National Audit Office

Report
by the Comptroller
and Auditor General

HM Treasury

Evaluating the government balance sheet: borrowing

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Foreword

In 2015-16, public sector net debt – the government's preferred measure for reporting on the sustainability of public finances – was £1,602 billion. By comparison, in 2015-16, the Whole of Government Accounts (WGA) reported net liabilities of £1,986 billion, of which £1,261 billion related to government's stock of debt from borrowing. This debt in the WGA makes up a third of all government liabilities. It is equivalent to around £47,000 per UK household and has increased by 61% since the WGA was first published in 2009-10. The government has spent £222 billion on interest costs in this time. It must manage the debt portfolio effectively to maintain confidence in the economy, control the costs to the taxpayer and manage the risk of it becoming unsustainable in the longer term.

At the same time, the risks attached to the public finances have grown following the financial crisis and as the range and volatility of assets and liabilities that the government has to consider have increased. This has raised the challenge for HM Treasury in forecasting the government's annual borrowing needs, which is likely to remain high as the tight spending environment continues and the government's use of its balance sheet to pursue policy objectives expands. In 2016, the Comptroller and Auditor General's reports evaluating the government's balance sheet (financial assets and investments; pensions; and provisions, contingent liabilities and guarantees) highlighted how its long-term risk profile in these areas is increasing.

This report is the next in a series that explores the major risks to public finances highlighted in the government's balance sheet and how the government currently manages them. Specifically, this report sets out the broad picture of government debt and borrowing and discusses some of the risks the government has to manage in order to continue to borrow cost-effectively in the future.

Key facts

£1.3tn

of government debt recorded on the 2015-16 Whole of Government Accounts (WGA) balance sheet

£222bn

spent on debt interest costs since 2009-10

61%

increase in government debt since the first WGA in 2009-10

£1.6 trillion	2015-16 public sector net debt
£2.0 trillion	2015-16 WGA net liabilities
£47,000	2015-16 WGA government debt per UK household
£28 billion	interest cost of government debt in 2015-16
2.2%	implied interest rate on government debt in 2015-16 WGA
£47 billion	forecast central government net cash requirement for 2017-18
£80 billion	cash needed to repay the principal of gilts falling due in 2017-18

Summary

1 Despite the government's focus on reducing the budget deficit since the financial crisis, annual spending has exceeded its income for the last 15 years. This budget deficit is met through borrowing. While there are strong short-term political incentives to borrow rather than increase revenue from tax, the government has to manage the risk that the stock of debt its borrowing builds up could become unsustainable.

2 A range of public sector bodies have a role in government borrowing. As the government's economic and finance ministry, HM Treasury (the Treasury) has overall responsibility for the government's financial strategy and fiscal policy. When deciding how much the government needs to borrow, the Treasury's starting point is the Office for Budget Responsibility's (OBR's) independent economic forecasts of the public finances. The government's fiscal policy and targets for debt and borrowing are based on statistical measures reported by the Office for National Statistics (ONS).

3 The government borrows by issuing government bonds – known as gilts – through the UK Debt Management Office (DMO) to large investors in the capital markets, or by encouraging savers to invest in National Savings and Investments (NS&I) retail products such as Premium Bonds. The DMO issues gilts to the market through intermediaries known as Gilt-edged Market Makers (GEMMs) which represent some of the world's largest financial institutions. Gilts provide investors with regular interest payments and a final repayment of the amount borrowed when the bond matures. They are a secure investment as the UK government is seen as relatively low risk compared with other countries and corporations. Similarly, the government guarantees investments in NS&I products.

4 Should tax receipts fall and spending increase, these methods of borrowing provide the government with the capacity to manage budget deficits and to invest to stimulate the economy. For example, following the financial crisis, the Treasury's support to the banking sector between 2007 and 2010 included £137 billion in cash support raised through borrowing from the capital markets and £1,029 billion of guarantees.

5 The government has a significant amount of debt outstanding from financing past annual deficits. In 2015-16, public sector net debt excluding public sector banks (PSND) – the government's preferred measure for reporting on the public finances – was £1,602 billion. By comparison, in 2015-16, the Whole of Government Accounts (WGA) reported net liabilities of £1,986 billion, of which £1,261 billion was debt from borrowing.[1] This debt makes up around a third of all liabilities and is equivalent to around £47,000 per UK household. Since the WGA was first published in 2009-10, debt from borrowing as reported in the accounts has increased by 61%. In March 2017, the Treasury forecast government's cash requirement for the 2017-18 financial year was £47 billion, with a further £80 billion needed to repay the principal of gilts falling due.

