

Public Sector Finance and Treasury Management Conference 2002

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Australia**



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AND TREASURY
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PROMOTING EXCELLENCE
IN FINANCIAL RISK MANAGEMENT

**The Changing Face of Public Sector
Finance and Treasury Management**

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Chief Executive, UK Debt Management Office

The Changing Face of Public Sector Finance and Treasury Management

- ◆ The UK Debt Management Office
 - principles and functions
- ◆ Recent market trends
- ◆ Issues arising
 - Governments
 - Markets
 - Treasurers



UK DMO: Headlines

- ◆ Established in April 1998 - an Agency of HM Treasury
- ◆ Corollary of interest rate setting responsibilities for the Bank of England announced in May 1997
- ◆ With the aim "...to minimise the Government's debt financing costs over the long term, taking account of risk, and manage the aggregate cash needs of the Exchequer in the most cost-effective way, while being consistent with monetary policy objectives."



The DMO's Functions

- ◆ The Government's debt manager
 - issuing gilts (and Treasury Bills), managing the gilts market
- ◆ The Government's cash manager
 - balancing the Government's daily cash flow
 - issuing T Bills; borrowing and lending (mainly secured) in the money markets
- ◆ The Government's asset manager
 - managing cash surpluses (inc from 3G licences)



Accountability

- ◆ Legally part of HMT
- ◆ Clear division of responsibilities and roles - in Framework Document
- ◆ Ministers set policy framework
 - set annual remit
 - approve Business Plan and targets
- ◆ Chief Exec accountable to Parliament for performance and expenditure
- ◆ Balancing synergies and transparency



Relationship with Bank of England

◆ Key principles

- separate debt and monetary policy responsibilities (separate operations; no inside information or policy discussions)
- [NB in UK, only a weak link between financing policies and monetary conditions; and monetary supply growth and inflation]
- separate domestic debt (DMO) and overseas reserves (Bank) management (UK does not borrow in FX for debt management reasons)

◆ Bank provides services

- settlement agent and banker, gilt registrar
- assists in end-of-day balancing processes



Relationship with Ministry of Finance (HM Treasury)

◆ Key Principles

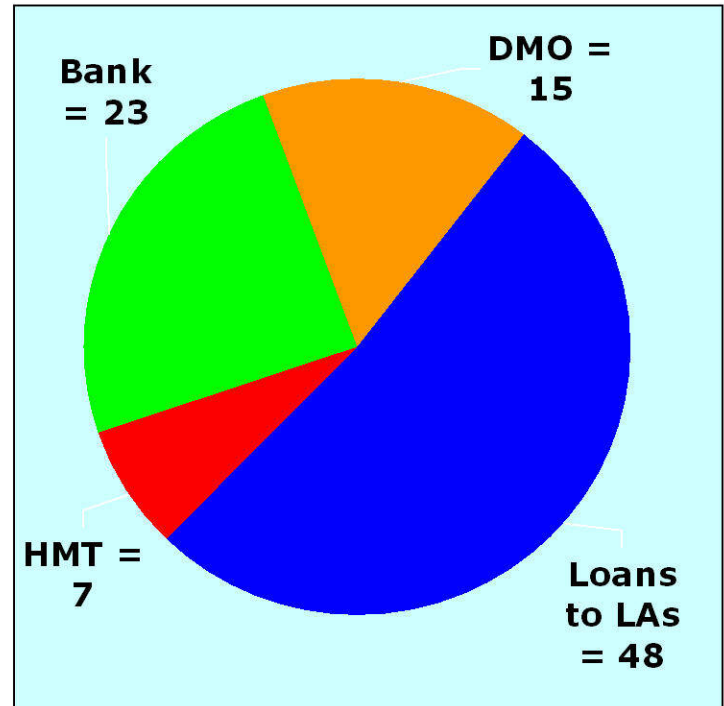
- Ministers set objectives and targets
- DMO with managerial and operational independence - for market credibility and to create centre of expertise
- DMO advises on its annual remit and portfolio objectives; but HM Treasury integrates with wider economic advice (on fiscal and balance sheet policies)



HMG Financial Assets

- ◆ DMO manages cash, holds gilts as collateral
- ◆ Bank mainly FX assets
- ◆ Local authorities substantially financed by loans from HM Treasury - cheaper and assists debt management
- ◆ LA loan function will be merged into DMO

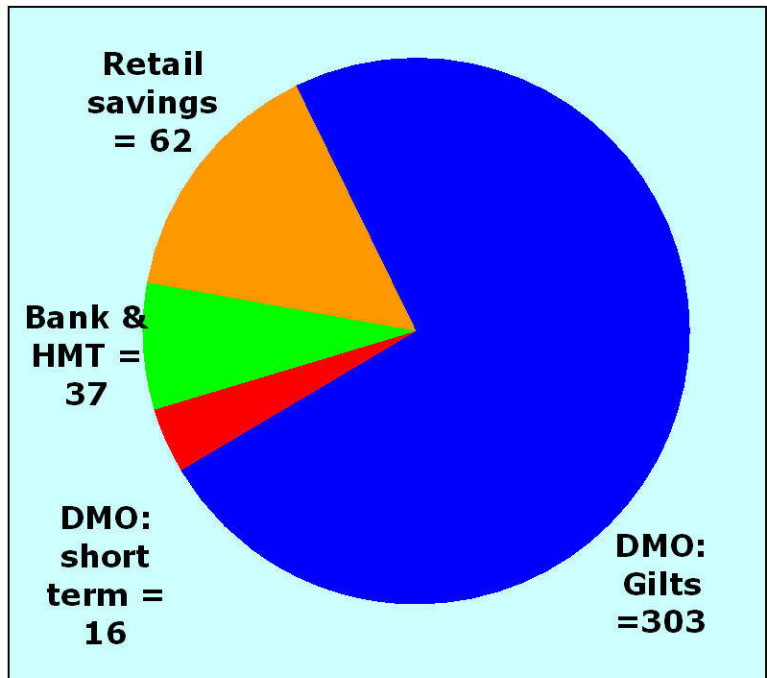
£ bn, estimated end Dec 2001



HMG Financial Liabilities

£ bn, estimated end Dec 2001

- ◆ DMO manages gilt portfolio, also repo for cash management
- ◆ Retail savings managed separately
- ◆ Bank mainly FX liabilities and lending to HMT (frozen)
- ◆ Agency concentration assists analysis



