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Debt Management Account Report and Accounts

2004 - 2005

Presented to Parliament in Pursuance of Section 5A of the National Loans Act 1968

Ordered by the House of Commons to be printed 20 July 2005

The United Kingdom
Debt Management Office
is an Executive Agency of
HM Treasury

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This publication is available in electronic form on the DMO website www.dmo.gov.uk.

All the DMO's publications are available on its website including:

- Annual Review covering the main developments during the financial year;
- Quarterly Reviews highlighting more recent developments in the DMO's gilts and cash market activities;
- guides for potential investors in gilts - both wholesale and retail;
- the DMO's annual Report and Accounts covering its administrative expenditure;
- the Debt Management Account annual Report and Accounts;
- Operational Notices covering the DMO's market activities in the gilts and cash markets;
- The DMO's annual Business Plan;
- The DMO's Framework Document (which sets out the DMO's relationship with HM Treasury).

Alternatively, hard copies of these publications are available from the DMO by telephoning 020 7862 6501.

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Foreword

Chief Executive's statement

2004-05 was the seventh year of the UK Debt Management Office's operations.

During the year, the DMO successfully met both its debt and cash management remits issued by HM Treasury. Gilt sales have risen steadily over the past few years from £26.3 billion in 2002-03 to £50.1 billion in 2004-05, the highest financing requirement in a decade. Partly as a consequence of this, turnover in the gilts market has risen rapidly, as outright issuance has increased. Average daily turnover has risen from £8.7 billion in 2002-03 to a record £12.8 billion in 2004-05 and reflects increased liquidity in the market. The outstanding stock of Treasury bills has also increased to £20.5 billion, while the total value of market transactions through the Debt Management Account exceeded £1 trillion for the first time.

During the year, the DMO consulted market stakeholders on the potential issuance of ultra-long gilts for the first time in a generation. As a result the Chancellor of the Exchequer announced in his Budget speech in March that such instruments would be issued from May 2005. Ultra-long gilts offer potential cost savings to the Government and represent an important and potentially attractive investment opportunity for the pensions and life insurance industry. The DMO has also announced that any new index-linked gilt issued from 2005-06 will use a three-month indexation lag as opposed to the current eight-month lag - this brings the UK into line with international best practice on index-linked instrument design.

Following the transfer of the gilt registration contract from the Bank of England to Computershare Investment Services PLC in December 2004 the DMO assumed responsibility on behalf of HM Treasury for management of the contract.

The DMO continues to benefit from the professionalism and expertise of its staff who ensure that operational effectiveness is of the highest standard. It is our aim to ensure a positive and supportive working environment for all, as we strive to meet the increasing challenges of our developing remit. The successes of the past year are the result of the collective efforts of all my colleagues, to whom I remain very grateful for their contribution.

Debt Management Account

Background

The DMO was established on 1 April 1998. Its aim is "to carry out the Government's debt management policy of minimising financing costs over the longer term, taking account of risk, and to manage the aggregate cash needs of the Exchequer in the most cost effective way".

The DMO assumed responsibility for debt management on 1 April 1998 and for cash management on 3 April 2000.

The Finance Act 1998 provided for the establishment of the Debt Management Account (DMA) and this was created by order on 15 November 1999. Its purpose is the management and reporting of the debt and cash dealing operations that the DMO undertakes to meet its objectives.

As the Government's debt manager, a key role of the DMO is to issue gilt-edged securities on behalf of HM Treasury. Gilt-edged securities, or gilts, are UK Government, sterling denominated, listed bonds. The DMO issues Treasury bills on its own account and undertakes other money market operations to meet the Government's daily cash requirements.

The accounts reflect trading activities relating to Government debt and cash management. Administration, staffing costs, and costs directly related to trading (such as auction costs and stock exchange listing fees) are not accounted for in the accounts of the DMA. These expenses are reflected in the accounts of the DMO, which are audited and published separately. The DMO annual Report & Accounts 2004-05 are available on the DMO's website at www.dmo.gov.uk.

Robert Stheeman, the DMO's Chief Executive, was appointed by HM Treasury through open competition, and commenced his role on 6 January 2003. A corporate governance structure is in place to assist the Chief Executive. This comprises a Managing Board with the following members:

- Robert Stheeman - Chief Executive
- Jo Whelan - Deputy Chief Executive
- Jim Juffs - Chief Operating Officer
- Sue Owen - non-executive HM Treasury representative
- James Barclay - non-executive Director (retired 31 March 2005)
- Colin Price - non-executive Director
- Brian Larkman - non-executive Director (appointed 1 January 2005)

Relationship with the National Loans Fund

The operations of the Consolidated Fund and the National Loans Fund (NLF) - the main central government funds - are central to an understanding of the role of the DMA in Government debt and cash management. HM Treasury manages both funds. The Consolidated Fund accounts for most central government expenditure and receipts, while the NLF mainly undertakes borrowing and financing transactions. As the Government's main borrowing account the principal role of the NLF is to balance the Consolidated Fund at the end of each day.

The DMA's role is to meet the financing needs of the NLF. These include long-term requirements (debt management), short-term requirements, and day-to-day cash needs (cash management). Lending by the DMA to the market (when the Government has excess cash) is an asset of the DMA, while borrowing by the DMA from the market is a liability. Day-to-day borrowing and lending largely takes the form of the issuance of Treasury bills, sale and repurchase transactions (repos), and reverse sale and repurchase transactions (reverse repos) with the market. The latter are collateralised, usually using gilts. For this purpose the DMA holds a large gilt portfolio comprising gilts bought from the NLF and from the former National Investments and Loans Office (NILO) early in the life of the DMA.

The DMO undertakes gilt issuance operations via the DMA on behalf of the NLF. The NLF creates the gilt that is to be issued and sells it to the DMA. The DMA then sells the gilt to the market. The responsibility for paying gilt coupons and redeeming the debt on maturity lies with the NLF, as the gilt remains a liability of the NLF. The DMA regularly undertakes secondary market gilt transactions in small volumes. The DMO also offers a buying and selling service to retail customers

Treasury bills are issued by the DMO, as part of its cash management operations. These are liabilities of the DMA.

Under the terms of the Finance Act 1998, the NLF made a cash advance of £6 billion to the DMA at inception in order to establish the account. This advance was initially used by the DMA to purchase a pool of gilts for use as collateral for repo borrowing in its cash management operations. Subsequent cash advances have been made either to enable the DMA to expand its activities, or to meet statutory requirements relating to NLF-DMA borrowing. A cap on borrowing by the DMA, other than from the NLF, which was a requirement of the Finance Act 1998, was repealed by the Finance Act 2003. For much of 2004-05 the outstanding NLF advance to DMA stood at £35 billion, but this balance was reduced to £20 billion by a single repayment before 31 March 2005.

At the end of each day, any surplus balance on the DMA (less a target float of £200 million) is returned to the NLF as a deposit. This is the means by which the DMA balances the daily financing needs of the NLF. The deposit was £50,912 million at 31 March 2005. The DMA pays interest on the advance at the Bank of England repo rate to the NLF. The DMA receives interest on any daily deposit made with the NLF at the same rate. This rate has been agreed with HM Treasury largely for administrative convenience rather than to provide a performance benchmark rate. The DMO is developing a benchmarking process to measure the effectiveness of the DMO's cash management operations and the DMO expects to implement the process in 2006-07, following a transitional phase during 2005-06.

Retained surpluses and deficits of the DMA are assets or liabilities of the NLF respectively. In the case of a retained surplus, HM Treasury may pay all or part of the surplus from the DMA to the NLF thereby reducing the liability of the DMA. The only such payment to date was made in March 2004, which reduced the liability of the DMA to the NLF by £650 million. In the case of a retained deficit, HM Treasury may pay all or part of the deficit to the DMA from the NLF. If there were to be a cessation of the DMA, with a corresponding liquidation of all balances, the NLF is entitled to the net amount realised. In such a situation the NLF will have a responsibility to meet outstanding liabilities including those relating to Treasury bills issued by the DMA.

Relationship with Commissioners for the Reduction of the National Debt (CRND)

Commissioners for the Reduction of the National Debt (CRND) is a separate entity within the DMO that performs a fund management service for a small number of public sector clients. The Comptroller General of CRND is also the Deputy Chief Executive of the DMO. CRND client mandates require the bulk of the funds to be invested in gilts or with the DMA Deposit Facility (DMADF). Surplus cash in CRND client accounts is regularly deposited with the DMADF. From time to time, the DMA transacts marketable gilts with CRND and trades these back-to-back with market counterparties. The DMA also transacts non-marketable gilts on behalf of CRND and trades these back-to-back with the NLF. These transactions are carried out on an arms length basis and in line with a Memorandum of Understanding between the DMO and CRND.

