National Audit Office

Report
by the Comptroller
and Auditor General

HM Treasury

Evaluating the government balance sheet: borrowing

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National Audit Office

HM Treasury

Evaluating the government balance sheet: borrowing

Report by the Comptroller and Auditor General

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National Audit Office

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This report examines government borrowing and debt in the Whole of Government Accounts (WGA), the associated risks and benefits to the UK's public finances and how the government manages its debt.

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Contents

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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.

Part One

Borrowing landscape

1.1 In the long term, the government must have enough cash to meet its spending commitments. The government raises most of the cash it needs through taxation; and other income, such as fees and charges. For the last 15 years, the government's annual spending has exceeded its income.[6] The government funds this budget deficit through borrowing. Although there are strong short-term political incentives to borrow rather than increase revenues from tax, the government has to manage the risk that the debt it builds up could become unsustainable in the longer term.

1.2 The government borrows from large investors in the capital markets, such as investment and pension funds, as well as directly from retail investors. It mainly does this by issuing government bonds through the UK Debt Management Office (DMO) or by encouraging savers to invest in National Savings and Investments (NS&I) products. Government bonds, known as gilts, promise the investor regular interest payments and a final repayment of the sum borrowed when the bond expires. Gilts are a secure investment as the UK government is seen as relatively low risk compared with other countries and corporations. This is due to its strong reputation and its ability to raise taxes. Similarly, investors in NS&I products are protected by a government guarantee with no upper limit (whereas deposits with other UK regulated financial institutions are guaranteed up to £85,000 under the Financial Services Compensation Scheme).

1.3 The government's ability to borrow in this way gives it the flexibility to support the economy, particularly if tax receipts fall and spending increases. The government may choose to borrow both to offset this increase in net expenditure, and to provide industry with investment to stimulate the economy. Between 2007 and 2010, HM Treasury (the Treasury) made a series of large financial interventions to support the banking sector. These included £137 billion in cash support raised through borrowing from the capital markets, as well as guarantees to UK banks of £1,029 billion.[7]

1.4 This part provides an overview of government borrowing and debt as measured and reported in the National Accounts and the Whole of Government Accounts (WGA). Part Two considers how the government manages its debt 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.

6 Based on public sector net borrowing reported by the Office for National Statistics.
7 Office for Budget Responsibility, *Economic and fiscal outlook*, March 2017.

How the government measures borrowing and debt

1.5 The government's fiscal policy and targets for borrowing and debt are based on statistical measures reported in the Office for National Statistics' (ONS) annual National Accounts and in its monthly bulletin on public sector finances. To help measure progress against its fiscal policy objective to "return the public finances to balance at the earliest possible date in the next Parliament", the government has:[8]

- a target to reduce cyclically-adjusted public sector net borrowing (PSNB) to below 2% of GDP by 2020-21;[9] and
- a target for public sector net debt (PSND) as a percentage of GDP to be falling in 2020-21.[10]

1.6 In the 2016 Autumn Statement, the Chancellor introduced two further fiscal measures with the aim of providing a more complete picture of the public sector balance sheet:[11]

- PSND excluding assets and liabilities held by the Bank of England (PSND ex BoE); and
- public sector net financial liabilities (PSNFL), which is a broader measure that includes all financial assets and liabilities in the National Accounts.

1.7 When considering PSNB and PSND, the Treasury, ONS and Office for Budget Responsibility (OBR) strip out the effects of the government's financial interventions in the banks following the financial crisis. **Figure 1** overleaf shows that, although PSNB has been falling each year since 2009-10, funding an annual deficit has added to PSND and PSNFL, which have increased by 59% and 71% respectively over the same period. Although the debt position on PSNFL follows a similar pattern to PSND, it has risen more steeply as the value of the government's investments in Lloyds Bank, the Royal Bank of Scotland and its mortgage loans have reduced. Including all financial assets means PSNFL is £140 billion lower than PSND as at 31 March 2016.

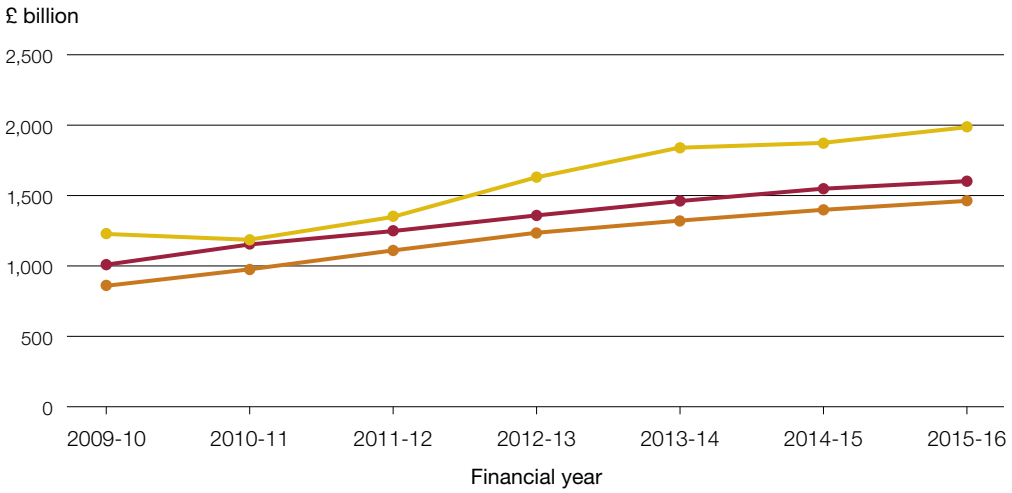
1.8 By comparison, the WGA provides a financial reporting view of the current deficit and overall debt. The WGA was first published for the 2009-10 financial year and now consolidates the accounts of over 6,000 organisations across the public sector to produce an accounts-based picture of the UK's public finances.[12] There is no more complete record of what the government owes, spends and receives.[13] In 2015-16, the WGA reported net liabilities of £1,986 billion and net expenditure of £244 billion.[14] Appendix Two provides a more detailed comparison of the WGA and National Accounts' measures.

8 HM Treasury, *Charter for Budget Responsibility: autumn 2016 update*, January 2017.
9 This is a measure of government's annual borrowing, and is the difference between current expenditure and receipts. Its financial reporting equivalent is 'net expenditure'.
10 This is a measure of the amount the government owes less liquid assets such as cash. Its financial reporting equivalent is 'net liabilities'.
11 HM Treasury, *Autumn Statement 2016*, Cm 9362, November 2016.
12 HM Treasury, *Whole of Government Accounts: year ended 31 March 2016*, HC 254, July 2017.
13 The WGA includes future liabilities such as public service pensions and provisions but, in line with accounting standards, does not reflect assets such as tax income which may be received in future years.
14 See footnote 13.

Figure 1

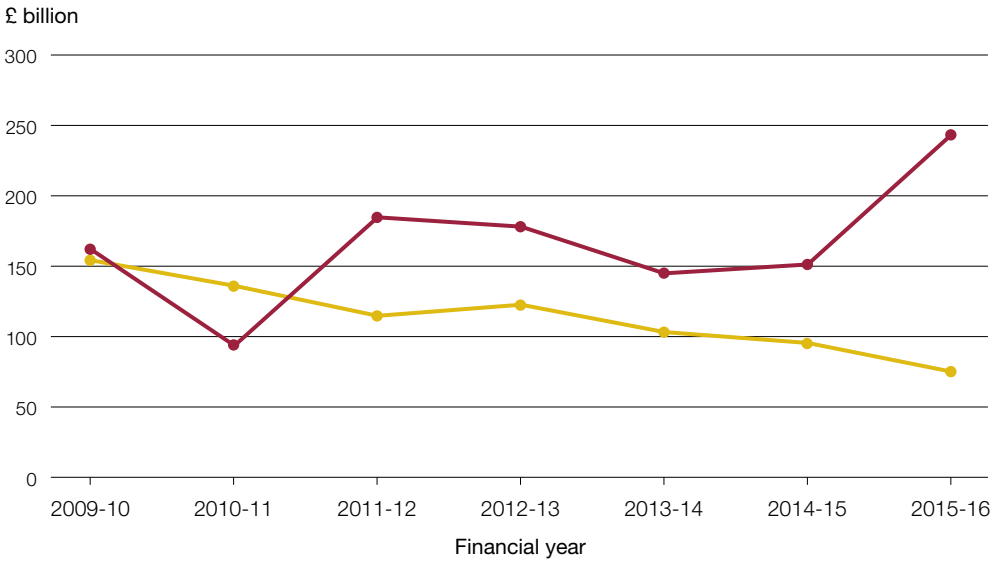
Comparability of financial reporting and statistical measures

The gap between net liabilities and PSND increases over time, in part due to growing uncertain liabilities that are reflected in the WGA



	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
PSND	1,007	1,152	1,247	1,358	1,460	1,548	1,602
WGA net liabilities	1,228	1,186	1,347	1,628	1,841	1,875	1,986
PSNFL	857	975	1,108	1,235	1,321	1,398	1,462

Financial reporting adjustments have affected the comparability of expenditure measures



	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
WGA net expenditure	163	94	185	179	146	152	244
PSNB	155	137	116	123	104	96	76

Note

1 Public sector net debt (PSND), public sector net borrowing (PSNB) and public sector net financial liabilities (PSNFL) shown here exclude the impact of the government's financial interventions following the financial crisis, such as its investment in Lloyds Bank and the Royal Bank of Scotland.

Source: National Audit Office analysis of Whole of Government Accounts and Office for National Statistics information

1.9 These WGA measures are broader in scope than the National Accounts statistics. Because they reflect the impact of uncertain liabilities, net liabilities and net expenditure are consistently higher than their PSND and PSNB equivalents (Figure 1). In 2015-16, there was a £384 billion difference between PSND and the WGA's net liabilities. As Figure 1 shows, net liabilities in WGA also increased more than PSND or PSNFL since 2009-10 because, unlike the other measures, it includes the following liabilities which increased significantly over the period:

- public sector pensions of £1,425 billion (26% increase since 2009-10); and
- provisions of £306 billion that the government is likely to have to pay out in the future but where the amount or timing of the payment is uncertain (200% increase since 2009-10).[15]

1.10 Similarly, net expenditure in the WGA will reflect changes in the estimates of these future liabilities, such as the discount rates used to value them in today's prices. Whereas PSNB has fallen steadily since 2009-10, net expenditure has fluctuated considerably over this time. In 2010-11, a one-off adjustment to change the index applied to pensions in part caused net expenditure to fall by 42% compared to the previous year. In 2015-16, the Treasury adopted a new methodology for calculating discount rates which reflect the government's low borrowing costs. For example, the rate applied to long-term provisions in 2015-16 changed from 2.2% to -0.8%. Changes in the discount rate caused a £125 billion increase in net expenditure in 2015-16.

1.11 Although the WGA sets out the key differences between these measures, the Committee of Public Accounts has recommended that the Treasury finds a way in the WGA to provide clarity about how the government uses different sources of information to manage public finances and the impact this has on the WGA balance sheet.[16]

15 Net liabilities also includes assets which are excluded from public sector net debt. Appendix Two provides more detail.
16 HC Committee of Public Accounts, *The Government Balance Sheet*, Nineteenth Report of Session 2016-17, HC 485, October 2016.

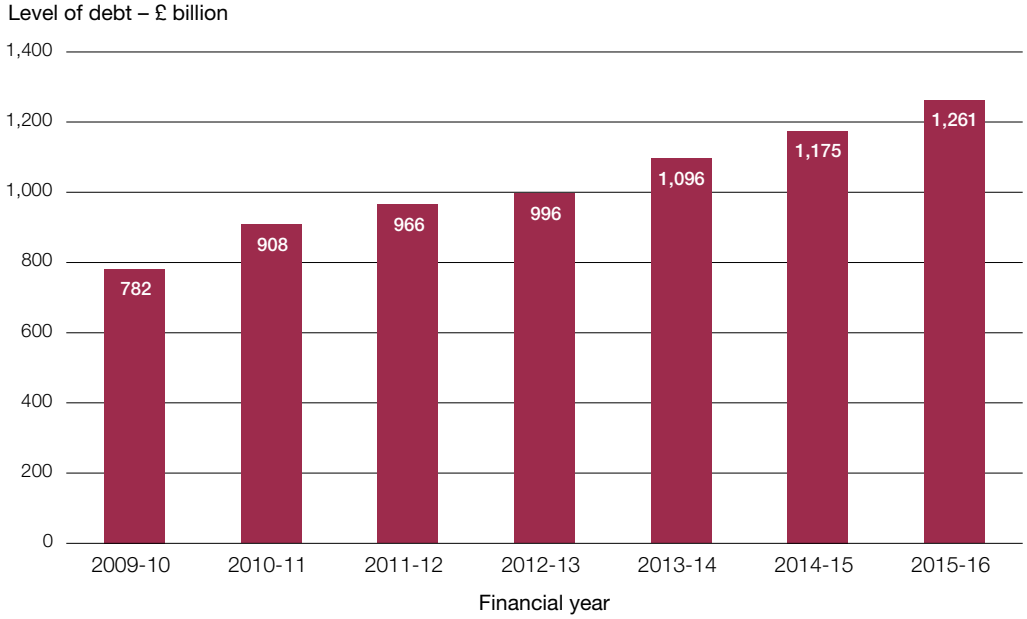
Overview of borrowing in the WGA

1.12 As the 2015-16 WGA shows, the government has a significant amount of debt as a result of borrowing to fund budget deficits each year (**Figure 2**). At 31 March 2016, government debt totalled £1,261 billion, equivalent to a third of all government liabilities (**Figure 3**) and around £47,000 per UK household.[17] Over the last six years, the stock of debt has increased by 61%, from £782 billion in 2009-10. In addition, the debt at 31 March 2016:

- was the second-largest liability on the balance sheet after the net public sector pension liability (£1,425 billion);
- increased by £86 billion, mainly due to new government bonds issued (£62 billion) and further saving through NS&I (£11 billion);
- was equivalent to 72% of the government's total assets (£1,743 billion); and
- cost around £28 billion in interest, representing 4% of total government expenditure (before financing).

