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# Debt Management Account

## Report and Accounts 2005-2006

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

Ordered by the House of Commons to be printed 19 July 2006

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 for 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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# Debt Management Account

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# Foreword

## Chief Executive's statement

### Innovation in UK Government financing

In 2005-06 the UK Debt Management Office (DMO) again successfully delivered its Debt and Cash Management Remits and also introduced significant innovations in gilt issuance.

A significant feature of 2005-06 was the continued interest by pension fund and insurance companies in long-dated gilts. In response to this particular area of investor interest, the DMO issued on behalf of the UK Government a new 50-year conventional bond in May 2005, thereby becoming one of only two G10 countries to issue a bond of such maturity during the financial year.

This event was followed in September 2005 by the launch of the first ever syndicated offering of a gilt. The 1¼% Index-linked Gilt 2055, which is the longest-dated sovereign index-linked bond in the world, also incorporated a shortened indexation lag. This design, which is consistent with international best practice, has been adopted for all new index-linked gilts issued with effect from September 2005. These innovations are described in more detail on page 9 to 10.

Since the DMO was established as the UK Government's debt manager in 1998, the Government's borrowing requirement has risen six fold to £52.3 billion in 2005-06. This requirement was successfully financed in terms of gilt sales through the conduct of 25 auctions and one syndicated offer.

The rising trend of gilt issuance was an operational challenge to those DMO staff involved in implementing the debt issuance programme. The effective way in which the programme was conducted is testament to their high standards of expertise and skill.

The DMO was also instrumental in providing advice on and implementing the UK Government's daily cash management requirements and the operational management of the Government's balance sheet. The DMO's fund management operation also continued to provide a cost-effective service to clients and the facility to provide loans to local authorities experienced increased demand as the maximum maturity of loans increased. The achievements against these and other organisational objectives and targets can be reviewed on page 12 to 17.

Looking forward, our financing Remit for 2006-07 is again challenging, but is supported by a robust and transparent policy framework combined with a pragmatic approach to implementation. Modifications to the Remit, approved by Ministers, have been introduced and designed both to enhance the predictability and transparency of the current framework and to increase the Government's ability to respond to any substantial changes in market conditions that may occur during the course of the financial year. These temporary changes form part of our Remit for 2006-07, which includes plans for a record level of gilt supply (£63.0 billion) including record amounts of long-dated and index-linked gilt issuance. In addition to a record amount of supply, the DMO is also aiming to increase the amount of certainty surrounding the core part of our issuance programme (of £53.0 billion) by providing long dated index-linked issuance each month and at least two long dated conventional auctions per quarter. During the year, we have also committed to issuance of at least £10.0 billion in each of the short and medium maturity bands. Alongside the core programme, £10.0 billion of gilt sales are to be allocated on a quarterly basis in a way designed to respond to any changes in market conditions or patterns of demand.

2005-06 has proved to be a year of innovation and the DMO has responded to the change in market conditions in the delivery of its objectives. It has continued to ensure that UK Government debt management not only continues to conform to international best practice, but also sets its own standards of excellence. As always, the continued success of the DMO depends on the efforts of its staff and I remain very grateful for their outstanding contribution throughout the year.

# 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 transactions 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 Report & Accounts 2005-06 are available on the DMO's website at www.dmo.gov.uk.

At the start of the financial year, Ministerial responsibility for the DMO was vested in the Financial Secretary to the Treasury, Stephen Timms, MP. Following an announcement in May 2005, this responsibility was transferred to the Economic Secretary to the Treasury, Ivan Lewis, MP, and this remained the case at the end of the financial year.

Robert Stheeman, the DMO's Chief Executive, is responsible for the operation of the DMO in accordance with its Framework Document. He was appointed by HM Treasury through open competition, and commenced his role on 6 January 2003. His initial appointment was for a fixed term of 3 years. The contract has subsequently been extended for a further fixed term period until 31 December 2007, and is subject to a 3-month notice requirement. Compensation for early termination would be paid in accordance with the relevant provisions of the Civil Service Compensation Scheme.

A corporate governance structure is in place to assist the Chief Executive.

## Corporate governance

A number of committees and other groups support the Chief Executive in carrying out his responsibilities. The Managing Board is the DMO's senior committee and supports the Chief Executive in delivering the DMO's objectives. It has the following members:

- Robert Stheeman – Chief Executive
- Jo Whelan – Deputy Chief Executive
- Jim Juffs – Chief Operating Officer
- Sue Owen – non-executive HM Treasury representative
- Colin Price – non-executive Director
- Brian Larkman – non-executive Director

Colin Price, who was appointed by the Chief Executive, was Finance Director of Shell Pensions Management Services Ltd between 1991 and 2001, and a member of the Board of IMRO from 1996 to 2000. This position is subject to regular review. Brian Larkman was Global Head of Money Markets at the Royal Bank of Scotland PLC from 2000 to 2001, and was Managing Director, Global Money Markets at National Westminster Bank PLC from 1991 to 2000. He is currently a member of the Regulatory Decisions Committee of the FSA. His appointment was made on the basis of open competition.

The Managing Board is supported by the following operational committees:

- Debt Management Committee
- Cash Management Committee
- Fund Management Committee
- Risk Committee
- Audit Committee

In line with private sector best practice, the DMO established an Audit Committee in 1999 as part of its internal risk management and control arrangements. During the year, the committee met quarterly and was chaired by Colin Price.

## 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 or operational 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 2005-06 the outstanding NLF advance to the DMA stood at £20 billion, but this balance was repaid in full by a single payment before 31 March 2006.

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 £9,609 million at 31 March 2006. 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.

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 2006 was £19.8 billion (31 March 2005: £18.5 billion).

# Management commentary

## Principal 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 neither managed by the DMA, nor disclosed in the DMA Report and Accounts: 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.

## Activities during the year

2005-06 was a successful year for the DMO in managing its daily operations. It successfully met both its Debt and Cash Management Remits as directed by HM Treasury, as well as meeting the majority of its objectives and published targets in full. A full account of these is given on page 12 to 17.

**Debt Management**

During 2004-05, the DMO conducted a wide-ranging, but informal consultation exercise with investors (fund managers), pension fund trustees, consultants, actuaries, and academics in order to fully understand the market interest in the issuance of a potential ultra-long gilt instrument. The feedback received, together with our own view of the potential benefits for the Government in such an issuance, saw HM Treasury Ministers instruct the DMO to launch a formal consultation exercise that was consistent with Government practice to widely consult stakeholders. The Chancellor of the Exchequer launched this exercise alongside the Pre-Budget Report on 2 December 2004.

This formal consultation confirmed the earlier assessment that it would be possible to issue ultra-long gilts at a favourable cost to the Government. Consequently, in his 2005 Budget speech, the Chancellor announced to Parliament that the DMO would issue ultra-long gilts as part of our financing Remit for 2005-06.

The gilt auction held on 26 May 2005 saw the DMO issue a new 50-year conventional bond, 4¼% Treasury Gilt 2055, the first gilt of such maturity to be issued since October 1960. During 2005-06, this gilt was auctioned on four occasions, which resulted in the issue of £9.5 billion (nominal).

As part of its strategy to efficiently manage the Government's debt portfolio, the DMO also issued a 50-year index-linked gilt by syndication during September 2005. This transaction was innovative in several respects: it marked a 20-year extension of the index-linked gilt curve as well as the global index-linked bond market (the gilt was – and remains – the longest-dated sovereign index-linked bond globally); it marked the introduction of a new design for index-linked gilts, with the adoption of a 3-month indexation lag, also used by most other sovereign issuers, to replace the 8-month indexation lag that had been used beforehand in the gilt market; and it was the first time a syndicated offering had been used by HM Government as the method of issuance.