The value of deposits outstanding at 31 March 2005 was £18.5 billion (31 March 2004: £17.2 billion).

Operating and financial review

Activities

The DMO is an Executive Agency of HM Treasury specialising in the delivery of treasury management services and related policy advice to central government. The DMO performs these functions with a view to contributing to the Government's objective of achieving sound and sustainable public finances and improving the cost effectiveness of public services.

The main activities of the DMO that are managed and reported through the Debt Management Account are:

- To issue gilts on behalf of the National Loans Fund;
- To issue Treasury bills;
- To enter sale and repurchase transactions (repos) using its holdings of gilts as collateral;
- To buy and sell money market instruments and transact unsecured borrowing and lending;
- To hedge the Government's position arising from issuance by National Savings & Investments of Guaranteed Equity Bonds.

There are two separate legal entities managed within the DMO that are not managed and reported in the DMA: the Public Works Loans Board (PWLB), and Commissioners for the Reduction of the National Debt (CRND). Their main activities are:

- PWLB – To lend money to local authorities and other prescribed bodies for capital investment purposes;
- CRND – To perform a fund management service for a small number of public sector clients.

Policy

The DMO is legally and constitutionally part of HM Treasury, but as an Executive Agency, it operates at arm's length from Ministers. The Chancellor of the Exchequer determines the policy and operational framework within which the DMO operates, but delegates operational decisions on debt and cash management, and the day-to-day management of the Office to the Chief Executive.

The DMO receives annual remits from HM Treasury covering both its debt and cash management operations. The remits are published in the Debt and Reserves Management Report, usually issued as part of the Budget announcements each spring. The DMO conducts its operations for the forthcoming financial year within the scope of these remits, and to meet its specified objectives and targets.

The gilt remit specifies the planned annual total of gilt sales in cash terms, the split between conventional and index-linked gilt sales and within conventional gilts the split by maturity band. The dates of scheduled outright auctions are also announced. The remit also provides the basis for the conduct of any switch, conversion or buy-back operations in a particular year. The cash remit includes information on the planned approach to Treasury bill issuance and the planned stock of Treasury bills at the end of the financial year.

Within the framework of the remit, the DMO decides the size of gilt auctions and the choice of gilts to be auctioned, and the size and maturity breakdown of Treasury bill tenders.

The DMO publishes Operational Notices describing how it will act in the gilts and sterling money markets – copies of these documents are available on the DMO website at www.dmo.gov.uk.

Performance against the DMO's strategic objectives

HM Treasury Ministers set the DMO's strategic objectives, which are published in the DMO's Business Plan and its Framework Document. The objectives for 2004-05 and the DMO's performance against them are summarised below.

Objectives 1 to 3 inclusive relate specifically to the DMA.

1. **To meet the annual remit set by HM Treasury Ministers for the sale and purchase of gilts, with high regard to long-term cost minimisation, taking account of risk.**

   - The gilt sales target has been met through the conduct of 26 outright auctions (sixteen conventional and ten index-linked). Outright sales of £48.0 billion were planned in the remit for 2004-05, published on 17 March 2004 – the highest level for over 10 years – and the sales target was increased to £50.3 billion in the PBR on 2 December 2004. The gilt sales outturn for 2004-05 was £50.1 billion (£0.2 billion below the published target but within agreed operational tolerances). The composition of issuance was £42.1 billion conventional gilts and £8.0 billion index-linked gilts. There were no uncovered gilt auctions.

	2004-05 £m	**2003-04** £m
Nominal value of gilts issued on behalf of the National Loans Fund	46,748	47,648
Proceeds paid to the National Loans Fund	50,101	49,854

2. **To offset, through its market operations, in a cost-effective manner, the expected daily cash flow into or out of the National Loans Fund (NLF); and to manage, in accordance with objectives set by HM Treasury Ministers, any assets and liabilities held on the DMA, and on behalf of clients.**

   - This was successfully achieved. Over the course of the financial year the stock of Treasury bills rose by £1.2 billion to meet the remit target of £20.5 billion. The stock of Treasury bills had peaked at £27.75 billion in mid-December 2004 to help manage seasonal cash outflows.

3. **To continue to lend to local authorities and collect the repayments; to manage and develop the Debt Management Account Deposit Facility (DMADF) and to participate actively in the development of local government finance arrangements.**

   - Changes were successfully made to the lending arrangements of the Public Works Loan Board to take account of the new system of local government capital finance, which came into effect on 1 April 2004. During the year the Board met its operational performance targets. Debt to the Board represents a Government asset of over £42 billion.

   - The Debt Management Account Deposit Facility (DMADF), through which a range of Local Authorities can deposit cash with the DMO, was operated successfully throughout the year.

Objectives 4 to 7 inclusive relate to the DMO as a whole, including the DMA.

4. To guide and assist in the formulation of strategy on debt, cash and fund management, including the remit, and to report to Ministers on the DMO's performance against its remit, objectives and targets.

- The DMO contributed specific advice in a number of areas of the 2004-05 remit:
  - ❑ the split between index-linked and conventional gilts, and within conventionals the maturity split between shorts, medium and longs;
  - ❑ the size and timing of auctions;
  - ❑ the split between an increase in the Treasury bill stock and a run-down in the DMO's net cash position as elements of short-term debt financing;
  - ❑ the range of contingencies to be implemented in the event of changes to the Government's financing requirement.
- The DMO also contributed substantially to preparation of the *'Debt & Reserves Management Report 2004-05'*.
- The DMO published information about the factors taken into account in formulating Government debt management strategy in its Annual Review published in summer 2005.
- The DMO reported performance against its remit to HM Treasury on a monthly basis, and on developments in the gilts portfolio and compliance against its published targets on a quarterly basis.

5. To participate pro-actively in the development of strategy for managing the Government's balance sheet and accordingly to contribute to and help develop solutions for financial cost-effectiveness and risk reduction, including by developing partnerships with other parts of the public sector and by providing advice and expertise to other Government departments (and other governments), as required.

- On 2 December 2004, the DMO launched a consultation paper on issuance of ultra-long gilt instruments following calls from the pension fund and insurance industries regarding the lack of supply of longer-dated (and index-linked) assets. The DMO sought formal feedback to assess the size and nature of the demand to inform decisions ahead of remit 2005-06. The deadline for responses was 21 January 2005 and the outcome of the consultation was published on 16 March 2005 in parallel with the DMO remit 2005-06.
- In December 2004, the DMO and HM Treasury ensured the successful migration of the gilts registration function from the Bank of England's Registrar's Department to Computershare Investor Services PLC.
- Throughout the year, the DMO has continued to work with National Savings & Investments in their programme of Guaranteed Equity Bond issuance, by executing equity index swaps to hedge the Government's exposure to movements in the FTSE-100 index.
- The gilt portfolio *cost-at-risk* modelling project, which aims to develop a simulation model that can be used to quantify the long-term cost-risk trade-off involved in financing the Government's debt management, has made good progress.

6. **To resource, staff and manage the DMO to deliver its objectives efficiently, cost-effectively and professionally, ensuring value for money is achieved in the office's administrative expenditure.**

    - From March 2004, a new board level committee was introduced - with the creation of the Managing Board.
    - As an accredited member of "Investors in People", the DMO has continued to support the training and development of staff to achieve organizational objectives, including support for professional qualifications and the development of a corporate training programme.

7. **To develop and maintain appropriate management, information and risk control systems (including procedures to combat potential money laundering); to ensure full and accurate presentation of and where appropriate facilitate access to financial, accounting and other information; to ensure accuracy of all DMO publications including its websites and to manage stakeholder relationships fairly and appropriately.**

    - The DMO continues to meet this wide-ranging objective with the aim of supporting the Accounting Officer and the Managing Board in the effective stewardship of the Agency. Among the routine and non-routine initiatives delivered this year are:
        - ❏ Implementing a project to enhance its quantitative risk analysis capability. A prototype system has been implemented and is used for analysis of risk in some specific operations.
        - ❏ Introducing an extension to the 'Approved Group' for users of the DMO Gilt Purchase and Sale Service ready for its launch in December 2004.
        - ❏ Publishing the Annual Report of the Public Works Loan Board in June 2004 and the audited DMA accounts and administrative accounts for 2003-04 on 21 July 2004.
    - The DMO has commissioned an automated reporting system and data warehouse for its website www.dmo.gov.uk. It is expected that this will be launched in the second half of 2005.

Financial performance

The DMA's operations for the financial year 2004-05 gave rise to net interest income of £24 million (2004 net interest income: £180 million), and dealing profits of £31 million (2004: losses of £229 million). This resulted in a surplus of £55 million (2004: deficit of £49 million).

