

EXCHANGE EQUALISATION ACCOUNT ACT 1979

Presented to Parliament 6 July 2005

Accounts, presented to Parliament in pursuance of the Exchange Equalisation Account Act 1979 (as amended by the Finance Act 2000).

Exchange Equalisation Account: Report and Accounts 2004–05

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Foreword

Introduction

1. The Exchange Equalisation Account (EEA) holds the UK's reserves of gold, foreign currencies and International Monetary Fund (IMF) Special Drawing Rights (SDRs). These holdings, together with the UK's Reserve Tranche Position (RTP)¹ at the IMF and certain other categories of loans made by the UK to the IMF, make up the UK's official holdings of international reserves (the "official reserves"). The EEA's links to the IMF are explained in paragraphs 30 to 32.

Origin and Purpose

2. The EEA was established in 1932 to provide a fund that could be used for "checking undue fluctuations in the exchange value of sterling"². Any UK Government exchange rate intervention would therefore be conducted through the EEA³. Subsequent legislation extended the possible uses of the fund and, under the consolidating Exchange Equalisation Account Act 1979, it may also be used:

- to secure the conservation or disposition in the national interest of the means of making payments abroad; and
- for certain purposes arising from the UK's membership of the IMF, including the holding, purchase and sale of SDRs.

3. Under the Act, the EEA is permitted to invest its funds in any assets denominated in the currency of any country, to purchase gold and to acquire SDRs.

Administration and Control

4. The EEA is under the control of the Treasury, which has appointed the Bank of England (the Bank) to act as its agent to carry out day-to-day dealing in foreign currencies and the investment of the reserves. The Bank also provides advice and performance analysis to the Treasury on issues relating to the reserves. The Bank's management costs are charged to the EEA (see Note 5). In restricted circumstances, and with appropriate authorisation and controls, the EEA can transact directly with the Bank. During the 2004-05 year, there were no such transactions directly with the Bank.

5. An annual Service Level Agreement (SLA), previously known as the Remit, between Treasury and the Bank specifies the parameters under which the reserves are managed. The SLA for 2004-05 specified:

- benchmarks for investing the reserves, with limits to the Bank's discretion to take currency or interest rate positions relative to these benchmarks;
- the framework for controlling credit, market, liquidity and other risks; and
- the programme for financing the reserves, covering the National Loans Fund's (NLF) foreign currency borrowing and currency swaps out of sterling (involving advances of sterling from the NLF). The links to the NLF are described in paragraphs 26 to 29.

¹ The glossary on pages 40 to 41 explains this and other terms.

² Section 24 of the Finance Act 1932.

³ As set out in the Chancellor's letter of 6 May 1997 to the Governor of the Bank of England, the Bank may also intervene in support of its monetary policy objective using the Bank's own resources rather than those of the EEA.

The terms of the SLA can be reviewed during the year at the Bank's or the Treasury's request.

6. The EEA Accounting Officer and the Bank's Executive Director, Markets met together with Treasury officials twice in the 2004-05 year to review the Bank's performance in managing the reserves. Monthly meetings between the Treasury's Debt and Reserves Management Team and the Bank's Foreign Exchange and Risk Management Divisions supplemented this process.

7. EEA assets were held by a range of custodians in 2004-05. US Treasury bonds and other US dollar-denominated securities were held on the EEA's behalf by JP Morgan Chase and the Federal Reserve Bank of New York. Euro-denominated bonds were held at State Street, whilst international bonds and short-term credit instruments, such as bank certificates of deposit and commercial paper, were held at JP Morgan Chase. Japanese government bonds were held at the Bank of Japan. Other yen-denominated bonds were held at JP Morgan Chase. SDRs were held as entries in the IMF's books. The gold bars in the reserves were held at the Bank. The gold coin in the reserves was held at the Bank and the Royal Mint.

Operating and Financial Review

Investment Policy

8. EEA investments need to be highly liquid in order that they can be made available quickly for intervention purposes, or other permitted uses, if necessary. Inevitably, these investments carry some element of credit risk. In order to reduce this risk and to ensure relative liquidity, the EEA predominantly holds securities issued or guaranteed by the national governments of the United States, euro area countries and Japan, and deposits with highly rated banks. The EEA may also use other authorised investments including:

- bonds issued by other national governments, supranational organisations and selected government and government-sponsored agencies;
- foreign currency spot, forward and swap transactions;
- interest rate and currency swaps;
- bond and interest rate futures;
- sale and repurchase agreements;
- forward rate agreements;
- gold deposits, location swaps and quality swaps;
- SDRs; and
- certificates of deposit and corporate commercial paper.

As in previous years, the EEA did not trade options during the 2004-05 financial year.

Size of the Assets in the EEA

9. The overall size of the assets in the EEA rose over the course of the year to £25.4 billion (2003-04: £24.3 billion). This rise consisted of an increase in retained earnings taken to equity of £0.3bn (the operating deficit for the year of £0.5bn, adjusted for the notional sterling charge of £0.8bn added back to equity – see note 15 on page 34); an increase in the use of repurchase agreements of £0.8bn to finance active management positions; an increase in borrowing from the NLF of £0.2bn; and a net decrease in other liabilities.

Intervention

10. No use was made of the EEA to intervene in the foreign exchange market during 2004-05.

Provision of Foreign Currency Services to Government Departments

11. The EEA continued to provide foreign currency services to various government departments and agencies, i.e. sales of foreign currency to departments with foreign currency obligations and purchases of foreign currency from departments with foreign currency receipts, in aggregate totalling £2.3 billion (*2004: £2.2 billion*). These purchases and sales were offset by transactions with the market.

Financing of the Reserves

12. The foreign currency reserves can be divided into two components, those that are unhedged ('the net reserves') and those that are hedged for currency and interest rate risk ('the borrowed reserves'). The net reserves are primarily financed out of sterling through the accumulation over time of unhedged sales of sterling for foreign currency or through retained earnings. A small element is financed by the EEA's net SDR liability – see paragraph 31. The borrowed reserves are primarily financed either by issuing Government securities denominated in foreign currency, with the Bank acting as Treasury's agent for the issue, or by sterling advanced from the NLF (see paragraphs 26 to 29), using cross currency swaps to hedge the exchange rate risk. The main determinant of which financing method to use is cost. The least cost method of financing can be determined by comparing, on a swapped basis, the cost of issuing bonds in foreign currency of a given maturity and nominal amount, with the cost of issuing in sterling.

13. Financing of the borrowed reserves primarily comprised sterling swapped into foreign currencies of £10.0 billion (*2004: £10.0 billion*) and foreign currency liabilities of £1.7 billion (*2004: £1.9 billion*) at the end of the year. In 2004-05, £3.9 billion (*2003-04: £1.6 billion*) of new swaps were entered into, replacing £3.9 billion (*2003-04: £3.7 billion*) of currency swaps that matured or were unwound (through offsetting swap transactions) over the year. No new foreign currency liabilities were issued during the year (*2003-04: £1.6 billion*).

Analysis of Returns for the Period

14. The EEA continued to hold a range of assets within the portfolio, based on the investment policy described in paragraph 8 above. The EEA's accounts for the year ended 31 March 2005 are given on pages 22 to 35 and show an operating deficit for the year of £477 million (*2003-04: deficit of £357 million*). The operating deficit was the result of a number of influences, notably sterling interest rates remained above the average of those on the foreign currency assets the EEA holds (see paragraph 19); and movements in dollar yields which reduced the capital value of bonds held in the net reserves (see paragraph 20).