DMO: Balance Sheet Indicators

◆ Gilt Portfolio (market value, end Dec 01)

- Conventionals £ 230.7 bn
- Index Linked £ 72.1 bn (inc uplift)
- Held by DMO £ 6.7 bn
- Modified duration (total) 7.79 years

◆ Short term assets and liabilities (end Dec 01)

- Treasury Bills in Issue £11.2 bn
- other short-term liabilities (mainly repo) £ 5.2 bn
- short-term assets £7.0 bn



Balance Sheet Management

- ◆ Integrated management of HMG's balance sheet
- ◆ facilitates
 - development of balance sheet strategy - to minimise financing costs and meet commitments
 - fuller risk analysis (market, budgetary, and credit risks)
 - greater transparency (IBRD/IMF guidelines)

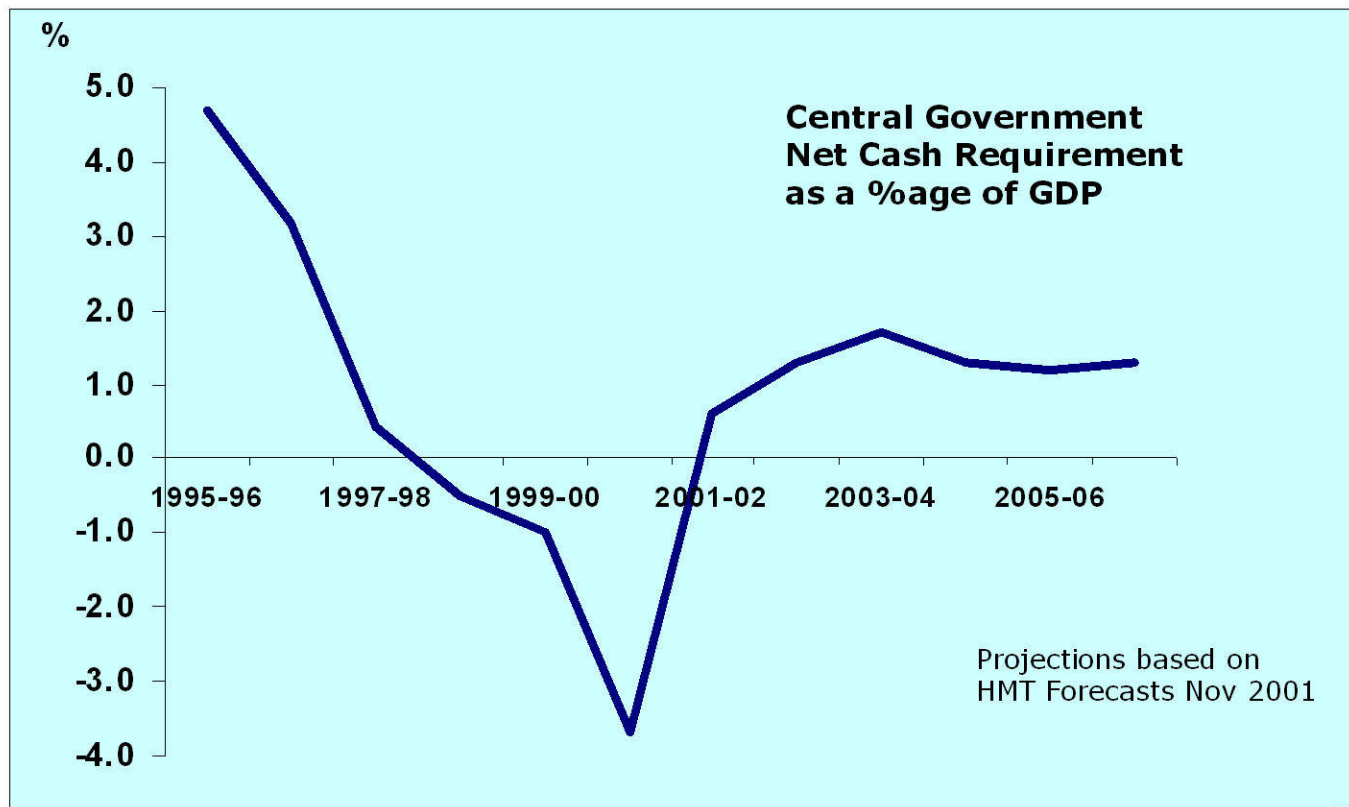


The Changing Face of Public Sector Finance and Treasury Management

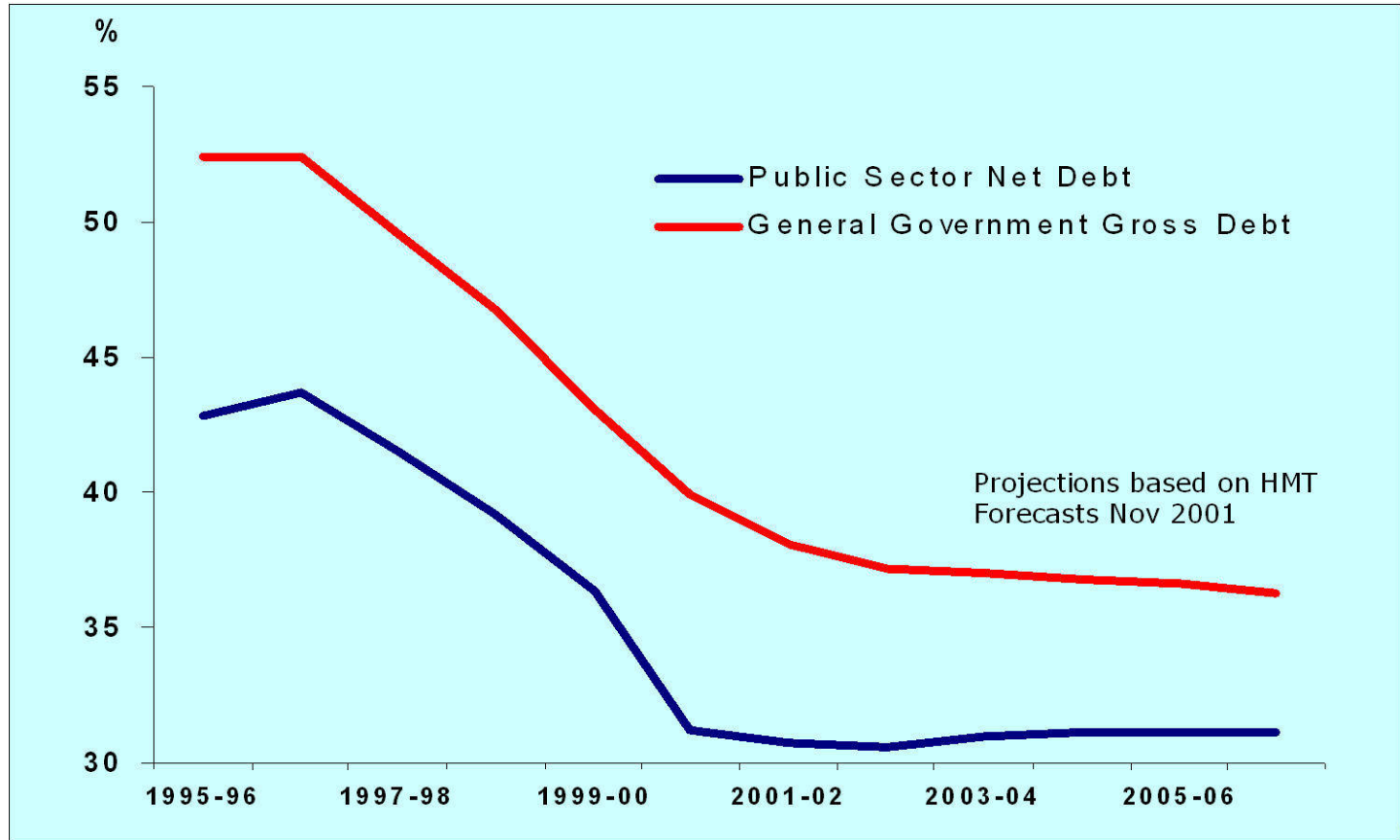
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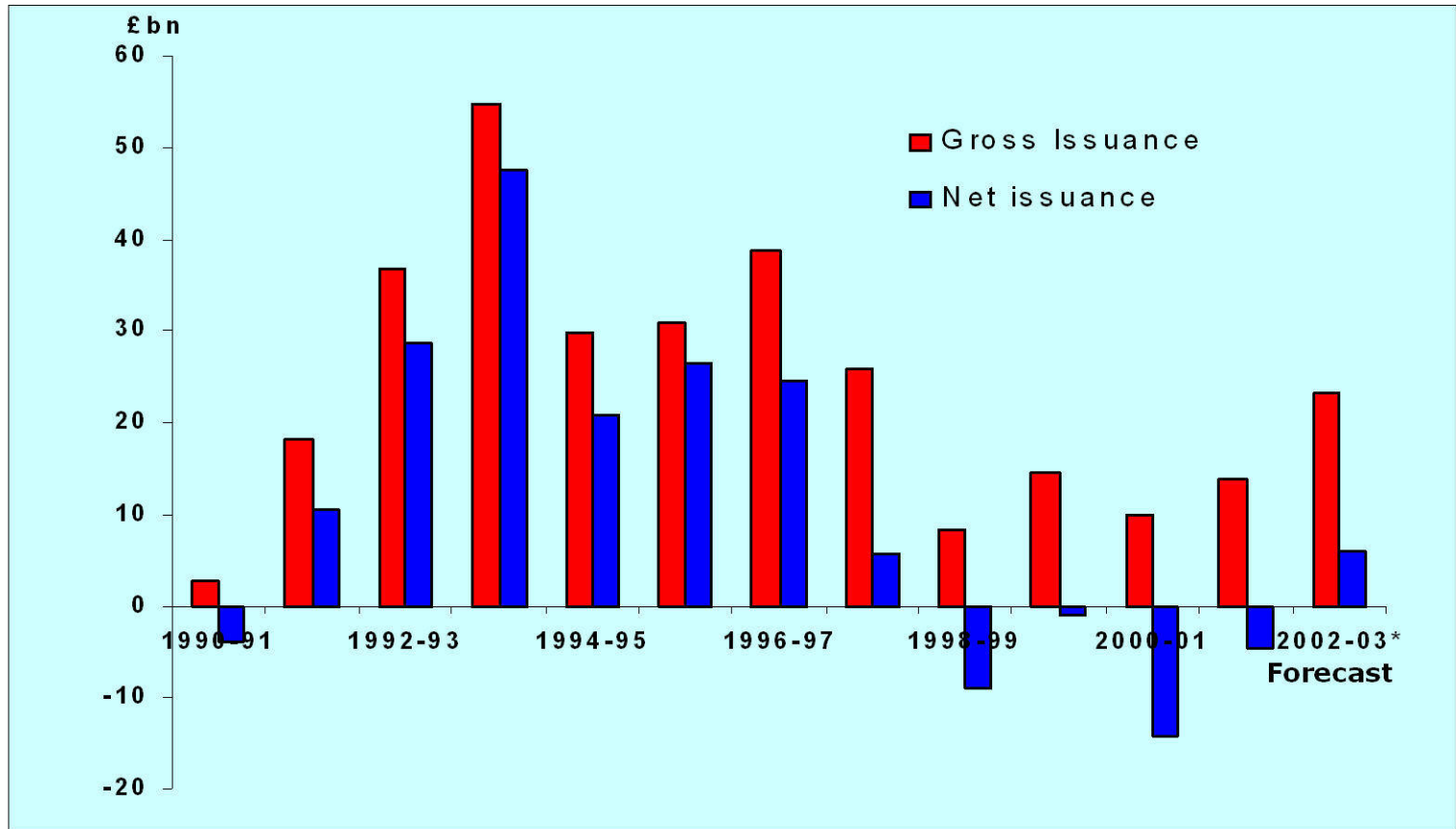
Government Borrowing Ratio