Dealing profits or losses largely reflect the impact of external interest rate movements on the market value of the DMO's holdings of gilts, which are predominantly held as collateral for the DMO's cash management operations rather than with an intention to trade. Additionally, dealing profits are influenced by the change in market value of the DMO's hedging derivatives to offset the Government's exposure to equity index risk relating to Guaranteed Equity Bonds issued by National Savings & Investments. The DMO has no corresponding agreement with National Savings & Investments because the exposure is within Government, and is offset in a consolidated view of the central government accounts.

During the year, the DMO issued Treasury bills with a total nominal value of £100.0 billion (excluding issuance to itself to provide extra collateral), which had maturities of one month (£45.2 billion), three months (£45.0 billion), and six months (£9.8 billion). At 31 March 2005, the total value of Treasury bills in issue was £20.5 billion, with maturities of one month (£4.8 billion), three months (£10.5 billion), and six months (£5.2 billion).

With regard to cash management operations, although the DMO seeks to conduct its market interactions cost effectively, it also has to take into account that the primary requirement is to respond to the Exchequer's cash flows and to balance the NLF daily. In some circumstances, this may reduce the range of available trading strategies.

The DMA's net operating results are heavily influenced by the interaction between transactions undertaken by the DMO to smooth Government daily cash flows, and market conditions over the course of the year. The size and composition of the DMA's balance sheet during the year, and the maturity of the DMO's money market transactions, will largely reflect the seasonal pattern of Government cash flows, rather than any trading view by the DMO. The seasonal pattern of the Government's cash flows generally requires borrowing to fund net Government expenditure in the early months of each financial year, prior to receipt of the main tax revenues in the later part of the financial year.

Future developments

Looking ahead, the DMO will introduce a number of operational initiatives over the next year with the aim of improving the effectiveness and accountability of Exchequer cash management. The DMO's cash management objective has been re-phrased for 2005-06 to clarify the primacy of cost minimisation, within an approved risk appetite. The introduction of an approved risk appetite will make it easier to form objective and measurable parameters within which the DMO will conduct its cash management operations and be accountable to Ministers. (More information about the use of a risk appetite is given in the DMO Annual Review 2004-05, Chapter 5: Review of Government Cash Management, which is available on the DMO's website at www.dmo.gov.uk.) This change will be implemented in two stages: an initial, transitional stage will operate in 2005-06 while preparations are completed for the second, full stage which is expected to occur in 2006, when the Bank of England's reform of the sterling money market will be fully in place.

Risk Management

DMO's approach to managing risk

The DMO attaches a high priority to risk management. It has developed a set of policies to limit its exposure to risk in the achievement of its objectives. The DMO's position differs from that of a commercial organisation in that it must always be in a position to transact the underlying business required to meet its remit, although it will seek to minimise risk in doing so. Implementation of these policies is the responsibility of the Chief Executive as the Accounting Officer of the DMA. Functional teams and committees comprising appropriately qualified staff assist the Chief Executive in this role. Risks to the reputation of the DMO are also routinely considered within operational risk management activities.

Further details of the DMO's risk management processes are given in the 'objectives and policies for holding and issuing financial instruments' below, and in the 'statement on internal control' on page 21 to 24.

Objectives and policies for holding and issuing financial instruments

The remit issued to the DMO by HM Treasury sets out the expected net borrowing of the DMA, and includes gilt issuance and Treasury bill issuance. The position of the DMA at 31 March 2005 is broadly representative given the seasonal nature of the DMA's transactions.

Short-term debtors and creditors are included in the following disclosures.

Cash management operations

The DMO's cash management objective is *"to offset, through its market operations, the expected cash flow into or out of the National Loans Fund (NLF) on every business day, in a cost effective manner with due regard to risk management"*.

The remit set by HM Treasury specifies that the DMO's main objective in cash management is to offset, through its market operations, the expected cash flow into or out of the NLF on every business day. It is to do this in a cost-effective way, balancing cost and risk in its strategies, and without influencing the level of short-term interest rates.

During the year, the DMO carried out its cash management objectives through a combination of regular weekly Treasury bill tenders and dealing with market counterparties. The latter involved sale and repurchase agreements (repos), reverse sale and repurchase agreements (reverse repos), taking unsecured deposits, and the purchase of certificates of deposit and commercial paper maturing within six months. These positions are taken in order to anticipate the net Government cash flow, and the DMO did not seek to hedge exposure to interest rate risk on these positions.

Throughout 2004-05, the DMO held gilts for use as collateral in repo borrowing. At 31 March 2005, gilts held specifically for collateral purposes had a market value of £7.7 billion. Four times during 2004-05, the DMO issued Treasury bills to itself in order to maintain sufficient collateral for its money market operations. The first three issues matured during the financial year, but the fourth issue, of £10 billion, was outstanding at 31 March 2005.

Debt management operations

HM Treasury's debt management objective is *"to minimise over the long term, the cost of meeting the Government's financing needs, taking into account risk, whilst ensuring that debt management policy is consistent with the aims of monetary policy".*

HM Treasury sets a specific remit each year for the DMO, which sets out in more detail the implementation of the Government's high-level debt objective.

As the Government's debt manager, a key role of the DMO is to issue gilt-edged securities. Gilts are issued by the DMO and pass through the DMA, but, as they are issued on behalf of HM Treasury, they remain a liability of the NLF.

The Government seeks to minimise the debt servicing costs of its debt over the longer-term rather than the debt interest bill in a single year. The long-term nature of many debt instruments and the importance of an issuer's relationship with the debt markets require the Government to take debt management decisions with a longer-term perspective.

The reference to risk in the Government's debt management policy means that it tries not only to choose a strategy that minimises the expected average debt cost over the longer term, but tries also to ensure that the chosen policy is robust against different economic outturns.

The main way in which the Government influences the composition of its debt portfolio is through the strategy of new issuance that it adopts each year. This sets the proportions of index-linked and conventional gilts and the pattern of issuance across different maturities. The Government is rarely in a position to know that issuing any one particular stock will prove 'cheaper' than another. Therefore, the strategy currently preferred is to structure new issuance so that the debt portfolio will not expose the Government to sharp fluctuations in its financing requirement and debt servicing costs under a range of possible economic outturns. Consequently, the portfolio is composed of both conventional and index-linked debt, and has a range of maturities.

The DMO advises HM Treasury in its selection of an appropriate debt issuance strategy.

The DMO undertakes gilt transactions in the secondary market with the Gilt Edged Market Makers (GEMMs). Under an agreement with the DMO, the GEMMs provide a secondary market in all gilts and are the point of access for institutional investors to the DMO's gilt auctions.

In addition to holding gilts to use as collateral in its cash management operations, the DMO holds relatively small portfolios of gilts for other purposes:

Purchase and sale service. The DMO holds a portfolio of gilts (£21 million) for purchase and sale transactions with retail investors. This service was introduced in December 2004, when gilt registration services were transferred from the Bank of England to Computershare Investor Services PLC.

Rump stocks. The DMO holds 'rump stock' gilts (£18 million). These are gilts in which the DMO will make a bid price upon request from a GEMM. GEMMs are not required to make a market in such gilts, due to the small nominal values outstanding.

Other tradable gilts. This portfolio (£404 million) is comprised of a residual from each gilt auction. A small amount of each gilt auction may be retained due to rounding of the allotment to the successful bidders of the gilts in the auction. The portfolio may also include any gilts bought by the DMO in the secondary market for other reasons.

The DMO may redeem gilts prematurely in any portfolio by selling them back to the NLF at the then current market rates. This reduces the amount of that gilt in issue and may be done for market management reasons.

Specific risks

Credit risk: the DMO is exposed to the issuers of those debt instruments that it holds within its portfolio and also to its counterparties involved in bilateral money market and derivative trading. The Risk Committee approves and regularly reviews credit limits according to a predominantly ratings-based policy. Exposures against these limits are monitored and reported upon by the Risk Management Unit (RMU). RMU also monitors a range of data sources in order to be aware of potential changes in credit quality of issuers and counterparties. All credit exposures to repo, reverse repo and equity derivative counterparties are subject to agreements allowing the DMO to call for collateral to offset the mark to market exposure on a daily basis.