The decision to open this gilt by syndication rather than by the usual auction method reflected the significant uncertainty that existed prior to issuance as regards the pricing of the bond, given its innovative character. A syndicated offering was deemed to provide a transparent and iterative price formation process that would be more conducive to an accurate pricing of the bond in the primary market than might have taken place through an auction. This decision therefore reflected the unusual circumstances of the initial opening of the bond. Auctions remain the preferred issuance method of the DMO and have been used for subsequent openings of this gilt as well as for (re-) openings of all other gilts.

On 13 September 2005, the DMO announced that it would issue the gilt through a syndicate of banks, composed of all fourteen index-linked Gilt-edged Market Makers, four of which were selected to be joint bookrunners. £1.25 billion (nominal) of the gilt was issued on 23 September 2005.

The outcome of the transaction (pricing at the high end of the initial price guidance range), and the stability of the gilt price in relation to the rest of the yield curve in the days following the transaction, suggest that the objectives have been achieved, in particular as regards the efficiency and cost-effectiveness of pricing in the primary market.

**Cash Management**

In June 2005, following recommendations of the 2004-05 Cash Management Review, the DMO began to assess Government active cash management against a single, quantified measure of performance, and within the context of a quantified definition of risk (a risk appetite) approved by HM Treasury Ministers. The approach that has been adopted compares the cost and risk of Government active cash management, including contributions from both forecasting and market operations, against the cost and risk of a simple passive default strategy. It is intended that these changes be introduced formally over the course of 2006-07, following further calibration in light of any changes to the Sterling money markets including those arising from the Bank of England's reforms.

Other developments in DMO cash management activities introduced in 2005-06 included the widening of the range of cash management counterparts, including via electronic platforms, and making more consistent use of interbank, certificate of deposit, and commercial paper markets.

### PWLB

PWLB had another year of successful operation that saw it increase its maximum lending maturity from 30 years to 50 years. Interest rates for new loans from the Board continued to decline over 2005-06, which resulted in a marked increase in customer activity. This in turn generated an unusually high amount of fee income.

### CRND

2005-06 was a year of consistency for CRND, which continued to provide an efficient, value-for-money investment service to various Government clients. The material objectives of all investments were to maintain sufficient liquid funds to meet withdrawals by clients, and to protect the capital value of the funds.

CRND continues to investigate the scope for providing a more active style of fund management from within the private sector in addition to the existing cash management and gilt index-tracking options on offer.

During the year CRND assumed responsibility for investing the new Olympic Lottery Distribution Fund, increasing the number of investment accounts managed to ten.

## 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 2005-06 and the DMO's performance against them are summarised below.

Objectives 1 to 3 inclusive relate specifically to the DMA.

**1. To develop, provide advice on, and implement the Government's debt management strategy.**

- The DMO provided analysis and advice to HM Treasury in connection with the preparation of its remit for 2005-06 and, in particular, recommendations about the prospects for ultra-long gilt issuance.
- Following consultation with the public and stakeholders the DMO launched ultra-long-dated gilts with original maturities of approximately 50 years. This represented the first issue of 50-year conventional gilts by the UK government for over 40-years, and the longest-ever issue of index-linked gilts. The DMO also introduced a new design of index-linked gilts, with a 3-month indexation lag, in line with international best practice. The 50-year index-linked gilt is the longest-dated indexed sovereign bond in the world.
- The gilt remit for 2005-06 was successfully delivered, with outturn gilt sales of £52.3 billion (cash) through the conduct of 25 gilt auctions and, for the first time ever, one syndicated offer – for the inaugural issue of the 50-year index-linked gilt – reflecting the unique characteristics of that first issue.

**2. To develop, provide advice on, and implement the Government's cash management requirement.**

- The DMO prepared the strategic and operational capability to deliver a new cash management objective introduced as part of the 2005-06 cash management remit in April 2005.
- Following work on the strategic and operational capability of DMO systems, Phase 1 of the Cash Management Review was successfully implemented on 27 June 2005. Relative performance measurement of the active cashbook against the default benchmark strategy in terms of risk and P&L measures is in place since then. Work is on going for the outstanding transitional issues necessary for the implementation of Phase 2.

**3. To advise on the development and implementation of HM Treasury's strategy for managing the Government's balance sheet to secure sound public finances.**

- The DMO has continued to provide analysis and advice to HM Treasury on the broader implications for HM Government's balance sheet of the management of the Government liabilities and assets entrusted to the DMO, with a view in particular to avoiding unwanted mismatch in the nature of assets and liabilities.
- This analysis has contributed to the decision to extend the maximum maturity of PWLB loans, responding to the similar extension of the maximum maturities of gilts issued by the DMO.
- At an operational level, the DMO has also continued to hedge HM Government's exposure to the equity market through the sale of National Savings and Investments' (NS&I) Guaranteed Equity Bond (GEB) product by implementing swap transactions with market counterparties.

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

**4. To develop and deliver its fund management responsibilities and, in particular, to provide a cost-effective service for stakeholders.**

- The DMO, through its Fund Management operation, continued to provide a cost-effective service to client funds that are the responsibility of the Commissioner's for the Reduction of the National Debt (CRND).
- The DMO continued to manage the gilt registration contract with Computershare Investor Services PLC ("Computershare") on behalf of HM Treasury following the transfer of the registration function from the Bank of England in December 2004. It also continued to offer the gilt purchase and sale service for retail investors, which is carried out in association with Computershare as HM Treasury's agent.

**5. To provide a cost-effective lending service to local authorities through the Public Works Loan Board.**

- The Public Works Loan Board continued to provide loans for capital purposes to local authorities and other prescribed borrowers. In December 2005 the Board, after consultation with HM Treasury, increased the maximum maturity of its loans from 30 to 50 years. This followed the successful issuance of 50-year gilts in accordance with the DMO's debt management remit. With rates on a declining trend for most of 2005-06 there was increased demand for loans and loans outstanding to the Board totalled £47.1 billion at 31 March 2006 (31 March 2005: £42.1 billion).

**6. To resource, staff, and manage the DMO efficiently and cost-effectively to ensure key responsibilities are achieved.**

- The DMO was reaccredited as an "Investor in people" in September 2005 and continues to work towards maintaining this status with the next formal review due by September 2008. The DMO's training and development policy is central to ensuring that the right people with the right skills are in the right job at the right time. The DMO's corporate training programme, complemented by additional specialist and individual training as well as support for ongoing professional studies, continues to enhance the skills base of its employees.

**7. To manage, operate and develop an appropriate risk and control framework.**

- The DMO continued to operate an effective risk and control framework throughout the year and has made some significant enhancements to the framework. An independent review of the risk reporting processes were carried out during the year and a number of recommendations have been implemented to improve the focus on key risks and controls and the usefulness of the information produced. In addition a range of new risk and performance measures were introduced governing the cash management operation.