15. The operating deficit represents, in broad terms, the sum of gains or losses in the period arising from foreign exchange rate and gold price movements, interest receipts and expenses (including the notional capital charge described in paragraph 19) and dealing profits. The term "dealing profits" refers to gains and losses resulting from changes to market valuations of the portfolios.

16. Overall there was a net exchange rate gain of £103 million (*2003-04: loss of £365 million*), primarily resulting from the effect of maturing currency swaps (see Accounting Policies on page 26) as well as spot and forward foreign exchange transactions.

17. The EEA continued to lend part of its gold holdings to market participants. The maximum amount of gold lent at any one time during the year was 47 tonnes (2003-04: 123 tonnes) and interest received on gold lending during 2004-05 amounted to £0.3 million (2003-04: £1.2 million). The reduction in interest received reflected the low gold lending rates that prevailed during the period and the lower volume of lending.

18. The total interest receivable from the EEA's portfolio of assets was £1,216 million (2003-04: £1,229 million). The interest received on debt securities fell to £647 million (2003-04: £699 million). The EEA also received income on money market deposits, IMF transactions, and from custodians using EEA assets for bond lending (see paragraph 42).

19. Interest payable of £1,414 million (2003-04: £1,344 million) was in excess of the interest receivable in the year. The interest payable figure was primarily the notional sterling capital charge for the net reserves and the EEA's sterling liability to the NLF and interest on the UK's SDR allocation. The notional sterling charge is calculated using the five-year gilt swap rate as the assumed cost of financing. The deficit on net interest income reflects the fact that during 2004-05, sterling interest rates were on average higher than dollar, euro and yen interest rates. The net interest expense figure for the year was £198 million (2003-04: £115 million). The notional sterling charge is taken through the income and expenditure account for the year and subsequently added back as equity to reserves, as shown in note 15 to the accounts.

20. The dealing loss for 2004-05 was £374 million (2003-04: profit of £130 million). The main components are the returns on the foreign currency debt securities held and, where appropriate, the related hedging instruments, mainly currency and interest rate swaps. Bond yield changes resulted in a loss of £395 million (2003-04: loss of £224 million). Currency and interest rate swaps positions made a dealing profit of £72 million (2003-04: £300 million). During the year, bond yields rose in the US and Europe and remained broadly unchanged in Japan. Taken together, bonds and related hedges (see Accounting Policies on page 25) incurred a loss of £323 million (2003-04: dealing profit of £76 million), reflecting the fact the bonds held in the net reserves are not hedged for interest rate (or currency) risk. The remaining elements were from spot and forward foreign exchange transactions.

21. The management charge for the costs incurred by the Bank of England in its management of the EEA during 2004-05 was £8.5 million (2003-04: £8.0 million).

Bank of England's Active Management

22. The reserves, excluding the RTP, are actively managed against a number of benchmarks. These benchmarks are reviewed regularly and are specified such that they are replicable and represent the Treasury's long-term investment strategy. These can be split into benchmarks for: the "borrowed reserves", on which the currency and interest rate exposure is hedged; the "net currency reserves", which are unhedged against exchange rate and interest rate risk; and gold lending. In broad terms the benchmarks used in the 2004-05 year were as follows:

- (a) Benchmarks for borrowed reserves. The borrowed reserves are hedged against both exchange rate and interest rate risk. The benchmarks in 2004-05 mainly comprised government and other eligible bonds financed out of swapped sterling, as described in paragraph 27 below. For example, in the US dollar element of this portfolio, a benchmark holding might comprise a US Treasury bond and a matching currency swap in which the EEA pays fixed rate dollars and receives floating rate sterling. The benchmark return on this element of the portfolio will represent a combination of capital gain (or loss) on the foreign currency assets purchased and the (generally)

offsetting loss (or gain) on the maturing swap. The benchmark return will also include any excess return on the floating rate sterling received compared to an assumed benchmark financing cost of the five-year gilt swap rate. Where assets in the borrowed reserves were financed by NLF foreign currency liabilities, described in paragraphs 12 and 26, the benchmark was a portfolio of assets with similar risk characteristics to the liabilities that financed them; and

- (b) Benchmarks for net currency reserves and gold lending. The net reserves are not hedged against currency or interest rate risk and have a benchmark currency allocation⁴ of 40% US dollars, 40% euros and 20% yen⁵. Each currency bloc has a benchmark for the assets within that bloc. The benchmark for assets denominated in US dollars comprised a combination of US Treasury and other US dollar-denominated bonds. The benchmark for euro-denominated assets comprised a combination of euro-denominated sovereign and other eligible securities. For yen, the benchmark was derived from 1-month forward rates against the euro and the dollar. For gold lending, the benchmark portfolio comprised a weighted average of one, three and six month gold deposits.

23. A short-term liquidity portfolio is used to manage cash flows arising from the borrowed and net currency reserves. The size of this portfolio is such that the scope for active management is very small and it does not have an explicit benchmark for this reason.

24. The return for active management against the benchmarks during 2004-05 was £15.5 million (2003-04: £16.7 million).

Strategy Positions

25. The Treasury may decide, on advice from the Bank, to set “strategy positions”, which are deviations from the benchmarks set out in the SLA. Any such positions would be the responsibility of the Treasury and would be separate from active management positions taken by the Bank. No strategy positions were set during 2004-05.

Links to the National Loans Fund

26. The Exchange Equalisation Account Act does not permit the EEA to borrow. The NLF undertakes such transactions and finances the EEA. Therefore, where the foreign currency reserves are financed by foreign currency liabilities, the debt is issued by, and is an obligation of, the NLF. The foreign currency raised is transferred to the EEA in return for payment in sterling. The NLF’s foreign currency liability to the market is hedged by a foreign currency asset on the EEA.

27. In the case of sterling financing of the borrowed foreign currency reserves, the NLF again advances sterling to the EEA but this is then invested in foreign currency assets, with risk exposures hedged via swaps with market counterparties. Upon consolidation, the inter-account sterling transactions again offset, leaving a swapped foreign currency asset on the EEA hedging the NLF’s sterling liability to the market.

28. As a result of the financing arrangements described above, the EEA when looked at in isolation from these NLF assets and liabilities, gives only a partial picture of the overall foreign currency assets and liabilities.

⁴ This benchmark is applied to currency exposures excluding the EEA’s holdings of gold and SDRs, and the UK’s RTP at the IMF.

⁵ The currency allocation within the benchmark is set taking into account three factors: the potential requirement to intervene; the possible need to finance trade flows; and the risk-return characteristics of the benchmark.

29. The NLF in addition holds the RTP at the IMF and may hold certain other loans to the IMF. All these foreign currency assets and liabilities are managed together. Table 2 on page 11 provides a complete picture of the asset and liability position of the UK's official reserves.

Links to the International Monetary Fund

30. The primary means of financing the IMF is through members' quotas. Each member of the IMF is assigned a quota, part of which is payable in SDRs or specified usable currencies ("reserve assets"), and part in the member's own currency. The difference between a member's quota and the IMF's holdings of its currency is a member's RTP. As stated in paragraph 1, although it is not held in the EEA, the UK's RTP forms part of the UK's official reserves.

31. SDRs are an international reserve asset created by the IMF and defined in terms of a basket of the US dollar; euro; yen; and sterling. The IMF has periodically issued SDRs, and allocated them to members in proportion to their quotas. The SDR allocation is a liability of the EEA and the resultant holding of SDRs by the UK is an asset of the EEA. IMF members are credited with interest on their holdings of SDRs and pay interest on their allocation of SDRs at the same rate. Interest payments and receipts are made in SDRs.

