

Presented to Parliament pursuant to Section 21(1) of the National Loans Act 1968

National Loans Fund Account 2011-12

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National Loans Fund Account 2011-12

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The National Audit Office scrutinises public spending on behalf of Parliament.

The Comptroller and Auditor General, Amyas Morse,
is an Officer of the House of Commons.
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He and the NAO are totally independent of government.

He certifies the accounts of all government departments
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and he has statutory authority to report to Parliament
on the economy, efficiency and effectiveness with which departments
and other bodies have used their resources.

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Foreword

Background to the National Loans Fund

The National Loans Fund (NLF) was established on 1 April 1968 by the National Loans Act 1968 to account for government borrowing and lending, which were until then accounted for as part of the Consolidated Fund (CF). The CF was first set up in 1787 as 'one fund into which shall flow every stream of public revenue and from which shall come the supply for every service'. The NLF was set up in order to separate government revenue and expenditure on the one hand and government borrowing and lending on the other. The accounts for the CF and NLF are now published separately.

Both the CF and NLF are administered by the Treasury, with the bank accounts maintained at the Bank of England. The CF can therefore be regarded as central government's current account, whereas the NLF can be regarded as central government's main borrowing and lending account. Most of the NLF's borrowing needs are now met indirectly through borrowing on its behalf by the Debt Management Office (DMO) and National Savings and Investments (NS&I).

The DMO was established as an executive agency of the Treasury on 1 April 1998. Its aim is 'to carry out the Government's debt management policy of minimising financing costs over the long term, taking account of risk, and to minimise the cost of offsetting the Government's net cash flows over time, while operating in a risk appetite approved by Ministers in both cases'. Its operations are managed through the Debt Management Account (DMA), which is a bank account at the Bank of England, linked closely with the NLF as described below. As the Government's debt manager, the DMO has a key role in the issue of gilt-edged securities on behalf of the Treasury. Gilt-edged securities, or gilts, are UK Government sterling-denominated listed bonds. There are two main types: conventional (i.e. fixed rate) gilts and index-linked gilts, on which the return is linked to movements in the Retail Price Index. They are issued from the NLF, sold initially to the DMA and then sold from the DMA by the DMO to the market. In addition, the DMO issues Treasury Bills from the DMA and undertakes other money market operations to meet the Government's daily cash requirements. Further details on these operations can be found in the Debt and Reserves Management Report 2012-13 published by the Treasury in March 2012 (ISBN: 978-1-84532-956-3).

The Exchange Equalisation Account (EEA) was established in 1932 to provide a fund that could be used, when necessary, to regulate the exchange value of sterling. It holds the UK's reserves of gold, foreign currency assets and International Monetary Fund (IMF) Special Drawing Rights. Combined with the UK's Reserve Tranche Position (RTP) with the IMF, these assets comprise the UK's official holdings of international reserves. The RTP is an asset of the NLF. The Bank of England acts as the Treasury's agent in the day-to-day management of the EEA.

National Loans Fund Activities

The NLF's main role is to meet the finance needs of the CF to the extent that taxation and other receipts are insufficient to meet the CF's outgoings. To this end the NLF undertakes borrowing and uses the proceeds to meet any deficits on the CF; conversely, any net surpluses on the CF are passed to the NLF to reduce the latter's need to borrow or to increase the amount that it can lend. The NLF finishes every day with a nil balance on its bank account because any cash surpluses or deficits are offset by transfers to or from the DMA.

The NLF's borrowing operations include the temporary borrowing of balances in various government bank accounts that are surplus to immediate requirements. Such borrowing minimises the amount that the NLF needs to borrow from other sources. Where the money borrowed in this way already counts as Exchequer money, interest is not paid. For the rest of its borrowing, however, the NLF normally has to pay interest and finance repayments when required. If the NLF's interest income is less than the interest it pays on its borrowings, which it generally is, the shortfall is met by a transfer from the CF.

The NLF provides finance for both the DMA and the EEA as required. It also makes loans to various statutory public sector bodies and provides the finance needed by the Public Works Loan Board (PWLB) for its loans to prescribed bodies, mainly Local Authorities. As a result, the NLF is not exposed to significant credit risk. Further detail on how credit risk is managed is included in note 16 to the accounts. The profits of the Issue Department of the Bank of England are also paid to the NLF under section 9(1) of the National Loans Act 1968. NS&I's savings products are liabilities of the NLF. In year surpluses and deficits of the DMA and the EEA are income and expenditure of the NLF respectively, and the net assets of the DMA and the EEA are assets of the NLF. The Capital Contribution Reserve of the EEA is periodically reduced, because when there is no outstanding specific liability to the NLF, sterling repayments by the EEA to the NLF are taken to the Capital Contribution Reserve.

By virtue of section 19(1) of the National Loans Act 1968, the net liabilities of the NLF are a liability of the CF.

Eurozone Interventions

The UK has continued to support the IMF through the NLF in 2011-12, in line with our commitments as a member of the IMF. The UK has provided such support through both our quota shareholding and our lending to the Fund. The UK's agreed bilateral loan to Ireland of £3.2 billion is being funded by HM Treasury's Vote, which receives its funding from the CF through the normal Supply procedures. Details can be found in HM Treasury's Annual Report and Accounts 2011-12. The UK is also a member of the European Financial Stabilisation Mechanism (EFSM), which provides support to all EU Member States. The CF is responsible for the United Kingdom's contribution to the EFSM. Details can be found in the Consolidated Fund Account 2011-12. The NLF is not party to either the bilateral loan to Ireland or the EFSM.

Special Liquidity Scheme (SLS) and Asset Purchase Facility

The SLS was the Bank of England's scheme which allowed banks to swap, for up to three years, their high quality mortgage-backed and other securities for Treasury Bills. Treasury Bills were issued by the NLF and sold to the DMA which made them available to be borrowed by the Bank of England. The drawdown period for the Special Liquidity Scheme closed on 30 January 2009. The scheme officially closed on 30 January 2012. All drawings under the scheme were repaid before the scheme closed. The Bank of England paid stock lending fees to the DMA for the loan of Treasury Bills under the Special Liquidity Scheme. A portion of these fees was payable to the NLF.

The Asset Purchase Facility was set up in 2008-09 at the Bank of England in order to improve liquidity in credit markets by purchasing securities (a process known as 'quantitative easing'). As at 31 March 2012, on an amortised cost basis, £277 billion (2010-11: £184 billion) of gilts from the NLF were held by the Bank of England for quantitative easing. More information on the scheme can be found on the Bank of England's website.

Summary of Outturn for 2011-12

The total comprehensive net expenditure of the Fund decreased by £11.1 billion from £37.7 billion in 2010-11 to £26.6 billion in 2011-12. This was predominantly due to significantly higher other income, which increased by £11.7 billion in the year, from £9.4 billion to £21.1 billion. This was almost wholly as a result of the DMA's total comprehensive income rising by £11.4 billion over the year, caused by fair value gains on their holdings of gilts. Excluding the profits and total comprehensive income of other entities, the NLF's total comprehensive net expenditure was £47.3 billion compared to £46.7 billion.

Liabilities

Total gross liabilities increased by £27.1 billion from £1,343.8 billion to £1,370.9 billion. Gilt-edged stock increased by £141.9 billion from £1,059.3 billion to £1,201.2 billion, other debt increased by £4.5 billion, and NS&I liabilities increased by £4.0 billion, but these increases were partly offset by the Treasury Bill liability falling from £122.8 billion to £nil, as the Special Liquidity Scheme closed and a fall in IMF liabilities of £0.5 billion.

Assets

The NLF's total gross assets decreased by £70.6 billion from £282.4 billion to £211.8 billion. This was mainly due to a repayment of advances made to the DMA. The principal outstanding has fallen by £105 billion since March 2011 as the DMA no longer required the advance to facilitate its operations in the short term, and the DMA also received cash from its holding of Treasury Bills upon cancellation of the Special Liquidity Scheme. This has been partly offset by net increases in the amounts advanced to the PWLB and EEA of £8.8 billion and £4.4 billion respectively, and increases in the net assets of the DMA and the EEA of £18.2 billion and £2.0 billion respectively.

Public Sector Net Debt

As a result of these changes, the net liabilities of the Fund increased by £97.7 billion from £1,061.4 billion to £1,159.1 billion. This is matched by a corresponding claim on the CF. The NLF lends to and borrows from other parts of the public sector. For example it makes advances to the PWLB and borrows directly from a range of public sector bodies (as described in note 12). In addition, some of the gilts it has issued are held in the public sector, including by the DMA which retains a portfolio of gilts as collateral for its money market activities. The DMA also has large advances to and from the NLF. Therefore, the NLF's net liabilities do not equate to the Public Sector Net Debt ('PSND'), which is a calculation of the net debt of the whole of the public sector after eliminating intra-public sector balances. Figures for PSND are published jointly by HM Treasury and the Office for National Statistics in the monthly "Public Sector Finances Statistical Bulletin", which can be found on the Treasury website.