## Performance against the DMO's operational targets

1. **To ensure full compliance with the Government's remit for the DMO as set out in the Debt and Reserves Management Report 2005-06, and to ensure consistency with the objectives of monetary policy.**

- The gilt sales target has been met through the conduct of 25 outright auctions (fifteen conventional and ten index-linked), and one syndicated offer. Outright sales of £53.5 billion were planned in the remit for 2005-06, published on 16 March 2005. The sales target was decreased to £52.3 billion in the PBR on 5 December 2005, but this was still the highest level for over 10 years. The gilt sales outturn for 2005-06 was £52.3 billion (therefore within agreed operational tolerances). The composition of issuance was £41.5 billion conventional gilts and £10.8 billion index-linked gilts. There were no uncovered gilt auctions.

| | 2005-06<br>£m | 2004-05<br>£m |
|---|---|---|
| Nominal value of gilts issued on behalf of the National Loans Fund | 47,925 | 46,748 |
| Proceeds paid to the National Loans Fund | 52,361 | 50,101 |

- 25 outright auctions were held as follows:

- 12 April: £800 million (nominal) of 2% IL 2035
- 14 April: £2,500 million (nominal) of 5% 2025
- 28 April: £3,000 million (nominal) of 4¾% 2010
- 24 May: £425 million (nominal) of 2½% IL 2016
- 26 May: £2,500 million (nominal) of 4¼% 2055
- 7 June: £2,750 million (nominal) of 4¾% 2020
- 23 June: £450 million (nominal) of 4⅛% IL 2030
- 14 July: £2,250 million (nominal) of 4¼% 2055
- 26 July: £400 million (nominal) of 2½% IL 2020
- 2 August: £3,000 million (nominal) of 4% 2009
- 6 September: £2,750 million (nominal) of 4¼% 2036
- 27 September: £2,750 million (nominal) of 4¾% 2020
- 13 October: £2,750 million (nominal) of 4¼% 2032
- 25 October: £675 million (nominal) of 1¼% IL 2055
- 8 November: £3,250 million (nominal) of 4¼% 2011
- 24 November: £525 million (nominal) of 2½% IL 2013
- 7 December: £2,250 million (nominal) of 4¼% 2055
- 14 December: £375 million (nominal) of 4⅛% IL 2030
- 10 January: £2,500 million (nominal) of 4¾% 2020
- 24 January: £650 million (nominal) of 1¼% IL 2055
- 26 January: £3,000 million (nominal) of 4¼% 2011
- 7 February: £1,000 million (nominal) of 1¼% IL 2017
- 16 February: £2,500 million (nominal) of 4¼% 2055
- 1 March: £3,000 million (nominal) of 4% 2016
- 7 March: £625 million (nominal) of 2% IL 2035

- In addition, the following gilt was issued by means of a syndicated offer:
  - 22 September: £1,250 million (nominal) of 1¼% IL 2055
- The stock of Treasury bills in market hands was £19.1 billion at 31 March 2006 (31 March 2005: £20.3 billion), which met the remit target.

2. **To ensure that the maximum time taken to issue the results of gilt auctions does not exceed 40 minutes, that for weekly Treasury bill tenders does not exceed 30 minutes, and that for ad hoc Treasury bill or other tenders does not exceed 15 minutes, whilst achieving complete accuracy.**

- Achieved. The gilt auction result release times during the year were all within the 40 minutes target:

| | |
|---|---|
| 12 April: 2% IL 2035 | 16 minutes |
| 14 April: 5% 2025 | 17 minutes |
| 28 April: 4¾% 2010 | 16 minutes |
| 24 May: 2½% IL 2016 | 18 minutes |
| 26 May: 4¼% 2055 | 23 minutes |
| 7 June: 4¾% 2020 | 20 minutes |
| 23 June: 4⅛% IL 2030 | 17 minutes |
| 14 July: 4¼% 2055 | 21 minutes |
| 26 July: 2½% IL 2020 | 16 minutes |
| 2 August: 4% 2009 | 15 minutes |
| 6 September: 4¼% 2036 | 20 minutes |
| 27 September: 4¾% 2020 | 21 minutes |
| 13 October: 4¼% 2032 | 21 minutes |
| 25 October: 1¼% IL 2055 | 19 minutes |
| 8 November: 4¼% 2011 | 19 minutes |
| 24 November: 2½% IL 2013 | 15 minutes |
| 7 December: 4¼% 2055 | 34 minutes |
| 14 December: 4⅛% IL 2030 | 17 minutes |
| 10 January: 4¾% 2020 | 15 minutes |
| 24 January: 1¼% IL 2055 | 22 minutes |
| 26 January: 4¼% 2011 | 15 minutes |
| 7 February: 1¼% IL 2017 | 15 minutes |
| 16 February: 4¼% 2055 | 26 minutes |
| 1 March: 4% 2016 | 21 minutes |
| 7 March: 2% IL 2035 | 17 minutes |

- The average release time for gilt auctions was 19 minutes.
- 22 September: the DMO launched the 1¼% index-linked Treasury Gilt 2055 via a syndicated offering. The gilt was issued on 23 September 2005.
- The target release time for the Treasury bill tenders was also met. The release times for the results of the 51 weekly tender bills held during the financial year ranged from 6 to 26 minutes and averaged 11 minutes. There were no ad hoc or other tenders.

**3. To achieve complete accuracy, within agreed accounting tolerances, in the recording and reporting of transactions through the Debt Management Account (DMA), and in delivering money (and reconciling payments) to the National Loans Fund (NLF) and to meet the required deadlines for the publication or submission for audit of the annual reports of the DMO agency and DMA.**

- The National Audit Office certified that:
  - the 2004-2005 DMO financial statements give a true and fair view of the state of affairs of the UK Debt Management Office as at 31 March 2005 and of the net operating cost, total recognised gains and losses and cash flows for the year then ended and have been properly prepared in accordance with the Government Resources and Accounts Act 2000 and directions made there under 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.
  - the 2004-2005 DMA 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 there under 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.
  - The DMO Report and Accounts 2004-05 were laid before Parliament on 18 July 2005 and the DMA Report and Accounts 2004-05 were laid on 20 July 2005.

**4. To acknowledge all letters and e-mail enquiries from the public within 4 working days and for at least 95 per cent to be sent a substantive reply within 2 weeks. Furthermore, the DMO will respond to enquiries under the Freedom of Information Act within the statutory timeframe.**

- Achieved. During the financial year, 282 queries were received (251 of which were e-mails). The average response time was 2 working days.

**5. To achieve less than 5 breaches of Operational market notices (excluding any breaches that HM Treasury accepts were beyond the control of the DMO).**

- Achieved. There were no breaches of the Operational market notices in the financial year.

**6. To ensure that, where there is a late change in the cash management forecast, any necessary use of end of day borrowing or lending facilities is notified by the due time.**

- Achieved. Deadlines for late lending and borrowing were met. In addition, in the event of a late shutdown the actual due time is moved, but the target remains the same. Once during the financial year there was an unexpectedly large surplus balance following an incorrect adjustment of a repo trade that had failed the previous day (caused by a temporary failure of the Bank of England's CREST settlement connection).

**7. To ensure that instructions to counterparties, agents and external systems are complete, accurate and timely, and that monitoring of the progress of transactions through settlement is effective, so that the DMO achieves at least 99% (by value) successful settlement of agreed trades on the due date.**

- Achieved. Total turnover in 2005-06 was £1,083.2 billion. During the year, trades with a value of £833 million failed, as a result of circumstances outside the DMO's control. No trades failed within the DMO's control. Failed trades represented 0.08% of turnover.

**8. To release all market sensitive data and announcements in a timely manner and to aim to achieve no factual errors in material published by the DMO on its wire service pages, its websites or its printed documents (insofar as the material is under the control of the DMO and not third parties).**

- Achieved re: timeliness. All releases were announced in a timely manner.
- Not achieved re: accuracy. 18 factual errors were discovered (and corrected quickly) on the DMO website during the financial year.