32. Over the years the IMF has supplemented the quota system with other sources of funding:

- General Arrangements to Borrow (GAB) – These are long-standing arrangements under which the Group of Ten industrial countries stand ready to lend to the IMF for the purpose of forestalling or coping with a situation that could impair the international monetary system.
- New Arrangements to Borrow (NAB) – Since 1998 the IMF has had a SDR 34 billion facility at its disposal, provided by GAB members and other IMF members. The intention is that the NAB would replace the GAB as the primary financial resource for the IMF in the event that it needs additional liquidity.

When the IMF draws on these facilities, the UK's contribution forms part of the official reserves.

Loans to the International Monetary Fund

33. In sterling terms, the UK's RTP at the IMF fell over the course of the year to £2,761 million (*2003-04: £3,407 million*). This was because of a fall in the value of the RTP to SDR 3,441 million at end March 2005 (*2003-04: SDR 4,262 million*). This movement reflected sterling repayments (mainly by Argentina, Brazil and Turkey) from IMF lending programmes more than offsetting new disbursements. The UK's IMF quota did not increase during the year nor did the UK lend to the IMF under the GAB or NAB during the course of the year.

34. The policy of neutralising changes in the level of the RTP on the level of the official reserves continued during 2004-05. Other things being equal, use of the UK's quota in IMF lending or an increase in the quota would lead to a rise in the UK's SDR assets and therefore in the official reserves. Conversely, when countries repay sterling borrowing from the IMF resulting in a decrease in the UK's RTP, other things being equal the official reserves would also fall. To offset a decrease in the reserves arising for this reason during 2004-05, the EEA purchased foreign currency for sterling.

UK Official Holdings of International Reserves and Related Returns

35. As stated in paragraph 28, looking at the EEA in isolation gives an incomplete picture of the overall foreign currency asset and liability position and returns, in relation to the UK's official holdings of international reserves. Tables 1 and 2 below show the complete picture. Table 2 is derived by consolidating the assets and liabilities of the EEA with those of the NLF associated with the official reserves.

36. There are differences between the returns figures for UK official reserves in Table 1 and those for the income and expenditure account for the EEA. The interest payable figure of £1,508 million (*2003-04: £1,451 million*) in Table 1 includes interest on foreign currency debt securities and loans, which is excluded from the EEA accounts. It also includes a notional charge, calculated at the five-year gilt swap rate, on the outstanding net assets and the outstanding 'sterling liability' figure. The latter represents the liability side of the RTP and the sterling side of currency swaps, which are used to finance the reserves. This differs from the notional sterling capital charge in the EEA accounts, which is described in the EEA accounting policies on page 25. The foreign exchange gain of £170 million (*2003-04: loss of £432 million*) differs by £67 million (*2003-04: £67 million*) from the EEA Income and Expenditure account because of foreign exchange gains on the RTP and the foreign currency debt.

37. The balance sheet for the official reserves in Table 2 differs on the asset side from the EEA reserves as the former includes the RTP (an NLF asset) of £2.8 billion (*2003-04: £3.4 billion*). The liabilities in the official reserves include £1.7 billion (*2003-04: £1.9 billion*) equivalent of foreign currency debt (an NLF liability) and the sterling liability of £12.6 billion (*2004: £13.2 billion*).

Table 1⁶: UK Official Holdings of International Reserves: Returns

For the year ended 31 March	2005 £ millions Unaudited	2004 £ millions Unaudited
Interest receivable	1,217	1,229
Interest payable	(1,508)	(1,451)
Net interest expense	(291)	(222)
Fees and commissions receivable and payable	1	(1)
Dealing (losses)/profits	(376)	130
Exchange gains/(losses) on foreign currencies and gold	170	(432)
Management charge	(9)	(8)
Operating deficit	(505)	(533)

⁶ See paragraphs 26 to 29 and 35 to 37 that provide an explanation of this table.

Table 2⁷: UK Official Holdings of International Reserves: Assets and Liabilities⁸

As at 31 March:	2005	2004
	£millions Unaudited	£millions Unaudited
Assets		
Cash (excluding sterling balance with Paymaster General)	107	101
Holdings of IMF Special Drawing Rights	177	184
Reserve Tranche Position	2,761	3,407
Items in course of collection from banks	525	473
Loans and advances to banks	2,395	3,670
of which:-		
USD bloc	1,695	2,034
Euro	622	1,482
Yen and other currencies	78	154
Debt securities	18,613	16,052
of which:-		
USD bloc	4,987	5,148
Euro	11,146	7,898
Yen and other currencies	2,480	3,006
Gold and gold receivables	2,265	2,319
Other assets	894	1,037
Prepayments and accrued income	236	247
Total assets	<u>27,973</u>	<u>27,490</u>
Liabilities		
Items in course of transmission to banks	460	481
Deposits by banks	3,354	2,542
Debt securities and loans (all USD bloc)	1,729	1,866
Sterling liability	12,613	13,244
SDR allocation	1,535	1,529
Other liabilities	964	1,097
Accruals and deferred income	45	37
Total liabilities	<u>20,700</u>	<u>20,796</u>
Net assets	<u>7,273</u>	<u>6,694</u>

⁷ See paragraphs 26 to 29 and 35 to 37 that provide an explanation of this table

⁸ This statement has been prepared on a different accounting basis to the IMF template of the UK International Reserves and Foreign Currency Liquidity. As a result total assets shown exceed the gross reserves in the end-March 2005 template by £2.6 billion (2004: £2.6 billion). This is because the template excludes the sterling leg of currency swaps and is adjusted for unsettled items.

Risk Management and Control

38. Although the reserves are not held primarily to make a profit, the Treasury seek to minimise the cost of holding the foreign currency reserves whilst avoiding exposing the public purse to unnecessary risk.

39. Risk is managed through an established control framework, including setting limits to credit risk and market risk exposures, combined with clear operational guidelines.

Control Framework

40. The key features of the control framework during 2004-05 were as follows:

- An annual Service Level Agreement (SLA) agreed between the Treasury and the Bank, in which the Treasury set out the parameters under which the Bank was to manage the reserves. A summary of the SLA was published in the Debt and Reserves Management Report⁹.
- A quarterly report from the Bank on risk controls and any breaches of the control framework.
- Operational Risk Officers in the Bank's Foreign Exchange and Risk Management Divisions with responsibility for co-ordinating and collecting analysis on the operational risk in the Divisions.
- A system of financial reporting in which the Bank accounted each month to the Treasury for the returns made and the market and credit risks incurred.
- An organisational structure in the Bank containing clear reporting lines. This included the Risk Management Division which was independent of the Foreign Exchange Division where trading activities were conducted. Both the Risk Management Division and the Foreign Exchange Division reported to the Executive Director, Markets. Settlements were carried out by Customer Banking Division, which reported to the Executive Director, Banking Services.
- A risk-based internal audit programme that delivered reports to the Executive Director, Markets, as well as a quarterly report which is forwarded to HMT.
- Trialling of the Bank's remote contingency facilities where EEA operations can be carried out in an emergency.
- Limits to credit and market risk exposures that are explained in the following paragraphs.

41. Credit risk: The management of the reserves involves exposure to counterparties and to the issuers of sovereign, agency, supranational and commercial paper. The creditworthiness of these counterparties and issuers is subject to regular scrutiny by the Bank, both through analysis in the Risk Management Division and review by the Bank's Credit Ratings Advisory Committee. Following this process, limits are agreed for the exposure to each counterparty and issuer, with such exposures being monitored in real time against the limits. A report of any limit excesses is sent to the Treasury each month. In addition, there are limits to contain the overall exposure to each relevant country's banking sector.

⁹ Produced by HM Treasury at the time of the Budget for the financial year ahead and available via www.hm-treasury.gov.uk.