Public Sector Debt to GDP



UK: Gross and Net Gilt Issuance

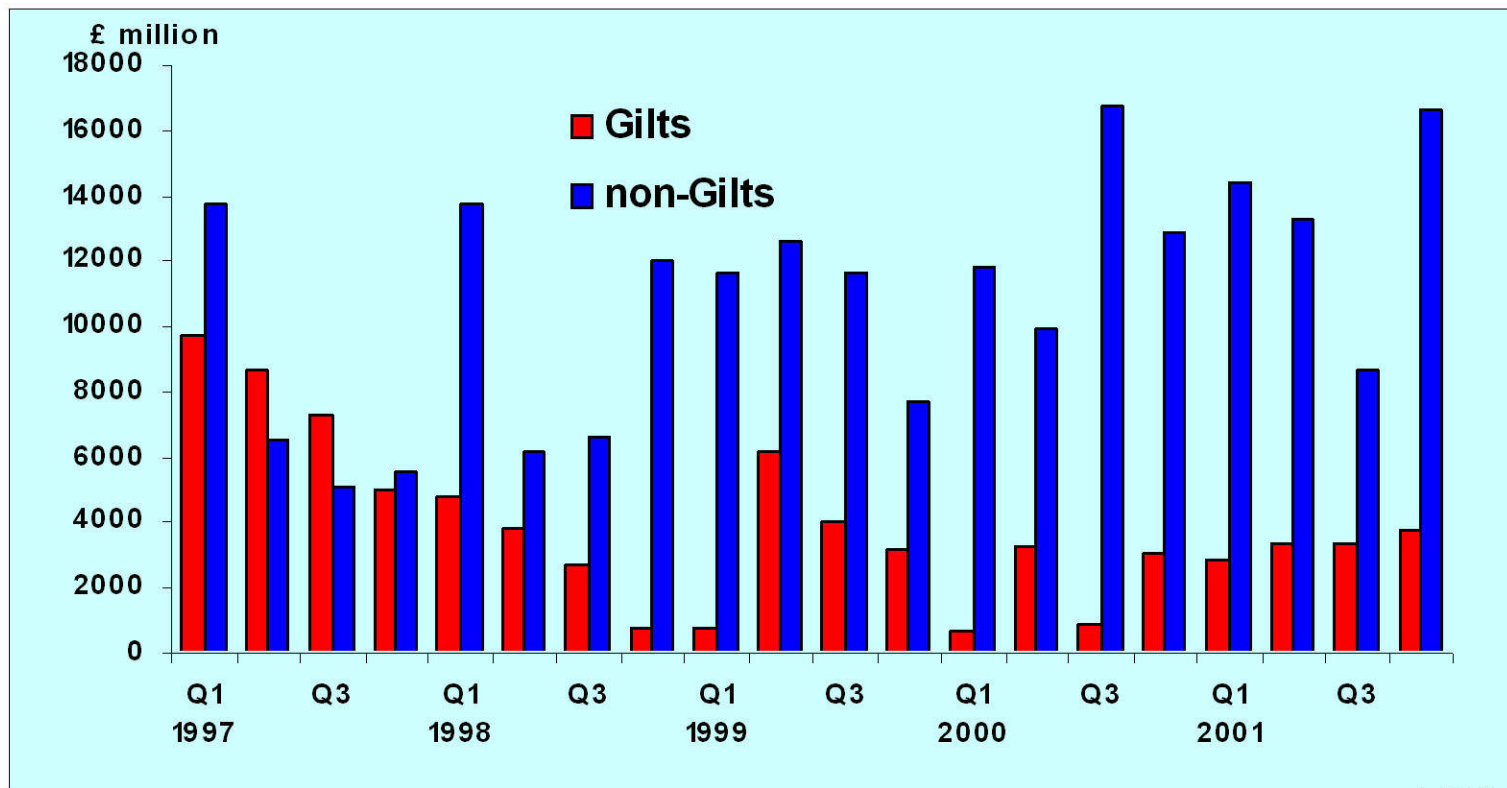


Growth of Surrogate Government Finance

- ◆ Private Finance Initiative
 - UK deals imply private sector capex c £ 20 bn - £ 3 bn plus a year
- ◆ Other public private partnerships
 - NATS, London Underground, joint ventures - DERA, Post Office
- ◆ Government Guarantees
 - Channel Tunnel Rail Link, £ 2.65 bn