Figure 2
Growth in debt since 2009-10

Between 2009-10 and 2015-16 the stock of government debt has increased by 61%



Note
1 This reflects 'government borrowing and financing' in the WGA. In 2015-16, debt made up one-third of gross liabilities recognised in the WGA.

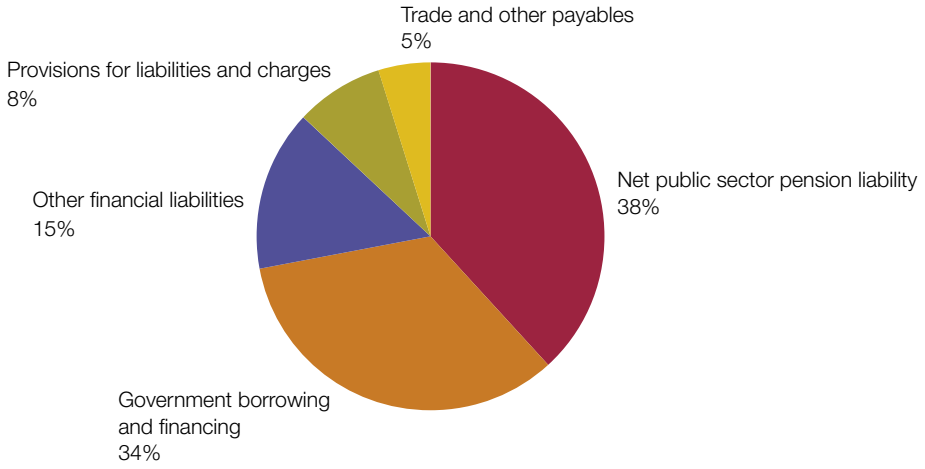
Source: National Audit Office analysis of Whole of Government Accounts information

17 Office for National Statistics, *Statistical bulletin: Families and Households: 2016*, November 2016.

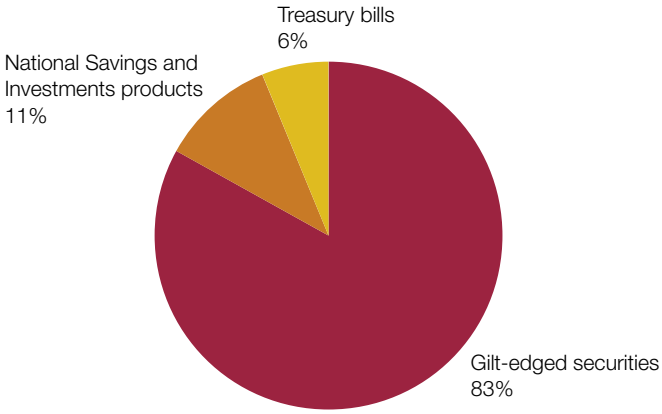
Figure 3

Breakdown of 2015-16 Whole of Government Accounts liabilities

Debt makes up around a third of total government liabilities



Gilts make up the majority of government debt



Source: National Audit Office analysis of *Whole of Government Accounts 2015-16*

1.13 Figure 3 shows that the main types of government debt on the WGA 2015-16 balance sheet were:

- **Gilt-edged securities (£1,047 billion)** – often referred to as 'government bonds' or 'gilts', these are UK government sterling denominated listed bonds issued by the DMO. The bonds are issued for different lengths of time (between five and 50 years) and at either a fixed or index-linked rate of interest.[18]
- **NS&I products (£135 billion)** – these are secure savings and investment products issued by NS&I, such as Premium Bonds or Income Bonds.
- **Treasury bills (£78 billion)** – these are short-term debt instruments issued by the DMO primarily to meet the government's daily cash needs, but they can be used to provide flexibility if borrowing needs change in-year.

1.14 The WGA reports other financial liabilities associated with borrowing such as private finance initiative (PFI) contracts, which are on balance sheet. Appendix Three provides further details. This report will focus on gilts and NS&I products as they are the most significant elements of government borrowing.

Cost of borrowing

1.15 The government has spent £222 billion on debt interest costs since 2009-10. In 2015-16, interest costs on government debt were £28 billion, representing an implied interest rate of 2.2% on £1,261 billion of total debt.[19] This rate has fallen by 1.7 percentage points since 2009-10 as a result of lower long-term borrowing rates on new government bonds.[20] Compared with other areas of government spending, debt interest costs in 2015-16 were over twice the budget of the Home Office (£12 billion) and over 11 times the amount spent on Jobseeker's Allowance (£2 billion).[21]

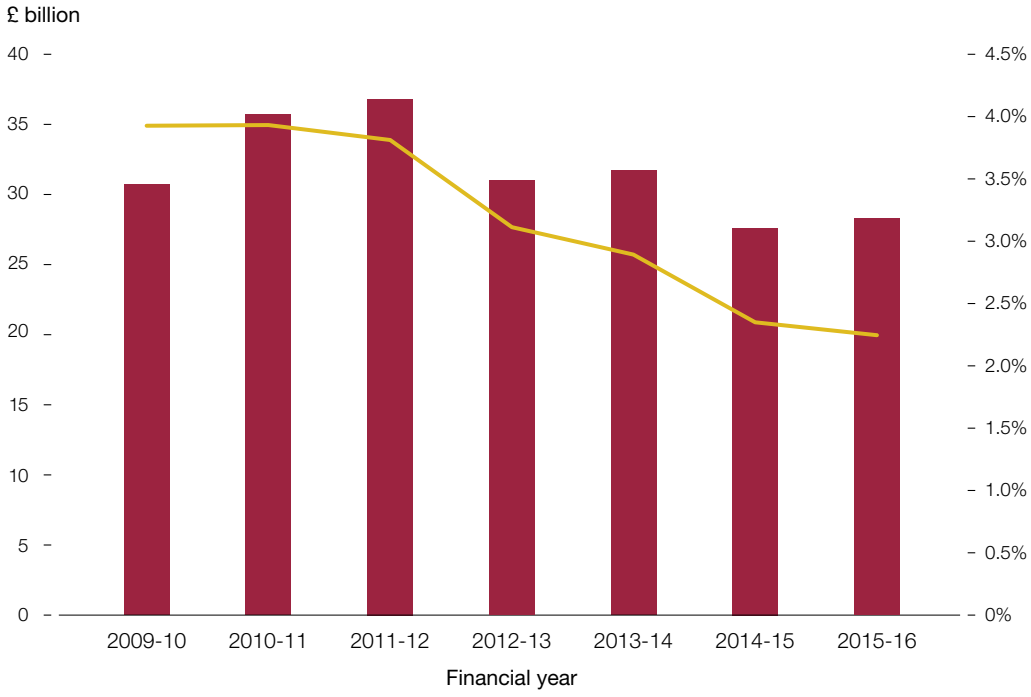
1.16 Despite the 61% increase in the stock of debt in the last six years, debt interest costs the government around £3 billion less in 2015-16 than in 2009-10 (**Figure 4**).[22] Historically low interest rates mean that as gilts have matured they have been replaced with new gilts at lower borrowing rates. We discuss how the government has changed its borrowing profile in Part Three. However, interest rates need to compensate investors for the risk they are taking on. Higher interest rates and falling gilt prices therefore could provide early warning that the perceived risk of lending to the government had increased.

18 The WGA measure of gilts excludes the Bank of England's quantitative easing holdings and the DMO's holdings for cash management purposes.
19 Calculated by taking the interest costs recognised in 2015-16 and dividing by the book value of government debt at the end of 2015-16.
20 Office for National Statistics public sector finances show debt interest costs totalling £246 billion (net of the Bank of England Asset Purchase Facility Fund Limited) since 2009-10. On this basis, in 2015-16, interest costs on government debt were £33 billion representing an implied interest rate of 2.1% on £1,606 billion of total debt. The rate has fallen by 0.5 percentage points since 2009-10. Paragraphs 1.8, 1.9 and Appendix Two set out some of the differences between the National Accounts and public sector finances and the WGA.
21 HM Treasury, *Central Government Supply Estimates 2015-16*: Main Supply Estimates, HC 215, July 2015.
22 In cash terms.

Figure 4

Interest cost and implied interest rate of debt since 2009-10

The debt interest costs have fallen in cash terms despite the larger stock of debt



	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
Interest costs in respect of government borrowing and financing	31	36	37	31	32	28	28
Implied interest rate	3.9%	3.9%	3.8%	3.1%	2.9%	2.3%	2.2%

Notes

1 This reflects 'interest costs in respect of government borrowing and financing' in the WGA. This excludes finance charges in respect of finance leases and PFI contracts, and other finance costs.

2 The implied interest rate is calculated by taking the interest costs recognised each year and dividing by the book value of government debt at the end of each year.

Source: National Audit Office analysis of Whole of Government Accounts information

The international context

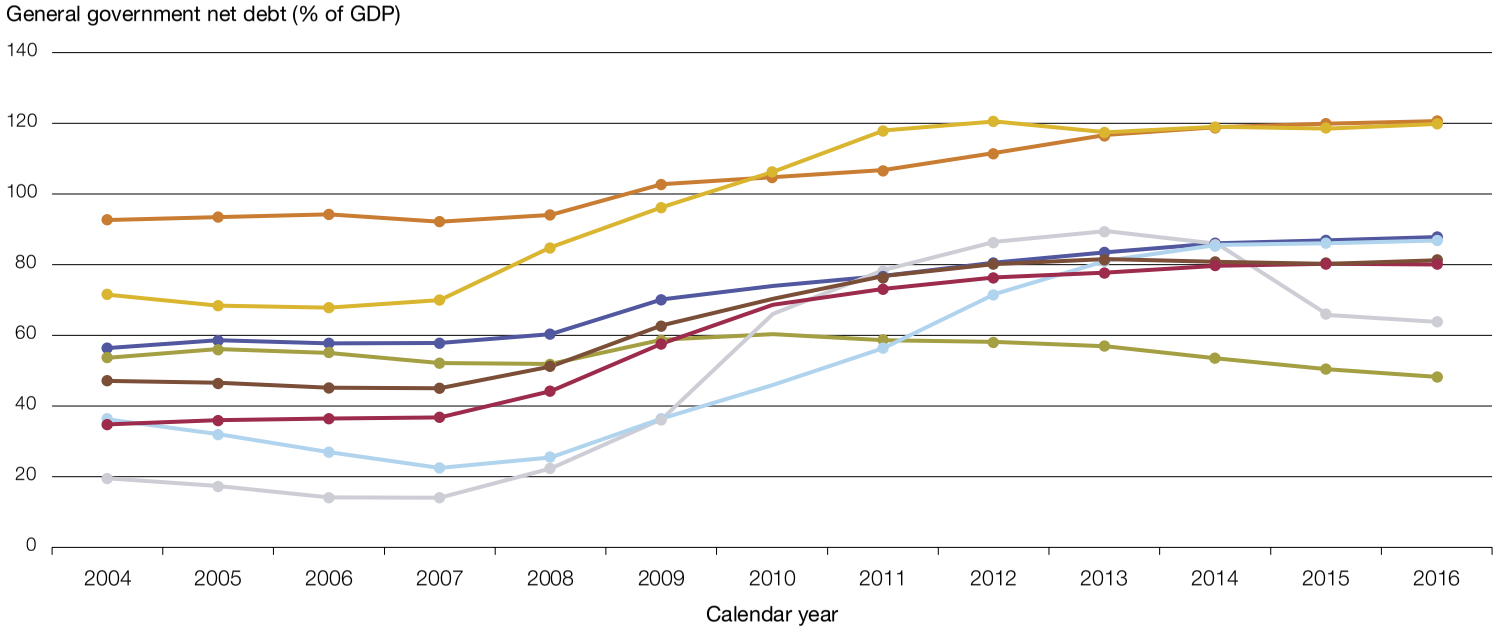
1.17 Although the level of UK government debt has increased, **Figure 5** overleaf shows how this compares to other economies. Similarly to the UK, debt rose globally in response to the financial crisis. In 2016, UK government debt was 80% compared to a range of 48–121%. Nonetheless, as highlighted by the International Monetary Fund (IMF) in 2016, there is no recognised level at which debt becomes unsustainable. Governments must balance the market's perception of the risk of default with the government's capacity and flexibility to respond to future recessions and economic shocks, which is reduced as debt levels rise.[23]

23 X Debrun and T Kinda, 'That Squeezing Feeling: The Interest Burden and Public Debt Stabilization', *IMF Working Paper*, International Monetary Fund, May 2016.