**9. To process all loans or early settlement applications from local authorities within two working days (between the date of agreement and completion of transaction).**

- All loans or early settlement applications were agreed and advanced within two working days of the dates of agreement within the quarter and indeed the financial year, apart from one occasion. The funds relating to one loan were advanced to the wrong account and, as this could not be corrected until the next day, a charge equal to one day's interest (approximately £600) was incurred by PWLB.

**10. To ensure that the gilts purchase and sales service is operated according to its published terms and conditions.**

- The gilt sale and purchase scheme was conducted fully in line with its terms and conditions in the financial year as a whole. The pattern of sales and purchases during the financial year is shown in the table below.

| | Sales (transactions) | Purchases (transactions) | Aggregate retail sales £m | Aggregate retail purchases £m |
|---|---|---|---|---|
| April – June 2005 | 1,674 | 915 | 10 | 15 |
| July – September 2005 | 1,680 | 700 | 12 | 10 |
| October – December 2005 | 1,400 | 1,144 | 11 | 18 |
| January – March 2006 | 1,712 | 613 | 16 | 8 |
| **Total** | **6,466** | **3,372** | **49** | **51** |

## The DMO's strategic objectives for 2006-07

1. **To develop, provide advice on and implement the Government's debt management strategy.**

2. **To develop, provide advice on and implement the Government's cash management requirements.**

3. **To advise HM Treasury on the development and implementation of strategies for managing the Government's balance sheet, to secure sound public finances.**

4. **To develop and deliver its fund management responsibilities and, in particular, to provide a cost-effective service for stakeholders.**

5. **To provide a cost-effective lending service to local authorities through the Public Works Loan Board.**

6. **To resource, staff and manage the DMO efficiently and cost-effectively to ensure key responsibilities are achieved.**

7. **To manage, operate and develop an appropriate risk and control framework.**

In the delivery of these objectives, the DMO seeks to primarily support HM Treasury's Objective I: "Maintain a stable macroeconomic environment with low inflation and sound public finances in accordance with the Code for Fiscal Stability". It also seeks to support HM Treasury's Objective III: "Promote efficient, stable and fair financial markets, for their users and the economy"; Objective VI: "Improve the quality and the cost-effectiveness of public services"; and Objective VII: "Achieve world-class standards of financial management in government".

## The DMO's operational targets for 2006-07

1. **To ensure full compliance with the Government's remit for the DMO (which is primarily set out in the Debt and Reserves Management Report 2006-07 but, in some areas, is subject to confidential parameters notified separately to the DMO).**

2. **To ensure that the maximum time taken to issue the results of gilt auctions does not exceed 40 minutes, that for weekly Treasury bill tenders does not exceed 30 minutes, and that for ad hoc Treasury bill or other tenders does not exceed 15 minutes, whilst achieving complete accuracy.**

3. **To achieve complete accuracy, within agreed accounting tolerances, in the recording and reporting of transactions through the DMA, and in delivering money (and reconciling payments) to the NLF and to meet the required deadlines for the publication or submission for audit of the annual reports of the DMO and DMA.**

4. **To acknowledge all letters and e-mail enquiries from the public within 4 working days and for at least 95 per cent to be sent a substantive reply within 2 weeks. Furthermore, the DMO will respond to enquiries under the Freedom of Information Act within the statutory timeframe.**

5. **To achieve less than 5 breaches of operational market notices (excluding any breaches that HM Treasury accepts were beyond the control of the DMO).**

6. **To ensure that, where there is a late change in the cash management forecast, any necessary use of end of day borrowing or lending facilities is notified by the due time, where applicable; and to ensure that target weekly balances and expected daily variations are notified according to the agreed schedule.**

7. **To ensure that instructions to counterparties, agents and external systems are complete, accurate and timely, and that monitoring of the progress of transactions through settlement is effective, so that the DMO achieves at least 99% (by value) successful settlement of agreed trades on the due date.**

8. **To release all market sensitive data and announcements in a timely manner and to aim to achieve no factual errors in material published by the DMO on its wire service pages, its web sites or its printed documents (insofar as the material is under the control of the DMO and not third parties).**

9. **To process all loan or early settlement applications from local authorities within two working days (between date of agreement and completion of transaction).**

10. **To ensure that the gilts purchase and sales service is operated according to its published terms and conditions.**

## The DMO's 3-year plan

- **To continue to deliver the DMO's core operations and activities to the excellent standard required.**

  This will include the following:

  - Managing the debt and cash management operations successfully to deliver the financing programmes incorporated within the 2006-07 remit.
  - Developing in due course the debt and cash management remit for 2007-08.
  - Delivering the PWLB lending objectives for local authorities and developing, where appropriate and feasible, enhancements to the service.
  - Managing the CRND funds in accordance with their respective mandates from clients.
  - Delivering the gilt purchase and sale service for retail investors efficiently and effectively.
  - Managing the registration contract with Computershare, on behalf of HM Treasury, in an effective and efficient way.
  - Continuing to manage hedging transactions as required and to meet NS&I's requirements in respect of its issuance of Guaranteed Equity Bonds.
  - Ensuring that the DMO's website, publications and information are managed effectively and are available to stakeholders when required.

- **To further the development of debt and cash management strategy in particular where this identifies initiatives that may provide cost and risk minimisation benefits for the Government.**

  This will include the following:

  - Developing further our understanding of the composition of, drivers for and issues relating to the investor base for gilts and Treasury bills.
  - Developing further analytical tools and techniques – in consultation with HM Treasury as necessary – that help inform debt and cash management strategy.
  - Assisting HM Treasury with the development of a consolidated profile of public finances and considering any associated asset/liability-related issues.
  - Continuing to work with the National Audit Office on their study on debt management.
  - Developing enhancements to the delivery and measurement of the effectiveness of cash management operations.

- **To improve efficiency and to reduce operational risk where possible.**

  This will include the following:

  - Taking forward the preparations for the introduction of electronic bidding at gilt auctions and Treasury bill tenders.
  - Reviewing further the DMO's banking and settlement arrangements with the intention of identifying efficiencies and where possible advances in operational effectiveness.
  - Developing and enhancing the DMO's business delivery capability to improve the operational efficiency of the agency.
  - Enhancing the DMO's risk management analytical and reporting framework and capability.
  - Continuing to enhance business continuity arrangements to develop further the DMO's operational resilience.
  - Implementing a programme of strategic IT work to enhance the DMO's core infrastructure and applications.
  - Developing further the management information produced to support the DMO's business and agency functions.
  - Implementing efficiencies in the management of information taking due account of the Freedom of Information Act requirements.
  - Continuing to deliver the programme of savings identified as part of the Efficiency Review.
  - To continue to contribute to the workstreams underpinning the ongoing Comprehensive Spending Review.

- **To ensure the core values of the DMO continue to make it an excellent place to work.**

  This will include the following:

  - Continuing to integrate and embed the DMO's core values into all aspects of the DMO's operations ensuring these activities are consistent with and build upon its "Investor in People" status.
  - Identifying and implementing where appropriate more effective ways of working.

## Financial performance

The DMA's operations for the financial year 2005-06 gave rise to net interest income of £7 million (2005: £24 million), and dealing profits of £692 million (2005: £31 million). This resulted in a surplus of £699 million (2005: £55 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 2005-06, the DMO issued Treasury bills with a total nominal value of £87.95 billion (excluding issuance to itself to provide extra collateral), which had maturities of one month (£28.2 billion), three months (£49.8 billion), and six months (£9.95 billion). At 31 March 2006, the total value of Treasury bills in market hands was £19.1 billion, with maturities of one month (£2.05 billion), three months (£11.7 billion), and six months (£5.35 billion).

