National Audit Office

REPORT

Managing government borrowing

HM Treasury

SESSION 2022-23
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HM Treasury

Report by the Comptroller and Auditor General

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Gareth Davies
Comptroller and Auditor General
National Audit Office

27 June 2023

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Key facts

£110.6bn

of central government debt interest payments in 2022-23, net of the Asset Purchase Facility (APF), compared with £60.8 billion in 2021-22

£242.8bn

the Debt Management Office's (DMO's) 2023-24 total target for net borrowing on behalf of government

£7.5bn

the National Savings and Investments' (NS&I's) 2023-24 target for net borrowing on behalf of government

£486 billion	of debt the DMO raised in 2020-21 from gilts issued
25%	of government gilts are inflation-linked
£120 billion	total money invested in NS&I Premium Bonds at 31 March 2022 – 58% of its total portfolio

Summary

1 Government borrows when it spends more than it raises, for example from taxes. Government spending has exceeded income in every year after 2000-01, and in all but five years from 1970-71. In any year where government borrows more than it repays, its stock of debt increases. Borrowing provides government with flexibility to deliver policies and support the economy, particularly if tax receipts fall and spending increases. Government needs to pay interest on the money it borrows.

2 Central government borrowing takes place within a legislative and policy framework. HM Treasury (HMT) is responsible for fiscal policy (public finances) within government, and for delivering the government's overall debt management objective. HMT's objective in relation to debt management policy is "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".

3 The Debt Management Office (DMO) and National Savings and Investments (NS&I) are HMT's agents for implementing debt management policy. The DMO borrows on government's behalf from wholesale investors such as financial institutions through products such as 'gilts' which are government bonds, while NS&I borrows on behalf of government from retail investors through products such as Premium Bonds. The Office for Budget Responsibility (OBR) has responsibilities that include forecasting the government's borrowing needs. The Bank of England (BoE) has relevant responsibilities, including: setting monetary policy independently of government to achieve an inflation target of 2%;[1] and identifying and monitoring risks that threaten the resilience of the UK financial system in order to maintain financial stability.

4 Government's actions to protect the economy and public health in response to 'shocks' have contributed to debt rising over time, which has in turn played a part in higher debt interest payments. Debt has increased since 2000 mainly because of the 2007–2009 global financial crisis when the government provided support to the banking sector, and the response to the COVID-19 pandemic, alongside the wider economic impact of these shocks on tax receipts, which fell. Other reasons include government support on energy bills provided to households and businesses in the wake of Russia's invasion of Ukraine. Increasing debt means increased interest payments, as does increasing interest rates. Inflation was more than 10% at March 2023, and around 25% of government's gilts are inflation-linked.[2]

1 As measured by the Consumer Prices Index (CPI).
2 General price inflation is measured by CPI; government gilts are linked to the Retail Prices Index (RPI).

5 Since our 2017 report, *Evaluating the government balance sheet: borrowing*, the environment within which government borrows has become more challenging.[3] The stock of government debt, as measured by public sector net debt excluding the Bank of England, was an estimated £2,247 billion at the end of 2022-23.[4] As a percentage of gross domestic product (GDP), this was the highest level since the 1960s and the OBR forecasts debt using this measure will peak in 2026-27, while in monetary terms the OBR forecasts debt will rise further in 2027-28. Rising debt following the financial crisis is a trend similar to other developed economies. Net borrowing for the 2020-21 financial year, measured by public sector net borrowing excluding public sector banks (PSNB ex) reached £331 billion, higher than any year from 1955-56 onwards, because of pandemic-related spending. Government debt interest payments were an estimated £110.6 billion in 2022-23, compared with £60.8 billion in 2021-22.

6 The increasing cost of government debt has significant implications. If debt costs rise, borrowing may need to increase further so that government can meet higher debt interest payments. There is a range of factors determining debt costs, including the level of borrowing, the composition of debt and the confidence of private markets in government's ability to repay debt, which informs investors' willingness to lend. As debt servicing costs rise, choices about spending in different government areas become more acute, particularly at a time when higher inflation places greater pressure on existing budgets. Ministers are responsible for making judgements about taxation, spending and borrowing, including assessments of the affordability of debt and borrowing levels.