Forward Look

The Debt Management Remit for 2012-13 was published by the Treasury with the budget on 21 March 2012. On the basis of a Central Government Net Cash Requirement forecast of £121.0 billion for 2012-13, the published net financing requirement was £166.4 billion. This difference relates to upwards adjustments of £52.9 billion for gilt redemptions and £6.0 billion additional sterling financing for the official reserves, and a downwards adjustment of £13.6 billion for short term financing. The DMO will meet the net financing requirement by gross gilt sales of £167.7 billion (gilts issued by the NLF) and a reduction in the DMA's Treasury Bill stock of £1.3 billion. More information can be found in the Debt and Reserves Management Report 2012-13 http://www.hm-treasury.gov.uk/budget2012_debtreserves.htm.

In April 2012, a G20-led agreement to temporarily increase IMF resources was agreed. This is explained further in note 18.

Also in April 2012, the assets of the Royal Mail Pension Plan, a private sector pension plan, were transferred into public ownership. The government is now in possession of gilts with a nominal value of £7.98 billion, which will be cancelled in 2012-13. Further information can be found in note 18.

Preparation of the Account

The Account is prepared under section 21(1) of the National Loans Act 1968. The Act requires the Treasury to prepare an account for the NLF for each financial year in such form and containing such information as the Treasury considers appropriate.

External Audit

The NLF Account is audited by the Comptroller and Auditor General under the requirements of the National Loans Act 1968.

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

The National Audit Office bears the cost of all external audit work performed on the NLF.

Nick Macpherson
Accounting Officer
HM Treasury

17 July 2012

Statement of Accounting Officer's responsibilities

Under section 21(1) of the National Loans Act 1968 HM Treasury is required to prepare an account relating to the National Loans Fund for each financial year in such form and containing such information as the Treasury considers appropriate.

The National Loans Fund Account is prepared on an accruals basis and must give a true and fair view of the state of affairs of the Fund and of the total comprehensive net expenditure and the cash flows for the financial year.

The Treasury has appointed its Permanent Secretary as Accounting Officer for the Fund, with overall responsibility for its operation, for preparing the annual account and for transmitting it to the Comptroller and Auditor General for audit.

In preparing the Account the Accounting Officer is required to observe the applicable accounting standards and generally accepted accounting practice in so far as they are relevant to the Account, and apply suitable accounting policies on a consistent basis.

The responsibilities of an Accounting Officer, including responsibility for the propriety and regularity of the public finances for which he is answerable, and for the keeping of proper accounting records, are set out in Chapter 3 of *'Managing Public Money'*, published by the Treasury.

Governance Statement

Governance Framework

The National Loans Fund is managed within the Treasury's governance framework as set out in the Treasury's Annual Report and Accounts 2011-12. This includes the Treasury Board's assessment of its compliance with the 'Corporate Governance Code'.

The Chancellor of the Exchequer, as Minister in charge of the Treasury, is responsible and answerable to Parliament on all the policies, decisions and actions of the Treasury, and ultimately of the National Loans Fund.

As Accounting Officer for the National Loans Fund, I am personally responsible and accountable to Parliament for the organisation and quality of management of the National Loans Fund, including its use of public money and the stewardship of its assets, in line with those responsibilities assigned to me in 'Managing Public Money'.

Audit Committee

The Treasury Audit Committee is a committee of the Treasury Board (sub-committee), and is tasked with supporting me, as Principal Accounting Officer, and the Treasury's Additional and other Accounting Officers in their responsibilities for managing risk, internal control and governance related to the:

- Treasury Group's Annual Report and Accounts.
- Consolidated Fund.
- Contingencies Fund.
- National Loans Fund.
- Exchange Equalisation Account.

I appoint members of the Committee for periods up to three years, extendable by no more than two additional three-year periods. The Chair of the Committee reports directly to me and is invited to report concerns or issues to the Treasury Board (sub-committee). The membership of the Audit Committee at the close of 2011-12 was:

- Michael O'Higgins (Chair) – Chairman of the Audit Commission; Chairman of the Pensions Regulator; Chairman, Investec Structured Products Calculus VCT plc;
- Mike Ashley – Head of Quality and Risk Management, KPMG Europe LLP; Board Member, KPMG Europe LLP;
- Janet Baker – Crown Commercial Lead, Better Business Models, Cabinet Office; Board Member and Audit Committee Member, Audit Commission; Non Executive Director, Remuneration Committee Chair and Audit Committee Member, Defence Support Group, MoD; Non Board Member and Audit Committee Member, Rural Payments Agency; and
- Bradley Fried – Managing Partner, Grovepoint Capital LLP, Non Executive Director of the Group Board, Investec plc; Non Executive Director and Audit Committee Chair, Investec Wealth and Investment Limited.

During 2011-12, two members, Zenna Atkins and Avinash Persaud, stepped down from the Audit Committee.

The Treasury Audit Committee has a robust Conflicts of Interest Policy, which requires members to excuse themselves from discussions where potential conflicts may occur. Members are required to inform me about any potential conflicts and highlight these at the start of each meeting as appropriate.

In addition to the independent members, the appropriate Accounting Officers, HM Treasury's Group Director of Finance, the Chief Executives of the Debt Management Office and the Asset Protection Agency, and the Treasury Accountant also attend Committee meetings as required. Members have the opportunity for a pre-committee discussion with the National Audit Office, Group Head of Internal Audit for HM Treasury and Head of Internal Audit for the Exchequer Funds.

The Treasury Audit Committee met four times during 2011-12.

The external auditor is the Comptroller and Auditor General and the National Audit Office (NAO) attend all Audit Committee meetings on his behalf.

The Treasury Audit Committee receives all NAO and Exchequer Funds Internal Audit Reports relating to the National Loans Fund.

Exchequer Funds Internal Audit

Internal Audit for the National Loans Fund is provided by Exchequer Funds Internal Audit (EFIA). EFIA reports directly to the Accounting Officer and the Audit Committee on audit reporting matters.

For the National Loans Fund, an annual risk-based internal audit programme is agreed with the Treasury Accountant in advance of the Audit Committee's approval. The work programme always includes a review of the receipts and payments process, due to the very high value of payments made by the Fund. The Audit Committee reviews the work programme and is kept informed of progress and amendments.

Management of the National Loans Fund

The National Loans Fund is managed by the Treasury Accountant and his managers within the Exchequer Funds and Accounts (EFA) Team of HM Treasury. The EFA team reports any matters concerning the National Loans Fund directly to me.

Reporting to the Treasury's Boards

The Economic, Fiscal and Operational Risk Groups, each chaired by a member of the Executive Management Board (EMB), meet every six weeks. The Risk Groups give evidence to the Ministerial Board and its sub-committee. EFA's risks are regularly reported to the Operational Risk Group.

EFA feeds into the Treasury's quarterly internal Performance Reporting which is produced for the Ministerial Board and its sub-committee. This includes key financial information from the NLF which feeds into the public finances.

As mentioned previously, the Chair of the Audit Committee is invited to report concerns or issues to the Treasury Board (sub-committee) and is a member of the Ministerial Board.

Risk management

EFA is managed within HMT's risk management framework which is set out in HMT's Annual Report and Accounts. The Treasury Accountant has overall responsibility on a day-to-day basis for risk management of those Funds managed by EFA, and for ensuring that my financial, regularity and propriety responsibilities as Accounting Officer of the National Loans Fund are discharged appropriately. He is supported by EFA management who are responsible for ensuring that the tasks in their area are compliant with operational policies and procedures, and legislation. EFA management provide me with a quarterly update report on changes to the control environment and changes in risk exposure.

Risk management is key to all processes within EFA, including business continuity resilience planning for those public funds for which EFA is responsible. Business continuity resilience is regularly tested locally and with business partners, and lessons learned feed into improved business continuity processes. The risk management strategy includes periodic horizon scanning to identify any changes in risk exposure, to evaluate the change and to identify appropriate mitigating actions. Significant risk issues are recorded in a risk register and are assessed by likelihood and impact. A risk owner, who is responsible for managing the risk, is assigned to each risk. The risk register is regularly reviewed by EFA management, and is circulated to me alongside the quarterly risks and controls report.

EFA management ensure that staff working on the National Loans Fund are trained and equipped to manage risk in a way appropriate to their authority and duties. Training on risk awareness and management is provided as required, either by management or by attending appropriate courses. Individuals' objectives reflect the need to manage risks. Training is also provided to staff to build the team's capability and to increase its resilience. EFA team members are encouraged to obtain professional qualifications in areas that are relevant to their roles.

During the year, there were no significant changes to the control environment.

The system of internal control

As Accounting Officer, I am responsible for maintaining a sound system of internal control that supports the achievement of the Fund's policies, aims and objectives, whilst safeguarding the public funds and assets, for which I am personally responsible, in accordance with the responsibilities assigned to me in 'Managing Public Money'.

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 eliminate all risk. It can therefore only provide reasonable and not absolute assurance of effectiveness. The system of internal control is based on an ongoing process designed to identify and prioritise the risks to the achievement of the National Loans Fund's 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 throughout the year ended 31 March 2012 and up to the date of approval of the financial statements, and accords with Treasury guidance.

Risk profile

The National Loans Fund is managed generally within the framework of the Treasury's system of internal control. This framework includes resourcing the administration of the National Loans Fund, security and the management of risks across the Treasury's business.