42. Custodians holding bonds owned by the EEA are authorised to use them in their bond lending programmes. These programmes involve lending the bonds against collateral consisting of either other bonds or cash. The authorised custodians are permitted to invest the cash collateral in money market instruments ranging from US Treasury repo to bank deposits. The credit limits delegated to these custodians are deducted from the limits available to the Bank for its own EEA management activities. Maturity mismatches between the collateral held and the corresponding investments are strictly limited. The Bank receives daily reports allowing compliance with the investment limits to be checked.

43. Market risk: Market risk is the exposure to movements in market variables. For the EEA, the main market variables are interest rates and exchange rates. The Bank monitors and controls market risk primarily by using a Value at Risk (VaR) model, which predicts, at a specified confidence level, the maximum likely loss for the portfolio over a certain time period. The Bank applies a 99% confidence interval and a two-week holding period, implying that losses should not exceed those suggested by the model in ninety-nine two-week periods out of a hundred. The VaR estimates are based on the historic volatility of returns on different asset classes and the historic correlation between returns on those asset classes.

44. The Bank measures the VaR and delta exposures on trading portfolios on a daily basis. Delta measures the change in value of the portfolio for each one basis point shift in the relevant yield curve. It supplements the VaR measure, and helps to test the sensitivity of the portfolio to changes in interest rates.

45. The Bank also conducts regular stress tests, to explore the vulnerability of the EEA to hypothetical severe market movements, and to estimate potential losses in these extreme conditions.

Operational Guidelines

46. In addition to the above control framework, risk was further managed by the following operational guidelines.

47. Whether the Treasury financed the borrowed foreign currency reserves either through borrowing in foreign currency or by engaging in foreign currency swaps out of sterling, it did so in a way which minimised the exposure to fluctuations in the value of currencies.

48. Where financing was through foreign currency borrowing with assets hedged into the currency of the liability, hedging happened automatically in that fluctuations in the sterling value of the NLF's foreign currency liabilities are matched by fluctuations in the sterling value of EEA assets, with the combined fluctuations offsetting each other.

49. Where financing was through sterling using currency swaps, the initial swap of sterling for foreign currency hedged the exchange rate risk. This was done through an initial exchange of sterling principal for foreign currency at the spot rate, receiving back the same amount of sterling principal at maturity, and regular exchanges of interest payments on the principal amounts.

50. Similarly, interest rate risk was controlled in two main ways, according to the method chosen for raising foreign currency to finance the reserves. Where financing was through the issue of NLF foreign currency liabilities, the interest rate risk was controlled by matching the risk characteristics, for example the maturity, of the EEA's assets to those of the NLF foreign currency liabilities. Where currency swaps out of sterling were used, interest rate risk was hedged through interest rate swaps. Typically, the EEA paid floating rate interest on the

currency it acquired through the initial swap out of sterling and generated fixed interest income in the same currency through purchasing an asset such as a bond. By swapping the fixed interest receipts for floating interest receipts through an interest rate swap, the EEA acquired an income stream that matched its interest payment liability and thus minimised its interest rate exposure.

51. The above arrangements produced a portfolio of assets that closely hedged the obligations to repay the NLF's foreign currency liabilities. The currency and interest rate risk in the net reserves was controlled through the selection of benchmarks. The Bank may incur currency risk by deviating from the benchmark in its operations, within the VaR limit mentioned below. In 2004-05 there were no significant deviations from the 40:40:20 currency benchmark, and the net currency assets were invested predominantly in long-term government (or other high quality) debt.

52. The Treasury may decide, on advice from the Bank, to set deviations from the 40:40:20 currency benchmark or the interest rate benchmarks (which are denoted 'strategy positions'). As detailed in paragraph 25, no currency benchmark deviations were set and no strategy positions were taken in 2004-05. Any intervention to influence the level of sterling or other currency would change the level and possibly the composition of the currency risk. No such intervention was undertaken in 2004-05.

53. Under the SLA, the Bank actively managed the borrowed and net reserves, in order to improve the return. The Treasury sets the Bank a VaR limit, with the VaR being calculated at close of business each day. In 2004-05 the limit was US\$40 million, and during the year the Bank's use of it did not exceed US\$8.06 million. The average use of VaR during the year was US\$5.05 million and the lowest VaR usage at the end of any one day was US\$2.47 million.

Accounting Policies

54. The accounts of the EEA for the year are drawn up on a UK GAAP basis as far as appropriate, to reflect best accounting practice in reporting on the EEA's activities. The accounts primarily reflect the results of transactions in activities that are carried out in ways and for purposes (though reserves are not held primarily for the purpose of making a profit) that make them comparable to those of a banking entity.

55. Accordingly, accounting requirements for banking entities form the basis of the EEA's Accounts Direction (page 36) and are reflected in its accounting policies. The effect is that, for example, securities are marked to market and the related unrealised gains and losses are recognised as income and expenditure in the year.

Audit and Publication

56. The accounts have been prepared in accordance with a direction given by HM Treasury in pursuance of section 5(1) of the Exchange Equalisation Account Act 1979 (as amended by the Finance Act 2000). The text of the direction is reproduced on page 36 of this document. The accounts and supporting notes relating to the EEA for the year ended 31 March 2005 have been audited by the Comptroller and Auditor General.

Jon Cunliffe
Accounting Officer

HM Treasury
29 June 2005

Statement of the Accounting Officer's Responsibilities

Under the Exchange Equalisation Account Act 1979 (as amended by the Finance Act 2000), the Treasury is required to prepare for each financial year, in such form and on such basis as they may prescribe, accounts in relation to the transactions, assets and liabilities of the Account.

The accounts are prepared on an accruals basis and to give a true and fair view of the state of affairs of its income and expenditure, total recognised gains and losses, and cash flows for the financial year.

The Treasury has appointed its Managing Director of Macroeconomic Policy and International Finance as the Accounting Officer for the Account, with responsibility for preparing the accounts and for transmitting them to the Comptroller and Auditor General.

In preparing the accounts, the Accounting Officer is required to comply with an Accounts Direction and in particular to:

- a** observe the relevant accounting and disclosure requirements, and apply suitable accounting policies on a consistent basis;
- b** make judgements and estimates on a reasonable basis;
- c** state whether applicable accounting standards have been followed, and disclose and explain any material departures in the accounts; and
- d** prepare the accounts on a going-concern basis.

The responsibilities of an Accounting Officer, including responsibility for the propriety and regularity of the public finances for which an Accounting Officer is answerable, for keeping proper records and for safeguarding the Department's assets, are set out in the Accounting Officers' Memorandum issued by HM Treasury and published in "Government Accounting". The Accounting Officer's Statement on Internal Control can be found on page 17.

Statement on Internal Control

1. Scope of responsibility

As Accounting Officer for the Exchange Equalisation Account (EEA), I have responsibility for maintaining a sound system of internal control that supports the achievement of the policies, aims and objectives of the Exchange Equalisation Account Act 1979 (as amended by the Finance Act 2000) as well as the targets set by Treasury Ministers, whilst safeguarding the public funds and assets for which I am personally responsible, in accordance with the responsibilities assigned to me in Government Accounting.

The management of the EEA is divided between the Bank of England (the Bank) and the Reserves branch of the Debt and Reserves Management (DRM) team at the Treasury. The Bank is responsible for the day-to-day management of the EEA. DRM has oversight of the Bank's EEA operations and reports directly to me on risk issues. An Annual Service Level Agreement (SLA) between the Treasury and the Bank specifies the parameters under which the reserves are managed. The SLA sets out the guidelines for investing the reserves, including risk limits and the associated management information required.