Growth in non-Government sterling bond issuance



Source: Bank of England and DMO



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 - **Governments**
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 - **Treasurers**



Issues for Government's Debt Manager

- ◆ maintaining market liquidity
 - focus on benchmark stocks
 - conversions, switch auctions
 - buy-backs
- ◆ interest rate swaps to meet duration targets (not in UK)
- ◆ market dislocation (standing repo); and price distortion



Issues for Government's Asset Manager

- ◆ Identify objectives
 - smoothing (in UK, 3G-auction build up in cash to be rundown)
 - matching long term liabilities (pensions, nuclear clean up costs)
 - 'funds for future generations'
- ◆ Political benefits
 - forced saving
 - transparency gains



Problems for Government's Asset Manager

- ◆ Expertise to manage surpluses
- ◆ Increases taxpayer exposure
 - to private sector credit risk, and/or
 - to equity market, FX, other sovereigns etc
- ◆ Creates conflicts of interest
 - e.g. impact of competition or taxation policies on equity market

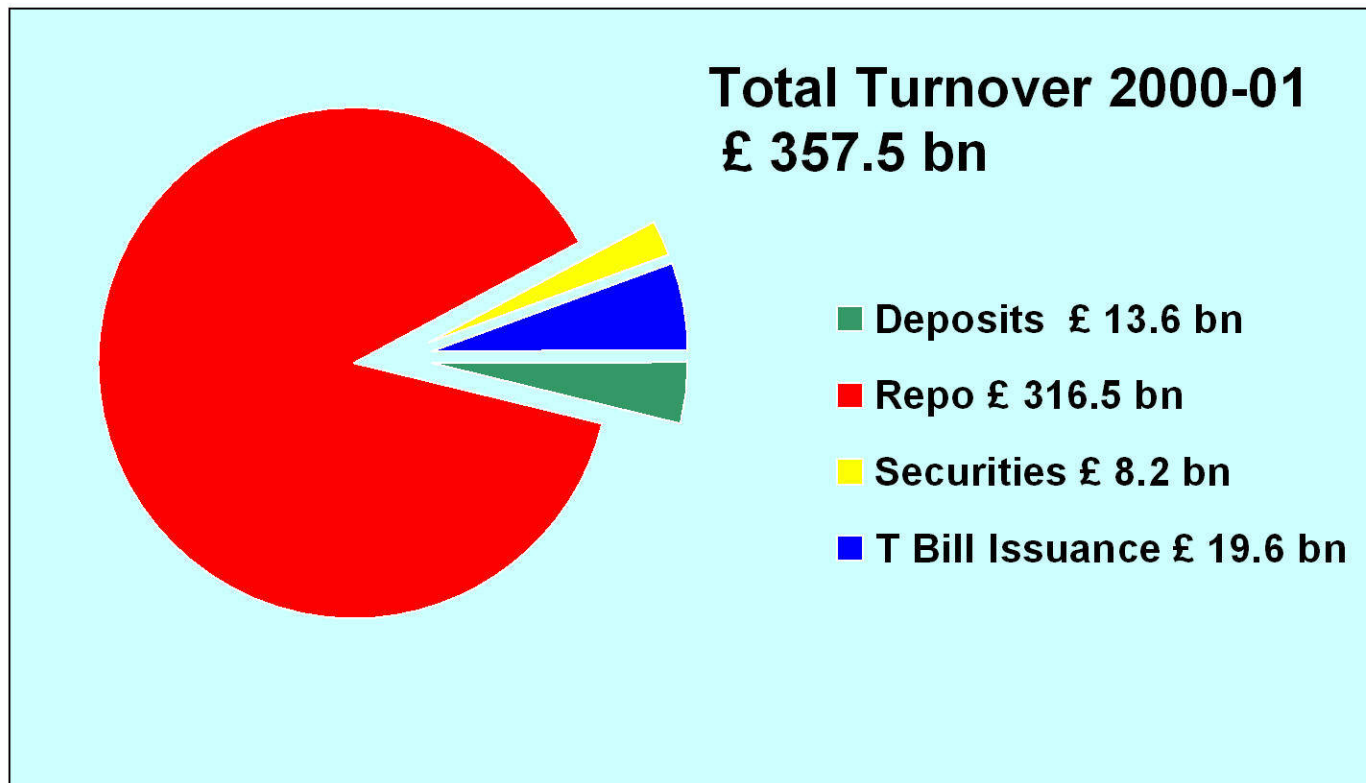


Issues for Government's Cash Manager

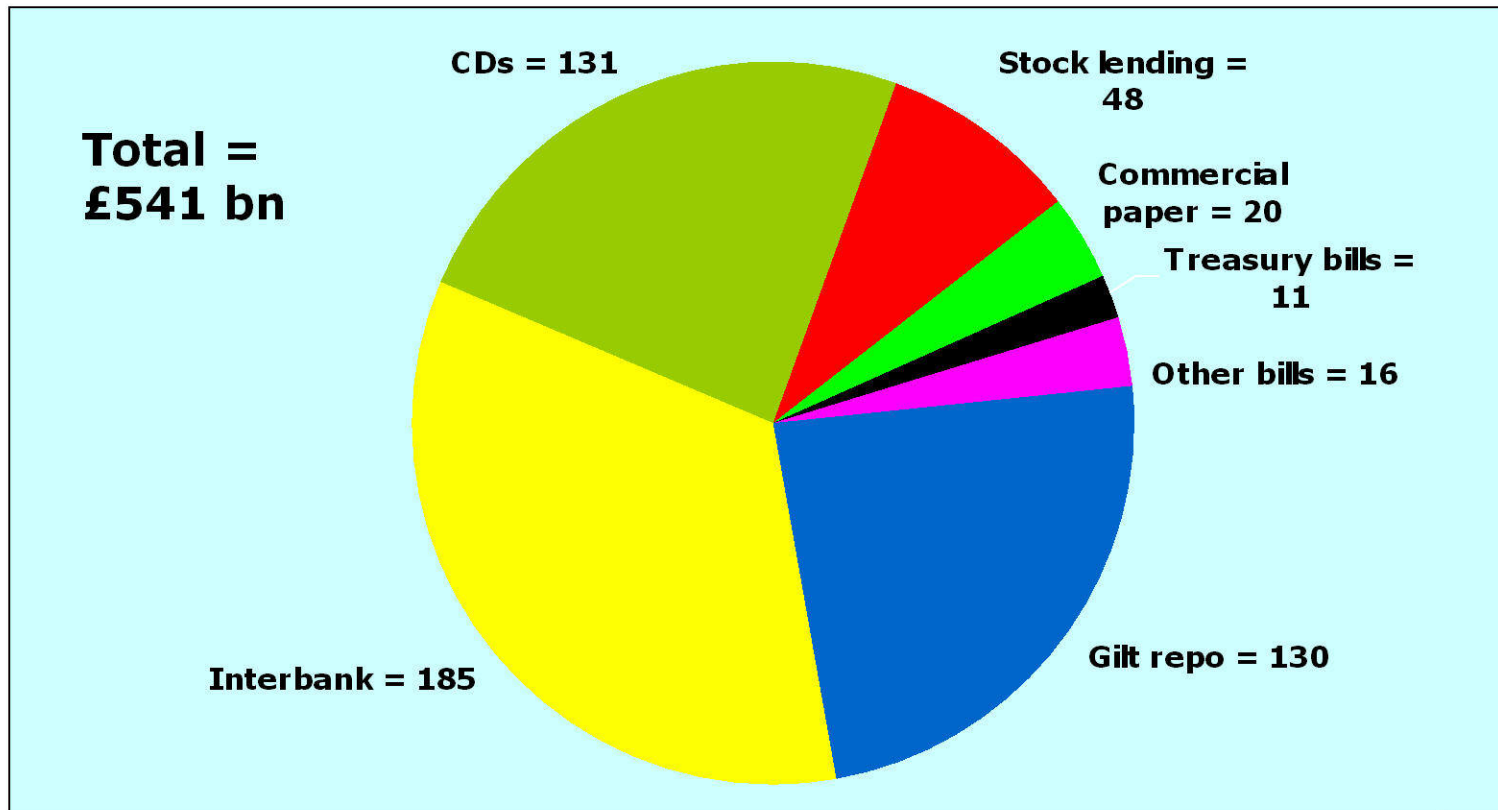
- ◆ Separation from Central Bank and Ministry of Finance
 - trading bilaterally as any other treasury
 - need for liquidity and collateral
 - lower issuance puts more pressure on gilt repo market
- ◆ In UK, growth in Treasury Bills