Market risk: management of market risk by the DMO takes account of the underlying objective for acquiring or holding the asset or liability position. The DMO is exposed to fluctuations in the market price of its holdings of securities over the short-term. But in the event of a downward valuation, only a very small proportion of the DMO's gilt holdings – those that are available for sale under its retail brokerage initiative – are likely to give rise to realised dealing losses. This is because the DMO intends to hold to maturity, or over the long-term, the majority of its holdings of gilts for use as collateral for its money market operations, or to redeem them early by selling them back to the NLF. Where this is the case, the DMO attaches a relatively low priority to containing market risk in the short-term if to do so would incur hedging costs. (In the case of early redemption of gilt holdings by sale back to the NLF, there is no net realised dealing profit or loss for central government.) But although outright external sales of these securities are not planned, the DMO cannot with certainty know that all will be held to maturity, or over the long-term, as it is not wholly autonomous in its policy setting. Because of this the DMO has chosen to report the market value of all of its gilt holdings in its financial statements so that unrealised dealing profits can be monitored.

The DMO calculates interest rate-sensitivity measures across its entire portfolio of financial instruments. At present, the DMO does not undertake daily value at risk analysis of its entire portfolio. The DMO is currently developing its capability to apply a wider range of measures and analyses.

Interest rate risk

	2005 Fixed rate instruments Weighted average interest rate	2005 Fixed rate instruments Weighted average period	2005 Fixed rate instruments	2005 Floating rate instruments	2005 Non rate instruments	2005 Total	2004 Total
	%	Years	£m	£m	£m	£m	£m
Currency							
Sterling							
Lending	5.89	7.24	10,629	50,912	5	61,546	75,448
Borrowing	4.75	0.12	40,574	20,978	-	61,552	75,533

The DMA is charged interest on the advance from the National Loans Fund (31 March 2005: £20,000 million) at the Bank of England repo rate. The benchmark rate for determining the interest payments on other floating rate borrowings is LIBOR.

The DMA held undated gilts with a market value of £28 million at 31 March 2005. This lending is included in the above interest rate risk disclosures except the weighted average period, as these gilts have no maturity date.

Interest rate profile

Items are allocated to time bands by reference to the earlier of the next interest rate repricing date and maturity date.

As at 31 March 2005

	0-3 months £m	**3-6 months** £m	**6-9 months** £m	**9-12 months** £m	**1-5 years** £m	**Over 5 years** £m	**Non rate** £m	**Total** £m
Assets								
Cash and balances at the Bank of England	385	-	-	-	-	-	-	385
Loans and advances to banks	1,890	-	-	-	-	-	-	1,890
Debt securities	295	-	489	1,325	2,267	3,982	-	8,358
Other assets	20	-	-	-	-	-	1	21
Prepayments and accrued income	-	-	-	-	-	-	334	334
National Loans Fund – deposit	50,912	-	-	-	-	-	-	50,912
Total assets	53,502	-	489	1,325	2,267	3,982	335	61,900
Liabilities								
Deposits by banks	2,071	-	-	-	-	-	-	2,071
Customer accounts	18,662	612	-	-	-	-	-	19,274
Debt securities in issue	17,262	2,946	-	-	-	-	-	20,208
Other liabilities	5	-	-	-	-	-	1	6
Accruals and deferred income	-	-	-	-	-	-	198	198
National Loans Fund – advance	20,000	-	-	-	-	-	-	20,000
National Loans Fund – DMA surplus	-	-	-	-	-	-	143	143
Total liabilities	58,000	3,558	-	-	-	-	342	61,900
Maturity gap	(4,498)	(3,558)	489	1,325	2,267	3,982	(7)	-
Cumulative gap	(4,498)	(8,056)	(7,567)	(6,242)	(3,975)	7		-

Active markets exist for the majority of the debt securities shown above (gilts, Treasury bills, certificates of deposit, and commercial paper) except for the small proportion of the DMO's gilt holdings made up of rump stocks.

Fair value of financial instruments

Financial instruments include financial assets, financial liabilities, and derivatives.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. The table below shows the carrying amount and fair value of the financial instruments held by the DMA.

		2005 Carrying amount £m	2005 Fair value £m	2004 Carrying amount £m	2004 Fair value £m
Assets					
a	Loans (including reverse sale and repurchase transactions)	1,890	1,890	4,269	4,269
b	Debt securities (excluding hedging derivatives)	8,358	8,358	10,860	10,860
c	Derivatives	20	20	8	8
Liabilities					
a	Deposits by banks	2,071	2,071	3,960	3,960
a	Customer accounts	19,274	19,274	17,393	17,393
b	Treasury bills	20,208	20,206	19,179	19,182
c	Derivatives	5	5	8	8

a Fair value approximates carrying value because the instruments are short-term in nature, having maturity of not more than 6 months.

b The valuation of listed debt securities is at quoted market prices. The valuation of unlisted debt securities is based on discounted future cashflows.

c The fair value of over-the-counter derivative contracts that hedge the Guaranteed Equity Bond product is calculated daily by an in-house valuation model. Forward foreign exchange contracts held to hedge currency exposure were valued with reference to the contracted forward foreign exchange rate and the spot foreign exchange rate as at 31 March 2005.

Derivatives and hedging

The DMA enters into derivative contracts for hedging equity index risk and foreign currency risk.

Foreign currency risk: the DMA held US dollar and Euro commercial paper and certificates of deposit in the year. For each position the foreign currency risk of holding the security was hedged by exactly matching its foreign currency cash flows with forward foreign exchange contracts agreed in parallel with the security purchase. Both the underlying security and the foreign exchange contract hedges are reported at market value in the accounts. However, the DMO held no foreign currency denominated instruments, or related forward foreign exchange contracts, at 31 March 2005.

Euro denominated government and supranational bonds were used as collateral for a significant proportion of the reverse repo lending to counterparties in the year. The DMO's daily collateral margining operations include management of exposures resulting from changes in Euro-sterling exchange rates.

Guaranteed Equity Bond (GEB): the DMA held a number of equity derivatives in the year (aggregate nominal value of £845 million at 31 March 2005). These hedge an equity index exposure of the Government that is external to the DMA. In March 2002, National Savings & Investments began to issue Guaranteed Equity Bonds in partnership with the DMO, which hedges the equity index exposure resulting from the sale of these products to investors. Each equity derivative comprises two forward derivatives that address the risk features of the positions being hedged: equity index risk and interest rate risk. Both transactions are reported at market value on the balance sheet. The market value of the derivatives was a net asset of £15 million at 31 March 2005 (31 March 2004: net liability of £1 million).

The DMA contracts the hedging derivatives, but does not hold the underlying position being hedged. As a result, the DMA is exposed to equity index risk and interest rate risk over the life of the derivatives. However, taking account of the position of both the DMA and National Savings & Investments, the Government has no exposure to equity index risk.

Principal amounts and fair values of derivatives

	2005 Principal amount £m	**2005 Year end positive fair value** £m	**2005 Year end negative fair value** £m	**2004 Principal amount** £m	**2004 Year end positive fair value** £m	**2004 Year end negative fair value** £m
Foreign exchange derivatives						
Forward foreign exchange	-	-	-	319	1	-
Equity/interest rate derivatives						
Over-the-counter derivatives	845	24	(9)	524	8	(9)
Effect of netting		(4)	4		(1)	1
		20	(5)		8	(8)

Net replacement cost (maturity and counterparty analysis)

	2005 Less than one year £m	2005 One to five years £m	2004 Less than one year £m	2004 One to five years £m
Foreign exchange derivatives				
Forward foreign exchange	-	-	1	-
Equity/interest rate derivatives				
Over-the-counter derivatives	-	20	-	7
	-	20	1	7

All derivatives were transacted with banks and other financial institutions.

Where the DMA has a legal right of offset with a counterparty, the positive and negative fair values of derivative transactions with that counterparty have been netted. A positive fair value after netting represents a net replacement cost to the DMA.

Preparation of the accounts

The accounts have been prepared in accordance with a direction given by HM Treasury in pursuance of Schedule 5A of the National Loans Act 1968. The text of the direction is reproduced on page 40 of this document. The accounts and supporting notes relating to the Debt Management Account for the year ended 31 March 2005 have been audited by the Comptroller and Auditor General.

ROBERT STHEEMAN
Chief Executive and DMA Accounting Officer
13 July 2005

Statement of Accounting Officer's responsibilities

Under Schedule 5A of the National Loans Act 1968, HM Treasury has directed the DMO to prepare a statement of the Debt Management Account for each period in the form and on the basis set out in the Accounts Direction on page 40 of these financial statements. The accounts are prepared on an accrual basis and must give a true and fair view of the operations of the Debt Management Account at the year end and of its income and expenditure, total recognised gains and losses and cash flows for the financial year.