2. The purpose of the system of internal control

The system of internal control is designed to manage risk to a reasonable level rather than to eliminate all risk of failure to achieve policies, aims and objectives; 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 EEA'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 in DRM together with the Bank has been in place for the year ended 31 March 2005 and up to the date of approval of the annual report and accounts, and accords with Treasury guidance.

3. Capacity to handle risk

There is a risk management strategy, set via the SLA, and clear segregation of duties within the Bank and the Treasury for the management of the EEA and the supporting processes.

At the Bank, staff have skills and receive training appropriate to their responsibilities. Those involved in managing financial and other risks have their objectives set accordingly, including responsibility for relevant aspects of the control framework. Policy and procedures manuals as well as job instructions are maintained to ensure staff carry out their responsibilities in a controlled manner. Where there are instances of control failure, staff are required to maintain a record in an incident log. These are reviewed on a regular basis to ensure lessons are learned. Control improvements and responses to control failures are summarised in the quarterly Turnbull report from the Bank to DRM described below.

At the Treasury, the Treasury internal audit team facilitates risk management workshops to maintain and develop DRM staff's risk awareness.

4. The risk and control framework

Within the Bank, risk analysis and measurement is undertaken by the Risk Management Division, which is independent from the Foreign Exchange Division where trades are carried out. Both the Risk Management and Foreign Exchange Divisions are independent from the Customer Banking Division where the trades are settled.

At the Treasury, DRM is responsible for monitoring the risk environment and performance of the Bank in managing the reserves and for providing the Accounting Officer with the assurance to sign off the Statement on Internal Control. To support this process, the Bank provides the following management information:

- Monthly financial reporting detailing the returns made with respect to the management of the EEA and the market and credit risks incurred.
- Quarterly management reports on risk issues and the Bank's compliance with the guidance issued by the Turnbull Report (*Internal Control: Guidance for Directors on the Combined Code issued by the Institute of Chartered Accountants in England and Wales*). These reports highlight the Bank's role in identifying, assessing, managing and monitoring the risks relating to its management of the EEA. This process is supported by an Operational Risk Officer in both the Foreign Exchange Division and, with specific responsibility for the co-ordination of the quarterly reporting framework, the Risk Management Division.
- The Bank's Internal Audit Division conducts an agreed internal audit programme as part of the SLA and the Executive Director, Markets area forwards to the Accounting Officer the Internal Audit quarterly reports on this activity.
- Bank and Treasury officials meet at monthly reserves meetings to review performance against the parameters set out in the SLA and to consider wider operational and policy issues. The Accounting Officer and the Bank's Executive Director for Markets met in May and November 2004 to discuss overall strategy and governance issues.

Using this information, as well as the Treasury's risk register and risk workshops, DRM provided quarterly reports to the Accounting Officer on the key risk indicators giving assurance on the overall effectiveness of the controls in place.

Some of the actions initiated during the year

The Bank and DRM aim continuously to identify possible areas for operational risk reduction and control improvements. Some of the actions initiated during the year were:

- The Bank's trading and risk management system was upgraded successfully.
- The Bank enhanced its framework for analysing operational risk, including introducing enhanced management information outputs.

- The Bank conducted a series of successful live tests of its operations at its contingency site.
- DRM improved their quarterly monitoring of the risk framework to ensure all instances of control failures are followed up to a successful conclusion.

Planned action for 2005-06

The Bank and DRM will continue to review and develop the control environment. No major changes to the control environment are envisaged, but work is already planned to enhance a number of detailed control processes in the front, middle and back offices.

5. Review of effectiveness

As Accounting Officer, I have responsibility for reviewing the effectiveness of the system of internal control. My review is informed by the work of the internal auditors and the executive managers within DRM and in the Bank, who have responsibility for the development and maintenance of the internal control framework, and comments made by external auditors in their management letter and other reports. I have been advised on the implications of the result of my review of the effectiveness of the system of internal control by DRM and Bank officials and a plan to address weaknesses and ensure continuous improvement of the system is in place. In June 2004 the Treasury Audit Committee agreed to include the Exchange Equalisation Account within its remit and papers on the Account have been presented to the November 2004 and March 2005 Treasury Audit Committee meetings.

Jon Cunliffe
Accounting Officer

HM Treasury
29 June 2005

Certificate and Report by the Comptroller and Auditor General to the House of Commons

I certify that I have audited the accounts on pages 22 to 35 under the Exchange Equalisation Account Act 1979 (as amended by the Finance Act 2000). These accounts have been prepared under the historical cost convention as modified by the revaluation of certain investments and the accounting policies set out on pages 25 to 26.

Respective Responsibilities of the Accounting Officer and the Auditor

As described on page 16 the Accounting Officer is responsible for the preparation of the accounts in accordance with the Exchange Equalisation Account Act 1979 (as amended by the Finance Act 2000) and Treasury directions made thereunder and for ensuring the regularity of financial transactions. The Accounting Officer is also responsible for the preparation of the other contents of the Annual Report. My responsibilities as independent auditor are guided by the Auditing Practices Board and the auditing profession's ethical guidance.

I report my opinion as to whether the accounts give a true and fair view and are properly prepared in accordance with the Exchange Equalisation Account Act 1979 (as amended by the Finance Act 2000) and Treasury directions made thereunder, and whether in all material respects the expenditure and income have been applied to the purposes intended by Parliament and the financial transactions conform to the authorities which govern them. I also report if in my opinion the Foreword is not consistent with the accounts, if the Accounting Officer has not kept proper accounting records, or if I have not received all the information and explanations I require for my audit.

I have read the other information contained in the Annual Report, and consider whether it is consistent with the audited accounts. I consider the implications for my certificate if I become aware of any apparent misstatements or material inconsistencies with the accounts.

I review whether the statement on pages 17 to 19 reflects compliance with the Treasury's guidance "Corporate Governance: statement on the system of internal control". I report if it does not meet the requirements specified by the Treasury, or if the statement is misleading or inconsistent with other information I am aware of from my audit of the accounts.

I am not required to consider, nor have I considered whether the Accounting Officer's Statement on Internal Control covers all risks and controls. I am also not required to form an opinion on the effectiveness of the EEA's corporate governance procedures or its risk control procedures.

Basis of Audit Opinion

I conducted my audit in accordance with United Kingdom Auditing Standards issued by the Auditing Practices Board. An audit includes an examination on a test basis of evidence relevant to the amounts, disclosures and regularity of financial transactions included in the accounts. It also includes an assessment of the significant estimates and judgements made by the Accounting Officer in the preparation of the accounts and of whether the accounting policies are appropriate to the 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 accounts are free from material misstatement, whether caused by error, or by fraud or other irregularity and that, in all material respects, the expenditure and income have been applied to the purposes intended by Parliament and conform to the authorities which govern them. In forming my opinion I also evaluated the overall adequacy of the presentation of information in the accounts.

Opinion

In my opinion:

- the accounts give a true and fair view of the state of affairs of the Exchange Equalisation Account at 31 March 2005, and of the operating deficit, total recognised gains and losses and cash flows for the year then ended, and have been properly prepared in accordance with the Exchange Equalisation Account Act 1979 (as amended by the Finance Act 2000) and directions made thereunder by Treasury; and
- in all material respects the expenditure and income have been applied to the purposes intended by Parliament and the financial transactions conform to the authorities which govern them.

I have no observations to make on these accounts.

*Sir John Bourn
Comptroller and Auditor General*

4 July 2005

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

The maintenance and integrity of the Treasury'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.