The key risks in managing the National Loans Fund and their associated controls are:

- **Irregularity of transactions, including fraudulent or erroneous payments:** Clear separation of duties is enforced by appropriate user permissions within the accounting system and payment approval panels. Up-to-date policy and procedures manuals including job instructions are readily accessible to all operational staff. Payment instructions are computer-generated and are derived from underlying transaction records. This minimises the risk of keying errors. Separately, the Comptroller and Auditor General, through the National Audit Office Exchequer Section approves National Loans Fund payments in advance and reconciles Fund transactions on a daily basis. There is also a clear and comprehensive audit trail in the IT system, to which the National Audit Office Exchequer Section has real-time access.
- **Incorrect accounting:** Application controls exist within the IT system used to manage financial transactions and account for receipts and payments on the Fund. Interest and amortisation are generated automatically by the accounting system at month end using pre-defined rules. New general ledger accounts are authorised by the Deputy Treasury Accountant before being set up. Gilts issuances are reported to senior management on the day. EFA reconciles the dividend claims received from the gilts registrar with its own records prior to each interest payment. The Debt Management Office reconciles principal amounts twice a year. Monthly management accounts for the Fund are also produced and reviewed by the Treasury Accountant, and are provided to me.
- **Failure of IT systems:** The Fujitsu data centre offers the highest level of resilience available as prescribed by Telecommunications Industry Standard TIA-942 with availability set to 99.995 per cent. A disaster recovery site is also provided by our outsourced information technology provider. EFA also has its own contingency plans in place.

- **Failure to provide an effective service in adverse circumstances, including disaster situations:** To ensure operational resilience in key areas in the event of a threat to business continuity, staff within EFA are trained to provide cover for times when other staff members are absent. Measures are in place to facilitate the National Audit Office Exchequer Section's normal payments approval process in the event of disruption to enable the essential payments business to continue. The risks that impact upon EFA's key stakeholders are managed by their involvement in business continuity planning and testing. Business continuity arrangements are regularly reviewed and tested within the framework of the Treasury's corporate Business Continuity Plan facilities. The National Loans Fund's operations were not affected by public sector strike action during the year.
- **Failure of principal counterparties to provide agreed services:** Well-developed Service Level Agreements (SLAs) for the provision of services from all principal counterparties are in place. They cover details of the monitoring and control arrangements that both parties are expected to observe. Quarterly meetings are held with managers at the Bank of England where service levels are discussed. A monthly report of any failure to meet the service requirements is also sent to the Bank of England by EFA. A monthly meeting is held with Government Banking Service management where service levels are discussed.
- **Information risk:** Data and information risk are managed in accordance with HMT's policies, which involve a range of controls to prevent unauthorised disclosures. These include encryption and physical and IT security. HMT adheres to Cabinet Office guidelines. EFA's own Data Handling Policy identifies risks specific to EFA. This policy is reviewed on a six-monthly basis or as required.
- **Financial risk:** Adverse results of the Debt Management Account and the Exchange Equalisation Account will affect the NLF's results, therefore all financial risks inherent in these accounts are also inherent in the NLF. Responsibility for risk management and the system of internal control is clearly delegated to the Accounting Officers of those accounts, which have their own control frameworks in place.

Review of effectiveness

In line with HM Government guidance, set out within the Corporate Governance Code of Good Practice for central government departments, I have reviewed the effectiveness of the system of internal control. My review is informed by the work of Exchequer Funds Internal Audit who provided positive assurance as to the management and control of the National Loans Fund in 2011-12, and the executive managers within EFA who have responsibility for the development and maintenance of the internal control framework, as well as comments made by external auditors in their management letter and other reports. I have been supported by the Treasury Audit Committee, and risk owners in addressing weaknesses and ensuring continuous improvement of the system is in place. The Treasury Audit Committee considered the 2011-12 accounts in draft and provided me with its views before I formally signed the accounts.

No significant internal control issues, including data related incidents, have been identified in 2011-12, and no significant new risks have been identified in the year. No ministerial directions have been given in 2011-12.

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

Nick Macpherson
Accounting Officer
HM Treasury

17 July 2012

The 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 National Loans Fund for the year ended 31 March 2012 under the National Loans Act 1968. The financial statements comprise: the Statement of Comprehensive Net Expenditure, the Statement of Financial Position, the Statement of Cash Flows, the Statement of Changes in the Liability of the Consolidated Fund to the National Loans Fund and the related notes. These financial statements have been prepared under the accounting policies set out within them.

Respective responsibilities of the Treasury, Accounting Officer and Auditor

As explained more fully in the Statement of Accounting Officer's Responsibilities, the Treasury and the Accounting Officer are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. My responsibility is to audit, certify and report on the financial statements in accordance with the National Loans Act 1968. I conducted my audit in accordance with International Standards on Auditing (UK and Ireland). Those standards require me and my staff to comply with the Auditing Practices Board's Ethical Standards for Auditors.

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the circumstances of the National Loans Fund and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the Accounting Officer; and the overall presentation of the financial statements. In addition I read all the financial and non-financial information in the Foreword and the Governance Statement, to identify material inconsistencies with the audited financial statements. If I become aware of any apparent material misstatements or inconsistencies I consider the implications for my certificate.

I am required to obtain evidence sufficient to give reasonable assurance that the expenditure and income recorded in the financial statements have been applied to the purposes intended by Parliament and the financial transactions recorded in the financial statements conform to the authorities which govern them.

Opinion on regularity

In my opinion, in all material respects the expenditure and income have been applied to the purposes intended by Parliament and the financial transactions recorded in the financial statements conform to the authorities which govern them.

Opinion on financial statements

In my opinion:

- the financial statements give a true and fair view of the state of the National Loans Fund's affairs as at 31 March 2012, and of the total comprehensive net expenditure for the year ended 31 March 2012; and
- the financial statements have been properly prepared in accordance with the National Loans Act 1968 and in the form prescribed by HM Treasury.

Opinion on other matters

In my opinion:

- the information given in the Foreword for the financial year for which the financial statements are prepared is consistent with the financial statements.

Matters on which I report by exception

I have nothing to report in respect of the following matters which I report to you if, in my opinion:

- adequate accounting records have not been kept or returns adequate for my audit have not been received from branches not visited by my staff; or
- the financial statements are not in agreement with the accounting records and returns; or
- I have not received all of the information and explanations I require for my audit; or
- the Governance Statement does not reflect compliance with HM Treasury's guidance.

Report

I have no observations to make on these financial statements.

Amyas C E Morse
Comptroller and Auditor General

17 July 2012

National Audit Office
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London SW1W 9SP

Statement of Comprehensive Net Expenditure for the year ended 31 March 2012

	Note	2011-12 £m	2010-11 £m
Finance costs of borrowing	2	52,988	51,248
Income from lending operations	3	(5,409)	(4,500)
Losses on foreign exchange transactions	4	107	30
Other expenditure	5	7	290
Other income	5	(21,112)	(9,385)
Total comprehensive net expenditure		<u>26,581</u>	<u>37,683</u>

The notes on pages 16 to 33 form part of this Account.

Statement of Financial Position as at 31 March 2012

	Note	At 31 March 2012 £m	At 31 March 2011 £m
Assets			
Advances	6	128,301	220,005
Loans	7	3,610	3,388
Other assets	8	67,510	47,323
IMF Quota Subscription & Lending	9	12,421	11,690
Total assets		211,842	282,406
Liabilities			
Gilt-edged stock	10	1,201,171	1,059,308
National Savings and Investments products	11	102,903	98,886
Liabilities to the IMF	9	6,819	7,316
Other debt payable in sterling:			
Treasury Bills	12	–	122,819
Other	12	60,007	55,465
Total liabilities		1,370,900	1,343,794
Net liabilities		1,159,058	1,061,388
Liability of the Consolidated Fund to the National Loans Fund		1,159,058	1,061,388

The notes on pages 16 to 33 form part of this Account.

Nick Macpherson
Accounting Officer
HM Treasury

17 July 2012

Statement of Cash Flows for the year ended 31 March 2012

	2011-12 £m	2010-11 £m
Cash flows from operating activities		
Interest received	5,330	4,531
Other receipts	845	483
Interest paid	(44,192)	(42,042)
Other flows	113	258
Transfer from the Consolidated Fund for the cost of debt servicing	37,904	36,770
Net cash flow from operating activities	<u>-</u>	<u>-</u>
Cash flows from investing activities		
Net decrease in advance to the Debt Management Account	105,000	85,000
Net increase in advance to the Public Works Loan Board	(8,791)	(1,918)
Net increase in loans	(1,187)	(1,050)
Net increase in advance to the Exchange Equalisation Account	(4,425)	(5,200)
Net cash inflow from investing activities	<u>90,597</u>	<u>76,832</u>
Cash flows from financing activities		
Net issuance of government stock	134,376	114,458
Net redemption of SLS Treasury Bills	(122,541)	(53,100)
Net issuance/(redemption) of National Savings products	2,477	(1,560)
Increase in other net sterling borrowing	4,559	4,487
Net transfers of IMF non-interest bearing securities	(475)	(1,436)
Net transfers to the Consolidated Fund	(108,993)	(139,681)
Net cash outflow from financing activities	<u>(90,597)</u>	<u>(76,832)</u>
Net change in cash and cash equivalents	-	-
Cash and cash equivalents at beginning and end of year	<u>-</u>	<u>-</u>

The notes on pages 16 to 33 form part of this Account.