In preparing accounts the DMO is required to:

- *observe the accounts direction issued by HM Treasury, including the relevant accounting and disclosure requirements, and apply suitable accounting policies on a consistent basis;*
- *make judgements and estimates on a reasonable basis;*
- *state whether applicable accounting standards have been followed, and disclose and explain any material departures in the financial statements;*
- *prepare the financial statements on the going concern basis, unless it is inappropriate to presume that the account will continue in operation.*

The Accounting Officer of HM Treasury has designated the Chief Executive of the Debt Management Office as the Accounting Officer for the Debt Management Account. His relevant responsibilities as Accounting Officer, including his responsibility for the propriety and regularity of the public finances and for the keeping of proper records, are set out in the Accounting Officers' Memorandum, issued by HM Treasury and published in "Government Accounting".

ROBERT STHEEMAN
Chief Executive and DMA Accounting Officer
13 July 2005

Statement on internal control

1. Scope of responsibility

As Accounting Officer, I have responsibility for maintaining a sound system of internal control that supports the achievement of the Debt Management Office's policies, aims, and objectives, whilst safeguarding the public funds and departmental assets for which I am personally responsible, in accordance with the responsibilities assigned to me in Government Accounting.

I am Accounting Officer for both the Debt Management Account (DMA) and the Debt Management Office (DMO), an executive agency of HM Treasury. My accountability is subject to the overall responsibility of the Permanent Secretary of HM Treasury (in his capacity as Accounting Officer) for the organisation and management of the department. In exercising my responsibilities for the DMA, I pay regard to the consequences for the National Loans Fund (NLF) and consult the Permanent Secretary if I consider that my actions could have implications for him in his role as NLF Accounting Officer.

CRND and PWLB are separate business entities within the DMO. Each has its own accounting officer who is responsible for maintaining a sound system of internal control that supports the delivery of the entity's agreed policies, objectives, and targets. However, I am responsible for the wider DMO control framework within which both CRND and PWLB are managed, and both accounting officers take assurance from me for the continued sound maintenance of this in relation to their own control responsibilities.

In exercising my specific responsibilities for debt and cash management I take regard of the objectives set by HM Treasury Ministers for the Government's debt and cash management. It is my responsibility to ensure that all activities brought to account on the DMA are conducted with due regard to value for money. I have put arrangements in place to ensure that there is a proper evaluation of the balance of cost and risk in our operations, taking account where appropriate of any cost, risk or other strategic objectives, parameters or guidelines agreed with HM Treasury.

As Agency Accounting Officer, I am responsible to the Chancellor and accountable to Parliament for the Agency's use of resources in carrying out its functions as set out in the Framework Document.

2. The purpose of the system of internal control

The system of internal control is designed to manage risk to an acceptable level, balancing the impact of potential risks with the resources required to manage them, rather than to eliminate all risk. It can therefore only provide reasonable and not absolute assurance of effectiveness. The system of internal control is based on a process designed to identify and prioritise the risks to the achievement of policies, aims and objectives, to evaluate the likelihood of those risks being realised and the impact should they be realised, and to manage them efficiently, effectively, and economically.

The system of internal control has been in place in the Debt Management Office for the year ended 31 March 2005 and up to the date of approval of the annual Report and Accounts, and accords with HM Treasury guidance. Not all components of the current system of internal control have been in place throughout the whole of the financial year 2004-05 because the DMO has made additions to the system of internal control over the course of the year.

3. Capacity to handle risk

The DMO has a formal risk management strategy and policy set by the Managing Board. This includes an outline of the DMO's capacity to handle risk. The DMO has produced a Risk Management Assurance Strategy comprehensively documenting its risk management processes.

The DMO Managing Board is responsible for setting strategic direction and considering high-level operational issues. An executive sub-committee of the Managing Board meets weekly. The terms of reference of these management committees and those of the Cash Management, Debt Management, Fund Management, and Risk Committees clearly set out their roles and responsibilities providing the organisational capability to consider issues and make relevant decisions at the appropriate level.

Staff have attended presentations on relevant elements of the DMO's risk management framework. These have covered specific issues such as anti-money laundering, whistle-blowing, fraud, and personal dealing in order to ensure a good level of awareness of DMO's risk policies and controls. Beginning in 2004-05, presentations on the implications of the Freedom of Information Act were made to staff most likely to be affected by this new legislation. All members of staff have job descriptions, including specific key risks they are expected to manage.

Management in each business function is responsible for ensuring that the operations within their area are compliant with plans, policies, procedures, and legislation. Most functional managers are responsible for maintaining compliance arrangements across the DMO in their area of specialism. Risk Management Unit has issued guidance on those sections of the Financial Services Authority handbook that are most pertinent to the DMO's business to all relevant business areas to support managers in meeting this responsibility.

4. The risk and control framework

The DMO has various formal mechanisms for managing the DMO's risks but it is recognised that the most important aspect is that a strong risk management culture pervades the organisation at all levels. This is embedded in both regular operations and the approach taken to new business initiatives. The DMO includes risk management considerations as part of normal business management. The DMO is making on-going efforts to embed a strong risk management culture in every part of the organisation.

The DMO's risk management strategy seeks to maintain a strong risk management culture by linking organisational objectives to the business planning process. Organisational objectives cascade down to individual objectives and job descriptions. This is intended to promote a clear understanding of the ownership of each risk within the organisation. There has been substantial progress in development of performance measures in the year, in particular through a review of cash management operations.

Heads of business units and functional teams assess regularly whether risks to their operations are being managed effectively. The DMO held risk workshops for operational staff on specific risk issues. New risks, and risks with an increased likelihood of occurrence, are highlighted and actions identified to ensure all risks will be effectively managed. Risk registers were used by teams responsible for delivering key projects. Senior managers have reviewed during the year the high level risks that the organisation faces, and the adequacy of the relevant controls. This process is supported by the maintenance of exception logs, which identify control weaknesses and resultant actions to improve controls. Key risks and exceptions are documented in a regular report produced by the Risk Management Unit for the Risk Committee and the Managing Board.

A key component of the DMO's control framework is the segregation of duties to promote independent checking and avoid concentration of key activities or related controls in individuals or small groups of staff. In particular segregation of duties takes place between front and back office activities.

All teams have documented procedures for their main activities. The DMO has policies on anti-fraud measures and whistle-blowing. In establishing controls to deter money laundering the DMO has followed best practice guidance in the Financial Services Authority's handbook and from the joint money laundering steering group. During the year, the DMO has introduced its own anti-money laundering handbook. DMO staff provide an annual report of anti-money laundering developments and processes to the Managing Board. The DMO has established a Security Group with a focus on ensuring continued security of DMO information.

The DMO's Business Continuity Plan (BCP), including disaster recovery site and other arrangements, is subject to continual review and update. The DMO tested the main elements of the BCP during the year. Assessment of business continuity requirements is a specific requirement for new projects and major business initiatives.

An independent review of the DMO's business planning and project management processes was undertaken in the year under review. The findings have led to a formal initiative to strengthen processes around budgeting, approval, monitoring and delivery of projects, and to assess more effectively the cost and benefit of each new business or project proposal.

An independent review of DMO financial controls and reporting was undertaken in 2004-05. This has led to the approval of an action plan to improve the regularity, reliability, and effectiveness of financial reporting to Managing Board and its sub-committee.

The DMO has established effective communication channels with its main stakeholders to help highlight issues that may affect either party's risks. In addition to maintaining bilateral contacts with market counterparties, the DMO also holds quarterly consultation meetings with market makers in gilts (GEMMs) and issues ad hoc public consultation documents on specific issues.

5. Review of effectiveness

As Accounting Officer, I have responsibility for reviewing the effectiveness of the system of internal control. My review of the effectiveness of the system of internal control is a continuous process. It is informed by the work of the executive managers within the department who have responsibility for the development and maintenance of the internal control framework, work of the internal auditors and comments made by the external auditors in their management letter and other reports. My review is based on a number of activities. Annually I formally review the key outcomes and findings of each activity in order to make my assessment.

- An Internal Controls team was formally established at the beginning of the 2003-04 financial year to assess actions required to maintain and improve the DMO's system of internal control. The team has met regularly since then to identify weaknesses in the control environment, recommend actions to management, and to implement changes where appropriate. The controls team comprises the Head of the DMO's Risk Management Unit, the Controls and Compliance Manager, the Head of Internal Audit and the Finance Manager. A Non-Executive Director attends meetings of the team periodically. The controls team has reported regularly to the Managing Board on progress to improve the internal control system during the year.

- The Managing Board met approximately every six weeks and considered risk management and operational control issues throughout the year. Additionally it received quarterly reports based on the outputs of DMO teams' risk registers on actions required as a result of changes in the DMO's risk profile. The executive sub-committee of the Managing Board met weekly and considered risk and control issues on a regular basis.

- The DMO's Audit Committee, chaired by a Non-Executive Director, met quarterly. Audit Committee reviews the adequacy and effectiveness of the DMO's management of risk and internal controls, and makes recommendations for improvement as appropriate. Following a review of the DMO's compliance with best practice in corporate governance, I stood down as a member of the Audit Committee in March 2005. However, I will continue to attend Audit Committee meetings regularly.