By comparison, during 2004-05, 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 market hands was £20.3 billion, with maturities of one month (£4.8 billion), three months (£10.3 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.

## Financial position

The assets and liabilities of the DMA reflect its relationship with the NLF, as described on page 6 to 7.

During the year, the value of the gilt collateral held by the DMA increased significantly, which resulted in an increase in debt securities. In addition, the repayment of the NLF advance to the DMA resulted in a decrease in the NLF advance, and a corresponding decrease in the NLF deposit.

## Future developments

In 2006-07 the DMO plans to implement formally the benchmarking process for Exchequer cash management that was recommended in its review of "active cash management" in 2004-05. This benchmarking process has been transitioned in cash management operations during 2005-06. A second phase of the review of cash management operations in 2006-07 will focus on the possible use of (or a change in current practices for using) hedging instruments such as SONIA (swaps based on the "sterling overnight interbank average" interest rate) and foreign exchange swaps.

The DMO is developing a new website that will offer greatly enhanced report facilities. The site is scheduled to go live in summer 2006 at www.dmo.gov.uk.

## 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 34 to 37.

## 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 2006 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 minimise the cost of offsetting the Government's net cash flows over time, while operating within a risk appetite approved by Ministers"*.

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 2005-06, the DMO held gilts for use as collateral in repo borrowing. At 31 March 2006, gilts held specifically for collateral purposes had a market value of £28.0 billion. Twice during 2005-06, the DMO issued Treasury bills to itself in order to maintain sufficient collateral for its money market operations. Both issues matured during the financial year.

**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 management objective.

As the Government's debt manager, a key role of the DMO is to issue gilt-edged securities (gilts). 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 costs of servicing its debt over the long-term, rather than the debt interest bill in a single year. Because the Government is a repeat issuer that will access the market on a regular basis in the future, and because of the long-term nature of many debt instruments, debt management decisions have a long-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 and can be delivered in a wide range of economic conditions.

Each year, HM Treasury sets the terms of the DMO's financing remit, which are published in the annual Debt and Reserves Management Report (DRMR), as part of the Budget. The remit sets the amount of gilts to be issued during the financial year and the breakdown of gilt sales between formats (conventional and index-linked) and maturities.

The composition of debt issuance is the primary means by which the Government adjusts the nature and maturity of its debt portfolio. In order to determine the composition, the Governments takes into account, inter alia, investors' demand for gilts, its own appetite for risk, the shape of the yield curve, and the expected effects of issuance.

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

In addition to gilt issuance (the primary market), the DMO contributes to the development of an efficient and liquid secondary market for gilts, by means including the establishment of the Gilt Edged Market Makers (GEMMs) system. Under an agreement with the DMO, GEMMs provide a secondary market in all gilts, and are the point of access for institutional investors who wish to take part in 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 (£20 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 (£20 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 (£96 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. During the year the DMO introduced additional interest rate sensitivity and value at risk measures for the most active parts of its portfolio.

**Interest rate risk**

| | Fixed rate instruments Weighted average interest rate | Fixed rate instruments Weighted average period | Fixed rate instruments | Floating rate instruments | Non rate instruments | Total |
|---|---|---|---|---|---|---|
| | 2006 | 2006 | 2006 | 2006 | 2006 | 2006 |
| | % | Years | £m | £m | £m | £m |
| **Currency** | | | | | | |
| Sterling | | | | | | |
| Lending | 5.74 | 8.06 | 26,919 | 18,357 | – | 45,276 |
| Borrowing | 4.42 | 0.12 | 42,847 | 3,547 | – | 46,394 |
| | 2005 | 2005 | 2005 | 2005 | 2005 | 2005 |
| | % | Years | £m | £m | £m | £m |
| **Currency** | | | | | | |
| Sterling | | | | | | |
| Lending | 5.89 | 7.24 | 10,629 | 50,912 | 5 | 61,546 |
| Borrowing | 4.75 | 0.12 | 40,574 | 20,978 | – | 61,552 |

The DMA is charged interest on the advance from the National Loans Fund (31 March 2006: zero, 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 £30 million as at 31 March 2006 (31 March 2005: £28 million). 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. Time bands are abbreviated as follows:

| Time band | Heading |
|---|---|
| In not more than 3 months | 0-3 months |
| In more than 3 months, but not more than 6 months | 3-6 months |
| In more than 6 months, but not more than 9 months | 6-9 months |
| In more than 9 months, but not more than 12 months | 9-12 months |
| In more than 1 year, but not more than 5 years | 1-5 years |
| In more than 5 years | Over 5 years |
| Items with no rate | Non-rate |

**As at 31 March 2006**

| | 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 | 125 | – | – | – | – | – | – | 125 |
| Loans and advances to banks | 3,867 | – | – | – | – | – | – | 3,867 |
| Debt securities | 3,490 | 850 | 1,622 | 6,979 | 6,490 | 12,244 | – | 31,675 |
| Other assets | 1,539 | – | – | – | 177 | – | – | 1,716 |
| Prepayments and accrued income | – | – | – | – | – | – | 394 | 394 |
| National Loans Fund – deposit | 9,609 | – | – | – | – | – | – | 9,609 |
| Total assets | 18,630 | 850 | 1,622 | 6,979 | 6,667 | 12,244 | 394 | 47,386 |
| **Liabilities** | | | | | | | | |
| Deposits by banks | 4,998 | – | – | – | – | – | – | 4,998 |
| Customer accounts | 20,580 | 306 | – | – | – | – | – | 20,886 |
| Debt securities in issue | 16,472 | 4,038 | – | – | – | – | – | 20,510 |
| Other liabilities | 4 | – | – | – | – | – | – | 4 |
| Accruals and deferred income | – | – | – | – | – | – | 146 | 146 |
| National Loans Fund – DMA surplus | – | – | – | – | – | – | 842 | 842 |
| Total liabilities | 42,054 | 4,344 | – | – | – | – | 988 | 47,386 |
| Maturity gap | (23,424) | (3,494) | 1,622 | 6,979 | 6,667 | 12,244 | (594) | – |
| Cumulative gap | (23,424) | (26,918) | (25,296) | (18,317) | (11,650) | 594 | | – |

**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.

| | | 2006 Carrying amount £m | 2006 Fair value £m | 2005 Carrying amount £m | 2005 Fair value £m |
|---|---|---|---|---|---|
| | **Assets** | | | | |
| a | Loans (including reverse sale and repurchase transactions) | 3,867 | 3,867 | 1,890 | 1,890 |
| b | Debt securities (including hedging derivatives) | 31,675 | 31,675 | 8,358 | 8,358 |
| c | Derivatives | 177 | 177 | 20 | 20 |
| | **Liabilities** | | | | |
| a | Deposits by banks | 4,998 | 4,998 | 2,071 | 2,071 |
| a | Customer accounts | 20,886 | 20,886 | 19,274 | 19,274 |
| b | Treasury bills | 20,510 | 20,510 | 20,208 | 20,206 |
| c | Derivatives | – | – | 5 | 5 |

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.

Debt 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. The fair value of these forward contracts is included in debt securities, and is calculated with reference to the contracted forward foreign exchange rate and the spot foreign exchange rate as at 31 March 2006.

c The fair value of over-the-counter derivative contracts that hedge the Guaranteed Equity Bond product is calculated daily by an independent specialist.