Figure 5

Government debt compared to other advanced economies

UK government debt as a percentage of GDP is at similar levels to other advanced economies



	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Italy	92.60	93.45	94.20	92.14	94.07	102.75	104.73	106.75	111.60	116.69	118.84	119.82	120.58
Japan	71.57	68.43	67.86	69.99	84.91	96.23	106.20	117.92	120.47	117.38	118.96	118.45	119.80
France	56.45	58.68	57.81	57.87	60.37	70.20	74.01	76.86	80.59	83.50	86.06	86.89	87.82
Germany	53.71	56.20	55.10	52.21	51.95	58.83	60.39	58.69	58.18	56.97	53.53	50.48	48.29
United States	47.20	46.69	45.26	45.12	51.24	62.86	70.38	76.79	80.19	81.57	80.83	80.22	81.28
United Kingdom	34.88	36.09	36.57	36.90	44.29	57.69	68.70	73.22	76.42	77.79	79.70	80.27	80.06
Spain	36.38	32.20	27.06	22.61	25.55	36.58	46.05	56.51	71.69	81.10	85.61	86.07	86.82
Ireland	19.70	17.52	14.29	14.19	22.45	36.45	66.09	78.53	86.49	89.47	85.89	65.81	63.84

Note

1 International Monetary Fund estimates used for 2016 figure for Japan.

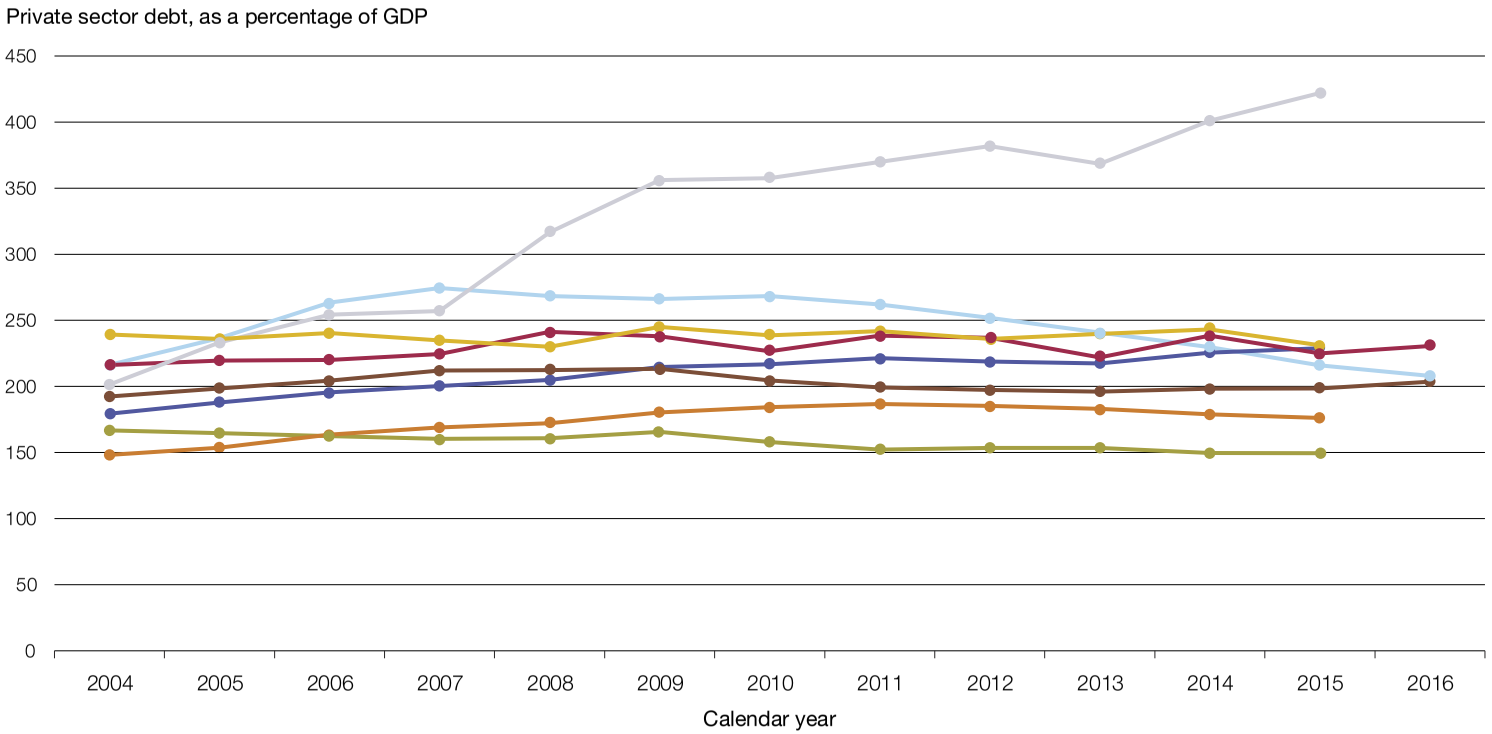
Source: National Analysis of International Monetary Fund, World Economic Outlook Database, October 2017

1.18 The financial crisis showed the impact that unsustainable levels of private sector debt could have on global economies and the consequences of this for public finances as seen in Figure 5. The UK was particularly exposed by the concentration of risks in the financial sector prior to the financial crisis. In the wake of the 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. **Figure 6** overleaf shows that UK private debt is around 230% as a percentage of GDP and at the upper end of the range (150–230%) for comparable nations.

Figure 6

Private debt compared to other advanced economies

UK private debt is at the upper end of the range



	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Japan	239	236	240	235	230	245	239	242	236	240	243	231	
Spain	216	237	263	275	268	266	268	262	252	241	230	216	208
United Kingdom	216	220	220	224	241	238	227	238	237	222	238	225	231
Ireland	201	233	254	257	317	356	358	370	382	368	401	422	
United States	192	198	204	212	212	213	205	199	197	196	198	198	204
France	179	188	195	200	205	215	217	221	219	217	226	229	
Germany	167	165	162	160	161	166	158	152	153	153	150	150	
Italy	148	154	163	169	172	180	184	187	185	183	179	176	

Source: National Audit Office analysis of Organisation for Economic Co-operation and Development data

Part Two

Meeting the government's borrowing needs

2.1 A range of public sector bodies have a role in government borrowing. HM Treasury (the Treasury), as the government's economic and finance ministry, has overall responsibility. Each year, the Treasury decides on the total amount of borrowing it needs and how much the Debt Management Office (DMO) and National Savings and Investments (NS&I) will each raise. **Figure 7** overleaf sets out the main organisations involved in borrowing.

Deciding how much to borrow

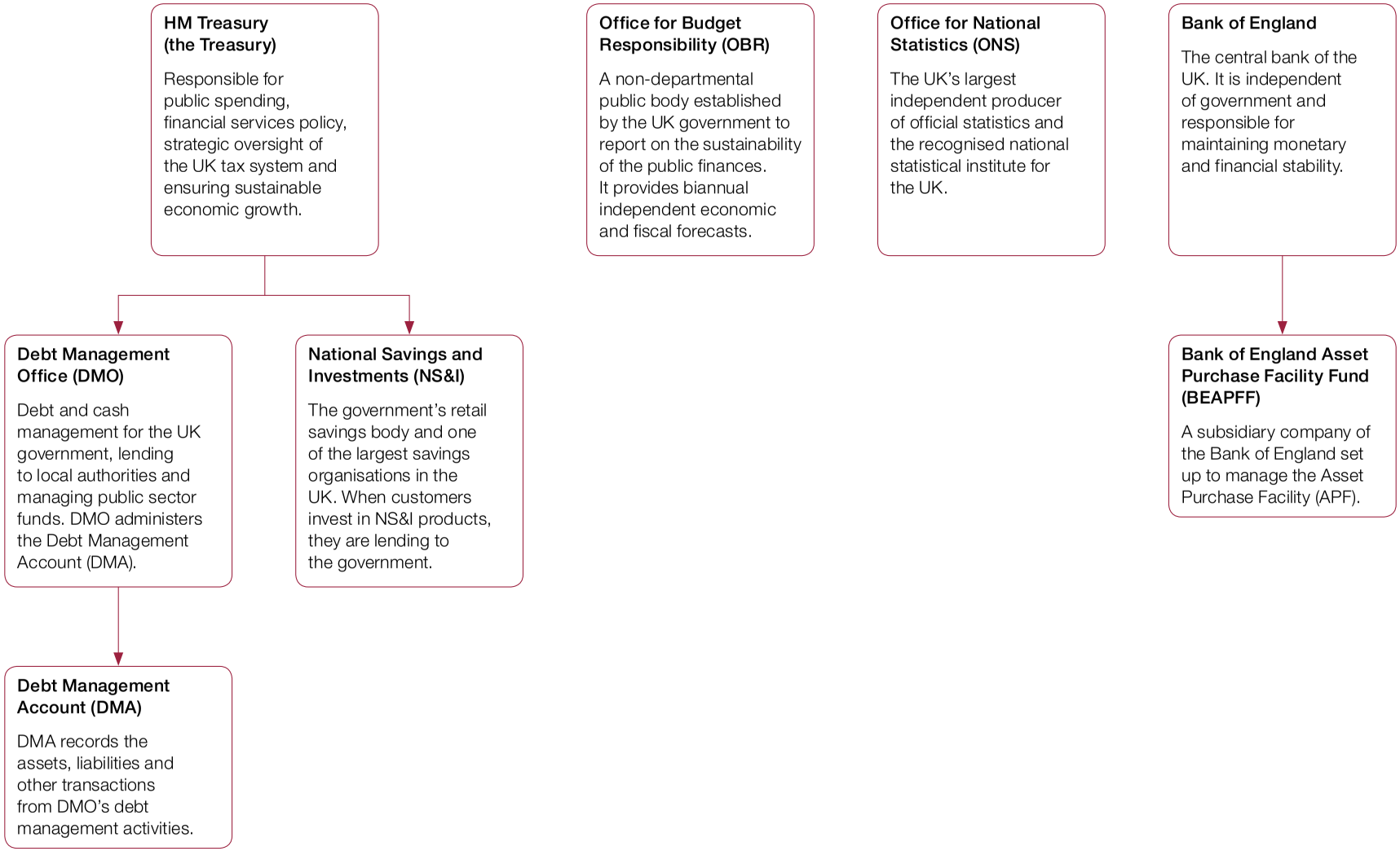
2.2 When deciding how much borrowing the government will need, the Treasury's starting point is the Office for Budget Responsibility's (OBR) *Economic and Fiscal Outlook* biannual forecast of the economy and public finances. These forecasts are published around the time of the Budget and Autumn Statement each year. The OBR forecasts borrowing needs for the coming year and net debt based on the effects of existing policies and any new tax and spending measures announced by the government.[24]

2.3 The OBR forecasts the central government net cash requirement (CGNCR) figure: the expected amount of cash the government needs to borrow for the year. The starting point for this is its forecast for public sector net borrowing (PSNB). The OBR then converts from accruals into cash and removes those parts not directly funded, such as local government, Network Rail and the public sector banks. The Treasury performs a bottom-up reconciliation of this figure, using assumptions consistent with those used by the OBR. This reconciliation is also used to split CGNCR into a monthly profile. In March 2017, the forecast CGNCR for the 2016-17 financial year was £47 billion, with an additional £80 billion required to refinance gilts falling due.

2.4 The Treasury's Debt and Reserves Management team works closely with the DMO and NS&I in advance of the Budget and Autumn Statement to decide how best to structure and profile borrowing. Each organisation analyses and makes recommendations on how the total amount of borrowing in the gilt and retail markets should be structured and how best to split the borrowing between different maturities and types of gilts or specific NS&I products. The Treasury then sets the annual 'remit' for the DMO and NS&I, which tells them how much to borrow, and, for DMO, how to structure the debt.

24 The Office for Budget Responsibility is an independent body, created in 2010, to provide independent and authoritative analysis of the UK's public finances.

Figure 7
Organisations involved in the government debt landscape



Source: National Audit Office analysis

2.5 Until now, the government has set the financing remit in the March Budget for the following financial year and reviewed it in the Autumn Statement around November. In November 2016, the Chancellor announced that he was abolishing the Autumn Statement and moving to one fiscal event, the Autumn Budget, in 2017.[25] Although the OBR will still produce at least two forecasts per year, the Treasury will need to assess how it revises the debt remits in response to changes in these forecasts.

Managing cash and spending

2.6 The Treasury must have enough cash each day to meet the government's spending commitments. To ensure spending is in line with budgets allocated to government departments, and to anticipate major cash flow needs, the Treasury monitors the daily fiscal position by collecting and analysing information relating to tax revenue, spending and cash.

2.7 Managing the government's daily cash needs is a well-established process with clearly defined roles and responsibilities. **Figure 8** overleaf outlines the relevant monthly information flows within the Treasury. The Treasury's Exchequer Funds and Accounts (EFA) team provides the DMO with seven intraday forecasts, and daily rolling forecasts, to undertake cash management operations to close any gap between inflows and outflows. It also provides the DMO with an annual forecast which the DMO uses to inform cash management and Treasury bill issuance.