Income and Expenditure account

For the year ended 31 March:

	Notes	2005 £ millions	2004 £ millions
Interest receivable			
Interest receivable and similar income arising from debt securities	2a	647	699
Other interest receivable and similar income	2b	569	530
Interest payable	3	<u>(1,414)</u>	<u>(1,344)</u>
Net interest expense		(198)	(115)
Fees and commissions receivable		1	1
Dealing (losses)/profits	4	(374)	130
Exchange gains/(losses) on foreign currencies and gold		103	(365)
Management charge	5	<u>(9)</u>	<u>(8)</u>
Operating deficit/Loss on ordinary activities		<u>(477)</u>	<u>(357)</u>
Retained deficit for the financial year	15	<u>(477)</u>	<u>(357)</u>

All income and expenditure arose from continuing operations.

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

The notes on pages 25 to 35 form an integral part of these accounts.

Balance Sheet

As at 31 March:

	Notes	2005 £ millions	2004 £ millions
Assets			
Cash and balances at central banks and Paymaster General	17	306	267
Holdings of IMF Special Drawing Rights		177	184
Items in course of collection from banks		525	473
Loans and advances to banks	6	2,395	3,670
Debt securities	7	18,613	16,052
Gold and gold receivables	8	2,279	2,334
Other assets	9	894	1,037
Prepayments and accrued income		236	247
Total assets		25,425	24,264
Liabilities			
Items in course of transmission to banks		474	496
Deposits by banks	10	3,354	2,542
Liability to NLF	11	910	670
SDR allocation	12	1,535	1,529
Other liabilities	13	964	1,097
Accruals and deferred income		18	12
Retained reserves	15	18,170	17,918
Total liabilities		25,425	24,264

The notes on pages 25 to 35 form an integral part of these accounts.

Jon Cunliffe
Accounting Officer

HM Treasury
29 June 2005

Cash Flow Statement

For the year ended 31 March:

	Notes	2005 £ millions	2004 £ millions
Net cash (outflow)/inflow from operating activities	16	(100)	434
Net inflow from the National Loans Fund	11	240	640
Capital repayments	15	<u>(100)</u>	<u>(970)</u>
Increase in cash in the year	17	<u>40</u>	<u>104</u>

The notes on pages 25 to 35 form an integral part of these accounts.

Notes to the Accounts

1 Accounting policies

Basis of accounting

These accounts have been 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 1985 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.

Income and expenditure and assets and liabilities are recognised in the accounts on the date on which they are incurred.

Interest receivable and payable

Interest receivable and payable is recognised on an accruals basis.

A notional sterling capital charge is included within interest payable. There is no cash movement in respect of this charge, which is intended to reflect an assumed cost of sterling capital used by the EEA. The charge is calculated on the outstanding reserves of the EEA (including the income and expenditure account) and the EEA's outstanding liability to the NLF, less cash balances with the Paymaster General, at the 5-year gilt swap rate, calculated on a daily basis. This charge is subsequently added back to reserves.

Special Drawing Rights (SDR) remuneration

The EEA is remunerated (in SDRs) on its holdings of SDRs. This income is included within interest receivable. Remuneration of the UK's Reserve Tranche Position (RTP) at the IMF (an NLF asset) is also received in the form of SDRs and is recognised in these accounts as interest receivable. Interest paid on SDRs is accounted for on an accruals basis.

Dealing profits

Dealing profits includes gains and losses resulting from changes in the market value of the portfolio and realised gains and losses on disposal or maturity.

Fees and commissions

Fees and commissions are recognised in the income and expenditure account as incurred.

Foreign currencies

The accounts of the EEA have been compiled in sterling. Transactions denominated in foreign currencies are recorded in sterling at the rate of exchange ruling on the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are converted into sterling at the rates of exchange prevailing on the balance sheet date. Exchange gains and losses are recognised in the income and expenditure account. The SDRs are calculated as

a basket in the proportional weightings on a daily spot basis, as explained in the Foreword, paragraph 31.

Debt securities

All debt securities are held for trading purposes and are reported at market value. Changes in the market value of debt securities are recognised in the income and expenditure account, within dealing profits, when they arise.

Bonds are valued at external mid-market prices. Certificates of deposit are valued using discounted cash flows techniques. All inputs into the certificates of deposit pricing model are externally sourced.

Loans and advances

Loans and advances are recorded at the cost of funds advanced.

Repurchase (repo) agreements

Securities which have been sold with an agreement to repurchase remain on the balance sheet and the sale proceeds are recorded as a deposit. Securities acquired in reverse sale and repurchase agreements are not recognised on the balance sheet and the purchase price is treated as a loan. The difference between the sale and repurchase price is accrued evenly over the life of the transaction and credited or charged to the income and expenditure account as interest receivable or payable.

Gold

Gold assets are recorded in the balance sheet at mid-market value. Changes in the market value of gold assets are recognised in the income and expenditure account, within dealing profits, when they arise.

Derivative transactions

Derivative transactions are used in trading activities to manage risk in the trading portfolios. Such instruments include exchange rate forwards, currency swaps, interest rate swaps and interest rate and bond futures. Derivatives are carried at fair value and changes in the fair values are reported within dealing profits in the income and expenditure account. Fair values are normally determined by reference to quoted market prices. Internal models are used to determine fair value in instances where no market price is available. Inputs used in these models are from externally generated sources.

Currency swaps, within other assets and other liabilities, are recognised at the present value of their future cash flows. The exchanges of principal are recognised in a position account on exchange.

2a. Interest receivable and similar income arising from debt securities

	2005	2004
	£ millions	£ millions
Bonds	627	699
Certificates of deposit	20	-
Total	647	699

2b. Other interest receivable and similar income

	2005	2004
	£ millions	£ millions
Currency swaps	474	413
Reserve Tranche Position	46	57
Money market deposits	18	34
Reverse repos	25	18
Special Drawing Rights	3	4
Securities lending	3	3
Gold deposits	-	1
Total	569	530

3 Interest payable

	2005	2004
	£ millions	£ millions
Notional sterling capital charge	829	661
Currency swaps	444	555
Interest rate swaps	56	69
SDR allocation	31	30
Repos	30	15
Interest on short positions in bonds	17	12
Interest on cash collateral taken	7	2
Total	1,414	1,344

The presentation of currency swaps has been changed to show gross interest.

4 Dealing losses

	2005	2004
	£ millions	<i>£ millions</i>
Debt securities	(395)	(224)
Futures	(6)	2
Foreign exchange transactions	(51)	53
Interest rate swaps	36	20
Currency swaps	36	280
Other instruments	6	(1)
Total	<u>(374)</u>	<u>130</u>

5 Management charge

The management charge of £8.5 million represents the cost of the Bank of England's management of the EEA during 2004-05 (2003-04: £8.0 million).