Statement of Changes in the Liability of the Consolidated Fund to the National Loans Fund for the year ended 31 March 2012

	2011-12	2010-11
	£m	£m
Liability of the Consolidated Fund to the National Loans Fund at 1 April	1,061,388	920,794
Net cash paid to the Consolidated Fund	108,993	139,681
Payment from the Consolidated Fund to the National Loans Fund for the cost of debt servicing during the year	(37,904)	(36,770)
Total comprehensive net expenditure	26,581	37,683
Liability of the Consolidated Fund to the National Loans Fund at 31 March	<u>1,159,058</u>	<u>1,061,388</u>

The notes on pages 16 to 33 form part of this Account.

Notes to the Account

1 Accounting policies

i Accounting convention

The National Loans Fund (NLF) was established on 1 April 1968 by the National Loans Act 1968 to account for government borrowing and lending, which were until then accounted for as part of the Consolidated Fund (CF). The National Loans Fund Account has been prepared under the historical cost convention and in accordance with International Financial Reporting Standards (IFRSs) as adapted or interpreted for the public sector context in so far as they are relevant to transactions and balances within the National Loans Fund. These include IFRS 7 'Financial Instruments: Disclosures' and IAS 39 'Financial Instruments: Recognition and Measurement'.

IFRS 9 'Financial Instruments', was issued in November 2009 and is set to replace IAS 39 'Financial Instruments: Recognition and Measurement'. This standard has not been applied for 2011-12 since the effective date is set for 1 January 2015. It is expected that the application of IFRS 9 should have no significant impact upon the financial statements of the NLF. IFRS 9 is subject to EU endorsement, the timing of which is uncertain, therefore its adoption date for the NLF is currently unknown.

ii Basis of presentation

The National Loans Fund Account is stated in millions of pounds sterling (£m). This Account presents the results and transactions of the NLF. The Statement of Financial Position is presented by order of increasing liquidity. The NLF is the government's main borrowing and lending account. By the nature of government financing, it is expected that the NLF will show a net liability. By virtue of section 19(1) of the National Loans Act 1968, the net liabilities of the NLF are a liability of the CF. The servicing of these liabilities is mainly met by tax revenue receipts. For this reason, the Accounting Officer continues to adopt the going concern basis in preparing the Account.

iii Change in presentation of financial statements

A new primary statement, the "Statement of Changes in the Liability of the Consolidated Fund to the National Loans Fund" has been adopted this year. Previously this information was contained within a note to the accounts. The new presentation gives increased prominence to this important information.

iv Recognition of finance income and costs

Premium Bond prizes are recognised in the period to which they relate. Other interest income and costs of financing are determined using the effective interest rate method. The effective interest rate method is a method of calculating the amortised cost of a financial asset or financial liability and of allocating the interest income or interest expense over the expected life of the asset or liability. The effective interest rate is the rate that exactly discounts estimated future cash flows to the instrument's initial carrying amount. The calculation takes into account premiums or discounts on acquisition or issue of financial assets and liabilities and all the contractual terms of the financial instrument.

The majority of the NLF's financial assets and liabilities have a fixed return. For those products that have a variable return, the current rate applicable to that product is used in the calculation of the finance income or cost. Gilts with the same maturity and coupon rate are sometimes issued in separate tranches. Because of market conditions each tranche may be issued with a different premium or discount and therefore a different effective interest rate. However, once issued, gilts with the same maturity and coupon rate are indistinguishable from each other and so are accounted for as one issue using a weighted average effective interest rate.

v Recognition of finance income – Special Drawing Rights (SDR)

The IMF remunerates the UK in SDRs on its Reserve Tranche Position (RTP) for balances in excess of SDR 700 million and on its bilateral loans. Under section 3(2) of the Exchange Equalisation Act 1979 any SDRs received by the Government must be treated as assets of the EEA, therefore all SDR income is accounted for in that Account and not the NLF.

vi Financial assets and liabilities

The assets and liabilities of the NLF are all accounted for as financial assets and liabilities except for those arising from the net assets of the EEA and the DMA, which are accounted for as explained in accounting policy (x). The NLF's financial assets are all designated as loans and receivables. In accordance with IAS 39, financial assets and liabilities are initially recognised at fair value. They are subsequently measured at amortised cost using the effective interest rate method. If gilts are issued by a syndication process, the syndication fees are borne by the NLF and are netted off from gross issuance proceeds as part of the calculation of amortised cost. Other directly related issue costs for assets and liabilities are negligible and are written off as incurred.

The distinction between loans and advances derives from the legislation that governs the operation of the NLF. On loans interest must be charged at a rate that at least covers the cost that the Fund would have to bear if it were to borrow the same sum for the period of the loan, plus the Treasury's own administration costs. There is no such requirement for advances, although interest is charged at base rate on advances to the DMA. No interest is charged on advances to the EEA. The NLF does not charge interest on its advances to PWLB, but interest on loans by the PWLB to local authorities financed by NLF advances is paid to the NLF under section 3(3) of the National Loans Act 1968.

The fair values of the financial assets and liabilities are disclosed in note 14. They are calculated by reference to market prices where instruments are traded on an active quoted market, or, where this is not the case, as the net present value of future cash flows.

Impairment of financial assets

EFA assesses at the end of each reporting date whether there is any objective evidence that a financial asset measured at amortised cost is impaired. An asset is impaired if there is objective evidence of impairment as a result of one or more events that occurred after the recognition of the asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset that can be reliably estimated. Objective evidence used by EFA in assessing whether a financial asset is impaired includes financial difficulties experienced by the borrower and breach of loan conditions, such as a default or delinquency in interest or principal payments. No impairment losses have been recognised during the year.

vii Foreign currencies

The financial statements of the NLF are presented in sterling, which is the Fund's functional currency, being the currency of the primary economic environment in which it operates. Transactions denominated in foreign currencies are recorded at the rate of exchange applicable to the transaction. Monetary assets and liabilities denominated in foreign currencies at the end of the reporting period are reported at the rates of exchange prevailing at that date. Liabilities to the IMF are denominated in sterling, but are subject to a revaluation adjustment reflecting the SDR/£ sterling exchange rate movement.

viii Administration expenditure

These financial statements reflect the activity through, and the financial position of, the NLF. The costs of gilts registration, listing fees and foreign currency debt issuance are met by the NLF. Administration costs, such as departmental staff costs and bank charges, are borne by the appropriate body and are accounted for through their respective accounts.

ix Fee Income

The Bank of England pays stock lending fees to the DMA for the loan of Treasury Bills under the Special Liquidity Scheme. A portion of these fees is payable to the NLF. Fee income receivable from the DMA is accrued as earned.

x *Exchange Equalisation Account and Debt Management Account*

Under section 11 of Schedule 5A to the National Loans Act 1968, any excess of the assets of the DMA over its liabilities shall be a liability of the Account to the NLF. Over time, the NLF has advanced sterling to the EEA in order to finance the UK's reserves of gold, foreign currency assets and IMF Special Drawing Rights. As a result, the EEA's net assets, having been derived from initial NLF financing, are ultimately due to the NLF. Annual financial statements are prepared for both the DMA and the EEA. Changes in the net assets are reported in Other Assets (Note 8) and recognised in the Statement of Comprehensive Net Expenditure as Other Income (Note 5). The NLF's assets and income are the result of the activity in the EEA and DMA during the year and the various accounting policies applied by them to that activity.

xi *Critical accounting judgements and key sources of estimation uncertainty*

The NLF's accounting policy for impairment losses arising on financial assets is described in vi above. No impairment losses have been recognised in the year. There are no other areas of the financial statements which are reliant on management's judgement in the process of applying the Fund's accounting policies. Fair values are included for disclosure purposes only. Their calculation is described in Note 14. As mentioned in accounting policy iv, the majority of the NLF's financial assets have a fixed return. For those products that have a variable return, the current rate applicable to that product is used in the calculation of the finance income or cost. Note 16 applies various assumptions to demonstrate the sensitivity of NLF's assets and liabilities to changes in interest rates, inflation and the SDR to sterling exchange rate.