Managing longer-term borrowing risks

2.8 The public finance landscape and economic conditions in which the government is borrowing highlight considerable fiscal risks and uncertainty which the government has to manage over the longer term (**Figure 9** on page 31). The government has to manage uncertainty and risks associated with:

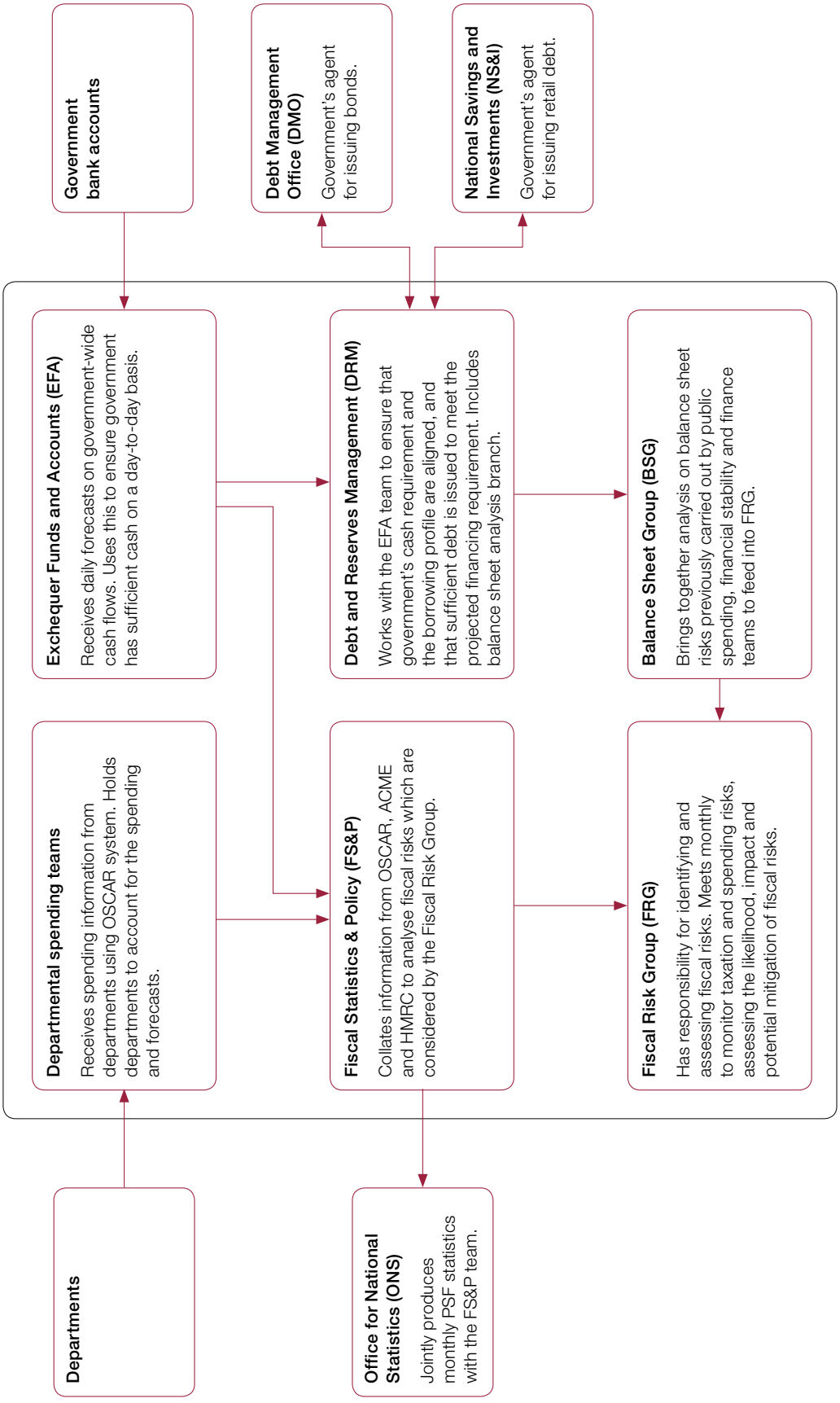
- revenue from tax receipts;
- levels of public sector spending;
- the impact of the balance sheet on revenue and spending; and
- potential economic shocks.

2.9 In normal times, the government is able to control expenditure through its spending control framework. However, its revenue base is threatened by structural changes in the employment market, affecting income tax and national insurance, and reductions in the rates of corporation tax.

2.10 Changes in the performance of the economy or government policies could cause borrowing needs to differ significantly from forecasts. For example, slower than expected economic growth could result in lower income tax receipts and higher welfare spending than forecast. Similarly, changes in, or delays to, government policy such as welfare reform or selling major assets will impact on the level of borrowing needed.

25 HM Treasury, *Autumn Statement 2016*, Cm 9362, November 2016.

Figure 8
Information flows within the Treasury



Notes
1 Arrows reflect flows of information.
2 Boxes within the black box represent teams within the Treasury.

Source: National Audit Office analysis

Figure 9
Fiscal risks and uncertainties

Specific risk/uncertainty	Example of potential effect
Wider economic risks	
Global and domestic risks to the economy	Sterling depreciation may affect the UK's export market share and cause import substitution and inflation.
Tax and spending risks	
Rising trend towards incorporation	Employment income is taxed more heavily than profits and dividends. As a greater proportion of people pay tax through personal companies rather than being employed or self-employed, tax revenues are likely to fall.
Future contributions to the EU institutions	The financial flows between the UK and EU are likely to change over the coming years, with uncertain spending implications.
Risks to the delivery of welfare reform	If reform is delayed, the budgeted savings may not be achieved in this spending period, and expenditure on welfare may be higher than expected.
Changes in government policy	Forecasts only reflect current government policy. Any changes may have tax or spending implications that are not included in the forecast.
Balance sheet risks	
Uncertainty around large financial asset sales	Asset sales may be deferred to future financial years due to market conditions or abandoned.
Higher interest rates	Changes to market interest rates may increase the cost of servicing new and refinanced borrowing.

Source: National Audit Office analysis of Office for Budget Responsibility, *Economic and fiscal outlook,* November 2016 and *Fiscal risks report*, July 2017

2.11 At the same time, the public finance landscape has become more complicated as the range and volatility of assets and liabilities that the government has to manage alongside its spending commitments have increased. Inherent difficulties in measuring some of these assets and liabilities, along with the challenges of estimating the likelihood and timing of contingent liabilities crystallising, make it more difficult for the government to forecast its borrowing needs accurately. This complexity is likely to remain as ongoing restrictions on spending increase the incentives for the government to use its balance sheet to pursue policy objectives. In 2016, the Comptroller and Auditor General's three reports on evaluating the balance sheet explored how the major risks to public finances highlighted on the balance sheet had changed in recent years. These reports considered the impact on the government's long-term risk profile of changes in financial assets, public sector pensions, and provisions, contingent liabilities and guarantees, specifically.[26,27,28]

26 Comptroller and Auditor General, *Evaluating the government balance sheet: financial assets and investments*, Session 2016-17, HC 463, National Audit Office, June 2016.
27 Comptroller and Auditor General, *Evaluating the government balance sheet: pensions*, Session 2016-17, HC 238, National Audit Office, June 2016.
28 Comptroller and Auditor General, *Evaluating the government balance sheet: provisions, contingent liabilities and guarantees*, Session 2016-17, HC 462, National Audit Office, June 2016.

Financial assets

2.12 In response to the financial crisis, the government bought shares in the Royal Bank of Scotland (RBS) and Lloyds Bank and took ownership of Northern Rock and Bradford & Bingley. The Bank of England initiated the quantitative easing programme to stimulate the economy and meet the 2% inflation target over the medium term. In 2015-16, financial assets, including cash and gold holdings, totalled £407 billion and had increased by over a third compared with 2009-10.

2.13 The scale and concentration of the government's financial assets in the banking, housing and student finance sectors exposes asset values to volatility in the same economic factors that affect tax revenue, particularly the employment market, interest rates and inflation. Further, it is hard to identify the economic value of unique assets such as the student loan book, which do not have a private sector comparator.

2.14 The government will look to sell assets unless there is a particular policy or strategic reason to keep them. It plans to sell an unprecedented number of financial assets over the remainder of the Parliament. Lloyds Bank returned to private ownership in May 2017 and the government is winding down the mortgage books. However, the timetable for some sales is uncertain and dependent on economic and market conditions. The strategy and timeline for exiting from RBS is less clear because of legacy issues that need to be resolved first. Further sales will also require careful management given the size of the shareholding and market conditions.

Pensions

2.15 The government's pension commitments are a significant part of the public finances. At 31 March 2016, the net public sector pension liability was £1,425 billion and the single largest liability on the balance sheet. It has grown by around a quarter since 2009-10. Government reforms to pensions have helped to reduce costs in the long term but the liability has continued to rise, largely due to the impact of the discount rate used to value it in today's prices.

2.16 Multiple and varied public sector pension arrangements create a complex environment in which the government has to balance risks to long-term affordability with its policy to provide for people in retirement. Demographic and economic trends significantly affect pension provision and the risks that the government has to manage. For example, an ageing population means the ratio of people in retirement to those in work is continuing to increase. At the same time, unfunded pensions, which make up most of the liability, will be paid from future tax revenue and therefore depend on long-term economic growth.

Provisions, contingent liabilities and guarantees

2.17 The government's long-term risk profile is increasing. Provisions and contingent liabilities, where the size, probability or timing of the cash outflow is uncertain, have been on an upwards trend in recent years. At £410 billion in 2015-16, they represent a significant and rising potential cash outflow, which the government has to manage alongside its other spending commitments and within the scope of its fiscal targets (paragraph 1.5). Inherent difficulties around measuring some of these liabilities further increases uncertainty about the government's overall exposure to financial risk.

2.18 The government's exposure is concentrated in particular sectors. In the main, its uncertain liabilities arise from:

- its long-term energy policies such as the legacy costs of decommissioning nuclear energy sites;
- legal challenges to the government's service delivery such as clinical negligence claims;
- the government's increasing use of guarantees to support infrastructure development, stimulate growth in certain sectors and address market failures – in particular, the scale of guarantees offered to financial institutions increases those liabilities that the government might have to pay out in the event of an economic downturn; and
- the government's role as an insurer of last resort where it may be expected to intervene to rescue a failing business or industry or ensure the continuing operation of key infrastructure and services.

2.19 The government manages its exposure to its significant liabilities through the Treasury's Fiscal Risk Group (FRG) and the Balance Sheet Group (BSG) which reports into it. To understand and better manage similar risks as a portfolio, the Treasury has been developing its data and modelling the probability and impact of the liabilities crystallising under different economic scenarios. This work was at an early stage when we reported last year.

2.20 At its hearing on the WGA balance sheet, the Committee of Public Accounts stressed the importance of this analysis and the need to develop contingency plans as a priority. The International Monetary Fund's Fiscal Transparency Evaluation of the UK also recommended that the Treasury should increase transparency around fiscal risks by strengthening controls over off-balance sheet commitments such as guarantees and by publishing a report on assets and liabilities that sets out risks to the balance sheet. The expansion of the OBR's role to report specifically on fiscal risks around assets and liabilities in July 2017 means the government will need to develop its analysis further in order to respond formally.

The Treasury's analysis of public finance risks

2.21 In response to the Committee of Public Accounts' recommendations, the Treasury is allocating more resources to analysing its balance sheet and evaluating fiscal risks. This work began in late 2016 and is at an early stage. Therefore it is not yet embedded in either departments' or Treasury spending teams' oversight functions. To date, the Treasury has:

- set up a Fiscal Risks analysis branch to strengthen its approach to analysing fiscal risk. It has developed and refined its fiscal risk model and has carried out stress-testing of the public finances. The Treasury's model is designed to assess how changes in economic variables such as inflation, changes in the labour market or technology may affect headline fiscal measures like public sector net debt (PSND) and public sector net borrowing (PSNB). The model also factors in the effect of specific liabilities that are likely to arise in certain economic conditions. The Treasury will continue to develop the model and plans to use it to conduct further ad hoc analysis of fiscal risk. It will report on this periodically to the FRG which monitors fiscal risk. This branch will also coordinate the Treasury's response to the OBR's report;
- created a new balance sheet analysis branch within its Debt and Reserves Management team and a Balance Sheet Group (BSG), which reports into the FRG. The division will bring together analysis previously carried out across the Treasury: from the FRG, public spending, financial stability, and finance teams. Its analysis feeds into the Balance Sheet Group's routine monitoring and balance sheet risks may be escalated to the FRG and the Treasury's Executive Management Board. 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; and
- strengthened the budgetary and approvals process around contingent liabilities. These are now approved centrally within the Treasury by the balance sheet analysis branch and the Treasury's General Expenditure Policy team. Around 24 new contingent liabilities have gone through the process since it began in January 2017.

Part Three

Borrowing through the Debt Management Office

3.1 The Debt Management Office (DMO) was established in April 1998 when responsibility for raising government debt was transferred from the Bank of England. The DMO is an executive agency of HM Treasury (the Treasury) and operates at arm's-length from ministers. Since it was set up in 1998, the DMO's objective has been to "minimise, over the long term, the costs of meeting the government's financing needs, taking into account risk, while ensuring that debt management policy is consistent with the aims of monetary policy".[29,30]