**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. The DMO held US dollar commercial paper and a related forward foreign exchange contract at 31 March 2006.

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 £927 million at 31 March 2006). 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. The DMO 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 £177 million at 31 March 2006 (31 March 2005: net asset of £15 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**

| | 2006 Principal amount £m | 2006 Year end positive fair value £m | 2006 Year end negative fair value £m | 2005 Principal amount £m | 2005 Year end positive fair value £m | 2005 Year end negative fair value £m |
|---|---|---|---|---|---|---|
| **Foreign exchange derivatives** | | | | | | |
| Forward foreign exchange | 102 | – | (2) | – | – | – |
| **Equity/interest rate derivatives** | | | | | | |
| Over-the-counter derivatives | 927 | 178 | (1) | 845 | 24 | (9) |
| Effect of netting | | (1) | 1 | | (4) | 4 |
| | | 177 | (2) | | 20 | (5) |

**Net replacement cost (maturity and counterparty analysis)**

| | 2006 Less than one year £m | 2006 One to five years £m | 2005 Less than one year £m | 2005 One to five years £m |
|---|---|---|---|---|
| **Equity/interest rate derivatives** | | | | |
| Over-the-counter derivatives | – | 177 | – | 20 |

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.

## Resources

### Sustainable development

As an executive agency of HM Treasury, the DMO is a party to the Joint Sustainable Development Statement, signed by the 'Green Minister' for the Chancellor of the Exchequer's Departments and Agencies, John Healey MP, and published on the DMO website.

The DMO is committed to contributing to the Government's objectives on Sustainable Development as contained in the Framework for Sustainable Development in the Government Estate.

### Service quality

The DMO does not provide services direct to the public, so it is not covered by existing arrangements for reporting service quality. However, the DMO has strong partnerships with parts of the public sector and provides advice and expertise to other Government departments (and other governments), in developing solutions for financial cost-effectiveness and risk reduction when managing the Government's balance sheet. The DMO has launched a consultation paper outlining its plans to introduce electronic bidding for gilt auctions and Treasury bill tenders, is frequently required to present to or host groups and individual officials from overseas countries, and promotes the gilts market when speaking at domestic and international bond conferences. The DMO has also continued to upgrade and expand the content of its website (www.dmo.gov.uk), on which all of its publications appear, and which acts as a means of communication for all those with an interest in the DMO's activities.

### Staff

The staff of the DMO manages the DMA. The DMO annual Report & Accounts 2005-06, which are available on the DMO's website at www.dmo.gov.uk, provide information on civil service pensions, pension liabilities, equal opportunities, employee relations, and improving good practice and investment in people.

# 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 52 of this document. The accounts and supporting notes relating to the Debt Management Account for the year ended 31 March 2006 have been audited by the Comptroller and Auditor General.

As far as I am aware, as Accounting Officer, there is no relevant audit information of which the Account's auditors are unaware. I have taken all the steps that I ought to have taken to make myself aware of any audit information and to establish that the Account's auditors are aware of that information.

**ROBERT STHEEMAN**
**Chief Executive and DMA Accounting Officer**
**12 July 2006**

# 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 52 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**
**12 July 2006**

# Statement on internal control

## 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.

## 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 2006 and up to the date of approval of the annual report and accounts, and accords with HM Treasury guidance. The DMO has made additions to the system of internal control over the course of the year.

## Capacity to handle risk

The DMO has a formal risk management strategy and policy set by 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. A Programme Board met regularly during the year to review progress for all DMO projects agreed as part of the business planning process. It reported on resourcing, prioritisation and delivery issues to the Managing Board's executive sub-committee.

Staff have attended presentations on relevant elements of the DMO's risk management framework. These have covered specific issues such as anti-money laundering, whistleblowing, fraud, and personal dealing, in order to ensure a good level of awareness of DMO's risk policies and controls. 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. 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.

## 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 achieve 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 for cash management operations.

Heads of business units and functional teams assess regularly whether risks to their operations are being managed effectively. New risks, and risks with an increased likelihood of occurrence, are highlighted and actions identified to ensure all risks will be effectively managed. The DMO has introduced Senior Risk Owners who undertake a cross-functional moderation process to promote better prioritisation of risks across the organisation. Project teams use risk registers to monitor and manage identified risks for each DMO project. Managing Board has 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. The DMO has 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'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 risk reporting framework was undertaken during 2005-06. Improvements to the DMO's risk reporting have been made in response to the report's recommendations, primarily a revised and more focused risk map linking detailed risks to high level risks and a more effective reporting process.

The DMO's business planning and project management processes, specifically around budgeting, approval, cost monitoring and delivery, have been strengthened in 2005-06 in response to recommendations made following an independent review. Further strengthening of controls in these areas will be implemented in 2006-07.

Improvements to financial controls and reporting were made in 2005-06 in response to recommendations made following an independent review. Further improvements and adoption of best practice will be implemented in 2006-07.

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.

## 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. There are a number of activities that form the basis of my review. Annually I formally review the key outcomes and findings of each activity in order to make my assessment.

An Internal Controls team meets regularly to review the DMO's system of internal control, 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 reports regularly to the Audit Committee 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 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, comprising two non-Executive Directors, met quarterly. The Audit Committee reviews the adequacy and effectiveness of the DMO's management of risk and internal controls, and makes recommendations for improvement as appropriate.

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 which 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.

The DMO's Risk Management Unit conducts monthly controls and compliance testing, providing the executive sub-committee of Managing Board with independent assurance on the effectiveness of operational controls and compliance with relevant FSA rules in the dealing and settlements areas. Compliance testing is also 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 2005-06 and remains so on the date I sign this statement.

**ROBERT STHEEMAN**
**Chief Executive and DMA Accounting Officer**
**12 July 2006**

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

I certify that I have audited the financial statements of the Debt Management Account for the year ended 31 March 2006 under the National Loans Act 1968. These comprise the Income and Expenditure Account, the Statement of Total Recognised Gains and Losses, the Balance Sheet, the Cash Flow Statement and the related notes. These financial statements have been prepared under the accounting policies set out within them.

## Respective responsibilities of the Accounting Officer and Auditor

As described on page 33, the Accounting Officer is responsible for the preparation of financial statements in accordance with Section 15 (1) of Schedule 5A of the National Loans Act 1968 and Treasury directions made thereunder, and for ensuring the regularity of financial transactions. The Accounting Officer is also responsible for the preparation of the Foreword. These responsibilities are set out in the Statement of Accounting Officer's Responsibilities.

My responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements, and with International Standards on Auditing (UK and Ireland).

I report to you my opinion as to whether the financial statements give a true and fair view and whether the financial statements have been properly prepared in accordance with the National Loans Act 1968 and Treasury directions made thereunder. I also report whether in all material respects the financial transactions of the Debt Management Account conform to the authorities which govern them.

I also report to you, if in my opinion, the Foreword is not consistent with the financial statements, if proper accounting records have not been kept or if I have not received all the information and explanations I require for my audit, or if information specified by relevant authorities is not disclosed.

I review whether the statement on page 34 to 37 reflects the Debt Management Office's compliance with HM Treasury's guidance on the Statement on Internal Control, and I report if it does not. I am not required to consider whether the Accounting Officer's statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the Debt Management Office's corporate governance procedures or its risk and control procedures.

I read the information contained in the Foreword and consider whether it is consistent with the audited financial statements. I consider the implications for my report if I become aware of any apparent misstatements or material inconsistencies with the financial statements. My responsibilities do not extend to any other information.