6 Since 2009-10, interest on debt has cost the government £222 billion. Interest costs were £28 billion in 2015-16, implying an interest rate of 2.2%. This rate has fallen by 1.7 percentage points since 2009-10 because of lower rates on new government borrowing.

Scope of our report

7 This report is one of a series that explores the major risks to public finances highlighted in the WGA balance sheet. It follows our 2016 reports on financial assets and investments; pensions; and provisions, contingent liabilities and guarantees.[2,3,4] These reports examine how the risks to the balance sheet have changed in recent years and consider how the government currently manages them. This report sets out the broad picture of government borrowing and discusses the risks government must manage to ensure it is able to continue to borrow cost-effectively in the future. In October 2016, the Committee of Public Accounts stressed the importance of using the WGA to strengthen financial management and improve the quality of long-term decision-making.

8 Part One provides an overview of government borrowing as measured and reported in the National Accounts and the WGA. Part Two considers how the government manages borrowing alongside the rest of the balance sheet. Parts Three and Four examine in greater detail how the government borrows through the DMO and NS&I.

1 The difference in borrowing in the WGA in comparison to public sector net debt is mainly due to the elimination of debt holdings by various parts of the public sector, most notably the Bank of England through its quantitative easing programme and the Debt Management Office's holdings that are used to manage the government's short-term cash requirements. The WGA borrowing figure, therefore, represents the debt held by private sector investors, domestically and internationally.

2 Comptroller and Auditor General, HM Treasury, *Evaluating the government balance sheet: financial assets and investments*, Session 2016-17, HC 463, National Audit Office, June 2016.

3 Comptroller and Auditor General, HM Treasury, *Evaluating the government balance sheet: pensions*, Session 2016-17, HC 238, National Audit Office, June 2016.

4 Comptroller and Auditor General, HM Treasury, *Evaluating the government balance sheet: provisions, contingent liabilities and guarantees*, Session 2016-17, HC 462, National Audit Office, June 2016.

Key findings

Borrowing and debt landscape

9 **Since the financial crisis, UK government debt has been increasing in line with similar economies while UK private debt is higher.** UK government debt as a percentage of Gross Domestic Product (GDP) was 80% in 2016, according to the International Monetary Fund, compared to a range of 48–121% in other countries. The 2007-08 financial crisis showed the influence private sector debt can have on global economies; and the potential for this to impact significantly on the public finances by creating instability in financial institutions. Due to the scale of the UK's financial sector, the UK government needs to monitor the risks of private sector indebtedness carefully. In the wake of the financial crisis, the government set up an independent Financial Policy Committee (FPC). It charged the FPC with identifying, monitoring and removing or reducing system risks to protect and enhance the resilience of the UK financial system. As such, the FPC monitors the risks of private sector indebtedness to financial stability. At around 230% of GDP, UK private debt is at the upper end of the range (150–230%) in comparison to other countries (paragraphs 1.17 and 1.18).

10 **The growing number of ways to measure and report on government debt and borrowing adds complexity and these different perspectives on the public finances could reduce transparency.** The government's fiscal policy and targets for debt and borrowing are based on its preferred statistical National Accounts measures of public sector net debt (PSND) and public sector net borrowing (PSNB). However, there are further measures which serve different purposes such as public sector net financial liabilities (PSNFL) which the Treasury introduced to provide a more comprehensive view of the balance sheet. PSNFL is more complete than PSND and includes all financial assets and liabilities in the National Accounts. By comparison, WGA measures of net liabilities and net expenditure provide a broader, financial reporting view which includes the impact on the public finances of uncertain liabilities.

The government's fiscal position and the trend over time varies depending on which measure is used. For example:

- Although they follow a similar trend, PSND rose by 59% between 2009-10 and 2015-16; and PSNFL increased more steeply and by 71%, because the value of the government's investments in Lloyds Bank, the Royal Bank of Scotland and its mortgage loans reflected in PSNFL decreased over this period.
- WGA net liabilities and net expenditure tend to be higher than their PSND and PSNB equivalents because they include uncertain future liabilities such as public sector pensions and provisions. In 2015-16, there was a £384 billion difference between net liabilities and PSND. Net liabilities also rose more sharply than PSND or PSNFL between 2009-10 and 2015-16, mainly because of significant increases in public sector pension liabilities (26% increase); and provisions (200% increase).
- Changes in the estimates of these uncertain liabilities mean that, whereas PSNB has fallen steadily since 2009-10, net expenditure has fluctuated. Changes in the discount rate used to value liabilities have had the most significant impact on net expenditure. In 2015-16, net expenditure increased by £125 billion, as a result.