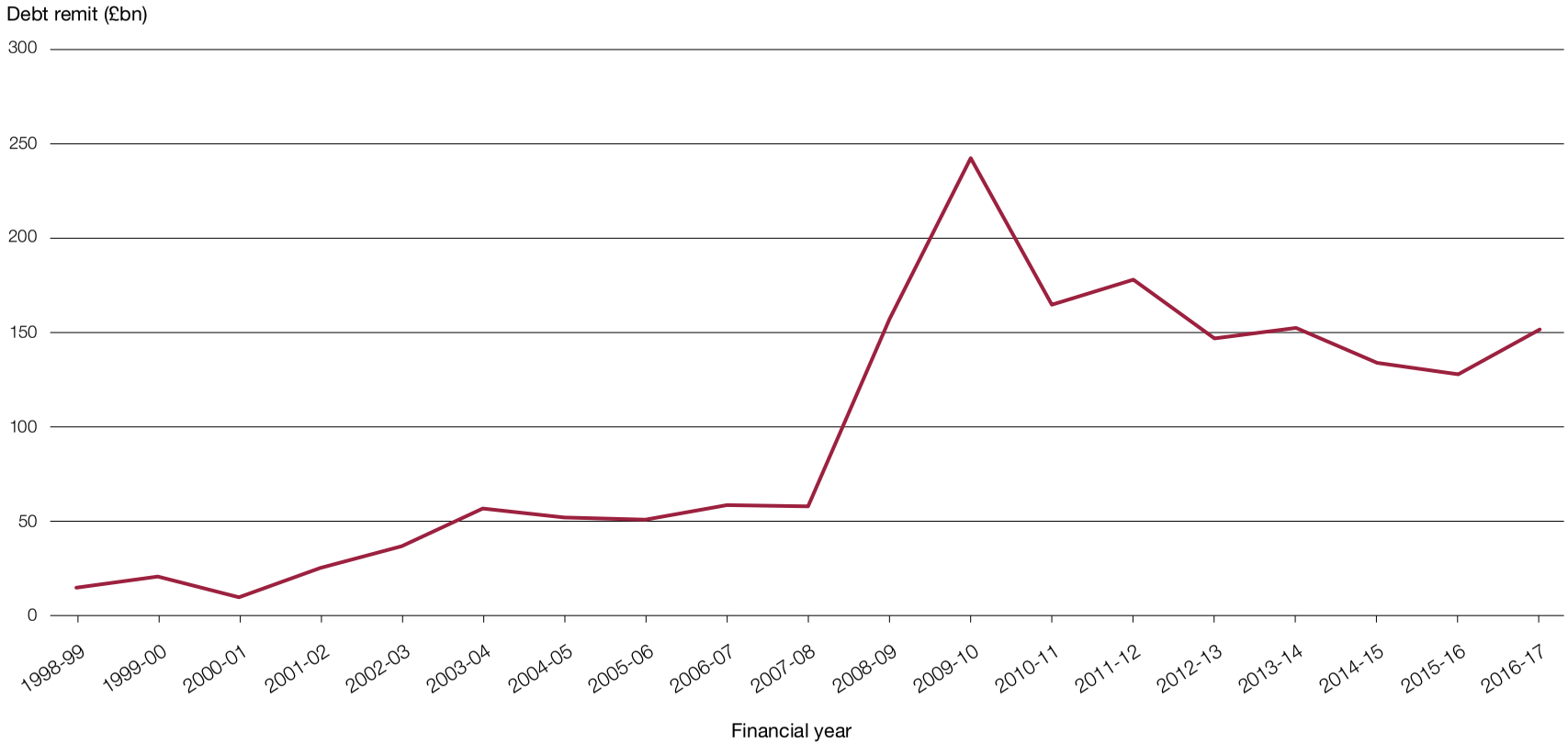
3.2 The DMO must raise cash to meet its debt remit, which is set by the Treasury. It achieves this by selling gilts to investors in capital markets on behalf of the government. **Figure 10** overleaf shows how the DMO's remit has changed since it was set up in 1998. In response to the financial crisis, the DMO's remit in 2009-10 reached a high of £243 billion, which is over four times greater than its remit two years before. Since 2009-10, the remit has been falling but remains over double pre-financial crisis levels. Gilts in issue have increased by £666 billion (71%) to £1,603 billion during this period (**Figure 11** on page 37).

29 HM Treasury, *Debt management report 2016-17*, March 2016.
30 National Audit Office, *The UK Debt Management Office – Borrowing on behalf of government*, January 2007, available at: www.nao.org.uk/wp-content/uploads/2012/11/debt_management_office.pdf

Figure 10

Debt Management Office (DMO) annual debt remit

The DMO's remit has fallen from its peak in 2009-10, but is still double pre-financial crisis levels

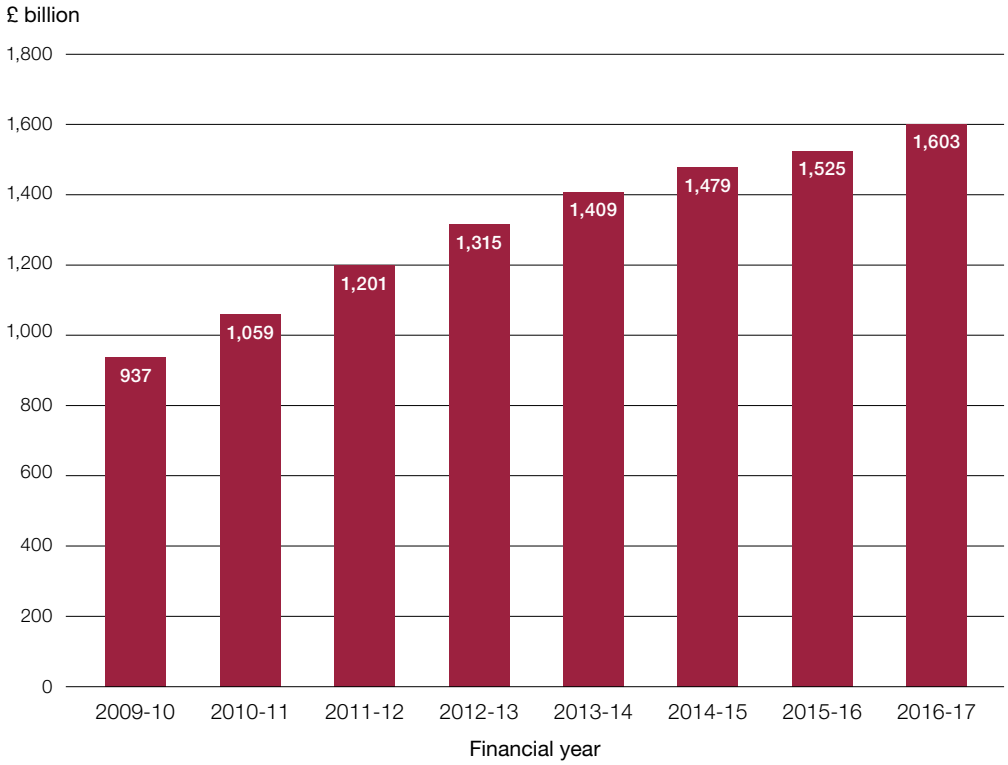


Source: National Audit Office analysis of HM Treasury, *Debt management reports*

Figure 11

Growth in debt through gilt borrowing since 2009-10

Gilts in issue have increased by £666 billion, or over 71% since 2009-10



Source: National Audit Office analysis of National Loans Fund information

Overview of gilt borrowing

3.3 The value of gilts in issue is not recorded on the DMO's balance sheet, but is recorded as a liability against the National Loans Fund (NLF).[31] The value of gilts in the NLF accounts is greater than the value of gilts shown in the WGA, due to the exclusion of gilts held by public sector bodies from these accounts.[32] For example, the latest WGA shows gilts at 31 March 2016 were £1,047 billion compared to £1,525 billion in the 2015-16 NLF accounts. Gilts held by the public sector are eliminated from the WGA to provide a true reflection of the government's borrowing through external investors. Significant balances that are not reflected in the most recent WGA include:

- **gilts held in the Debt Management Account (£121 billion)** – gilts held in the DMO's Debt Management Account for use as collateral in the government's cash management activities; and
- **gilts held by the Bank of England (£339 billion)** – The Bank of England, through its Asset Purchase Facility Fund (BEAPFF), is one of the largest holders of gilts as a result of its monetary policy responses to large economic shocks at the time of the financial crisis and thereafter.[33]

3.4 The DMO meets its remit primarily by issuing two types of gilt:

- **Conventional gilts** – a conventional gilt guarantees to pay the holder a fixed cash payment (coupon) every six months until the redemption date, when the holder receives the principal. At the end of March 2017 there were £1,128 billion of conventional gilts in issue, in nominal terms.
- **Index-linked gilts** – similar to conventional gilts; however, the biannual coupon payments and the principal are adjusted in line with the UK Retail Prices Index (RPI). At the end of March 2017 there were £394 billion of index-linked gilts in issue, in nominal terms (including an uplift for inflation).[34]

3.5 The period between a gilt being issued and its redemption date is known as a gilt's 'maturity' and is measured in years. The DMO issues conventional gilts in three maturity brackets:

- **short** – gilts with a maturity of up to seven years;
- **medium** – gilts with a maturity of between seven and 15 years; and
- **long** – gilts with a maturity of over 15 years.

31 National Loans Fund, *National Loans Fund Account 2015-16*, HC 476, July 2016.
32 HM Treasury, *Whole of Government Accounts: year ended 31 March 2015*, HC 28, May 2016.
33 Measured at amortised cost which reflects any repayments or interest received in the future. Based on market rates, the £375 billion of gilts purchased by the BEAPFF as at 31 March 2016 were valued at £407 billion. The Bank has since increased the programme from £375 billion to £435 billion of gilts.
34 There is a difference between gilts in issue in nominal terms and the value of gilts which are disclosed in NLF's accounts at amortised cost in line with accounting rules.

3.6 Decisions about the issuance profile are ultimately taken by Treasury ministers, who set the required composition of the debt as a part of DMO's remit. The Treasury's Debt and Reserves Management team works closely with the DMO in advance of the Budget and Autumn Statement to decide how best to structure the borrowing it needs. The DMO provides advice on its analysis of the market and makes recommendations on the total amount of borrowing the gilt market can absorb and how best to split the borrowing between different maturities and types of gilts.

Cost of borrowing through gilts

3.7 In 2016-17, interest cost of gilts reflected in the National Loans Fund (NLF) was £49 billion, representing an implied interest rate of 3.0% on £1,603 billion of gilts (**Figure 12** overleaf).[35] This figure includes finance costs paid on gilts held by the public sector (see paragraph 3.3). Falling interest costs, as shown by Figure 12, are a result of historically low interest rates available in the market. **Figure 13** on page 41 shows that long-term interest rates on gilts have fallen by almost 3% since the end of 2009-10. These falling rates are in part due to the monetary policy actions of the Bank of England in response to the financial crisis but market conditions and other economic factors will have also had an impact. Quantitative easing is a means by which the Bank of England can inject money into the economy to boost spending. It does this by creating new money electronically to buy government gilts. This cash injection lowers the cost of borrowing for business and boosts asset prices to support spending. Since the programme began in 2009, the Bank has purchased £435 billion of gilts.

3.8 While the implied interest rate on the gilt portfolio has fallen since 2010-11, it has done so at a slower pace than the rates available in the market. This is due to the government being 'locked in' to a specific interest rate and redemption date when a gilt is issued.[36] This means that the government is only able to access lower interest rates available in the market when existing gilts are redeemed and refinanced, or when borrowing to fund new spending. Equally, this characteristic of gilts offers the government some protection when market interest rates are rising. We can expect the implied interest rate on gilts to continue to fall even if rates remain at their current levels, as higher-cost gilts are replaced with lower cost gilts as they fall due.

3.9 Since 2009-10, the DMO has reported £129 million in net operating costs. During this period it has issued gilts with a nominal value of £1,302 billion, implying that the DMO has cost the taxpayer 1 pence for every £100 of gilts issued during this period.[37]

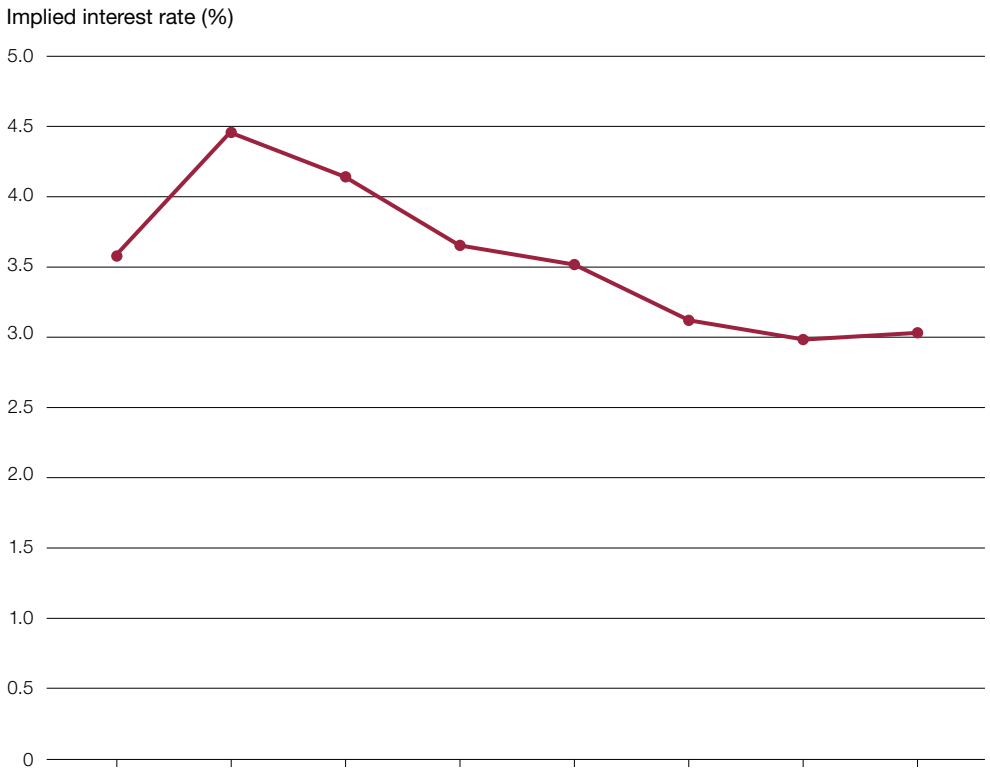
35 NLF figures used as this detail is not available in the WGA. This implied interest rate on gilt debt is different to the rate on total debt, including NS&I borrowing, as expressed in WGA (paragraph 1.15). WGA eliminates borrowing held by the public sector.

36 For conventional gilts the interest rate is fixed. For index-linked gilts the rate moves with inflation, but the price of the gilt is based on inflation expectations at the time of the sale.