## Basis of audit opinion

I conducted my audit in accordance with International Standards of Auditing (UK and Ireland) issued by the Auditing Practices Board. My audit includes examination, on a test basis, of evidence relevant to the amounts, disclosures and regularity of financial transactions 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 Debt Management Account'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 fraud or error and that in all material respects the financial transactions conform with the authorities which govern them. In forming my opinion I 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, in accordance with the National Loans Act 1968 and directions made thereunder by Treasury, of the financial position of the Debt Management Account as at 31 March 2006 and of the surplus, total recognised gains and losses and cash flows for the year ended 31 March 2006;
- the financial statements have been properly prepared in accordance with the National Loans Act 1968 and directions made thereunder by Treasury; and
- in all material respects, the financial transactions of the Debt Management Account 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**
**14 July 2006**

***National Audit Office***
***157-197 Buckingham Palace Road***
***Victoria, London, SW1W 9SP***

# Income and expenditure account

**For the year ended 31 March 2006**

| | Note | 2006 £m | 2005 £m |
|---|---|---|---|
| Interest receivable | 2 | | |
| Interest receivable and similar income arising from debt securities | | 1,122 | 459 |
| Other interest receivable and similar income | | 1,943 | 3,031 |
| Interest payable | 3 | (3,058) | (3,466) |
| Net interest income | | 7 | 24 |
| Dealing profits | 4 | 692 | 31 |
| Operating surplus | | 699 | 55 |
| Surplus for the financial year | | 699 | 55 |

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 43 to 51 form part of these accounts.

# Balance sheet

**As at 31 March 2006**

| | Note | 2006 £m | 2005 £m |
|---|---|---|---|
| **Assets** | | | |
| Cash and balances at the Bank of England | | 125 | 385 |
| Loans and advances to banks | 5 | 3,867 | 1,890 |
| Debt securities | 6 | 31,675 | 8,358 |
| Other assets | 7 | 1,716 | 21 |
| Prepayments and accrued income | 8 | 394 | 334 |
| National Loans Fund – deposit | 9 | 9,609 | 50,912 |
| Total assets | | 47,386 | 61,900 |
| **Liabilities** | | | |
| Deposits by banks | 10 | 4,998 | 2,071 |
| Customer accounts | 11 | 20,886 | 19,274 |
| Debt securities in issue | 12 | 20,510 | 20,208 |
| Other liabilities | 13 | 4 | 6 |
| Accruals and deferred income | 14 | 146 | 198 |
| National Loans Fund – advance | 9 | – | 20,000 |
| National Loans Fund – DMA surplus | 15 | 842 | 143 |
| Total liabilities | | 47,386 | 61,900 |

The notes on page 43 to 51 form part of these accounts.

**ROBERT STHEEMAN**
**Chief Executive and DMA Accounting Officer**
**12 July 2006**

# Cash flow statement

**For the year ended 31 March 2006**

| | Note | 2006 £m | 2005 £m |
|---|---|---|---|
| Net cash flow from operating activities | 16a | (21,563) | 5,979 |
| Net cash flow before financing | | (21,563) | 5,979 |
| Financing | 16b | 21,303 | (5,796) |
| (Decrease)/increase in cash | | (260) | 183 |

The notes on page 43 to 51 form part of these accounts.

# Notes to the accounts for the year ended 31 March 2006

## 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. In particular, they have been prepared in accordance with the "Statement of Recommended Practice on Advances", "Statement of Recommended Practice on Securities", and "Statement of Recommended Practice on Derivatives" issued by the British Bankers' Association (BBA).

**(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 (2006: £58 thousand, 2005: £115 thousand).

**(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.

Forward foreign exchange transactions are recognised in accordance with the accounting treatment of the underlying transactions being hedged.

Interest rate/equity index swaps transacted by the DMA hedge an equity index exposure of the Government that is external to the DMA. Each hedge comprises two forward derivatives that address the risk features of the positions being hedged: equity index risk and interest rate risk. Both transactions are recognised at fair value (calculated daily by an independent specialist), as the DMA does not hold the underlying position 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, as the DMO is subject to 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.

**(vi) Disclosure of derivatives and other financial instruments**

FRS 13 "Derivatives and Other Financial Instruments: disclosures" requires narrative and numerical disclosures. Numerical disclosures are presented with the narrative disclosures on page 23 to 31.

## 2 INTEREST RECEIVABLE

| | 2006 | 2005 |
|---|---|---|
| | £m | £m |
| **Interest receivable and similar income arising from debt securities** | | |
| British Government securities | 1,021 | 433 |
| Other securities | 101 | 26 |
| | 1,122 | 459 |
| **Other interest receivable and similar income** | | |
| National Loans Fund deposit | 1,795 | 2,913 |
| Reverse sale and repurchase transactions | 105 | 101 |
| Other deposits | 43 | 17 |
| | 1,943 | 3,031 |

## 3 INTEREST PAYABLE

| | 2006 | 2005 |
|---|---|---|
| | £m | £m |
| Interest payable on National Loans Fund advance | (912) | (1,588) |
| Discounts on issued bills | (886) | (871) |
| Interest payable and similar charges on sale and repurchase transactions | (307) | (257) |
| Interest payable on customer accounts | (953) | (750) |
| | (3,058) | (3,466) |

## 4 DEALING PROFITS

| | 2006 | 2005 |
|---|---|---|
| | £m | £m |
| British Government securities | 530 | 17 |
| Other securities | – | (2) |
| Equity derivatives | 162 | 16 |
| | 692 | 31 |

## 5 LOANS AND ADVANCES TO BANKS

| | 2006 | 2005 |
|---|---|---|
| | £m | £m |
| Reverse sale and repurchase transactions | 2,567 | 1,850 |
| Fixed term deposits | 1,300 | 40 |
| | 3,867 | 1,890 |

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 zero at 31 March 2006 (31 March 2005: £194 million). These transactions are excluded from the balance sheet as they are offset by sale and repurchase transactions.

## 6 DEBT SECURITIES

| | 2006 £m | 2005 £m |
|---|---|---|
| **6a. Debt securities (market value)** | | |
| Listed | | |
| Issued by public bodies | | |
| British Government securities | 28,185 | 8,158 |
| | | |
| Unlisted | | |
| Issued by other issuers | | |
| Other securities | 3,490 | 200 |
| | 31,675 | 8,358 |

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.

| | 2006 Nominal £m | 2006 Market value £m | 2005 Nominal £m | 2005 Market value £m |
|---|---|---|---|---|
| **6b. Debt securities (maturity analysis)** | | | | |
| Due within 1 year | | | | |
| In not more than 3 months | 3,502 | 3,490 | 295 | 295 |
| In more than 3 months but not more than 1 year | 2,290 | 2,315 | 301 | 309 |
| | 5,792 | 5,805 | 596 | 604 |
| Due after 1 year | | | | |
| In more than 1 year but not more than 5 years | 5,825 | 6,002 | 2,276 | 2,379 |
| In more than 5 years | 17,162 | 19,868 | 4,630 | 5,375 |
| | 22,987 | 25,870 | 6,906 | 7,754 |
| | | | | |
| | 28,779 | 31,675 | 7,502 | 8,358 |

During the year, gilts with a nominal value of £15.8 billion (2005: zero) were created by the NLF and sold to the DMA as collateral. The DMO uses gilts as collateral in repo borrowing, and the additional collateral was created in order to maintain sufficient collateral for its money market operations.