Scope of this report

7 This report examines how public bodies pursue the government's debt management objective, and particularly how government manages the risks of borrowing. It focuses on debt that central government issues. The report does not seek to comment on the merits of fiscal and monetary policy objectives, and levels of tax, spending and borrowing, which are decisions for ministers. Nor does it evaluate whether government is meetings its fiscal objectives and targets, which is the OBR's responsibility.

3 Comptroller and Auditor General, HM Treasury, *Evaluating the government balance sheet: borrowing*, Session 2017-2019, HC 526, National Audit Office, November 2017.

4 In this report, we have shown OBR and Office for National Statistics (ONS) data on public sector net debt, public sector net borrowing and debt interest in 2022-23 prices. Unless otherwise stated, all other amounts are shown in current prices at the time they were reported.

Key findings

The government's debt management approach and performance

8 **Government's debt management approach is long-established and reviews of individual elements to date have found that it is operating effectively.** The processes of issuing debt through the DMO and NS&I have remained broadly unchanged since the late 1990s, when the DMO was set up. While the framework has been tested – most notably during the financial crisis and the pandemic – external conditions affecting the framework have changed over time and events can move quickly. HMT has undertaken separate 'Tailored Reviews' of the DMO and NS&I which found they were operating effectively; and the OBR's evaluation of its forecasts for net borrowing found that they are more accurate than HMT's were before the OBR's creation. There are opportunities for HMT, the DMO and NS&I to capture and apply lessons from those testing conditions, to inform assessment of whether the framework is still optimal as external circumstances change. To date HMT has not conducted a review of how the debt management framework as a whole is adapting to a changing external environment, or how well the individual elements of the framework fit together (paragraphs 2.18 to 2.22).

9 **Government has been able to borrow to meet its spending needs, including during the financial crisis and the pandemic**. HMT ministers set the DMO and NS&I each an annual target, called a 'remit', to borrow what government needs. The DMO delivered its remit in 2020-21 when its gilt remit increased by £330 billion during the year to £486 billion of borrowing to support the government's pandemic response. NS&I has borrowed on government's behalf at or above HMT's expectations in the past 10 years except in 2020-21, when it raised £24 billion after its remit was revised upwards from £6 billion to £35 billion. At times the DMO may need to prioritise delivering its remit over other factors, including minimising the impact on borrowing costs (paragraphs 2.2, 2.3 and 2.12 to 2.15 and Figure 7).

10 **The parties who hold most government debt have changed over the past 15 years.** In 2008, during the financial crisis, insurance companies and pensions funds collectively held the highest proportion of government debt. In 2009 the BoE began a quantitative easing (QE) programme with the aim of lowering interest rates, encouraging spending in the economy, and meeting the Monetary Policy Committee's (MPC's) inflation target. It does this by creating new money electronically to buy government gilts in the secondary market (from financial institutions, rather than directly from the DMO). At the end of December 2022, the BoE held the highest proportion of government gilts, at £650 billion (paragraphs 2.8 and 3.17, and Figure 13).

11 **Measuring performance against government's debt management objective is complex.** The objective (paragraph 2) is high-level and not directly measurable. It also requires simultaneous assessments of both cost and risk "over the long term" of the debt portfolio. HMT and the DMO do not have a set of more measurable intermediate objectives, success criteria and indicators allowing a quantitative assessment of whether government is meeting the debt management objective. Instead, government takes assurance about cost-effectiveness from a range of factors, including the healthy functioning of the competitive auctions by which the DMO raises most debt, and the DMO's analysis of different maturities and which mix of gilts can be expected to offer better value at different levels of inflation. These factors should be seen in the context of comments made in our interviews with the International Monetary Fund (IMF) and the Organisation for Economic Co-operation and Development (OECD), who told us that the UK debt management framework and the DMO's role in it is widely respected internationally. NS&I used a 'Value Indicator' that provided some evidence over time that its borrowing on government's behalf was cost-effective. However, HMT has withdrawn the Value Indicator for formal monitoring purposes because NS&I had limited influence over factors upon which the calculation was based (paragraphs 1.4, 1.5 and 2.15 to 2.17).