- The DMO's Risk Management Unit provides control advice on risks throughout the DMO. In the DMO's management reporting structure the Risk Management Unit is separate and independent of the DMO's trading operations. The risk management function also conducts risk analysis and provides an operational, market, and credit risk capability for the DMO.

- The DMO's Internal Audit team evaluates the effectiveness of the DMO's processes for risk management, control, and governance in order to provide me with an independent and objective opinion. To inform this opinion an Internal Audit strategy is produced that enables a systematic and prioritised review of the systems and controls established by management. This involves production and delivery of an annual audit plan including operational audit, project audit, and provision of controls consultancy. The audit strategy is subject to review and approval by the Managing Board sub-committee and Audit Committee.

- Compliance testing is a component of each operational review undertaken by Internal Audit.

In my opinion, the DMO's system of internal control was effective throughout the financial year 2004-05 and remains so on the date I sign this statement.

ROBERT STHEEMAN
Chief Executive and DMA Accounting Officer
13 July 2005

The Certificate and Report of the Comptroller and Auditor General to the Houses of Parliament

I certify that I have audited the financial statements on page 27 to 39 under Schedule 5A of the National Loans Act 1968. These financial statements have been prepared under the historical cost convention as modified by the revaluation of certain investments and the accounting policies set out on page 30 to 31.

Respective responsibilities of the Accounting Officer and Auditor

As described on page 20, the Accounting Officer is responsible for the preparation of the financial statements in accordance with Schedule 5A of the National Loans Act 1968 and HM Treasury directions made thereunder and for ensuring the regularity of financial transactions. The Accounting Officer is also responsible for the preparation of the other contents of the Report. My responsibilities, as independent auditor, are established by statute and guided by the Auditing Practices Board and the auditing profession's ethical guidance.

I report my opinion as to whether the financial statements give a true and fair view and are properly prepared in accordance with Schedule 5A of the National Loans Act 1968 and HM Treasury directions made thereunder, and whether in all material respects the expenditure and income have been applied to the purposes intended by Parliament and the financial transactions conform to the authorities which govern them. I also report if, in my opinion, the Foreword is not consistent with the financial statements, if the Debt Management Office (DMO) has not kept proper accounting records, or if I have not received all the information and explanations I require for my audit.

I read the other information contained in the report and consider whether it is consistent with the audited financial statements. I consider the implications for my certificate if I become aware of any apparent misstatements or material inconsistencies with the financial statements.

I review whether the statement on page 21 to 24 reflects the DMO's compliance with HM Treasury's guidance 'Corporate governance: statement on internal control'. I report if it does not meet the requirements specified by HM Treasury, or if the statement is misleading or inconsistent with other information I am aware of from my audit of the financial statements. I am not required to consider, nor have I considered whether the Accounting Officer's Statement on Internal Control covers all risks and controls. I am also not required to form an opinion on the effectiveness of the DMO's corporate governance procedures or its risk and control procedures.

Basis of audit opinion

I conducted my audit in accordance with United Kingdom Auditing Standards issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts, disclosures and regularity of financial transactions included in the financial statements. It also includes an assessment of the significant estimates and judgements made by the Accounting Officer in the preparation of the financial statements, and of whether the accounting policies are appropriate to the DMO's circumstances, consistently applied and adequately disclosed.

I planned and performed my audit so as to obtain all the information and explanations which I considered necessary in order to provide me with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by error, or by fraud or other irregularity and that, in all material respects, the expenditure and income have been applied to the purposes intended by Parliament and the financial transactions conform to the authorities which govern them. In forming my opinion I have also evaluated the overall adequacy of the presentation of information in the financial statements.

Opinion

In my opinion:

- the financial statements give a true and fair view of the state of affairs of the Debt Management Account as at 31 March 2005 and of the surplus, total recognised gains and losses and cash flows for the year then ended and have been properly prepared in accordance with Schedule 5A of the National Loans Act 1968 and directions made thereunder by HM Treasury; and

- in all material respects the expenditure and income have been applied to the purposes intended by Parliament and the financial transactions conform to the authorities which govern them.

I have no observations to make on these financial statements.

The maintenance and integrity of the UK Debt Management Office's website is the responsibility of the Accounting Officer; the work carried out by the auditors does not involve consideration of these matters, and accordingly the auditors accept no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the website.

JOHN BOURN
Comptroller and Auditor General
13 July 2005

National Audit Office
157-197 Buckingham Palace Road
LONDON
SW1W 9SP

Income and expenditure account

For the year ended 31 March 2005

	Note	**2005** £m	**2004** £m
Interest receivable	2		
Interest receivable and similar income arising from debt securities		459	604
Other interest receivable and similar income		3,031	2,040
Interest payable	3	(3,466)	(2,464)
Net interest income		24	180
Dealing profits/(losses)	4	31	(229)
Operating surplus/(deficit)		55	(49)
Surplus/(deficit) for the financial year		55	(49)

All income and expenditure arose from continuing operations.

No separate statement of total recognised gains and losses has been prepared, as there are no recognised gains or losses other than those included in the statement above.

The notes on page 30 to 39 form part of these accounts.

Balance sheet

As at 31 March 2005

	Note	**2005** £m	**2004** £m
Assets			
Cash and balances at the Bank of England		385	202
Loans and advances to banks	5	1,890	4,269
Debt securities	6	8,358	10,861
Other assets	7	21	7
Prepayments and accrued income	8	334	349
National Loans Fund – deposit	9	50,912	60,116
Total assets		61,900	75,804
Liabilities			
Deposits by banks	10	2,071	3,960
Customer accounts	11	19,274	17,393
Debt securities in issue	12	20,208	19,179
Other liabilities	13	6	8
Accruals and deferred income	14	198	176
National Loans Fund – advance	9	20,000	35,000
National Loans Fund – DMA surplus	15	143	88
Total liabilities		61,900	75,804

The notes on page 30 to 39 form part of these accounts.

ROBERT STHEEMAN
Chief Executive and DMA Accounting Officer
13 July 2005

Cash flow statement

For the year ended 31 March 2005

	Note	**2005** £m	**2004** £m
Net cash flow from operating activities	16a	5,979	16,997
Returns on investments and servicing of finance	16b	-	(650)
Net cash flow before financing		5,979	16,347
Financing	16c	(5,796)	(16,464)
Increase/(decrease) in cash		183	(117)

The notes on page 30 to 39 form part of these accounts.

Notes to the accounts for the year ended 31 March 2005

1. Accounting policies

(i) Accounting convention

The accounts have been prepared under the historical cost convention modified by the inclusion of certain investments at valuation. The DMA's financial statements have been prepared in accordance with the Accounts Direction given by HM Treasury. Although the DMA's financial statements are not subject to the requirements of the Companies Acts, and are not technically those of a bank, they have also been prepared in accordance with the provisions of Schedule 9 of the Companies Act 1985 where relevant, and in accordance with applicable Accounting Standards and Statements of Recommended Practice in so far as they are appropriate to the DMA.

(ii) Valuation of securities (bills, gilts, and other debt securities)

All securities held as assets by the DMA are included in the balance sheet at their market value.

Where securities have been purchased at a premium or discount, these premiums and discounts are amortised through the income and expenditure account over the period from the date of purchase to the date of maturity. The amortisation of premiums and discounts is included in interest receivable.

Purchases and sales of securities are recognised on trade date.

Treasury bills issued by the DMA are included in the balance sheet at their issue price as adjusted to take account of the amount of discount amortised on these securities as at the balance sheet date.

In accordance with the practice agreed with HM Treasury, any stock that remains uncovered at gilt auction is purchased by the DMA. For conventional gilts, the DMA purchases the uncovered stock at the lowest price accepted at the auction. For index-linked gilts, the DMA purchases the uncovered stock at the striking price achieved at the auction.

(iii) Sale and repurchase transactions (repos and reverse repos)

Securities sold via sale and repurchase transactions (repos) continue to be recognised in the balance sheet, and the sale proceeds are recognised within deposits by banks. Securities acquired via reverse sale and repurchase transactions (reverse repos) are not recognised in the balance sheet, and the related payments are recognised within loans and advances to banks. The difference between the sale price and repurchase price is accrued evenly over the life of the transaction and recognised in the income and expenditure account as interest receivable or payable.

Sale and repurchase transactions (and reverse sale and repurchase transactions) are recognised on the settlement date of the first cashflow. Forward starting sale and repurchase transactions (and forward starting reverse sale and repurchase transactions) are treated as interest rate forwards, and are recognised at fair value from trade date until the settlement date of the first cashflow.