37 This excludes those gilts still in issue which were issued before 2009-10.

Figure 12
Cost of borrowing through gilts

The implied interest rate on gilts has fallen since 2010-11



	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
Implied interest rate (%)	3.6	4.5	4.1	3.7	3.5	3.1	3.0	3.0

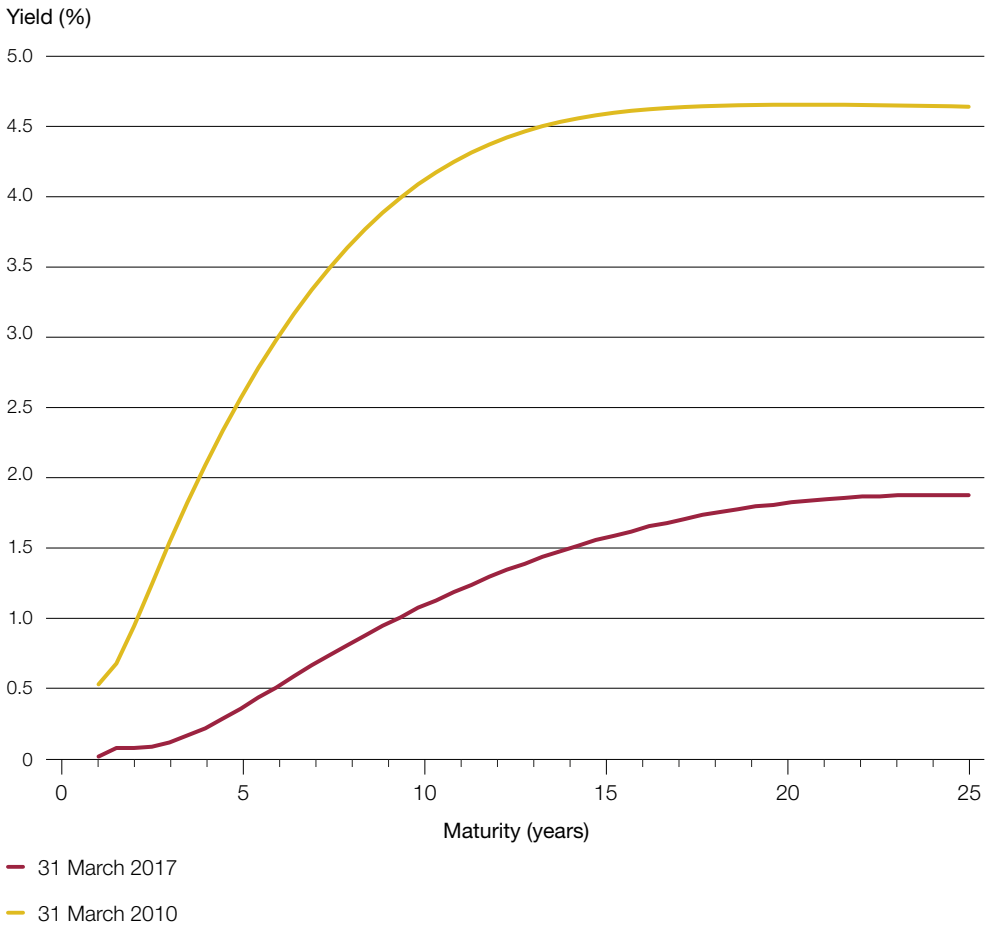
Note

1 The implied interest rate is calculated by taking the interest costs recognised in each year and dividing these by the book value of gilts at the end of each year.

Source: National Audit Office analysis of National Loans Fund and Debt Management Office information

Figure 13
UK government gilt yield curves

Long-term interest rates have fallen by almost three percentage points since the end of 2009-10



Note

1 The yield is the return an investor obtains from a gilt, taking account of the price paid and the interest payable.

Source: National Audit Office analysis of Bank of England data

Managing long-term risks to borrowing

3.10 Almost half of the current debt portfolio will mature within the next ten years. In order for the DMO to refinance these gilts, and to finance new spending, there must be sufficient demand and capacity within the gilt market. There are a number of risks that the DMO is managing to ensure it can meet its debt remit. Some risks are driven by the market and are outside the DMO's control. In other instances, the DMO is able to mitigate risk to some extent, for example, by altering certain components of its auctions within the parameters of the debt remit and the composition of the debt it issues. Ultimately the DMO looks to maintain sustainable demand and act in a predictable and transparent way in order to maintain confidence.

Changes to the debt remit during the year

3.11 Revisions to the DMO's remit during the year can make it more difficult for the DMO to achieve its target, particularly where the market is not expecting an increase in the amount of gilts on offer. Until 2017-18, revisions were normally made twice a year, around fiscal events such as the Budget and Autumn Statement. In the last quarter of 2016-17 for example, the financing remit was revised upwards by £21 billion in the Autumn Statement, an increase of 16% over the original remit figure.[38] The change in the remit was due to changes in the fiscal forecast to account for a delay in sales of Lloyds Bank and Royal Bank of Scotland shares, the UK Asset Resolution mortgage book, and the student loan book. While the DMO has always managed to meet its remit, this change highlights how government decisions, driven by economic or policy concerns, can impact on the amount of cash that the government requires the DMO to raise within a short time frame. The government needs to assess how this risk will change as a result of the move to one annual fiscal event (see paragraph 2.5).

Delivering a sustainable market for gilts

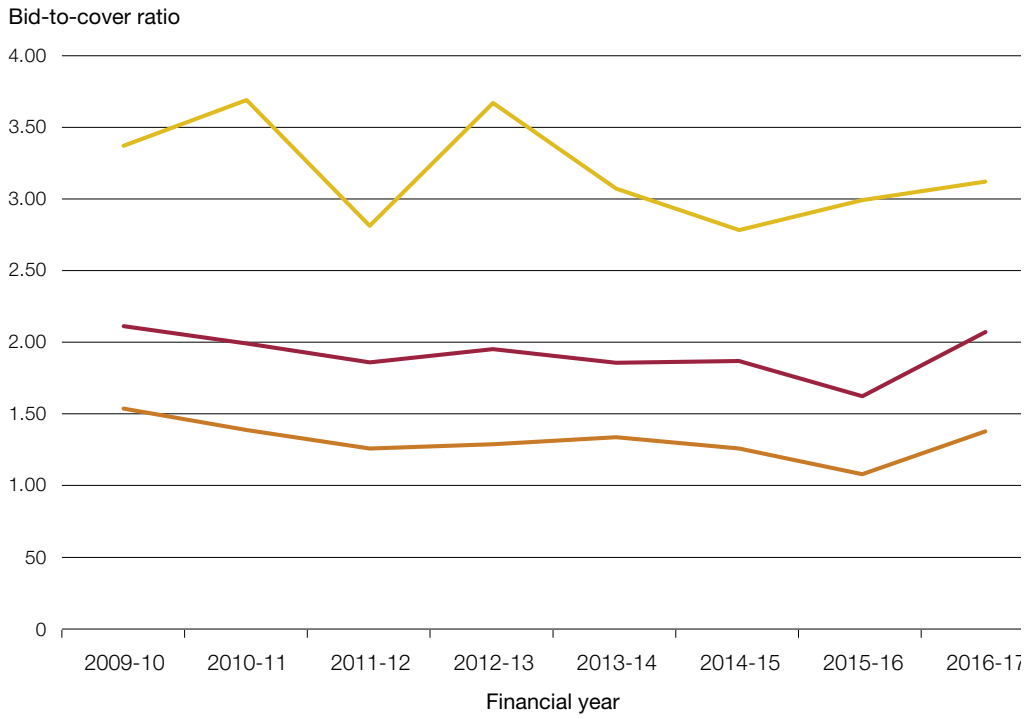
3.12 The DMO issues gilts to the market through approved intermediaries. These intermediaries, the Gilt-edged Market Makers (GEMMs), are made up of some of the worlds largest financial institutions (such as investment banks). Most gilts are sold through regular gilt actions, held at least every two weeks, where GEMMs make competitive bids for the gilts on offer. The DMO publishes a detailed auction calendar in advance of each quarter. The DMO also offers some gilts through syndications, where the DMO appoints GEMMs to manage a sale on its behalf, and may offer gilts through tenders.

3.13 While facilitating the DMO in selling a large amount of gilts to market, the GEMMs must meet the demands of both their shareholders and their regulators, including regulations aimed at reducing exposure to risk. As intermediaries, GEMMs deploy regulatory capital and take on risk as gilts must be held on their balance sheet before being sold on. **Figure 14** shows how the average annual bid-to-cover ratio, an indicator of demand for gilts at auction, has changed since 2009-10. In 2016-17, in response to the pressures faced by GEMMs in holding gilt stock, the DMO reduced the size of its auctions and held auctions more regularly. This allows the GEMMs to manage their capital more efficiently. As Figure 14 shows, bid-to-cover ratios improved, reaching their highest average since 2009-10.

38 HM Treasury, *Autumn Statement 2016*, Cm 9362, November 2016.

Figure 14
Average annual bid-to-cover ratios since 2009-10

Bid-to-cover ratios improved in 2016-17, reaching their highest average since 2009-10



	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
Maximum bid-to-cover ratio	3.37	3.69	2.81	3.67	3.07	2.78	2.99	3.12
Average bid-to-cover ratio	2.11	1.99	1.85	1.95	1.85	1.86	1.62	2.07
Minimum bid-to-cover ratio	1.53	1.38	1.25	1.28	1.33	1.25	1.07	1.37

Source: National Audit Office analysis of Debt Management Office auction data

Managing changes in the composition of the debt

3.14 Changes to the composition of the debt may provide new opportunities and give rise to new risks for the government to manage. In deciding on the future composition of the debt, the government must balance the appetite of investors and the long-term cost of meeting the government's financing needs.

3.15 **Figure 15** overleaf shows that the average maturity of the gilt portfolio has increased from around 14 years in March 2009 to 16 years in March 2017. This has the benefit of extending the period of time before the government must refinance the debt. This protects the government if interest rates were to rise. However, if rates were to fall further, government would be locked in to paying a higher interest rate than is available in the market. **Figure 16** overleaf shows the forecast effect of changes in interest rates on debt interest costs.

Figure 15
Breakdown of gilts in issue

Gilts in issue now have a longer average maturity and a greater proportion are index-linked

Gilt type	31 March 2009	31 March 2013	31 March 2017
Conventional gilts	76%	76%	74%
Index-linked gilts	24%	24%	26%
Excluding conventional gilts held by the BEAPFF[1]			
Conventional gilts	76%	68%	66%
Index-linked gilts	24%	32%	34%
Average maturity of portfolio	14.3 years	14.8 years	15.6 years
Average maturity of conventional gilts	14.3 years	13.4 years	13.8 years
Average maturity of index-linked gilts	14.4 years	19.4 years	20.7 years

Notes

1 Bank of England Asset Purchase Facility Fund Limited.

2 The operating parameters of the BEAPFF does not allow for the purchase of index-linked gilts. The BEAPFF holds conventional gilts only.

3 This analysis is prepared on a nominal basis, including an inflation uplift for index-linked gilts.

Source: National Audit Office analysis of Debt Management Office data

Figure 16
OBR's sensitivity analysis of debt interest costs

Change to forecast assumption	Change in forecast debt interest costs between 2017-18 and 2021-22
1% increase in conventional gilt rates	£11 billion increase
1% increase in short-term interest rates	£28 billion increase
1% increase in RPI[2] inflation	£26 billion increase
£5 billion increase in debt remit	£1 billion increase

Notes

1 All increases are assumed to take effect at the beginning of 2017-18 and continue throughout the forecast.

2 Retail Prices Index.

Source: National Audit Office analysis of Office for Budget Responsibility *Fiscal Risk Report*, July 2017

3.16 Figure 15 also shows that the proportion of index-linked gilts in the gilt portfolio has increased from 24% in March 2009 to 26% in March 2017. However, if gilts held by the Bank of England are excluded, the proportion of index-linked gilts increases to 34% in March 2017. Payments on conventional gilts are fixed, meaning the investor bears any inflation risk. With index-linked gilts the government bears the inflation risk, as coupon payments and the principal payment are adjusted in line with inflation. At the end of March 2017, the average yield on index-linked gilts was 3 percentage points lower than conventional gilts (-1.96% compared to 1.00%). However, as coupon and principal payments increase in line with the Retail Prices Index (RPI) measure of inflation, the government is exposed to greater financing costs should inflation rise. The longer the maturity of the index-linked gilt, the greater the risk exposure of the government; Figure 15 shows that the average maturity of index-linked gilts at 21 years is longer than the maturity of conventional gilts. Figure 16 also shows OBR's analysis of the forecast effect of changes in RPI inflation on debt interest costs.

3.17 The government is aware of the impact of inflation on its debt portfolio. In the most recent *Debt management report 2017-18*, the DMO's analysis shows that index-linked gilts will prove to be more cost-effective than equivalent maturity conventional gilts, assuming that RPI remains constant at 3% over a bond's life.[39] Using the same assumptions, this analysis also shows 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, this exceeds current market expectations and 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.

Managing changes in the distribution of gilt holdings

3.18 The Office for National Statistics collects information on the distribution of gilt holdings by sector. **Figure 17** overleaf shows how the distribution of the holders of gilts has changed following the financial crisis, and in recent years.