Managing risks to debt management objectives

Maintaining confidence among investors

12 **DMO's ability to borrow on government's behalf depends on the willingness of lenders.** In deciding what type of gilts to issue, and over what period, the DMO seeks to meet the government's objective around long-term cost minimisation subject to appropriate management of risk, while also considering market appetite to ensure government's borrowing needs are met. Market confidence is critical to borrowing costs, as events following the Growth Plan, also known as the mini-budget, in September 2022 illustrated. The DMO maintains market confidence by being transparent and predictable in its market engagement. We interviewed representatives of approved intermediaries, called Gilt-edged Market Makers (GEMMs), through which the DMO issues gilts, who were strongly positive about DMO's approach (paragraphs 3.5 and 3.19 to 3.21).

Striking a balance between benefits and risks

13 **Government must weigh up the benefits and risks when deciding for how long to borrow.** When issuing gilts, government must consider how long it wishes to borrow for – the debt's 'maturity'. The longer the maturity, the longer the interest rate is locked in on a fixed-rate gilt and the lower the government's exposure to changes in interest rates. But investors may prefer shorter maturities as it means they will not be locked into a poor rate if interest rates go up. During the COVID-19 pandemic the DMO was able to sell very high amounts of short-dated debt to fulfil its remit. When demand is high for short maturity gilts, the DMO must balance meeting this demand with the fact that short-dated debt exposes government to the risk of having to regularly refinance the debt, potentially at a worse rate. The BoE's QE programme bought large volumes of gilts and created new central bank reserves to finance these purchases. This means that this portion of government debt is more sensitive to the BoE's 'Bank Rate' movements because the interest rate on gilts is usually fixed, and rates on central bank reserves are variable. As the Bank Rate rises, government's debt interest payments rise faster than they would have done in the absence of the QE programme. The converse applies when the Bank Rate falls (paragraphs 1.13, 2.7, 3.6 and 3.10 to 3.14, and Figure 9).

14 **Government must also decide how much of the debt it issues is linked to inflation.** In the UK around 25% of total government gilts in issue are index-linked – which means the debt payments are linked to inflation. In 2018, following OBR analysis, HMT decided to reduce the proportion of new index-linked gilts issued in a "measured fashion over the medium term", as it was concerned about potential exposure to inflation.[5] In 2022 HMT decided that the proportion of index-linked gilts issued each year was appropriate. UK investors' demand for index-linked gilts is higher than in other countries partly because of demand from defined benefit pension schemes, which are more common in the UK than elsewhere. At times when borrowing needs are most acute, achieving a balance is complex – in recent years the DMO has been able to secure better value on its index-linked gilts because of strong demand from investors seeking inflation protection. The DMO's analysis prior to the Spring Budget in March 2023 showed that index-linked gilts were forecast to be more cost-effective than conventional gilts at maturities greater than or equal to 20 years, if inflation (RPI) does not exceed an average of 3% over the gilts' life (paragraphs 2.6, 3.5 to 3.9, and Figure 8).

5 HM Treasury, *Budget 2018*, October 2018.

15 In providing savings products for retail investors, NS&I must balance three factors. HMT requires that NS&I balances three factors: the interests of savers; the interests of taxpayers; and the stability of the broader financial services sector, including by maintaining an appropriate competitive position. NS&I has 25 million savers and more than half (58%) of its debt portfolio, nearly £120 billion invested, is in one product – Premium Bonds. NS&I told us its average customer age is 51 and that one of the challenges it faces to attract younger customers, who tend to follow market-leading rates, is that it cannot match these rates as it needs to maintain an appropriate competitive position. If NS&I were to always offer market-leading rates, it would not be balancing its three factors. NS&I told us it is taking steps to address the ageing demographic of its customers by making products more accessible, and appealing, to a younger age group (paragraphs 2.9 to 2.11 and 3.24, and Figure 6).

Making the system work

16 Government's financing needs have changed in-year more frequently recently than in the past. Between 2019-20 and 2021-22, government changed the amount it expected NS&I and DMO to borrow on its behalf outside of the usual Budget cycle (the March Budget and the autumn fiscal event). For example, in responding to the pandemic, HMT revised upwards DMO's gilt remit for 2020-21 through successive increases, from £156 billion in March 2020 to £486 billion in November 2020, and NS&I's remit from £6 billion to £35 billion in July 2020. To minimise risks of an impact on monetary policy, HMT instructs DMO to borrow no more than it needs in-year; this means, for example, that if the DMO's remit reduces in-year, the DMO will likely reduce the pace and volume of sales. HMT asks the OBR for forecasts at least twice each year, which are used to make remit-setting as accurate as possible. However, forecasting is time-consuming and costly, so HMT does not always ask for additional forecasts before changing remits in-year. The OBR told us that it could support remit revision reviews at other times, which could improve accuracy. It acknowledged that, because of the cost, this would need to be done in a proportionate way (paragraphs 2.3, 2.12 to 2.14, 3.15 and 3.16).