Repos and reverse repos undertaken by the DMO are offset in the balance sheet if they are entered into specifically for stock lending and borrowing purposes rather than to meet the DMO's main cash management objectives of offsetting the expected daily cash flows into or out of the NLF. Interest payable and receivable are netted off and the net amount credited to fees receivable (2005: less than £0.1 million, 2004: £0.3 million).

(iv) Accounting for derivatives

The DMA has transacted forward foreign exchange and interest rate/equity index swaps in order to hedge the risk arising from movements in foreign exchange rates, interest rates, and equity prices. These are recognised in accordance with the accounting treatment of the underlying transactions being hedged.

(v) Income recognition

Income is recognised within the accounts on the following basis:

- Interest income and charges are recognised in the income and expenditure account as they accrue;
- Gains and losses on dealing activities are calculated as the difference between sale proceeds (net of interest) and cost, or between fair value and cost. Transaction costs arising from dealing activities are not charged to the DMA. It is considered that these costs are more appropriately accounted for through the DMO to enable Government budget controls;
- Realised gains and losses on dealing activities are taken to the income and expenditure account for the period in which they arise;
- Gains and losses arising on the repurchase or early settlement of DMA issued Treasury bills are recognised in the operating statement in the period during which the repurchase or early settlement is made;
- Valuation gains and losses on dealing securities are taken to the income and expenditure account for the period in which they arise. Valuation changes are also reflected in balance sheet carrying values.

The proceeds arising from the auction of gilts are received on behalf of the NLF, and as such are not recognised within the DMA. However, any gains or losses realised from the subsequent sale of stock purchased from uncovered gilt auctions are recognised within the DMA.

2. Interest receivable

	2005 £m	2004 £m
Interest receivable and similar income arising from debt securities		
British Government securities	433	543
Other securities	26	61
	459	604
Other interest receivable and similar income		
National Loans Fund deposit	2,913	1,892
Reverse sale and repurchase transactions	101	135
Other deposits	17	13
	3,031	2,040

3. Interest payable

	2005 £m	2004 £m
Interest payable on National Loans Fund advance	(1,588)	(1,294)
Discounts on issued bills	(871)	(682)
Interest payable and similar charges on sale and repurchase transactions	(257)	(123)
Interest payable on customer accounts	(750)	(365)
	(3,466)	(2,464)

4. Dealing profits

	2005 £m	2004 £m
British Government securities	17	(244)
Other securities	(2)	1
Equity derivatives	16	14
	31	(229)

5. Loans and advances to banks

	2005 £m	2004 £m
Reverse sale and repurchase transactions	1,850	4,269
Fixed term deposits	40	-
	1,890	4,269

All loans and advances were repayable in not more than 3 months.

Securities 'purchased' via reverse sale and repurchase transactions are not included on the balance sheet.

Reverse sale and repurchase transactions arising from stock swap operations had a market value of £194 million at 31 March 2005 (31 March 2004: £1,673 million). These transactions are excluded from the balance sheet as they are offset by sale and repurchase transactions.

6. Debt securities

	2005 Listed £m	2005 Unlisted £m	2005 Total £m	2004 Total £m
6a. Debt securities (market value)				
Issued by public bodies				
British Government securities	8,158	-	8,158	9,992
Issued by other issuers				
Other securities	-	200	200	869
	8,158	200	8,358	10,861

Other securities include foreign currency denominated commercial paper. Foreign currency risk associated with the holding of foreign currency denominated securities is fully hedged through forward foreign exchange contracts. These forward contracts are included in the market values disclosed above.

6b. Debt securities (maturity analysis)

	2005 Nominal £m	2005 Market value £m	2004 Nominal £m	2004 Market value £m
In not more than 3 months	295	295	1,335	1,332
In more than 3 months but not more than 1 year	301	309	676	689
In more than 1 year but not more than 5 years	2,276	2,379	2,290	2,468
In more than 5 years	4,630	5,375	5,574	6,372
	7,502	8,358	9,875	10,861

7. Other assets

	2005 £m	2004 £m
Unsettled cash	1	1
Gains on derivatives	20	6
	21	7

Gains on derivatives arise from the equity derivative contracts that hedge the Government's exposure to the equity index risk and interest rate risk resulting from the Guaranteed Equity Bond product issued by National Savings and Investments.

8. Prepayments and accrued income

	2005 £m	2004 £m
Accrued interest - gilts	98	133
Accrued interest - National Loans Fund deposit	233	193
Accrued interest - reverse sale and repurchase transactions	3	21
Accrued interest - other	-	2
	334	349

9. National Loans Fund - net financing

	Deposit	Advance	Net financing
	£m	£m	£m
As at 31 March 2004	60,116	(35,000)	25,116
Repayments of advance by DMA	-	15,000	15,000
Net change in deposit by DMA	(9,204)	-	(9,204)
As at 31 March 2005	50,912	(20,000)	30,912

The National Loans Fund (NLF) has provided cash advances to the DMA to fund the DMA's operations. The DMA is charged interest on this advance at the Bank of England repo rate. Each day, the DMA deposits any surplus cash with the NLF. The DMA receives interest on this deposit at the Bank of England repo rate.

10. Deposits by banks

	2005	2004
	£m	£m
Sale and repurchase transactions	2,071	3,950
Fixed term deposits	-	10
	2,071	3,960

All deposits were repayable in not more than 3 months.

Securities 'sold' via sale and repurchase transactions (including those that are part of stock swap transactions) continue to be included on the balance sheet. These securities had a market value of £2,278 million at 31 March 2005 (31 March 2004: £5,643 million).

The DMA has entered forward starting sale and repurchase transactions that have settlement date of their first cashflow after 31 March 2005. Such transactions related to deposits of £400 million at 31 March 2005 (31 March 2004: zero). Securities 'sold' via these transactions (including those that are part of stock swap transactions) continue to be included on the balance sheet. These securities had a market value of £404 million at 31 March 2005 (31 March 2004: zero).

Sale and repurchase transactions arising from stock swap operations had a market value of £194 million at 31 March 2005 (31 March 2004: £1,673 million). These transactions are excluded from the balance sheet as they are offset by reverse sale and repurchase transactions.

11. Customer accounts

11a. Customer accounts (maturity analysis)	**2005** £m	**2004** £m
In not more than 3 months		
Fixed term deposits	17,684	16,086
Call notice deposits	978	1,307
	18,662	17,393
In more than 3 months but not more than 6 months		
Fixed term deposits	612	-
	19,274	17,393

11b. Customer accounts (counterparty analysis)

Commissioners for the Reduction of the National Debt		
Fixed term deposits	17,538	15,867
Call notice deposits	978	1,305
	18,516	17,172
Other government counterparties		
Fixed term deposits	758	219
Call notice deposits	-	2
	758	221
	19,274	17,393

Call notice deposits are repayable on demand.

12. Debt securities in issue

All debt securities in issue were Treasury bills.

The market value of these Treasury bills was £20,206 million at 31 March 2005 (31 March 2004: £19,182 million). All Treasury bills had maturity of not more than 6 months.

Treasury bills with a nominal value of £10 billion (2004: zero) have been issued by the DMA to itself as collateral. Neither the asset nor the liability is included on the balance sheet, as they did not arise from external transactions.

13. Other liabilities

	2005 £m	2004 £m
Unsettled cash	1	-
Losses on derivatives	5	8
	6	8

Losses on derivatives arise from the equity derivative contracts that hedge the Government's exposure to the equity index risk and interest rate risk resulting from the Guaranteed Equity Bond product issued by National Savings and Investments. The contracts have maturity of between two and five years.

14. Accruals and deferred income

	2005 £m	2004 £m
Accrued interest - National Loans Fund advance	122	119
Accrued interest - sale and repurchase transactions	6	12
Accrued interest - deposits	70	45
	198	176

15. National Loans Fund – DMA surplus

	2005 £m	2004 £m
As at 31 March 2004	88	787
Surplus/(deficit) in the year	55	(49)
Paid to National Loans Fund	-	(650)
As at 31 March 2005	143	88

A DMA operating surplus or deficit is an asset or liability respectively of the National Loans Fund. The National Loans Fund may demand repayment of all or part of any DMA surplus. Such a payment would reduce the liability.