6 Loans and advances to Banks

	2005	2004
	£ millions	<i>£ millions</i>
Repayable on demand	5	4
Repayable in not more than 3 months	2,390	3,000
Repayable in more than 3 months but not more than 1 year	-	666
Total	<u>2,395</u>	<u>3,670</u>
Of which, reverse repo transactions are:	1,717	1,854

7 Debt securities

All amounts in £ millions

	2005			2004		
	Listed overseas	Unlisted	Total	Listed overseas	Unlisted	Total
Issued by Public Bodies:						
Government Securities	13,778	-	13,778	13,121	-	13,121
Other Public Sector	2,212	125	2,337	2,798	80	2,878
	<u>15,990</u>	<u>125</u>	<u>16,115</u>	<u>15,919</u>	<u>80</u>	<u>15,999</u>
Other Issuers:						
Bank and building society certificates of deposit	2,420	-	2,420	-	-	-
Other debt securities	78	-	78	53	-	53
	<u>2,498</u>	<u>-</u>	<u>2,498</u>	<u>53</u>	<u>-</u>	<u>53</u>
Total	<u>18,488</u>	<u>125</u>	<u>18,613</u>	<u>15,972</u>	<u>80</u>	<u>16,052</u>
Amounts maturing:						
Within less than one year			4,514			3,091
In one year and over			<u>14,099</u>			<u>12,961</u>
Total			<u>18,613</u>			<u>16,052</u>

8 Gold and gold receivables

	2005 £ millions	2004 £ millions
Gold stock	1,925	2,098
Gold deposits	<u>354</u>	<u>236</u>
Total	<u>2,279</u>	<u>2,334</u>

9 Other assets

	2005	2004
	£ millions	£ millions
Margin accounts	1	2
Balances arising from other financial instruments:		
- Currency swaps	705	745
- Interest rate swaps	81	36
- Foreign exchange transactions	107	254
Total	894	1,037

10 Deposits by Banks

All amounts in £ millions

	2005			2004		
	3 months or less	Over 3 months but less than 1 year	Total	3 months or less	Over 3 months but less than 1 year	Total
Repo transactions	2,638	355	2,993	2,095	80	2,175
Cash collateral received	361	-	361	367	-	367
	<u>2,999</u>	<u>355</u>	<u>3,354</u>	<u>2,462</u>	<u>80</u>	<u>2,542</u>

There were no deposits by banks repayable on demand as at 31 March 2005 (2004: nil).

11 Liability to National Loans Fund

When the sterling balance held by the EEA at the Paymaster General falls, it can be increased by a fresh issue of capital from the NLF under the terms of section 7 of the National Loans Act 1968. This creates a liability on the EEA's balance sheet to the NLF. Conversely, when foreign currency is sold for sterling with the result that the sterling balance is in excess of the EEA's requirements, the Treasury can decide that some reduction should be made by a transfer from the EEA to the NLF. If there is no outstanding liability at the time of a sterling transfer from the EEA to the NLF the transfer is treated as a 'capital repayment' and used to reduce the retained reserves. Capital repayments made during the year ended 31 March 2005 amounted to £0.1 billion (2003-04: £1.0 billion). The sterling transfers to and from the NLF during the year were:

	2005 £ millions	2004 £ millions
Liability to NLF at 1 April	670	30
Transfers to NLF:	(1,850)	(2,900)
- Of which capital repayments	<u>100</u>	<u>970</u>
	(1,750)	(1,930)
Transfers from NLF	<u>1,990</u>	<u>2,570</u>
Liability to NLF at 31 March	<u><u>910</u></u>	<u><u>670</u></u>

12 SDR allocation

The EEA has a liability to the IMF for those SDRs that have been allocated since the UK became a participant in the Special Drawing Rights Agreement. If the UK withdraws from participation or the Agreement is wound up, payment to the IMF would be required at current exchange rates. The SDR liability as at 31 March 2005 was £1,535 million (2004 £1,529 million).

13 Other liabilities

	2005 £ millions	2004 £ millions
Short positions in securities	484	434
Balances arising from other financial instruments:		
- Currency swaps	282	379
- Interest rate swaps	88	79
- Foreign exchange transactions	<u>110</u>	<u>205</u>
Total	<u><u>964</u></u>	<u><u>1,097</u></u>

Short positions in securities relate to the sale of bonds acquired through reverse repo transactions. All bonds are Government or other Public Sector securities listed overseas and are due in one year or over. *(The same applies to 2004).*

14 Financial instruments

Risk management and control

A detailed review of the way in which risk is managed is given in the Foreword to the accounts (paragraphs 38 to 53).

Currency risk

The table below analyses the net monetary assets of the EEA by currency. These figures have been adjusted to include the impact of derivatives used to hedge currency exposure.

These, along with fluctuations in the value of gold and the effects of certain foreign exchange derivatives, are the items that give rise to the foreign exchange gain, disclosed on the face of the Income and Expenditure statement:

	£ millions
USD	2,464
EUR	2,481
JPY	1,236
Other	3
Total	6,184

Market risk

As described in the Foreword to the accounts, Value at Risk (VaR) is the primary market risk management tool employed for the EEA. A summary of the method of calculation of VaR is given in paragraph 43. The EEA's usage of VaR during the year, (calculated at the close of business each day in USD as the primary risk currency), was as follows:

	\$ millions 2004-05	\$ millions 2003-04
VaR usage as at 31 March	6.13	3.58
Maximum VaR usage during the year	8.06	4.32
Minimum VaR usage during the year	2.47	1.54
VaR limit during the period	40.0	40.0

Maturity profile of financial assets and liabilities

The following table gives the maturity profiles of assets and liabilities held by the EEA, excluding certain items for which a maturity categorisation is not relevant (notably gold and collateral items):

Amounts falling due:	Assets £ millions	Liabilities £ millions
On demand or in 1 year or less	6,739	3,236
In more than 1 year but not more than 2 years	3,780	128
In more than 2 years but not more than 5 years	10,148	170
In more than 5 years	615	421
Total	21,282	3,955

All items are included in the category that applies to the earliest date on which liabilities may fall due.

Interest Rate Risk

Methods employed for hedging interest rate risk in the EEA are described in detail in the Foreword to the accounts (paragraphs 50). The majority of the assets and liabilities of the EEA, after taking account of the effect of derivatives that alter the interest rate risk profile of instruments, are floating rate. Indices used to set floating rates are typically current 3-month LIBOR rates.

Derivatives

The EEA uses derivatives to manage its exposure to interest rate and exchange risks in the trading portfolio. A description of the use of derivatives in 2004-05 is given in the Operating and Financial Review on pages 4 to 7. All derivative instruments are marked to market. Mark-to-market values, or fair values, are determined by reference to market rates prevailing on the date of valuation or by discounting future cash flows. The notional principal amounts of these instruments indicate the volume of transactions outstanding at the balance sheet date and are not a representation of the amount of risk.

Notional principal amounts and fair values of trading instruments entered into with third parties were as follows:

All amounts in £ millions

	2005			2004		
	Notional Principal Amounts	Fair values Assets	Fair values Liabilities	Notional Principal Amounts	Fair values Assets	Fair values Liabilities
Exchange rate contracts:						
Spot and forwards	15,587	107	(110)	10,266	254	(205)
Currency Swaps	10,960	705	(282)	11,029	745	(379)
	<u>26,547</u>	<u>812</u>	<u>(392)</u>	<u>21,295</u>	<u>999</u>	<u>(584)</u>
Interest rate contracts:						
Interest rate swaps	5,281	81	(87)	4,950	36	(79)
Interest rate futures	1,343	1	(1)	1,212	2	-
	<u>6,624</u>	<u>82</u>	<u>(88)</u>	<u>6,162</u>	<u>38</u>	<u>(79)</u>
Total	<u>33,171</u>	<u>894</u>	<u>(480)</u>	<u>27,457</u>	<u>1,037</u>	<u>(663)</u>

The maturity of the notional principal amounts and replacement cost of derivative contracts entered into with third parties is shown below. The replacement cost is the total positive fair value of derivatives after netting positive and negative fair values where there is legal right of offset.

				2005
	£ millions	£ millions	£ millions	£ millions
	Under 1 Year	1 to 5 Years	Over 5 Years	Total
Exchange rate contracts:				
- Notional Principal Amount	14,181	12,366	-	26,547
- Net replacement cost	213	208	-	421
Interest rate contracts:				
- Notional Principal Amount	2,053	4,131	440	6,624
- Net replacement cost	19	(27)	1	(7)
				2004
	<i>£ millions</i>	<i>£ millions</i>	<i>£ millions</i>	<i>£ millions</i>
	<i>Under 1 Year</i>	<i>1 to 5 Years</i>	<i>Over 5 Years</i>	<i>Total</i>
Exchange rate contracts:				
- Notional Principal Amount	10,735	10,560	-	21,295
- Net replacement cost	170	245	-	415
Interest rate contracts:				
- Notional Principal Amount	1,065	4,785	312	6,162
- Net replacement cost	(17)	(22)	(2)	(41)

As at 31 March 2005, the maximum exposure with financial institutions on cross currency and interest rate swaps, after taking account of netting agreements, was £792 million (2004: £390 million). The exposure, net of collateral held, was £109 million (2004: £23 million).