17 The DMO is liaising operationally with the BoE regarding unwinding of its QE programme. The BoE's MPC is responsible for monetary policy decisions. In our 2017 report we recommended that, consistent with the MPC's statements, the BoE should liaise closely with the DMO when carrying out market operations to reduce the stock of assets held under the QE programme. We noted that effective coordination was required to mitigate the risk of disruption to gilt market conditions. The MPC voted to reduce the stock of UK government bonds held under the QE programme by £80 billion in the 12 months from September 2022, through gilt sales, and gilts maturing; the BoE began selling gilts in November 2022. The DMO and the BoE are engaging with each other operationally over their respective gilt sales to manage potential risks as the BoE unwinds the QE programme (paragraphs 1.6, 3.17 to 3.18).

18 **DMO and NS&I are managing organisational risks.** Debt management activities are often complex, requiring experience and judgement.

- The DMO's role requires it to recruit and retain skills most commonly found in financial markets. These skills often attract remuneration beyond the DMO's 'offer', which presents recruitment and retention risks. Additionally, there are risks regarding key personnel retiring. The DMO has established a team to look at recruitment and retention challenges, and succession planning; the DMO is identifying areas, including its resources, to discuss with HMT (paragraphs 3.22 and 3.23).
- NS&I relies on one service provider – Atos – which operates its entire back-office and customer-facing operations. The Tailored Review found that NS&I believes this contract works well, but there have been issues with change and transformation projects. NS&I is undertaking a transformation programme moving to a model involving several service providers. This is aimed at ensuring NS&I can respond proactively to market changes and scale up its business more efficiently when required. The Atos contract was due to expire in 2024 but, because of delays to the transformation programme, NS&I activated a contract clause to retain Atos until April 2025 at the earliest. NS&I has shared with us documentation relating to planning for its future operating model and transition to a multi-provider model. However, we have not seen an NS&I plan specifically around internal skills and capacity needed to deliver this work (paragraphs 2.21, 3.22, 3.24 and 3.25).

Concluding remarks

19 The environment for borrowing and debt management has become more challenging since our last report in 2017. As in other countries, the pandemic led to a large increase in borrowing to accommodate higher government spending to protect public health and the economy. More recently, interest rates have increased as central banks seek to combat inflation – this raises the interest costs of new government borrowing. Against this backdrop the government has been able to borrow its target amounts through the work of the DMO and NS&I. But at the time of this report, debt interest payments are one of the largest items in government spending.

20 The environment within which the DMO and NS&I borrow on behalf of government continues to change, and there are substantial challenges ahead for debt management including refinancing the borrowing made in response to the pandemic. The DMO and NS&I recognise these challenges, but some risks require an increased focus. For example, the DMO faces significant retention risk that it and HMT will need to manage carefully, and NS&I is concentrated in its operations, products and investors and will need to develop ways of diversifying these risks.

Recommendations

21 We make the following recommendations:

a **HMT should consider ways to align and extend how it measures progress against the debt management objective, while recognising the inherent challenges.** This should include developing further its quantitative and qualitative evidence base to feed into an overall assessment, aligning with performance metrics and monitoring of the DMO and NS&I where appropriate.

b **HMT should periodically review the appropriateness of individual elements of the debt management framework, and how the individual elements work together.** It should formally capture lessons from when the framework has responded to testing conditions.

c **HMT, working with the OBR, should explore how remit revisions outside regular fiscal events can be supported by quicker, more focused OBR assurance.** This assurance should be proportionate, taking account of the event under assessment and the costs to public bodies in producing forecasts.

d **The government should ensure that it has plans to manage skills and capacity risks to its debt management operations.**

- The DMO should implement a plan for mitigating the risks of losing key personnel.
- The NS&I should implement a plan for internal skills and capacity, clearly linking this to how it manages major projects and to its plans for contract management as it moves away from a single provider model.
- HMT should review these plans and examine whether the resources needed to deliver the plans are appropriate.