2 Finance costs of borrowing

	2011-12	2010-11
	£m	£m
Gilt-edged stock	49,762	47,247
National Savings and Investments products	2,405	2,581
Treasury Bills	495	1,067
Other finance costs	326	353
Total finance costs of borrowing	52,988	51,248

3 Income from lending operations

	2011-12	2010-11
	£m	£m
Interest on loans advanced by the National Loans Fund to:		
Public corporations	100	93
Central government bodies	88	93
	188	186
Interest on loans by the Public Works Loan Board financed by National Loans Fund advances	4,503	2,978
Interest on funding advanced to the Debt Management Account	718	1,336
Total income from lending operations	5,409	4,500

4 Losses on foreign exchange transactions

	2011-12	2010-11
	£m	£m
Loss on Reserve Tranche Position at the IMF	65	26
Loss on Lending to the IMF (Note 9)	42	4
Net loss on foreign currency transactions	107	30

5 Other income and expenditure

	2011-12	2010-11
	£m	£m
Other expenditure		
Debt management administration costs ¹	4	4
Expenditure in respect of depreciation of Issue Department Assets ²	3	286
Total: Other expenditure	<u>7</u>	<u>290</u>
Other income		
Exchange Equalisation Account total comprehensive income ³	(2,033)	(1,764)
Profits of the Bank of England Issue Department ²	(452)	(475)
Income in respect of appreciation of Issue Department Assets ²	(396)	(294)
Debt Management Account total comprehensive income	(18,221)	(6,802)
SLS Fee income from the Debt Management Account	(5)	(44)
Miscellaneous receipts	(5)	(6)
Total: Other income	<u>(21,112)</u>	<u>(9,385)</u>
Net total	<u>(21,105)</u>	<u>(9,095)</u>

- 1 Debt management administration costs mainly comprise amounts paid to the Gilts Registrar for administering the gilt-edged stock register.
- 2 Under section 9 of the National Loans Act 1968, the profits of the Issue Department are paid into the NLF. A sum of £452 million in respect of these profits was credited to the Statement of Comprehensive Net Expenditure in 2011-12 (£475 million in 2010-11). In addition, the Bank of England Issue Department is required by the Currency and Bank Notes Act 1928 to hold investments equal to the value of bank notes in issue. Periodically these investments are revalued to market value. If the market value is less than the value of notes in issue, legislation requires the NLF to pay an amount equal to the deficiency to the Issue Department to finance the purchase of additional investments. Conversely, if the market value of the assets exceeds the value of the notes in issue, the Issue Department sells investments to the value of the surplus and pays the proceeds to the NLF.
- 3 Of the EEA's profit of £2,033 million (£1,764 million in 2010-11), £13 million (£8 million in 2010-11) relates to interest receivable on the Reserve Tranche Position and the bilateral loans to the IMF in line with accounting policy (v).

6 Advances

	Public Works Loan Board		Debt Management Account		Exchange Equalisation Account		Total	
	£m		£m		£m		£m	
	2011-12	2010-11	2011-12	2010-11	2011-12	2010-11	2011-12	2010-11
Principal outstanding at 1 April	53,165	51,247	157,000	242,000	9,160	3,960	219,325	297,207
Advances	16,111	5,255	–	55,000	5,375	6,550	21,486	66,805
Advances repaid	(7,320)	(3,337)	(105,000)	(140,000)	(950)	(1,350)	(113,270)	(144,687)
Principal outstanding at 31 March	61,956	53,165	52,000	157,000	13,585	9,160	127,541	219,325
Accrued interest	718	579	42	101	–	–	760	680
Total advances outstanding	62,674	53,744	52,042	157,101	13,585	9,160	128,301	220,005

7 Loans and commitments to lend**Loans**

	2011-12			2010-11		
	Public Corporations	Central Government	Total	Public Corporations	Central Government	Total
	£m	£m	£m	£m	£m	£m
Principal outstanding at 1 April	1,918	1,442	3,360	1,641	1,522	3,163
Loans advanced	15,243	375	15,618	3,552	37	3,589
Loans repaid	(15,283)	(111)	(15,394)	(3,275)	(117)	(3,392)
Principal outstanding at 31 March	1,878	1,706	3,584	1,918	1,442	3,360
Accrued interest	12	14	26	13	15	28
Total loans outstanding	1,890	1,720	3,610	1,931	1,457	3,388

Commitments to lend

	2011-12			2010-11		
	Public Corporations	Central Government	Total	Public Corporations	Central Government	Total
	£m	£m	£m	£m	£m	£m
Undrawn commitments to lend	356	–	356	381	–	381

Commitments to lend are agreements to lend to a customer in the future, subject to certain conditions. Such commitments are either made for a fixed period, or have no specific maturity but are cancellable by the lender. During the year a commitment of £37 million expired. The NLF has not made any loans, and does not have any commitments to lend, in respect of financial institutions classified as 'Financial Sector (public)' following the banking crisis. In addition to the above, the NLF has loans to, and has a commitment to lend to the IMF, which is explained in Note 9.

8 Other assets

	At 31 March 2012	At 31 March 2011
	£m	£m
Exchange Equalisation Account net assets	30,030	27,997
Debt Management Account net assets	36,934	18,713
National Savings and Investments' cash and other holdings:		
From sale of investment products	298	409
For repayment of principal	156	110
For payment of interest and prizes	65	63
National Savings and Investments Total	519	582
SLS accrued fee income from the Debt Management Account	-	5
Commitment Fees Receivable	1	-
Sterling balances at Bank of England advanced to IMF	26	26
Total other assets	67,510	47,323

9 IMF Reserve Tranche Position and Lending to the IMF

The United Kingdom's relationship with the International Monetary Fund is accounted for in the National Loans Fund, and the EEA. The UK's Quota Subscription to the IMF, 10,738.5 million Special Drawing Rights (SDRs) – equivalent to £10,391 million¹ at 31 March 2012 (£10,581 million at 31 March 2011), was paid from the NLF and is recognised as an NLF asset. Part of the Subscription is deposited by the IMF in the NLF in return for sterling non-interest-bearing securities (NIBS) which totalled £6,828 million at 31 March 2012 (£7,303 million at 31 March 2011). NIBS represent a liability of the NLF to the IMF. There is a remaining small liability of £26 million (£26 million at 31 March 2011) against which an equal amount of sterling cash is made available in an account at the Bank of England as an advance to the IMF.

The difference between the gross Quota Subscription and the NLF's sterling liability to the IMF is the UK's Reserve Tranche Position (RTP). Under the arrangements for membership of the Fund, valuation adjustments are made between the IMF and NLF annually to reflect any changes in value, in SDR terms, of the NLF's sterling liability to the IMF. An annual settlement payment is made between the NLF and the IMF, normally in May. The cumulative valuation adjustment at 31 March 2012 was £35 million (£13 million at 31 March 2011).

The table below sets out the composition of the RTP at 31 March 2011 and 31 March 2012, and shows the make-up of changes over the year.

The RTP represents an SDR asset that can be drawn on by the UK if needed. Because the RTP is a net asset of the NLF it is therefore also considered as part of the UK's Foreign Exchange Reserves. Sterling transactions by the IMF impact on the level of NIBS, and hence on the RTP. Under current policy, changes in the RTP lead to adjustments in the composition of other Reserve Assets, in order to keep the portfolio composition of the Reserves in line with plan.

Interest is payable by the IMF on the RTP balance in excess of SDR 700 million. This interest is retained in the EEA. Separately, the EEA also holds the UK's allocation of SDRs (SDR 10,134 million at 31 March 2012), as a liability to the IMF, and retains an asset in the form of the UK's holdings of SDRs (SDR 9,560 million at 31 March 2012).

During 2011-12 a net payment was made from the quota of £372 million to the IMF in support of funding programmes (a net payment to the IMF of £1,230 million in 2010-11).

During 2009-10, the UK agreed to provide a bilateral loan facility to the IMF for an amount up to the equivalent of SDR 9.92 billion (£9.6 billion at the 31 March 2012 exchange rate). The drawn loans represent a claim on the IMF, and therefore an asset of the NLF. The undrawn loans are a commitment of the NLF. Interest is payable by the IMF on the loan balance, and is retained in the EEA in line with accounting policy (v).

¹ The GBP/SDR exchange rate at 31 March 2012 was 1.03345 (31 March 2011: 1.01494).

The G20 Quota Agreement, agreed in November 2010 will double the IMF's quota resource limit. As a result, the UK's quota subscription will increase from SDR 10,738.5 million to SDR 20,155.1 million, an increase of SDR 9,416.6 million (£9,111.8 million at the 31 March 2012 exchange rate). In order to implement this, the IMF requires that three fifths of member countries with a collective voting share of at least 85 percent finalise their domestic legislative requirements. This increase was approved by Parliament in July 2011. The required 85 per cent has not yet been reached.

On 1 April 2011, IMF members agreed to the activation of the expanded New Arrangements to Borrow (NAB), the IMF's main backstop for quota resources. The NAB was subsequently re-activated for a six month period on 1 October 2011. The UK's commitment to the expanded NAB is SDR 18.66 billion (£18.06 billion at the 31 March 2012 exchange rate). The new NAB, however, can only be used to finance programmes agreed after its activation. Previously agreed programmes will continue to be funded from the quota and bilateral loans. The UK, along with all other major bilateral creditors, has agreed to keep open its bilateral loan facility for this purpose, on the condition that the combined drawings from the UK's share of the NAB and the UK's bilateral loan do not exceed SDR 18.66 billion. As part of the 2010 Quota Agreement to double quota resources, there will be a corresponding decrease in the total NAB, which will become effective when the 2010 quota increase becomes effective.

In April 2012, a G20-led agreement to temporarily increase IMF resources was agreed. This is explained further in Note 18.