The Committee of Public Accounts has recommended that the Treasury uses the WGA to provide clarity on how the government uses different sources of information to manage public finances and the impact this has on the WGA balance sheet (paragraphs 1.5 to 1.11).

Managing risks associated with borrowing

11 The process for managing the government's borrowing needs is well established with clearly defined roles and a separation of responsibilities, which provide a good level of challenge. The Treasury is responsible for public spending, financial services policy, strategic oversight of the UK tax system and ensuring sustainable economic growth. It has ultimate responsibility for managing borrowing risks. In advance of fiscal events, such as the Budget and Autumn Statement, the Treasury decides how much the government needs to borrow, and works closely with the DMO and NS&I to decide how best to do this. Once instructed by the Treasury, the DMO and NS&I are tasked with delivering their respective remits, overseen by the Treasury's Debt and Reserves Management team (paragraphs 2.2 to 2.7).

12 **To maintain a predictable and transparent approach to borrowing, the government needs to adjust how it communicates the impact of changes in forecasts following its move to one fiscal event.** In November 2016, the Chancellor announced that he was abolishing the Autumn Statement and moving to one fiscal event, the Autumn Budget, in 2017. Although the OBR will still produce biannual forecasts and the Treasury will respond to them, the Treasury is working through how and when it will communicate changes under this revised framework (paragraphs 2.5 and 3.11).

13 **The government has to manage a range of risks and uncertainty around its revenue and spending, which have a considerable impact on borrowing levels.** As the OBR highlights, tax revenue is particularly affected by economic growth. Further, structural changes in the employment market, including a rising trend towards individuals paying tax through personal companies; and reductions in the rate of corporation tax, mean tax revenues may fall in the future. Spending may also be greater than expected if, for example, delays to the delivery of welfare reform mean that expected savings are not achieved (paragraphs 2.8 to 2.10).

14 **Changes to government policies can cause borrowing needs to differ significantly from forecasts.** For example, in the 2016 Autumn Statement, the Treasury asked the DMO to raise a further £21 billion over the last quarter of 2016-17, equivalent to a 16% increase on its original remit, due to delays in planned asset sales set out in the 2016 March Budget. This illustrates the challenge the government faces in managing its asset portfolio and predicting the timing and impact of cash raised from sales. While the DMO has always met its remit, changes in year can make achieving it more difficult if it has to raise the cash within a short time frame and if the market is not expecting a significant change in the volume and type of gilts on offer (paragraph 3.11).

15 **Managing the public finances has become more difficult since the financial crisis and as the government has used its balance sheet to pursue its policy objectives.** As a result, the range and complexity of assets and liabilities that the government has to manage alongside its spending commitments have increased. The Comptroller and Auditor General's 2016 reports on financial assets; pensions; and provisions, contingent liabilities and guarantees highlighted how the government's long-term risk profile is increasing. The scale and concentration of the government's assets in the banking, housing and student finance sectors expose asset values to volatility in the economy. Inherent difficulties in measuring some of these assets and liabilities and their impact on cash flows, along with the challenges of estimating the likelihood and timing of liabilities crystallising, make it more difficult for the government to forecast its borrowing needs accurately. At the same time, delays to large financial asset sales or the profile of contingent liabilities, which may crystallise in the event of an economic shock, could mean significant increases in the government's borrowing needs (paragraphs 2.11 to 2.18).

16 The Treasury has begun to strengthen its approach to analysing the government's balance sheet and evaluating fiscal risk. However, the work is at an early stage and not yet sufficiently embedded to provide the Treasury with a common view of risk to inform its decision-making. In response to recommendations from the Committee of Public Accounts, the International Monetary Fund (IMF) and the National Audit Office (NAO), the Treasury has increased its resources for analysing the government's balance sheet. Since late 2016, it has:

- Created a fiscal risks analysis branch to develop its fiscal risk model, and to stress test the impact of economic variables (such as inflation) on headline fiscal measures. This analysis will feed into the Fiscal Risk Group's (FRG) existing monitoring. The branch will also respond to the OBR's first biennial report on fiscal risks published in July 2017. The branch needs to remain aware of the concentrated risks that the UK carries in relation to its financial sector, which drove the significant increase in borrowing following the past financial crisis.
- Set up a new balance sheet analysis branch which brings together analysis previously carried out by the Treasury's public spending, financial stability and finance teams to support the newly-established Balance Sheet Group, FRG and executive management board's view of risk. The branch reports its analysis to the Balance Sheet Group on a quarterly basis and to the Fiscal Risk Group when required. At the time of our review, the branch was yet to develop the indicators it would use for routinely reporting changes in balance sheet risk.
- Strengthened its budgetary and approvals process around contingent liabilities, increasing the central oversight and risk monitoring of new liabilities. Twenty four new contingent liabilities have gone through the revised process so far (paragraphs 2.19 to 2.21).