UK DMO: Cash Management



Sterling Money Market, £bn Dec 2001

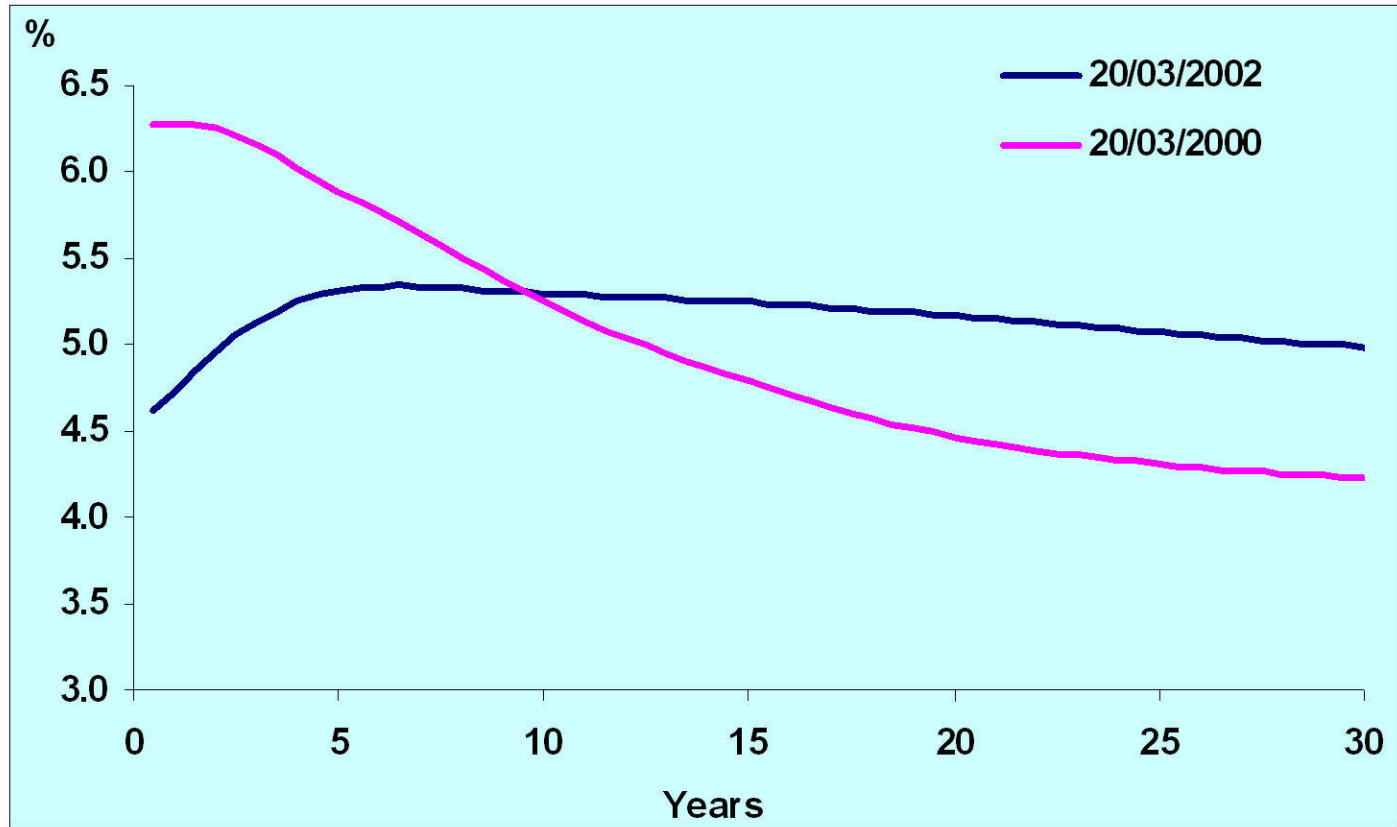


Issues for the Market

- ◆ Shortage of Government stock
 - to meet eg pension liabilities
(implies risk transfer to pensioners)
 - to provide a risk-free hedge
- ◆ Yield curve distortion
 - credit spread volatility
 - problematic using swaps as a hedge
at time of market stress



UK Gilts - par yield curve

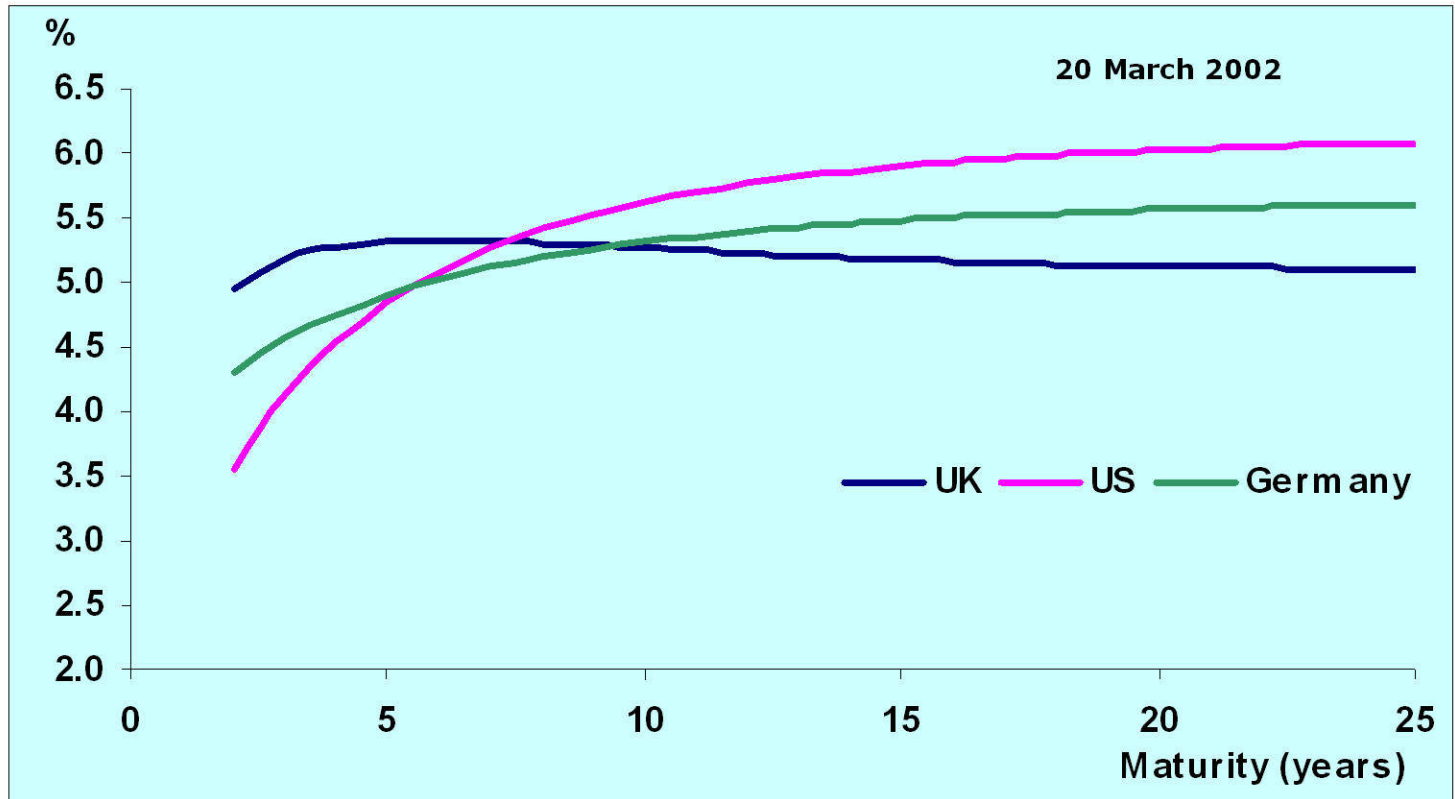


Source: DMO



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International Par Yield Curves