NLF Assets and Liabilities: Composition of the Reserve Tranche Position and Lending² to the IMF

	Asset	Liabilities			Total liabilities	Reserve Tranche Position
	IMF Quota Subscription	Non-interest-bearing securities	Other quota liability	Valuation adjustment		
	£m	£m	£m	£m	£m	£m
Balances at 31 March 2011	10,581	(7,303)	(26)	13	(7,316)	3,265
Exchange rate losses for the year on the Quota subscription	(190)					(190)
Change in year-end valuation adjustment				22	22	22
Change in loan notes as a result of the valuation settlement		103			103	103
Change in cash on No 1 account			-		-	-
Net decrease in loan notes		372			372	372
Balances at 31 March 2012	10,391	(6,828)	(26)	35	(6,819)	3,572

Lending to the IMF	£m
Loans outstanding as at 31 March 2011	1,109
Loans advanced in 2011-12	963
Loss on foreign exchange	(42)
Lending as at 31 March 2012	2,030
IMF Quota Subscription and Lending	12,421

At 31 March 2012, the UK's total undrawn commitment under both the NAB and the bilateral loan facility was SDR 16.56 billion, or £16.02 billion (SDR 8.79 billion, or £8.66 billion at 31 March 2011).

² Lending includes both loans made under the NAB and the bilateral loan facility.

10 Gilt-edged stock

	At 31 March 2012	At 31 March 2011
	£m	£m
Conventional	926,602	819,160
Index-Linked	274,569	240,148
Total gilt-edged stock	<u>1,201,171</u>	<u>1,059,308</u>

On an amortised cost basis at 31 March 2012, £126,474 million (£119,580 million at 31 March 2011) of the total gilt-edged stock liability was held by the DMA, and £276,923 million was held by the Bank of England for quantitative easing (£184,147 million at 31 March 2011). The remaining £797,774 million (£755,581 million at 31 March 2011) was held by other investors.

Syndication fees are borne by the NLF and are netted off from gross issuance proceeds as part of the calculation of amortised cost. Other directly related issue costs for assets and liabilities are negligible and are written off as incurred. Total syndication fees for the year were £66.94 million (2010-11: £49.50 million).

11 National Savings and Investments products

	2011-12	2010-11
	£m	£m
Principal outstanding at 1 April	97,824	97,842
Cash repayments from the National Loans Fund	(14,211)	(15,498)
Principal cash received in the National Loans Fund	16,688	13,938
Capitalised interest and other returns to savers	1,720	1,672
Change in cash and other holdings for principal	(65)	(130)
Principal outstanding at 31 March	<u>101,956</u>	<u>97,824</u>
Accrued interest and other returns to savers	947	1,062
Total principal and accrued interest outstanding	<u>102,903</u>	<u>98,886</u>

12 Other debt payable in sterling

	At 31 March 2012	At 31 March 2011
	£m	£m
Treasury Bills	–	122,819
Other		
Debt Management Account	34,067	30,546
Bank of England Issue Department	370	370
Balances from government accounts at the Government Banking Service	16,827	16,037
Deposits from public sector bodies	8,093	7,819
Other	650	693
	<u>60,007</u>	<u>55,465</u>
Total other debt payable in sterling	<u>60,007</u>	<u>178,284</u>

Treasury Bills have been issued by the NLF to the DMA in connection with the Bank of England's Special Liquidity Scheme. When the drawdown period for the scheme closed on 30 January 2009 the face value of Bills lent to financial institutions by the Bank of England was £185.7 billion. The scheme officially closed on 30 January 2012. All drawings were repaid before the scheme closed. Further information on the scheme is provided in paragraph 10 of the Foreword.

The next two items reflect deficit funding from the DMA and the Issue Department of the Bank of England. The fourth item reflects the transfer to the NLF of any temporary cash surpluses on other government accounts held at the Government Banking Service. Deposits from public sector bodies represents deposits by public sector bodies which are directly held with the NLF. Other amounts comprise almost entirely of Certificate of Tax deposits held by the NLF.

13 Contingent liabilities

The following contingent liabilities fall outside the scope of IAS 37 as the possibility of an outflow of resources is remote. However, disclosure of these liabilities is necessary under Parliamentary reporting requirements. These are as follows:

- i Under the National Loans Act 1968 section 9(3), the NLF has a contingent liability to the Bank of England Issue Department in respect of that part of the assets backing the note issue that is not represented by government securities. This liability would only crystallise if government securities were insufficient to meet demand from holders of notes to exchange them for another instrument. This contingent liability was £50,285 million at 31 March 2012 (£47,080 million at 31 March 2011).
- ii The NLF also has a contingent liability to the Commissioners for the Reduction of National Debt (CRND) in respect of unclaimed dividends received in previous years. This represents old uncleared amounts surrendered by NS&I and the gilts registrar to CRND, and then onto the NLF, and stood at £24.9 million at 31 March 2012 (£23.6 million at 31 March 2011). This contingent liability would crystallise if NS&I investors or holders of gilts requested amounts owed to them.

14 Fair values

Carrying Value and Fair Value of NLF assets and liabilities

	Values at 31 March 2012		Values at 31 March 2011	
	Carrying Value	Fair Value	Carrying Value	Fair Value
	£m	£m	£m	£m
Assets				
<i>Advances</i>				
Public Works Loan Board	61,956	76,904	53,165	61,113
Debt Management Account	52,000	52,000	157,000	157,000
Exchange Equalisation Account	13,585	13,585	9,160	9,160
Accrued interest	760	760	680	680
<i>Loans</i>				
Principal	3,584	4,300	3,360	3,765
Accrued interest	26	26	28	28
Other assets	67,510	67,510	47,323	47,323
IMF quota subscription and lending	12,421	12,421	11,690	11,690
TOTAL ASSETS	211,842	227,506	282,406	290,759
Liabilities				
<i>Gilts</i>				
Marketable	1,200,908	1,389,765	1,058,989	1,118,431
Non-marketable	263	279	319	320
National Savings and Investments:				
Principal	101,956	102,367	97,824	97,915
Accrued interest	947	953	1,062	1,062
IMF liabilities	6,819	6,819	7,316	7,316
<i>Other sterling debt</i>				
Treasury Bills	–	–	122,819	122,832
Debt Management Account	34,067	34,067	30,546	30,546
Issue Department of Bank of England	370	370	370	370
Government balances	16,827	16,827	16,037	16,037
Deposits from public sector bodies	8,093	8,093	7,819	7,819
Other	650	650	693	693
Total Liabilities	1,370,900	1,560,190	1,343,794	1,403,341

The NLF's assets are classified as financial assets except for the net assets of the EEA and DMA. The carrying value of financial assets (all of which are designated as loans and receivables) is £144,878 million (2010-11: £235,696 million) and their fair value is £160,542 million (2010-11: £244,049 million). All the NLF's liabilities are financial liabilities. In instances where the fair value differs from the carrying value, the fair value has been calculated by reference to market prices where instruments are traded on an active quoted market, or, where this is not the case, as the net present value of future cash flows.

The fair value of advances to the PWLB are calculated as the net present value of future cash flows. Loans by the PWLB are usually at a fixed rate of interest and so their fair value increases or decreases according to changes in the difference between the fixed rate of interest earned on the loan and current market values. Differences between the fair and book value will not be realised as the PWLB loans are not traded by the NLF.

The fair value of gilts and Treasury Bills are calculated by reference to their market prices. Gilts are generally left in issue until they are very close to maturity and so the difference between their fair value and book value will normally not be realised in the NLF accounts. Treasury Bills were created for use in the Bank of England's Special Liquidity Scheme until the scheme closed in January 2012. Under the scheme, Treasury Bills could be replaced on maturity until the last rollover window in September 2011. The remaining Treasury Bills at the date the scheme closed were cancelled at no gain and no loss to the NLF.

15 Maturity of assets and liabilities

The following table shows the split between current and non-current assets and liabilities based on contract date of maturity or expected maturity if there is no contract date.

	As at 31 March 2012			As at 31 March 2011		
	Current £m	Non-current £m	Total £m	Current £m	Non-current £m	Total £m
Assets						
Advances	–	128,301	128,301	–	220,005	220,005
Loans	666	2,944	3,610	657	2,731	3,388
Other assets	546	66,964	67,510	613	46,710	47,323
IMF quota subscription (SDR) & lending	–	12,421	12,421	–	11,690	11,690
Total assets	1,212	210,630	211,842	1,270	281,136	282,406
Liabilities						
Gilts						
Conventional	61,341	865,261	926,602	50,873	768,287	819,160
Index-linked	–	274,569	274,569	14,432	225,716	240,148
Gilt-edged stock	61,341	1,139,830	1,201,171	65,305	994,003	1,059,308
National Savings and Investments	102,710	193	102,903	98,640	246	98,886
IMF liabilities	–	6,819	6,819	–	7,316	7,316
Treasury Bills for SLS	–	–	–	122,819	–	122,819
Other debt payable in sterling	60,007	–	60,007	55,465	–	55,465
Total liabilities	224,058	1,146,842	1,370,900	342,229	1,001,565	1,343,794

The following table shows an analysis of current and non-current assets and liabilities by type of counterparty.