Borrowing through the Debt Management Office

17 To date, the government has successfully balanced its preferred structure and profile for borrowing with investor demand at a time when the cost of borrowing has remained low. Against a backdrop of historically low interest rates, the government has lengthened the average maturity of gilts, extending the period of time before it must refinance the portfolio (paragraph 3.15 and Figures 13 and 15).

18 The government's exposure to inflation risk is affected by the proportion and maturity profile of the index-linked portfolio. The proportion of index-linked gilts in the gilt portfolio has grown from 24% in March 2009 to 26% in March 2017. If gilts currently held by the Bank of England are excluded, the proportion of index-linked gilts increased to 34% in March 2017. The government bears the inflation risk on index-linked gilts and the government is exposed to greater interest costs should inflation rise. Higher average maturities on index-linked gilts (around 21 years compared to 14 years for conventional gilts) mean the government is exposed to this risk for longer than the rest of the portfolio. This is balanced by their lower initial costs to government; and the inflation protection provided by conventional gilts (paragraph 3.16 and Figure 15).

19 The rising proportion of index-linked gilts has the potential to increase the risks to the public finances from inflation. The OBR forecasts that the direct impact of a 1% increase in Retail Prices Index inflation will increase debt interest costs by £26 billion between 2016-17 and 2020-21. The DMO's analysis shows that if inflation remained constant at 3.5% or above over the bond's life, index-linked gilts may be less cost effective than equivalent maturity conventional gilts. However, the Bank of England's role in maintaining price stability by targeting a level of 2% inflation over the medium term limits the risk to the government of high interest costs on its index-linked debt (paragraphs 3.14 to 3.17, Figures 15 and 16).

20 The DMO responded successfully to signs that the Gilt-edged Market Makers' (GEMMs) capacity to hold gilts may be decreasing. The GEMMs face conflicting pressures in their role as intermediaries for the DMO. They must meet the demands of their shareholders and banking regulators. As intermediaries, GEMMs deploy regulatory capital and take on risk, as gilts must be held on their balance sheet before being sold on to investors. Changes to the regulatory regime since the financial crisis have increased the capital requirements for GEMMs of holding assets on their balance sheet, potentially limiting their capacity to absorb gilts before distributing them to the market. The average annual bid-to-cover ratio for gilt auctions – one indicator of demand for gilts on offer at auction – fell between 2009-10 and 2015-16. In response, in 2016-17, the DMO reduced the size of its auctions and held them more regularly, allowing GEMMs to manage their capital more efficiently and bringing the bid-to-cover ratio back up to around 2009-10 levels (paragraphs 3.12 and 3.13).

21 Changes in the distribution of investors who hold gilts creates risks for the Treasury and the DMO. The Bank of England holds over a quarter of all gilts in issue as part of its quantitative easing programme. It has purchased £435 billion of gilts since the programme began in 2009. The Bank's Monetary Policy Committee (MPC) has indicated that it will consider reducing the stock of purchased assets after the Bank Rate reaches a level from which it can be materially cut. In 2015, the MPC expected that level to be around 2%. While this is a policy decision for the MPC, it has stated its intention to liaise with the DMO on operational details to mitigate the risk of disruption to gilt market conditions. Over a quarter of gilts in issue are held by overseas investors, who may be sensitive to the risk of movement in exchange rates. Uncertainty about exchange rate movements and the UK's exit from the European Union may directly affect the appetite of overseas investors to invest in gilts in future years (paragraphs 3.18 to 3.20).

Borrowing through National Savings and Investments

22 NS&I gives the government flexibility, by providing an alternative source of cost-effective borrowing to gilts. NS&I continues to meet its remit while keeping running costs low. Nonetheless, NS&I's measure of cost-effectiveness, the Value Indicator, has fallen in recent years from £1.4 billion in 2009-10 to £74 million in 2016-17.[5] This is largely due to government bond rates falling faster than NS&I product rates (paragraphs 4.7 and 4.13).