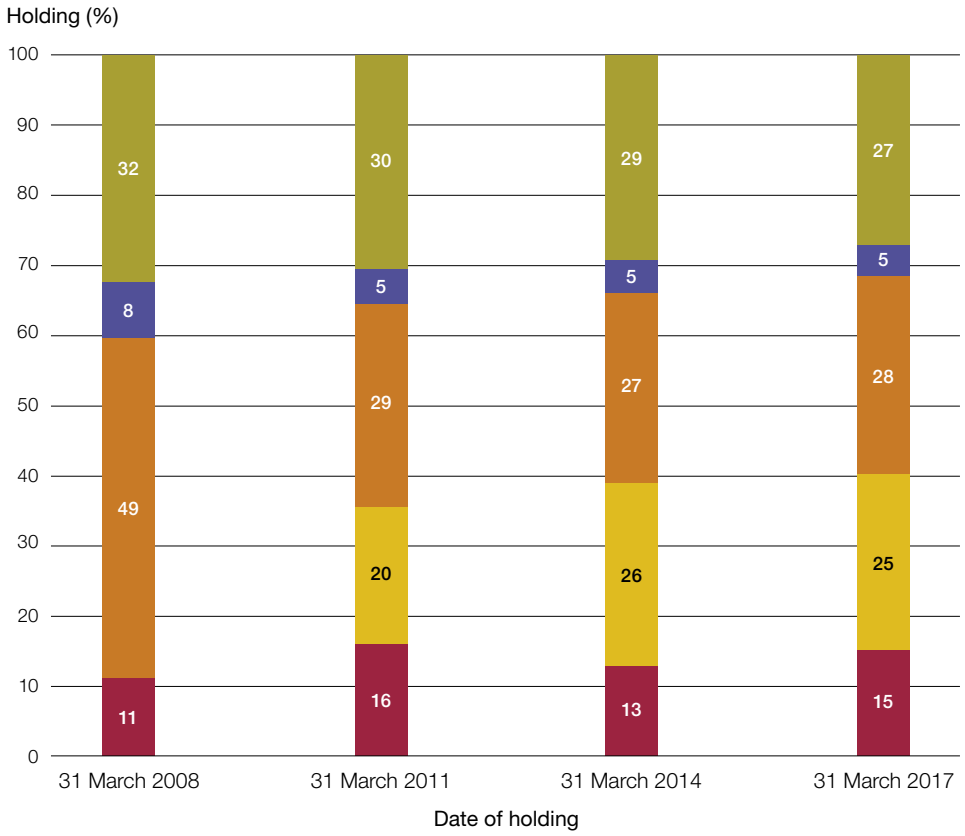
3.19 The most significant change is the addition of the Bank of England as a holder of gilts in the Asset Purchase Facility, accounting for over a quarter of all gilts in issue (see paragraph 3.7). The Bank's Monetary Policy Committee (MPC) has indicated that it will consider reducing the stock of purchased 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.

3.20 As at 31 March 2017, overseas investors held 27% of gilts in issue. As UK government gilts are issued in sterling, overseas investors are likely to be exposed to risk in the movement of exchange rates. While the government is protected from this risk for gilts in issue, uncertainty over 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.

39 HM Treasury, *Debt management report 2017-18*, March 2017.

Figure 17
Distribution of gilt holdings by sector

The proportion of gilts held by the Bank of England, as a holder of gilts in the Asset Purchase Facility, has increased from 0% at 31 March 2008 to 25% at 31 March 2017



Notes

1 'Households & Other' includes households, public corporations, and local government entities.

2 Information is based on market value, which means that some of the movement in holdings will reflect changes in market prices.

Source: National Audit Office analysis of Debt Management Office and Office for National Statistics information

Part Four

Borrowing through National Savings and Investments

4.1 National Savings and Investments (NS&I) is a government department and an executive agency of the Chancellor of the Exchequer.[40] It is one of the largest savings organisations in the UK, with around 25 million customers. NS&I was originally the 'Post Office Savings Bank', set up in 1861 to provide savers with secure investments, backed by the Treasury. NS&I continues to borrow on behalf of government, providing an alternative source of funding to gilts. Its mission is to "help reduce the cost to the taxpayer of government borrowing now and in the future".[41] NS&I also provides products to support government policy as well as payment services to other areas of government.

4.2 NS&I's operating framework requires it to balance:

- the interests of savers by offering a fair rate;
- the interests of the taxpayer by delivering long-term cost-effective finance; and
- the stability of the broader financial services sector by acting transparently and maintaining an appropriate competitive position.

4.3 This part will focus on borrowing through NS&I, examine how borrowing has changed and consider the long-term risks that NS&I has to manage.

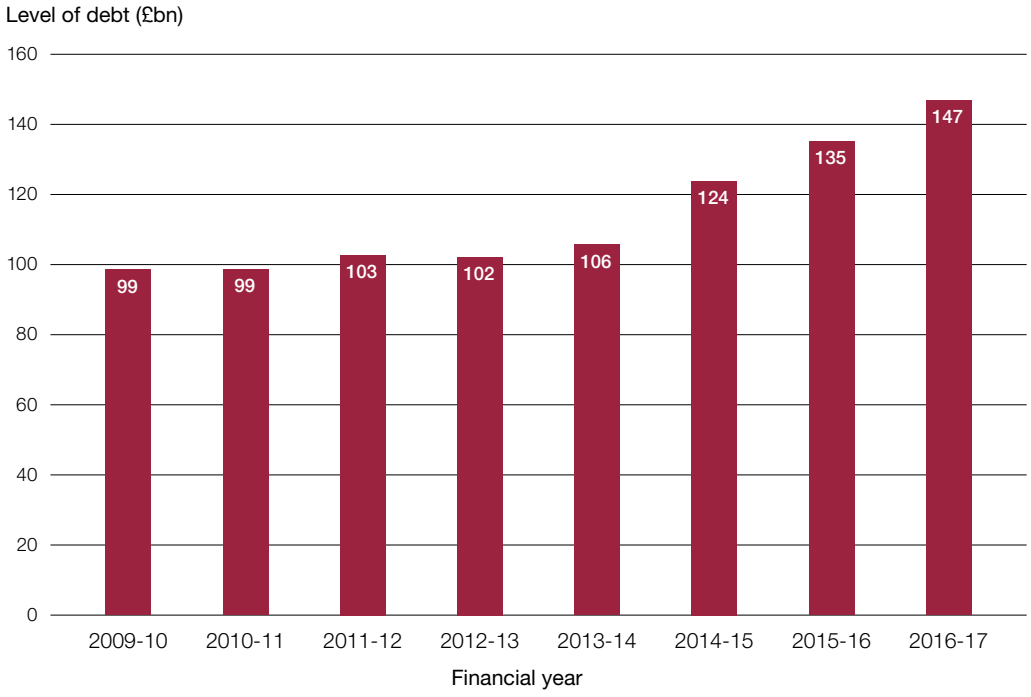
Overview of NS&I borrowing

4.4 At the end of 2016-17, NS&I held a debt portfolio of £147 billion compared to £99 billion in 2009-10. NS&I debt remained broadly static until 2014-15, when it went up by £18 billion (17%) (**Figure 18** overleaf).

40 Because of its unusual status as both a department and an executive agency, NS&I is not consolidated into the Treasury Group.
41 National Savings and Investments, *Annual Report and Accounts and Product Accounts 2016–17*, HC 23, June 2017.

Figure 18
Growth in NS&I debt since 2009-10

NS&I debt has grown by 49% since 2009-10



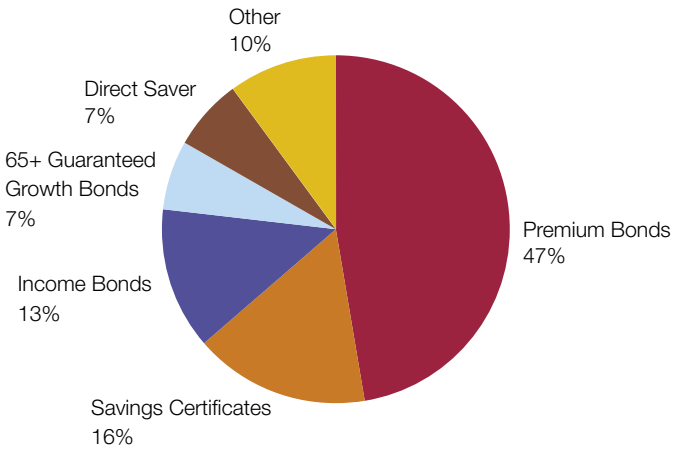
Source: National Audit Office analysis of National Savings and Investments information

4.5 NS&I's debt portfolio is made up of a range of products, some of which are not currently available for new customers. **Figure 19** shows the breakdown of the debt portfolio into products, most of which relates to five products. These are:

- **Premium Bonds (£70 billion)** – saving bonds on which no interest is earned, but the interest rate funds a monthly prize draw for tax-free prizes. Funds can be withdrawn at any time. Bond holders do not receive a fixed interest rate but can win prizes from an annual prize fund equivalent to 1.15% of the stock of bonds (reduced from 1.25% in May 2017). The odds of winning a prize is 30,000 to one for every £1 of Premium Bonds.
- **Savings Certificates (£24 billion)** – fixed-term investments, most of which are linked to the Retail Prices Index (RPI) and offer tax-free returns.
- **Income Bonds (£19 billion)** – bonds that provide a monthly interest income at a variable interest rate. The bonds have no expiry date and can be cashed in at any time.
- **Direct Saver (£10 billion)** – an easy access savings account with a variable interest rate.
- **65+ Guaranteed Growth Bonds (£9 billion)** – a special issue bond announced by the Treasury in January 2015, accessible only to those aged 65 and over. The bond earns a fixed rate of interest over a set period of time. The bonds are no longer on sale.

Figure 19
Breakdown of NS&I debt at the end of 2016-17

Premium Bonds make up nearly half of NS&I's current debt portfolio



Source: National Audit Office analysis of National Savings and Investments information

4.6 Some NS&I products are introduced by HM Treasury (the Treasury) for policy reasons rather than to raise funds for government specifically. For example, the government introduced 65+ Guaranteed Growth Bonds in 2015 to encourage pensioners to save by offering a return above the market rate. The issue was a success and the government announced the bonds to be the "biggest selling retail financial product in Britain's modern history", receiving sales in excess of the original £10 billion cap on how much NS&I could offer, and with over £2 billion of subscriptions in the first three days.[42] In April 2017, following the government's announcement in Budget 2017, NS&I introduced a new three year Investment Guaranteed Growth Bond which was launched with a market leading rate of 2.2% on up to £3,000.[43]

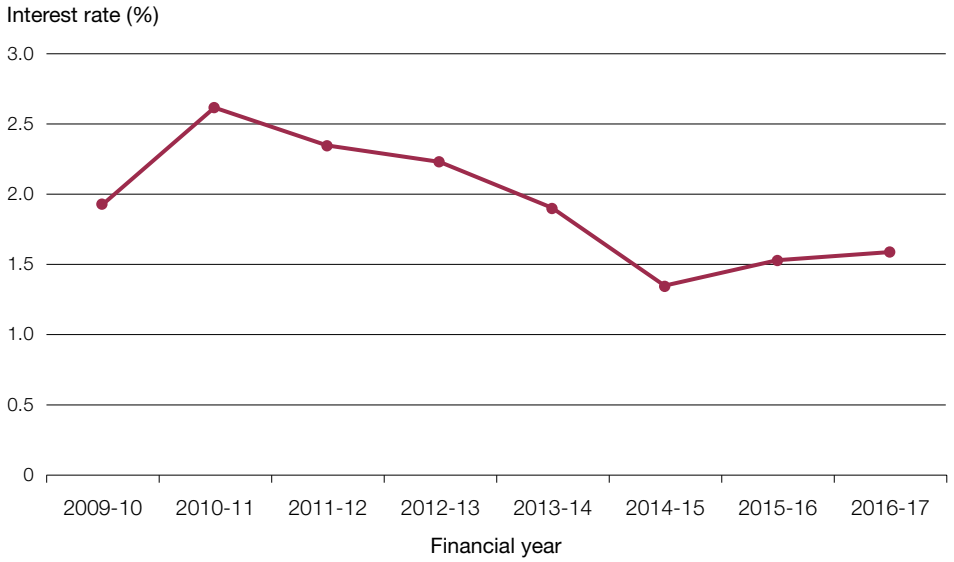
Cost of borrowing through NS&I

4.7 NS&I had net operating costs of £138 million in 2016-17, equivalent to less than 10 pence for every £100 borrowed. Compared with the level of borrowing it raises, NS&I's total running costs are relatively low and have fallen as a proportion of total debt since 2009-10 from 18.5 basis points to 9.4 basis points. At the same time, as **Figure 20** overleaf shows, the interest NS&I pays to borrowers has also fallen.[44]

42 HM Treasury, *More than a million buy popular pensioner bonds*, May 2015, available at: www.gov.uk
43 HM Treasury, *Spring Budget 2017*, HC 1025, March 2017.
44 The implied interest rate is calculated by taking the interest costs recognised in each financial year and dividing by the book value of NS&I debt at the end of that financial year.

Figure 20
Cost of borrowing through NS&I since 2009-10

The implied interest rate of NS&I debt has fallen since 2010-11



	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
Implied interest rate of NS&I debt (%)	1.9	2.6	2.3	2.2	1.9	1.3	1.5	1.6

Note

1 The implied interest rate is calculated by taking the interest costs recognised each year and dividing by the book value of NS&I debt at the end of each year.

Source: National Audit Office analysis of National Savings and Investments information

Managing long-term risks to borrowing

4.8 NS&I must achieve two outcomes to meet its core mission: raise the amount of borrowing set by the Treasury in its debt remit, and be cost effective compared with other forms of borrowing. NS&I must achieve this while balancing the interests of savers and taxpayers, and doing so without distorting the retail savings market.

Meeting the borrowing remit

4.9 The Treasury's Debt and Reserves Management team works with NS&I to form its debt remit. This is based on the government's borrowing needs, the conditions in the retail financial services market and NS&I's ability to raise finance without distorting the market. NS&I identifies the risk of not meeting its debt remit set by the Treasury as its principal risk.

4.10 To meet its remit, NS&I must manage investment inflows with withdrawals, as many NS&I products allow savers instant access to their funds. For example, between April 2016 and March 2017, around 235,000 customers joined NS&I and 464,000 left, including 144,000 deceased customers. As at October 2017, around 80% of the total value of NS&I borrowing was held by 7% or 1.7 million of NS&I's 25 million customers. Based on analysis it received, NS&I has concluded that this distribution is broadly in line with the concentration of wealth in the UK population. To manage the risk of falling short of, or exceeding, its borrowing remit, NS&I can:

- adjust interest rates on its products, which influences demand compared with other investments on the market – NS&I's Pricing Committee regularly monitors the net financing position of NS&I and competitor data, and works with the Treasury's Debt and Reserves Management team to agree proposed changes;
- increase the investment limit on products such as Premium Bonds – increasing these limits allows NS&I to raise further funding from existing investors without having to increase the interest rates of its products;
- tailor marketing campaigns throughout the year to manage demand for its products; and
- make products available or take them off sale to manage demand.