	As at 31 March 2012			As at 31 March 2011		
	Current £m	Non-current £m	Total £m	Current £m	Non-current £m	Total £m
Assets						
Balances with:						
Other central government bodies	533	196,972	197,505	595	268,164	268,759
Public corporations and trading funds	653	1,237	1,890	649	1,282	1,931
Total intra government balances	1,186	198,209	199,395	1,244	269,446	270,690
Balances with bodies external to government	26	12,421	12,447	26	11,690	11,716
Total assets	1,212	210,630	211,842	1,270	281,136	282,406

	As at 31 March 2012			As at 31 March 2011		
	Current £m	Non-current £m	Total £m	Current £m	Non-current £m	Total £m
Liabilities						
Balances with:						
Other central government bodies	154,254	193	154,447	145,916	246	146,162
NHS Trusts	103	–	103	94	–	94
Public corporations and trading funds	8,360	–	8,360	8,095	–	8,095
Total intra government balances	162,717	193	162,910	154,105	246	154,351
Balances with bodies external to government	61,341	1,146,649	1,207,990	188,124	1,001,319	1,189,443
Total liabilities	224,058	1,146,842	1,370,900	342,229	1,001,565	1,343,794

16 Financial risks related to the NLF

The Government's debt management policy is set out in the annual Debt and Reserves Management Report. The debt management policy remains:

“to minimise, over the long term, the costs 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”.

The debt management policy objective is achieved by:

- meeting the principles of openness, transparency and predictability;
- developing a liquid and efficient gilt market;
- issuing gilts that achieve a benchmark premium;
- adjusting the maturity and nature of the Government's debt portfolio, primarily by means of the maturity and composition of debt issuance and potentially by other market operations including switch auctions, conversion offers and buy-backs; and
- offering cost-effective savings instruments to the retail sector through National Savings & Investments.

For cash management, the aggregate balance on government accounts is swept daily to the National Loans Fund, and then to the DMA. The Debt Management Office deals with the financial markets to manage the daily cash surplus or deficit on the DMA relative to its target overnight balance, lending when there is a surplus and borrowing when there is a deficit.

The NLF's liabilities include conventional and index-linked gilt-edged securities and a wide range of NS&I products. There is a wide spread of maturities. No foreign currency debt was issued in 2011/12. The NLF's liabilities also include deposits from several other public sector accounts.

NLF assets include advances to the DMA, the PWLB and the EEA. The UK's gross Quota Subscription to the IMF is also an asset of the National Loans Fund, and is denominated in Special Drawing Rights (SDRs). NLF assets also include the net assets of the DMA and EEA.

Set out below are certain risk factors that could affect the National Loans Fund's operations.

Interest rate and inflation risk

The NLF is exposed to cash flow interest rate risk on its floating rate borrowing and lending, due to the risk that future interest rates will fluctuate. It is not exposed to fair value interest rate risk as its financial assets and liabilities are measured at amortised cost and not fair value. Some of the NLF's assets and liabilities are zero-rated, and are therefore not exposed to changes in interest rates.

Inflation risk arises because interest and redemption amounts paid on index-linked gilts vary in line with changes in the UK Retail Price Index (RPI) since the initial issue of each stock.

The table below analyses the NLF's interest rate and inflation risk. Assets and liabilities are included at carrying amount and are shown at the earlier of contractual re-pricing or maturity dates.

Interest rate and inflation risk analysis as at 31 March 2012

	Up to 1 month/ repayable on demand £m	1-12 months £m	1-5 years £m	Over 5 years £m	Undated £m	Zero- rated £m	Total carrying value £m	Fixed rate £m	Floating rate £m
Assets									
Advances	52,397	1,892	6,843	52,785	–	14,384	128,301	60,904	53,013
Loans	615	50	165	2,754	–	26	3,610	3,584	–
Other assets	–	–	–	–	–	67,510	67,510	–	–
IMF quota subscription	–	–	–	–	–	10,391	10,391	–	–
IMF loans	–	–	–	–	–	2,030	2,030	–	–
Total	53,012	1,942	7,008	55,539	–	94,341	211,842	64,488	53,013
Liabilities									
Gilts									
Conventional	–	60,807	251,490	604,999	2,653	6,653	926,602	919,949	–
Index-linked	274,569	–	–	–	–	–	274,569	–	274,569
Gilt-edged stock	274,569	60,807	251,490	604,999	2,653	6,653	1,201,171	919,949	274,569
National Savings and Investments	89,391	1,363	11,086	–	–	1,063	102,903	12,449	89,391
IMF liabilities	–	–	–	–	–	6,819	6,819	–	–
Treasury Bills for SLS	–	–	–	–	–	–	–	–	–
Other debt payable in sterling	46,693	2,151	–	–	–	11,163	60,007	8,091	40,753
Total	410,653	64,321	262,576	604,999	2,653	25,698	1,370,900	940,489	404,713
Period gap	357,641	62,379	255,568	549,460	2,653	(68,643)	1,159,058		
Cumulative gap	357,641	420,020	675,588	1,225,048	1,227,701	1,159,058			

Interest rate and inflation risk analysis as at 31 March 2011

	Up to 1 month/ repayable on demand £m	1–12 months £m	1–5 years £m	Over 5 years £m	Undated £m	Zero- rated £m	Total carrying value £m	Fixed rate £m	Floating rate £m
Assets									
Advances	157,384	2,121	6,799	43,832	–	9,869	220,005	52,287	157,849
Loans	254	401	210	2,495	–	28	3,388	3,360	–
Other assets	–	–	–	–	–	47,323	47,323	–	–
IMF quota subscription	–	–	–	–	–	10,581	10,581	–	–
IMF loans	–	–	–	–	–	1,109	1,109	–	–
Total	157,638	2,522	7,009	46,327	–	68,910	282,406	55,647	157,849
Liabilities									
Gilts									
Conventional	–	50,473	226,755	532,962	2,694	6,276	819,160	812,884	–
Index-linked	240,148	–	–	–	–	–	240,148	–	240,148
Gilt-edged stock	240,148	50,473	226,755	532,962	2,694	6,276	1,059,308	812,884	240,148
National Savings and Investments	82,888	2,014	12,840	–	–	1,144	98,886	14,581	83,161
IMF liabilities	–	–	–	–	–	7,316	7,316	–	–
Treasury Bills for SLS	17,256	105,563	–	–	–	–	122,819	122,819	–
Other debt payable in sterling	44,055	51	–	–	–	11,359	55,465	7,812	36,294
Total	384,347	158,101	239,595	532,962	2,694	26,095	1,343,794	958,096	359,603
Period gap	226,709	155,579	232,586	486,635	2,694	(42,815)	1,061,388		
Cumulative gap	226,709	382,288	614,874	1,101,509	1,104,203	1,061,388			

Foreign currency risk

The NLF's only direct exposure to foreign exchange movements is through the UK's transactions with the IMF. These are described in note 9. The quota subscription to the IMF and lending to the IMF are both SDR denominated assets and are subject to valuation adjustments by the IMF and also at the year end. Whilst being denominated in sterling, the UK's liabilities of the IMF are subject to SDR valuation adjustments by the IMF.

Sensitivity analysis

The following analysis, required by IFRS 7, is intended to illustrate the sensitivity of the NLF's financial assets and liabilities to changes in UK interest rates, the UK Retail Price Index and the SDR to sterling exchange rate. The sensitivity analysis has been calculated on the basis that the components of financial assets and liabilities, the amount of instruments held at fixed, floating and zero interest rates and the amount of instruments held in SDRs are all constant and are as at the end of the reporting period.

The following assumptions have been made in calculating sensitivity:

- All sensitivities impact the Statement of Comprehensive Net Expenditure and thereby the net liability of the CF to the NLF.
- Finance income and costs and the net liability of the CF to the NLF will be affected by changes in interest rates on floating rate instruments.

- All instruments are held at amortised cost and are therefore not subject to changes in fair value as a result of interest rate changes.
- No sensitivity is provided for interest accruals where these are based on pre-agreed interest rates and are therefore not susceptible to further rate changes.
- 100 basis points and 10 per cent are management's assessment of the reasonably possible change in interest, RPI and FX rates at the end of the reporting period. This is not a forecast.

Using the above assumptions, the following table shows the illustrative impact on the Statement of Comprehensive Net Expenditure that would result from an increase in the UK interest rates and the UK Retail Prices Index, and if the SDR to sterling exchange rate were to strengthen.

	2011-12	2010-11
	Statement of Comprehensive Net Expenditure	Statement of Comprehensive Net Expenditure
	£m	£m
UK interest rates + 100bp (expense)/income	(771)	384
UK Retail Prices Index + 100bp (expense)	(2,746)	(2,402)
SDR exchange rate + 10 per cent income	560	437

An equal, but opposite effect would result if there was a decrease in UK interest rates and the UK Retail Prices Index, and if the SDR to sterling exchange rate were to weaken.

Liquidity risk

NLF liabilities carry a wide range of maturities, spreading funding requirements for redemption payments across a wide time period into the future. The longest stock in existence at 31 March 2012 matures in 2062. A small number of stocks are undated and can be redeemed by the Treasury at a time of its choosing. Deposits in the NLF have a shorter maturity profile, since they can change on demand. However, in practice, balances change only slowly due to re-investment. The NLF is the government's main borrowing and lending account. By the nature of government financing, it is expected that the NLF will show a net liability. By virtue of section 19(1) of the National Loans Act 1968, the net liabilities of the NLF are a liability of the Consolidated Fund. The servicing of these liabilities is met mainly by tax revenue receipts. For this reason, the Accounting Officer continues to adopt the going concern basis in preparing the Account.

