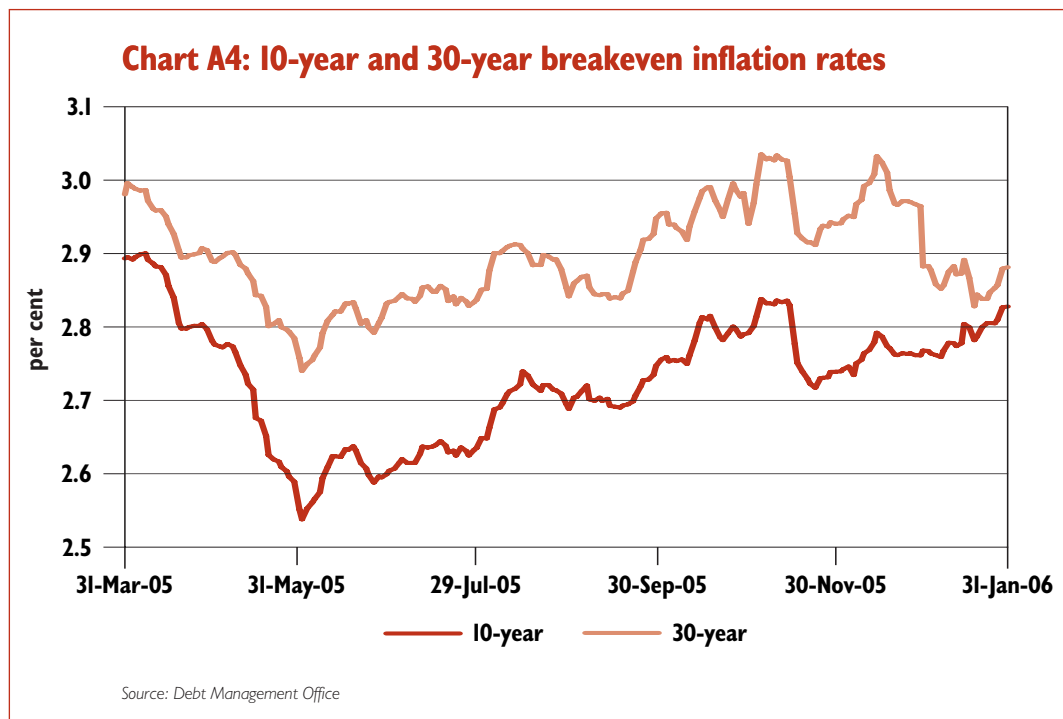
## Index-linked real yields

**A.5** Real yields on index-linked gilts fell steadily throughout the year following the same broad trend as conventional gilt yields (although index-linked gilts under-performed conventional gilts in the first quarter of the financial year (see paragraph A.6 below)). The most notable event for the market during 2005-06 was the launch of the world's first 50-year sovereign index-linked bond (by a syndicated offering on 22 September 2005). Following the launch of this bond real yields (and in particular real yields on long-maturity index-linked gilts) fell consistently and sharply, moving below 1 per cent in November 2005 and reaching a record low of 0.38 per cent (for the 50-year index-linked gilt) during 18 January 2006. The fall in yields to these low levels received extensive media coverage, particularly during January 2006. Over the course of the financial year to end-January 2006, the real yield on the 2035 maturity gilt fell from 1.56 per cent to 0.82 per cent.



## Breakeven inflation rates

**A.6** Measured by the breakeven inflation rate<sup>23</sup> index-linked gilts slightly underperformed relative to conventionals with the 10- and 30- year breakeven rates falling by 6 basis points (to 2.83 per cent) and 10 basis points (to 2.88 per cent) respectively over the financial year to end-January 2006. However, this disguises intra-year trends where index-linked gilts significantly underperformed conventional gilts at the start of the year with 10- and 30-year breakeven inflation rates reaching in-year lows of 2.54 per cent and 2.74 per cent respectively in early June 2005. Thereafter, breakeven inflation rates rose steadily particularly at the 10-year maturity.



<sup>23</sup> 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. It can be interpreted as a measure of inflation expectations.