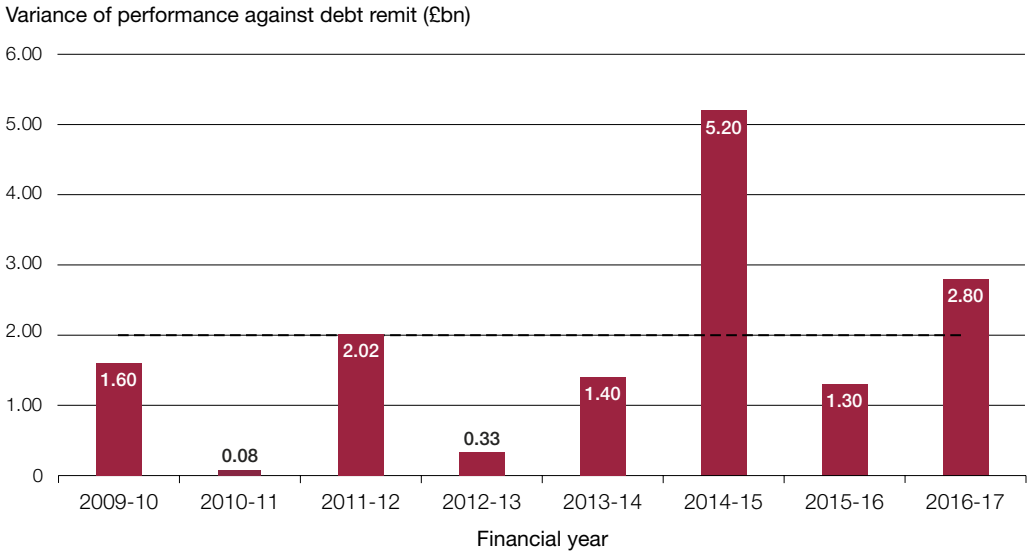
4.11 The Treasury allows NS&I a £2 billion tolerance either side of its remit, increased to £3 billion for 2017-18. NS&I has breached this tolerance three times in recent years (**Figure 21** overleaf):

- In 2011-12, it exceeded the tolerance by £20 million (0.5%) due to unseasonably high saving deposit levels across the market, towards the end of the financial year.
- NS&I attributed its £3.2 billion breach (21%) in 2014-15 to faster than expected sales; the removal of the cap on the amount of 65+ Guaranteed Growth Bonds that NS&I could offer; and an increase in the maximum investment limit of Premium Bonds to £40,000 (subsequently raised to £50,000 in 2015-16).
- In 2016-17, continuing low market rates caused high levels of inflows and lower than normal withdrawals which resulted in NS&I breaching the tolerance by £0.8 billion (7%). NS&I announced that it was reducing interest rates on variable rate products and lowering the prize fund rate of Premium Bonds, in response, but the time frame agreed with the Treasury meant the changes took effect after year end.

Figure 21

Variance between finance raised by NS&I and its remit since 2009-10

NS&I has breached the £2 billion tolerance allowed on its debt remit three times since 2009-10



Note

1 The dotted line represents the tolerance allowed to the NS&I remit, as set by the Treasury. This tolerance has increased to £3 billion for 2017-18.

Source: National Audit Office analysis of National Savings and Investments information

Relative cost-effectiveness

4.12 To measure performance against its high-level objective, NS&I's measure of cost-effectiveness is the Value Indicator, which indicates the cost of borrowing through NS&I compared with that of issuing gilts. **Figure 22** outlines how the Value Indicator is calculated. A positive figure indicates the value created by borrowing through NS&I; a negative indicates the value lost by borrowing through NS&I.

Figure 22
Calculating the Value Indicator

Calculation	Includes
Notional cost of delivering NS&I's borrowing through wholesale markets	• This is the cost of raising the funds in the gilt market of an equivalent term. For variable-term products, the average length of time the product is held by the customer is used.
Less: cost of borrowing through NS&I[1]	• Interest on NS&I investments and Premium Bond prizes. • Management costs of NS&I over and above those of the DMO. • Tax foregone on NS&I's tax-free products.

Note

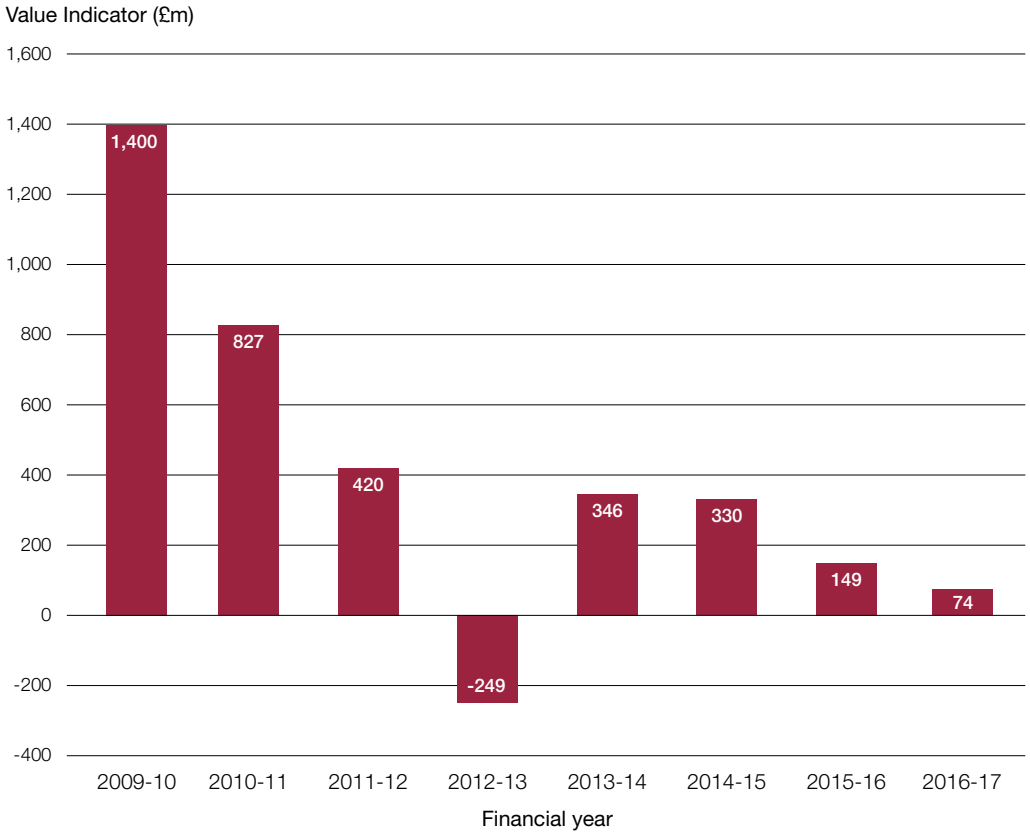
1 Costs associated with 65+ Guaranteed Growth Bonds are not included in the Value Indicator calculation. The Investment Guaranteed Growth Bond introduced in April 2017 is also excluded from the Value Indicator calculation for 2017-18 onwards.

Source: HM Treasury, *Debt management report 2016-17*, March 2016

4.13 Figure 23 overleaf shows how the value created through NS&I has fallen in recent years, from £1.4 billion in 2009-10, to £74 million in the 2016-17 financial year. This is largely due to government bond rates falling faster than NS&I product rates. As the Value Indicator compares borrowing through NS&I to equivalent maturity gilts, it is sensitive to movements in government bond rates. There is variation in the value produced by specific products, with variable interest rate products and Premium Bonds creating the most value and fixed interest products the least. Products with policy elements, such as 65+ Guaranteed Growth Bonds, are part of the debt portfolio but are excluded from the Value Indicator calculation. This is because such products have policy objectives beyond raising funds for government, often offering rates of return above market rates, and to include them would negatively skew the performance measure. Instead, the incremental costs of these products compared to borrowing through gilts are reflected alongside the relevant fiscal event. For example, the government set out the potential cost implications of 65+ Guaranteed Growth Bonds alongside the 2014 Budget.

Figure 23
Value Indicator since 2009-10

Although NS&I's value indicator has been falling since 2009-10, in 2016-17 NS&I delivered value for the taxpayer of £74 million over other means of borrowing



Note

1 Products with policy elements, such as 65+ Guaranteed Growth Bonds, are part of the debt portfolio but are excluded from the Value Indicator calculation.

Source: National Audit Office analysis of National Savings and Investments data

4.14 NS&I and the Treasury recognise that the Value Indicator is only an indicator of cost-effectiveness and that it could lead to short-term decision-making if considered in isolation. Instead they take a longer-term view when deciding which products to offer and withdraw, and when setting interest rates which take into account the needs of their customers.

Avoiding distortions in the market

4.15 NS&I Pricing Committee monitors the market for signs that NS&I products are distorting the wider retail savings market. In August 2017 NS&I had a £148 billion share of the £1.7 trillion UK retail savings market, roughly an 8.6% share of the market according to NS&I's measure. The Pricing Committee also monitors NS&I products against competitor products.

4.16 NS&I does not set itself a maximum market share, nor limit the positions its products may occupy relative to the wider retail savings market segment. Rates of return on products introduced for policy purposes such as the current Investment Guaranteed Growth Bond can be higher than other similar products (see paragraph 4.6). By monitoring the market, the Pricing Committee is able to take action if NS&I's market share grows significantly, or if the rates on NS&I products become more competitive relative to the rest of the market. This may involve reducing interest rates on specific, variable rate products, making the terms of products less favourable, or taking products off sale. In doing this, the Pricing Committee must balance the interests of both savers and taxpayers and do so without distorting the wider retail savings market. Taking action to reduce market share may also affect NS&I's ability to meet its debt remit. In this case, the NS&I and the Treasury would agree which objective would take priority based on the specific circumstances.

4.17 Products becoming more competitive relative to the market and rapid growth in market share may indicate a growing risk that NS&I is experiencing challenges in balancing the interests of the taxpayer, the customer and the broader financial services sector. The Pricing Committee reviews this risk regularly and, where necessary, recommends action to the Treasury such as adjusting interest rates. In February 2017, NS&I announced it was reducing interest rates on four of its variable rate products: Premium Bonds, Direct ISA, Direct Saver and Income Bonds.

Appendix One

Our audit approach and evidence base

1 This study examined government borrowing and debt in the Whole of Government Accounts (WGA), the associated risks and benefits to the UK's public finances and how the government manages its debt. We reviewed:

- how borrowing and debt are valued and reported;
- the current size, profile and nature of borrowing and how it is changing;
- the long-term financial risks associated with these liabilities;
- the government's approach to managing its debt; and
- how the WGA could help the government's understanding and management of these liabilities.

2 We reviewed the information relating to liabilities in all WGAs published since its inception in 2009-10 and some individual financial accounts that are consolidated into the WGA. Much of our assurance comes from the significant body of financial audits that we carry out across central government. We reviewed fiscal sustainability reports published by the Office for Budget Responsibility to gain insight into the long-term implications of the government's commitments. We reviewed other relevant information in the public domain, including publications by the Office for National Statistics, HM Treasury and the International Monetary Fund.

Appendix Two

Comparison of WGA and National Accounts balance sheet measures

Balance sheet element	Example	PSND[1]	PSNFL[2]	Net liabilities[3]
Non-financial assets	Buildings and fixed assets			✔
Illiquid financial assets	Working capital		✔	✔
Liquid financial assets	Cash held in bank accounts	✔	✔	✔
All liabilities accumulated to date	Gilts issued to finance past activities	✔	✔	✔
Future assets and revenues	Expected future revenues from taxation			
Future liabilities incurred in the future	Future policy commitments			
Future liabilities incurred from past activities	The future cost of nuclear decommissioning			✔
Contingent liabilities	Potential liabilities under the UK Guarantees scheme for infrastructure			✔[4]

Notes

1 Public sector net debt (Office for National Statistics).

2 Public sector net financial liabilities (Office for National Statistics).

3 Net liabilities per the Whole of Government Accounts (WGA).

4 Not included in the 'net liabilities' measure but disclosed as a part of the WGA.

Source: National Audit Office analysis of Office for Budget Responsibility information

Appendix Three

Other financial liabilities

1 The WGA reports other financial liabilities associated with borrowing. At 31 March 2016 these were:

- **Finance lease element of on-balance sheet private finance initiative (PFI) contracts (£39 billion)** – the principal amount that the government owes under PFI contracts which are accounted for on the WGA balance sheet. PFI contracts which are off balance sheet due to financial reporting rules are not recognised on the balance sheet.
- **Bank and other borrowings (£46 billion)** – outstanding balances held by organisations across central and local government, including bank overdrafts held by local authorities.
- **Network Rail debt (£29 billion)** – the outstanding amount of historic borrowing by Network Rail. After it took over the network from Railtrack in 2002, Network Rail carried out a Debt Issuance Programme to fund capital investment. In 2014, Network Rail began borrowing directly from government, through a loan facility, rather than issuing its own debt. Network Rail's borrowing from 2014 onwards is reflected in the WGA under gilt-edged securities.
- **UK Sovereign Sukuk (£200 million)** – bonds issued by the UK government, structured to generate returns to investors without infringing Islamic law. This typically involves would-be bondholders investing in a special company that owns an asset (such as an office building) with an income stream (such as a rental agreement). This provides rental income for the investors in lieu of interest. The profit rate on the UK Sovereign Sukuk is comparable with gilts of a similar issue and expiry date.

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