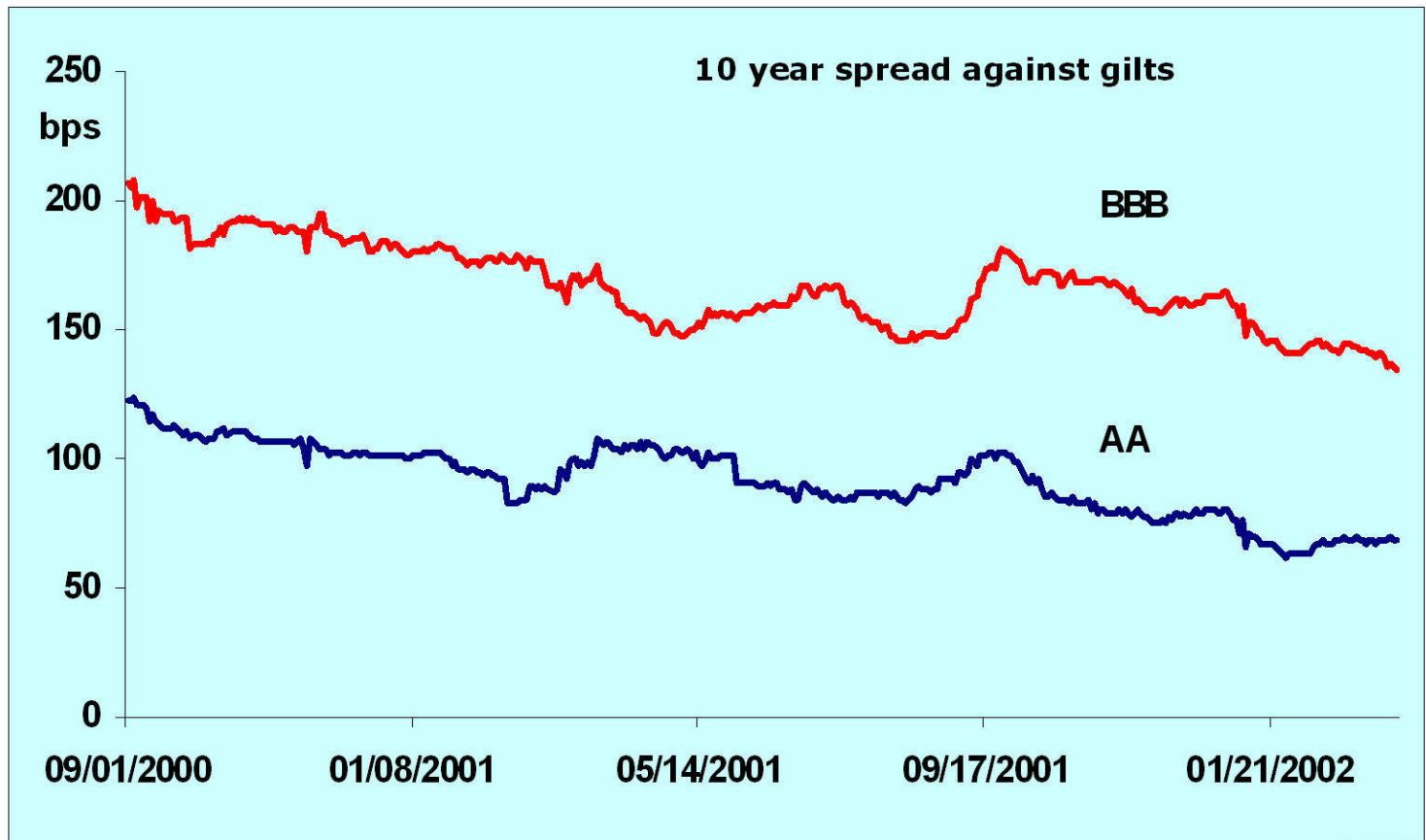


Source: Bank of England



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Sterling credit spreads



Source: Bloomberg



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Issues for Government: Micro

- ◆ PFI brings substantial benefits
 - cost savings (approaching 20%)
 - transfer of risk to private sector - who can manage it better
 - focus on whole life cost
- ◆ Provided
 - no distortion in expenditure management incentives
 - risks well monitored
 - contract well managed



Issues for Government: Macro

- ◆ Surrogate financing complicates balance sheet analysis (market risk exposure; cost risk trade-off)
- ◆ Growth in credit risk - potentially hits sovereign credit rating
- ◆ Reduction in transparency
 - guarantees, real and implied
 - guaranteed income flows
- ◆ Governments' response - control contingent liabilities, improve risk evaluation & intergenerational accounting



Issues for Treasurers

- ◆ Much more choice - among assets and liabilities
- ◆ Poor liquidity in Government markets
- ◆ Growth of money market funds
- ◆ Increased exposure to credit risks
- ◆ Debt finance attractive - but increasingly exposed to pension liabilities - and increased gearing



Issues for Debt Managers of Emerging Countries

- ◆ External investors - potentially attracted by private sector issues
- ◆ Private sector or quasi-gov agencies trailblaze - establish techniques
- ◆ But:
 - Crowding-in or Crowding-out
 - competition for time slots and liquidity
 - whose credit



Some Conclusions

- ◆ Challenges for debt offices
 - greater focus on balance sheet
 - but growth of financing surrogates mean balance sheet increasingly difficult to measure
 - reduced issuance distorts debt market
- ◆ Opens up options
 - for private sector issuers
 - for corporate treasuries
- ◆ But greater risk and volatility