5 National Savings and Investments Value Indicator compares the cost of borrowing through NS&I with that of issuing gilts

23 **Some NS&I products are introduced by the Treasury to support government policy.** For example, the government launched 65+ Guaranteed Growth Bonds in 2015 to encourage pensioners to save by offering a return above the market rate. In 2014-15, NS&I raised £3 billion more than its debt remit which it attributes to the removal of the cap on the amount of 65+ Guaranteed Growth Bonds that it could offer, as well as an increase in the Premium Bonds investment limit. The rates of return on these products can be significantly higher than similar products in the market and other methods of government borrowing. Such products are excluded from NS&I's Value Indicator target because they have policy objectives beyond raising funds for the government, although the potential cost implications are set out alongside the relevant fiscal event (paragraphs 4.6, 4.11 and 4.13 to 4.17).

Concluding remarks

24 The Treasury, DMO and NS&I have responded to the government's need to increase borrowing since the financial crisis and have done so at a relatively low cost. The division of responsibilities between the Treasury, the DMO and NS&I is effective and long standing; and provides a well structured approach with a good level of challenge. The expertise, knowledge and flexibility offered by the DMO and NS&I will be essential in responding to changes in market demand for borrowing. This is particularly important given the level of uncertainty in the public finances arising from the UK's exit from the European Union and in the eventual unwinding of the quantitative easing programme.

25 The Treasury, DMO and NS&I have so far succeeded in a challenging environment. However, as the risks attached to the public finances have increased and the government's balance sheet becomes increasingly volatile, its approach to forecasting its cash and borrowing needs will require greater sensitivity to manage the ongoing budget deficits alongside its investments and uncertain liabilities. The Treasury is responding to this by building its understanding and analysis of the government's balance sheet and by working with the OBR to improve its oversight and analysis of fiscal risk. The Treasury has taken steps to increase its resources and oversight arrangements around balance sheet and fiscal risk analysis, but the effectiveness of its approach will not be clear until the economic cycle is complete. It will be important that this approach is joined-up with its spending controls and cash and debt management functions, making greater use of the information available at each level, and providing a common view of risk upon which to base fiscal decisions. The government's reporting on its balance sheet, including its debt and borrowing, needs to be transparent to enable Parliament and taxpayers to understand and challenge the public finances appropriately.

Recommendations

26 This landscape report has highlighted a number of issues with the government's approach to managing borrowing:

Reporting on the public finances

a **The government should ensure that its reports on the public finances aid transparency and focus on the needs of Parliament and taxpayers.** This should include explaining in simple terms the range of measures that the government uses for different purposes and the rationale for its preferred measures. It will be important for the Treasury to use the available measures consistently and outline the main differences between them to aid transparency and the public's understanding of its approach to managing the public finances.

b **The government should use its new measure – public sector net financial liabilities (PSNFL) – to inform its management of the balance sheet and its approach to asset sales, in particular.** PSNFL provides a more nuanced view of the government's indebtedness as it includes assets that may generate cash through sales into the future. This will provide increased focus within the Treasury on its approach to managing its asset portfolio, and should be supported by a strategic overview of its approach to managing its legacy from the financial crisis and those assets that are being generated currently, such as student loans.

Managing risks to borrowing

c **The Treasury should integrate its analysis of the government's balance sheet and fiscal risk with departments' and Treasury spending teams' oversight functions and the independent assurance provided by the OBR.** It is important that the Treasury's newly established analysis and oversight functions are embedded in the routine business of its spending teams as well as departments which form the first lines of defence in managing balance sheet risk. The Treasury should set out clearly the respective roles and responsibilities for identifying and reporting new or changing risks to the balance sheet. Doing so, will help to ensure that it has a common view of the risks it needs to manage and that the mechanisms becomes embedded in its control framework as the economic cycle unfolds.

d **The government should align its policy announcements with its balance sheet oversight and borrowing needs.** With the move to one fiscal event, the government will need to ensure that it maintains its predictable and transparent approach to debt issuance. The Treasury's approach to raising cash from assets is particularly important in this context.

e **When assessing the composition of the debt portfolio, the Treasury and the DMO should consider whether the proportion of index-linked and conventional gilts is appropriate given the government's appetite for inflation risk and affordability.** The government will need to balance continued market demand for index-linked gilts against the shift in risks to public finances that a sustained increase in them could represent. A continued increase in the proportion of index-linked gilts will raise the government's exposure to higher debt interest costs when inflation is above market expectations.

f **Consistent with the MPC's statements, the Bank of England should liaise closely with the DMO when carrying out market operations to reduce the stock of assets held under the quantitative easing programme.** This will require effective coordination to mitigate the risk of disruption to gilt market conditions.

g **When developing future NS&I products with specific policy objectives, the government should design and introduce them in a way which ensures value for money for taxpayers.** In doing so, the focus should be on striking an appropriate balance between ensuring that such products meet government's wider policy aims and represent value for money.