## 7 OTHER ASSETS

| | 2006 £m | 2005 £m |
|---|---|---|
| Unsettled cash | 1,539 | 1 |
| Gains on derivatives | 177 | 20 |
| | 1,716 | 21 |

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. The contracts have maturity of between one and five years.

## 8 PREPAYMENTS AND ACCRUED INCOME

| | 2006 £m | 2005 £m |
|---|---|---|
| Accrued interest – gilts | 259 | 98 |
| Accrued interest – National Loans Fund deposit | 105 | 233 |
| Accrued interest – reverse sale and repurchase transactions | 2 | 3 |
| Accrued interest – other | 28 | – |
| | 394 | 334 |

## 9 NATIONAL LOANS FUND – NET FINANCING

| | Deposit £m | Advance £m | Net financing £m |
|---|---|---|---|
| As at 31 March 2005 | 50,912 | (20,000) | 30,912 |
| Repayments of advance by DMA | – | 20,000 | 20,000 |
| Net change in deposit by DMA | (41,303) | – | (41,303) |
| As at 31 March 2006 | 9,609 | – | 9,609 |

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

| | 2006 £m | 2005 £m |
|---|---|---|
| Sale and repurchase transactions | 4,860 | 2,071 |
| Fixed term deposits | 138 | – |
| | 4,998 | 2,071 |

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 £4,802 million at 31 March 2006 (31 March 2005: £2,278 million).

The DMA has entered forward starting sale and repurchase transactions with a first cashflow of settlement date after 31 March 2006. Such transactions related to deposits of zero at 31 March 2006 (31 March 2005: £400 million). 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 zero at 31 March 2006 (31 March 2005: £404 million).

Sale and repurchase transactions arising from stock swap operations had a market value of zero at 31 March 2006 (31 March 2005: £194 million). These transactions are excluded from the balance sheet as they are offset by reverse sale and repurchase transactions.

## 11 CUSTOMER ACCOUNTS

| | 2006 £m | 2005 £m |
|---|---|---|
| **11a. Customer accounts (maturity analysis)** | | |
| In not more than 3 months | | |
| Fixed term deposits | 17,033 | 17,684 |
| Call notice deposits | 3,547 | 978 |
| | 20,580 | 18,662 |
| In more than 3 months but not more than 6 months | | |
| Fixed term deposits | 306 | 612 |
| | 20,886 | 19,274 |

| | 2006 £m | 2005 £m |
|---|---|---|
| **11b. Customer accounts (counterparty analysis)** | | |
| Commissioners for the Reduction of the National Debt | | |
| Fixed term deposits | 16,288 | 17,538 |
| Call notice deposits | 3,547 | 978 |
| | 19,835 | 18,516 |
| Other government counterparties | | |
| Fixed term deposits | 1,051 | 758 |
| | 20,886 | 19,274 |

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 £20,510 million at 31 March 2006 (31 March 2005: £20,206 million). All Treasury bills had maturity of not more than 6 months.

Of those Treasury bills in issue at 31 March 2006, Treasury bills with a nominal value of zero (31 March 2005: £10 billion) were 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

| | 2006 £m | 2005 £m |
|---|---|---|
| Unsettled cash | 4 | 1 |
| Losses on derivatives | – | 5 |
| | 4 | 6 |

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 one and five years.

## 14 ACCRUALS AND DEFERRED INCOME

| | 2006 £m | 2005 £m |
|---|---|---|
| Accrued interest – National Loans Fund advance | 72 | 122 |
| Accrued interest – sale and repurchase transactions | 5 | 6 |
| Accrued interest – deposits | 69 | 70 |
| | 146 | 198 |

## 15 NATIONAL LOANS FUND – DMA SURPLUS

| | 2006 £m | 2005 £m |
|---|---|---|
| As at 31 March 2005 | 143 | 88 |
| Surplus for the financial year | 699 | 55 |
| As at 31 March 2006 | 842 | 143 |

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

| | 2006 £m | 2005 £m |
|---|---|---|
| **16a. Reconciliation of operating profit to net cash flow from operating activities** | | |
| Operating surplus | 699 | 55 |
| (Increase)/decrease in loans and advances to banks | (1,977) | 2,379 |
| (Increase)/decrease in debt securities | (23,317) | 2,503 |
| (Increase) in other assets | (1,695) | (14) |
| (Increase)/decrease in prepayments and accrued income | (60) | 15 |
| Increase/(decrease) in deposits by banks | 2,927 | (1,889) |
| Increase in customer accounts | 1,612 | 1,881 |
| Increase in debt securities in issue | 302 | 1,029 |
| (Decrease) in other liabilities | (2) | (2) |
| Decrease/(increase) in accruals and deferred income | (52) | 22 |
| Net cash flow from operating activities | (21,563) | 5,979 |
| **16b. Financing** | | |
| Repayment of deposit with National Loans Fund | 41,303 | 9,204 |
| (Repayment) of advance from National Loans Fund | (20,000) | (15,000) |
| | 21,303 | (5,796) |

## 17 GILT ISSUANCE

| | 2006 £m | 2005 £m |
|---|---|---|
| Nominal value of gilts issued on behalf of National Loans Fund | 47,925 | 46,748 |
| Proceeds paid to National Loans Fund | 52,361 | 50,101 |
| Nominal value of uncovered stock purchased from National Loans Fund | – | – |

There were no uncovered gilt auctions.

During the year, gilts with a nominal value of £15.8 billion (2005: zero) were created by the NLF and sold to the DMA as collateral. The DMO uses gilts as collateral in repo borrowing, and the additional collateral was created in order to maintain sufficient collateral for its money market operations.

## 18 POST BALANCE SHEET EVENTS

As at 31 March 2006 the NLF advance to the DMA was zero. On 26 April 2006, the NLF made a cash advance of £5 billion to the DMA.

From 18 May 2006, following the reforms of the framework for the Bank of England's operations in the sterling money markets, the DMO's end of day arrangements with the Bank of England via the late repo facility, and the special end of day transfer arrangement (SEDTA) with the settlement banks, were discontinued. In their place, the DMO will target a cumulative weekly balance on its account at the Bank of England. The target balance is intended to provide a cushion against unanticipated cashflows, and will vary from week to week depending on uncertainty about forecast cashflows across the account. This is expected to result in an average daily balance held by the DMA at the Bank of England (cash) that is higher than the previous daily target of £200 million, leading to a corresponding decrease in the average DMA deposit with the NLF (National Loans Fund – deposit).

## 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 £151.8 billion (2005: £126.6 billion). The value of deposits outstanding was £19.8 billion at 31 March 2006 (31 March 2005: £18.5 billion). The DMA bought non-marketable gilts of nominal value £1.1 billion from CRND during the year, and sold non-marketable gilts of nominal value £7.6 billion to CRND (2005: purchases £4.5 billion, sales £6.9 billion).

**(iv) DMO Managing Board and senior managers**

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

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

1. HM Treasury shall prepare accounts for the Debt Management Account (the Account) for the year ended 31 March 2006 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 Financial Reporting 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.

5. This accounts direction supersedes that issued on 11 December 2001.

**DAVID WATKINS**
**Head of Financial Reporting Policy Team**
**HM Treasury**
**22 June 2006**

# Appendices

## Appendix A
## APPLICATION OF THE FINANCIAL REPORTING 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 Financial Reporting Manual (FReM). Accordingly, an income and expenditure account shall be prepared instead of an 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. A statement of parliamentary supply, and a consolidated statement of operating costs by departmental aim and objectives, are also not relevant.

2. In other respects, the accounts shall be consistent with relevant requirements of the FReM 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 Financial Reporting 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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