16. Analysis of cash flow

	2005 £m	2004 £m
16a. Reconciliation of operating profit to net cash flow from operating activities		
Operating surplus/(deficit)	55	(49)
(Increase)/decrease in loans and advances to banks	2,379	2,695
(Increase)/decrease in debt securities	2,503	2,098
(Increase)/decrease in other assets	(14)	(5)
(Increase)/decrease in prepayments and accrued income	15	(51)
Increase/(decrease) in deposits by banks	(1,889)	(1,934)
Increase/(decrease) in customer accounts	1,881	17,258
Increase/(decrease) in debt securities in issue	1,029	(3,013)
Increase/(decrease) in other liabilities	(2)	(74)
Increase/(decrease) in accrual and deferred income	22	72
Net cash flow from operating activities	5,979	16,997

16b. Return on investments and servicing of finance

	2005 £m	2004 £m
DMA surplus paid to National Loans Fund	-	(650)

16c. Financing

	2005 £m	2004 £m
(Increase)/decrease in deposit with National Loans Fund	9,204	(23,464)
Increase/(decrease) in advance from National Loans Fund	(15,000)	7,000
	(5,796)	(16,464)

17. Gilt issuance

	2005 £m	2004 £m
Nominal value of gilts issued on behalf of National Loans Fund	46,748	47,648
Proceeds paid to National Loans Fund	50,101	49,854
Nominal value of uncovered stock purchased from National Loans Fund	-	-

18. Post balance sheet events

On 20 April 2005 the DMO created and issued additional gilts (nominal value £8.5 billion, market value £11.1 billion), and Treasury bills maturing on 18 July 2005 (nominal and market value £1.0 billion), for use as collateral in the DMA's cash management operations. Specific gilts will not be available to the repo market for three months. During this period, the gilts will be used only in 'delivery by value' (DBV) transactions. The additional Treasury bills will only ever be used in DBV transactions. This collateral was created as a contingency in the event that the gilt collateral already held in the DMA was insufficient to support its required borrowing.

19. Related party transactions

(i) HM Treasury

The DMO is an Executive Agency of HM Treasury, and the DMA undertakes activities on behalf of HM Treasury. Therefore HM Treasury and the DMA are related parties.

The main services provided to HM Treasury during the year were:

- Debt management, including the management of auctions and taps, for the issue of gilt-edged securities on behalf of the National Loans Fund and market making operations;
- Cash management, including responsibility for the issue and redemption of Treasury bills.

In turn HM Treasury has provided the following services to the DMA, which have been funded through the HM Treasury Vote relating to DMO administration expenditure, and accounted through the DMO Agency accounts:

- Daily provision of Central Government cashflow information;
- Payroll, purchasing, and various administrative services.

(ii) National Savings & Investments

Since March 2002, the DMO has worked in partnership with National Savings & Investments to hedge the Government's equity index and interest rate exposure arising from National Savings & Investments' issuance of Guaranteed Equity Bonds to retail investors.

(iii) Commissioners for the Reduction of the National Debt

Commissioners for the Reduction of the National Debt (CRND) is a separate entity within the DMO that performs a fund management service for a small number of public sector clients. The DMO and CRND are located together and share many support services. The Comptroller General of CRND is also the Deputy Chief Executive of the DMO. Processes and internal controls exist to ensure CRND investment decisions are carried out in accordance with CRND client mandates and are kept distinct from other DMO business. CRND client mandates require the bulk of the funds to be invested in gilts or with the DMA Deposit Facility (DMADF). Surplus cash in CRND client accounts is regularly deposited with the DMADF. From time to time, the DMA transacts marketable gilts with CRND and trades these back-to-back with market counterparties. The DMA also transacts non-marketable gilts on behalf of CRND and trades these back-to-back with the NLF. These transactions are carried out on an arms length basis and in line with a Memorandum of Understanding between the DMO and CRND.

The total amount of cash deposits taken by the DMA from CRND during the year was £126.6 billion (2004: £119.3 billion). The value of deposits outstanding was £18.5 billion at 31 March 2005 (31 March 2004: £17.2 billion). The DMA bought non-marketable gilts of nominal value £4.5 billion from CRND during the year, and sold non-marketable gilts of nominal value £6.9 billion to CRND (2004: purchases £2.8 billion, sales £3.0 billion).

(iv) DMO Managing Board and senior managers

No member of the Managing Board and no senior managers have undertaken any transactions with the DMO during the year.

Accounts Direction given by HM Treasury under the National Loans Act 1968

1. The Treasury shall prepare accounts for the Debt Management Account ("the Account") for the period ending 31 March 2001 and each subsequent financial year comprising:

    (a) A foreword
    (b) A statement of Accounting Officer's responsibilities
    (c) A statement on the system of internal control
    (d) An income and expenditure account
    (e) A statement of total recognised gains and losses
    (f) A balance sheet
    (g) A cash flow statement
    (h) Notes to the accounts

2. The accounts shall give a true and fair view of the state of affairs of the Account at the balance sheet date and of its income and expenditure, total recognised gains and losses and cash flows for the year then ended. The accounts shall be prepared under the historical cost convention modified to include certain investments at valuation and in accordance with applicable accounting standards and where appropriate, although not subject to the Companies Act and technically not being the accounts of a bank, the special provisions of Schedule 9 of the Companies Act 1985 relating to banking companies and the Statements of Recommended Practice issued by the British Bankers' Association and the Irish Bankers' Federation.

3. The accounts shall also be consistent with relevant requirements of the Resource Accounting Manual, except to the extent set out in Appendix A and shall meet the extra information requirements set out in Appendix B.

4. This Accounts Direction shall be reproduced as an Appendix to the Accounts.

David Loweth
Head of Central Accountancy Team
HM Treasury
11 December 2001

Appendices

Appendix A

APPLICATION OF THE RESOURCE ACCOUNTING MANUAL

Background

1. The Debt Management Account reflects activity that more closely resembles that of a bank than that of an entity covered by the Resource Accounting Manual (RAM). Accordingly, an income and expenditure account shall be prepared instead of Schedule 2, the operating cost statement, and both it and the balance sheet shall be prepared in the same format as those required by Schedule 9 of the Companies Act 1985. Schedule 1 – Summary of Resource Outturn, and Schedule 5 – Resources by Departmental Aim and Objective, are also not relevant.

2. In other respects, the accounts shall be consistent with relevant requirements of the RAM except in so far as is necessary to reflect the special requirements stated below.

Income and expenditure account

3. Segmental information shall be given where appropriate, inclusive of separate classes of business.

Balance sheet

4. Subject to paragraphs 6 to 8 below, investments shall be valued at market price or at an appropriate estimate of market or fair value.

5. Interests in securities maintained for the purposes of hedging shall be carried at a value that properly reflects the hedge.

6. Investment securities, being securities held for use on a continuing basis in the activities in the Account, shall be carried at cost as adjusted for:

   (a) the amortisation of the premium or discount representing the premium or discount between cost and the redemption proceeds, for redeemable securities;
   (b) any diminution in their value that is expected to be other than temporary;
   (c) translation differences where the investment securities are denominated in foreign currencies.

7. Advances and loans shall be carried at cost less appropriate provision for doubtful debts.

8. All movements in values of investments shall be reflected in the income and expenditure account, including translation differences arising in relation to investment securities denominated in foreign currencies.

Cash Flow Statement

9. The return on investments and servicing of finance will form a separate line in the cash flow statement.

Appendix B

EXTRA INFORMATION REQUIRED TO BE DISCLOSED

1. In addition to meeting appropriate requirements of the Companies Act, the banking SORPs and the Resource Accounting Manual, the following extra information shall be disclosed, including an order to facilitate the preparation and consistency of Whole of Government Accounts.

Foreword

2. The foreword shall include:

   (a) A brief history of the Account, and its statutory background;

   (b) An outline of the scope of the Account, its status in relation to HM Treasury and other central funds, and its management arrangements;

   (c) An operating and financial review:

      i) meeting relevant requirements of the Accounting Standards Board's Statement and the narrative disclosure requirements of FRS 13, "Derivatives and other financial instruments - disclosures" for banks and similar institutions; and

      ii) including appropriate information on financial performance and position reflecting the relationship between the Account and other relevant central funds, and information on targets set by HM Treasury and their achievement.

Notes to the accounts

3. The notes to the accounts shall include the following:

   (a) Analyses of assets, between fixed and current assets.

   (b) Analyses of debtors and creditors, between those falling due within and after one year.

   (c) Where not separately disclosed on the face of the income and expenditure accounts, analyses of income and expenditure giving totals for the following:

      i) Interest receivable and similar income

      ii) Interest payable and similar charges

      iii) Other operating income, including income derived from the provision of services

      iv) Operating costs

   (d) Disclosure of income and expenditure, and assets and liabilities, relating to other central government funds, including the National Loans Fund, including analyses by funding purpose;

   (e) Disclosures meeting the requirements of FRS 13, "Derivatives and other financial instruments – disclosures" as applying to banks and similar institutions, including numerical disclosures about interest risk, currency risk, fair values, and financial instruments used for trading (including information on the market price risk of the trading book).

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