Contractual undiscounted cash flows of financial liabilities

The following table shows the contractual undiscounted cash flows of the NLF's liabilities. The amounts shown are the cash flows arising from the NLF's financial liabilities during the period up to and including maturity. This is in contrast to the basis on which the Statement of Financial Position amounts are calculated. As described in note 1, items on the Statement of Financial Position are valued at fair value upon initial recognition and subsequently held at amortised cost. Therefore totals in the following table will not agree to the Statement of Financial Position.

The treatment of coupon payments is of particular significance. The table includes contractual coupon payments for the period to maturity based on interest rates or, in the case of index-linked gilts, the Retail Price Index at 31 March 2012. Because of the many coupon payments to be made for longer dated gilts the table below reports coupon cash flows of £598,237 million (£549,843 million at 31 March 2011) whereas the gilts liability in the Statement of Financial Position contains accruals to the end of the reporting period of £37,075 million (£26,006 million at 31 March 2011). Undated gilts do not have a contractual maturity date and so coupon payments on them (currently £90 million per annum) are not included in the table below.

The cash flows reported in the table will be funded by replacement debt issues, the proceeds of assets or by finance from the Consolidated Fund.

At 31 March 2012

	0-12 months £m	1-2 years £m	2-5 years £m	Over 5 years £m	Undated £m	Total £m
Liabilities						
Conventional Gilts:						
Principal	60,324	43,438	204,078	587,795	2,653	898,288
Coupons	38,286	35,709	92,891	368,671	-	535,557
Index-Linked Gilts:						
Principal	-	20,049	22,953	222,806	-	265,808
Coupons	4,281	4,030	11,051	43,318	-	62,680
Total Gilts	102,891	103,226	330,973	1,222,590	2,653	1,762,333
National Savings and Investments	102,595	112	89	-	116	102,912
IMF	6,819	-	-	-	-	6,819
Temporary Deposits	8,095	-	-	-	-	8,095
Other debt payable in sterling	51,914	-	-	-	-	51,914
	272,314	103,338	331,062	1,222,590	2,769	1,932,073

The maturity of liabilities after five years is:

	5-10 years £m	10-20 years £m	20-30 years £m	30-40 years £m	Over 40 years £m	Total £m
Conventional Gilts:						
Principal	236,529	100,682	139,892	61,374	49,318	587,795
Coupons	112,487	137,864	76,921	31,900	9,499	368,671
Index-Linked Gilts:						
Principal	33,354	67,641	64,932	35,604	21,275	222,806
Coupons	14,593	17,858	6,919	2,988	960	43,318
	396,963	324,045	288,664	131,866	81,052	1,222,590

At 31 March 2011

	0-12 months £m	1-2 years £m	2-5 years £m	Over 5 years £m	Undated £m	Total £m
Liabilities						
Conventional Gilts:						
Principal	50,188	59,646	162,535	524,576	2,694	799,639
Coupons	36,162	33,273	90,217	332,325	-	491,977
Index-Linked Gilts:						
Principal	14,405	-	19,101	200,156	-	233,662
Coupons	4,025	3,845	10,343	39,653	-	57,866
Total Gilts	104,780	96,764	282,196	1,096,710	2,694	1,583,144
National Savings and Investments	98,558	57	205	-	82	98,902
IMF	7,316	-	-	-	-	7,316
Treasury Bills for SLS	123,182	-	-	-	-	123,182
Temporary Deposits	7,823	-	-	-	-	7,823
Other debt payable in sterling	47,646	-	-	-	-	47,646
	389,305	96,821	282,401	1,096,710	2,776	1,868,013

The Cash Flow Analysis after five years is:

	5–10 years £m	10–20 years £m	20–30 years £m	30–40 years £m	Over 40 years £m	Total £m
Conventional Gilts:						
Principal	173,416	138,315	120,803	57,920	34,122	524,576
Coupons	99,554	125,750	69,869	28,205	8,947	332,325
Index-Linked Gilts:						
Principal	53,779	56,305	48,648	28,968	12,456	200,156
Coupons	13,627	16,402	6,246	2,600	778	39,653
	340,376	336,772	245,566	117,693	56,303	1,096,710

Credit risk

The NLF makes loans to UK public corporations and central government entities, advances to other UK central Exchequer Funds and subscribes to the IMF. The NLF also lends to the IMF. As a result the NLF is not exposed to significant credit risk. Details of this can be found in notes 6, 7 and 9. Total loans and advances stand at £131,911 million (2010-11; £223,393 million) and gross IMF exposure stands at £12,421 million (2010-11 £11,690 million).

In respect of loans financed by the NLF, the financial relationship with the borrower is managed by the department responsible for the relevant public corporation. The sponsoring department performs due diligence on the borrower and proposes the loan. The Treasury reviews the proposal and, if the proposal is approved, the NLF will make the loan. The NLF is not allowed to accept losses on its loans. Any such losses can only be written off by primary legislation; however, in 1990 the Treasury gave an undertaking to the Public Accounts Committee that it would not seek Parliament's approval to such a course except as part of a reconstruction of the borrower's finances prior to privatisation. In other cases the Treasury would look to the borrower's sponsor department to cover any losses from its resource account.

In the case of advances to the PWLB for loans to Local Authorities, the PWLB manages the financial relationship with the borrower, though the credit risk is borne by the NLF.

In the context of NLF loans issued to trading organisations at market rates, under the Treasury's Commercial Lending policy, the terms and interest rates are designed to reflect the terms on which a private sector lender, such as a commercial bank, would lend to the borrower if the borrower were a wholly private sector body, rather than a government body.

Ceilings on total lending from the NLF to specific bodies are prescribed in the statutes governing each loan. The PWLB is allowed to lend up to an aggregate amount of £70 billion (2010-11: £70 billion). For short-term lending to public bodies, the maximum exposure of the NLF is determined by prescribed credit ceilings appropriate for the circumstances of the body.

The IMF maintains a level of resources as prudential cover in order to ensure the continued security and liquidity of its members' claims. Other factors that help safeguard the Fund's resources include the conditions associated with Fund lending and the Fund's status as a creditor who has the preferential right to receive payment. This covers the bilateral loan agreement with the IMF as per Note 9.

None of the NLF's financial assets are past due or impaired.

Derivatives and hedging

The NLF itself does not use derivatives or undertake hedging. However, as explained in more detail below, some of the risks on the NLF are offset by hedging and other activities of the DMA and the EEA.

NS&I have issued a number of Guaranteed Equity Bonds that expose the NLF to equity index risk. The Debt Management Office have hedged this exposure through derivatives that are held on the DMA. For the government overall (and the NLF) this ensures that the equity index risk is negated, and replaced with a LIBOR exposure.

The Exchange Equalisation Account Act 1979 constrains how the EEA may borrow from outside government. Where the EEA's foreign currency reserves are financed by foreign currency borrowing, the debt is issued by and is an obligation of the NLF. The foreign currency raised is sold to the EEA for sterling. While the NLF remains exposed to the interest rate and exchange rate risks from the foreign currency loan it has issued, in practice these risks are offset through the EEA's programme of asset management and swaps. No foreign currency debt has been issued or is outstanding at 31 March 2012.

17 Related parties

The Treasury is the ultimate controlling party of the NLF. There have been no direct transactions between the Treasury and the NLF in 2011-12.

The main related parties of the NLF are the CF, DMA, EEA, PWLB, Bank of England and NS&I. The relationship between the NLF and CF is explained in the Foreword. The NLF has provided finance in the year to the DMA, the EEA, the PWLB and to various statutory public sector bodies. The NLF has also transacted with the Bank of England and NS&I. Transactions with these bodies are all disclosed in these accounts. The NLF has also had a significant number of transactions with other government bodies via its temporary borrowing of balances in various Government Banking Service bank accounts.

During the year there have been no transactions between key management personnel at the Treasury and the NLF.

18 Events after the reporting period

The NAB (see Note 9) was re-activated again, for a six month period, on 1 April 2012.

In April 2012, a G20-led agreement to temporarily increase IMF resources was agreed. As part of this, the UK agreed to provide a new bilateral loan facility to the IMF for around \$15 billion. Any increase will be within the limits approved by Parliament, and will only be available once the 2010 Quota Agreement to double quota resources comes into effect.

At Budget 2012 the government reiterated its intention to transfer assets of the Royal Mail Pension Plan (RMPP), a private sector pension scheme, into public ownership in April 2012. As a result of this transfer, the government is now in possession of conventional gilts with a nominal value of £2.24 billion and index-linked gilts with a nominal value of £5.74 billion. Details of the gilt portfolio can be found at <http://www.dmo.gov.uk/documentview.aspx?docName=/gilts/press/pr210512.pdf>. The government's intention is to cancel these gilts during 2012-13. Any gains or losses on cancellation will be taken through the NLF.

19 Date of Authorisation for Issue of Account

The Account was authorised for issue on 17 July 2012.

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