15 Retained reserves

All gains and losses are taken to retained reserves, except the notional sterling capital charge.

	2005	2004
	£ millions	£ millions
At 1 April	17,918	18,584
Capital repayments	(100)	(970)
Retained deficit for the year	(477)	(357)
Notional sterling capital charge	829	661
At 31 March	18,170	17,918

16 Reconciliation of operating deficit to net cash outflow from operating activities

	2005	2004
	£ millions	£ millions
Operating deficit	(477)	(357)
Notional sterling capital charge	829	661
Net decrease in prepayments and accrued income	11	54
Net (decrease)/increase in accruals and deferred income	7	11
Net cash inflow from trading activities	370	369
Net decrease in SDRs	7	19
Net (increase)/decrease in items in course of collection / transmission	(74)	17
Net decrease in loans and advances to banks	1,275	597
Net (increase)/decrease in debt securities	(2,561)	707
Net decrease/(increase) in gold and gold receivables	55	(196)
Net decrease/(increase) in other assets	143	(483)
Net increase/(decrease) in deposits by banks	812	(312)
Net increase/(decrease) in SDR allocation	6	(119)
Net decrease in other liabilities	(133)	(165)
Net cash (outflow)/inflow from operating activities	(100)	434

17 Analysis of the balances of cash as shown in the balance sheet

	1 April 2004	Cash flow £ millions	31 March 2005
	£ millions	£ millions	£ millions
Balance with Paymaster General	166	33	199
Balances at Central Banks	101	6	107
	267	39	306
Loans and advances to banks (Note 6) repayable on demand	4	1	5
Total	271	40	311

Accounts Direction given by HM Treasury under the Exchange Equalisation Account Act 1979¹⁰

1. The Treasury shall prepare accounts for the Exchange Equalisation Account (“the Account”) for the year ended 31 March 2001 and each subsequent financial year comprising:
 - a) A foreword
 - b) A statement of Accounting Officer’s responsibilities
 - c) A statement on the system of internal financial control¹¹
 - d) An income and expenditure account
 - e) A statement of total recognised gains and losses
 - f) A balance sheet
 - g) A cash flow statement
 - h) Notes to the accounts
2. The accounts shall give a true and fair view of the state of affairs of the Account at the balance sheet date and of its income and expenditure, total recognised gains and losses and cash flows for the year then ended. The accounts shall be prepared under the historical cost convention modified to include certain investments at valuation and in accordance with applicable accounting standards and where appropriate, although not subject to the Companies Act and technically not being the accounts of a bank, the special provisions of Schedule 9 of the Companies Act 1985 relating to banking companies and the Statements of Recommended Practice issued by the British Bankers’ Association and the Irish Bankers’ Federation.
3. The accounts shall also be consistent with relevant requirements of the Resource Accounting Manual, except to the extent set out in Appendix A and shall meet the extra information requirements set out in Appendix B.
4. This Accounts Direction shall be reproduced as an Appendix to the Accounts.

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

¹⁰ As amended by the Finance Act 2000.

¹¹ From 2001-02, a statement on the system of internal control.

Accounts Direction given by HM Treasury under the Exchange Equalisation Account Act 1979

Appendix A

APPLICATION OF THE RESOURCE ACCOUNTING MANUAL

Background

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

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

Income and expenditure account

3. Such management costs as are debited to the Account shall be disclosed on the face of the income and expenditure account as an identifiable component of other operating charges.

4. A notional cost of capital charge shall apply at a rate determined by the Treasury. The cost shall be disclosed in the income and expenditure account and credited direct to the reserve at the year-end.

5. Segmental information shall be given where appropriate, including of separate classes of business.

Balance sheet

6. Subject to paragraphs 7 to 10 below, investments shall be valued at market price or at an appropriate estimate of market or fair value.

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

8. 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.

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

10. 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

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

Accounts Direction given by HM Treasury under the Exchange Equalisation Account Act 1979

Appendix B

EXTRA INFORMATION REQUIRED TO BE DISCLOSED

1. In addition to meeting appropriate requirements of the Companies Act, the banking SORPs and the Resource Accounting Manual, the following extra information shall be disclosed, including 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, separately identifying any notional cost of capital charge;
 - 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 where appropriate.
- 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).

Glossary

Active management is the difference between actual returns and the returns which would have been achieved from a passive investment strategy.

Basis point (bp) is equal to 100th of a percentage point, e.g. 0.5% is equal to 50bp.

Benchmark is a neutral or passive investment strategy, against which actual performance is measured.

Borrowed reserves refers to part of the reserves, financed by sterling swapped into foreign currencies or foreign currency liabilities, on which currency and interest rate exposure is hedged.

Corporate commercial paper is a short-term debt issued by companies.

Custodian is a bank or other financial institution that keeps custody of assets of the EEA.

Credit risk is the risk of financial loss arising from a counterparty to a transaction defaulting on its financial obligations under that transaction.

Currency risk is the risk of financial loss arising from fluctuations in exchange rates.

Delta measures the change in the value of a portfolio for each one basis point shift in the relevant yield curve.

Derivatives are a collective name for contracts whose value is derived from the prices of another (underlying) investment. The main derivatives are futures, options, and swaps.

Euro area is the area of 12 nations which have adopted the euro as a single currency.

Forward rate agreement - a contract obligating two parties to exchange the difference between two interest rates at some future date; one rate being fixed now and the other being a rate to be fixed in the future.

Forward transaction - an agreement to pay a specific amount at a specific time in the future for a currency or financial instrument.

Futures - a contract to buy or sell a specified asset at a fixed price at some future point in time.

Gold location swap - exchange of gold stored in one location for gold stored in another location with a commitment to reverse the exchange at some specified future date.

Gold quality swap - exchange of gold of one delivery standard (purity) for gold of another delivery standard with a commitment to reverse the exchange at some specified future date.

Hedge - an asset or derivative whose market risk offsets the risk in another asset held or liability.

Interest rate risk is the risk of financial loss arising from fluctuations in interest rates.

Intervention is the purchase or sale of a currency by central banks or governments with the intention of influencing its market exchange rate.

Liquidity is the ease with which one financial claim can be exchanged for cash as a result of the willingness of third parties to transact in these assets. Liquidity risk is the risk that financial claims can only be turned into cash with a delay or at some cost, or both.

Market Risk is the risk of financial loss arising from movements in market variables such as in interest rates or exchange rates.

National Loans Fund (NLF) - the account used for most of the Government's borrowing transactions, payments of debt interest and some domestic lending transactions.

Net reserves refer to the part of the reserves where the currency and interest rate exposure is not hedged.

Operational risk is the risk of financial loss arising from failures in the transaction, settlement and resource management processes associated with reserves and liability management. This broad definition includes risks such as fraud risk, settlement risk, IT risks, legal risk, accounting risk, personnel risk and reputational risk.

Reserve Tranche Position (RTP) - the difference between the IMF's holdings of sterling and the UK's subscription (or quota) to the IMF. In effect, the amount of the UK's subscription the IMF has called. The RTP is a reserve asset as in the event of need, the UK could exchange sterling for useable foreign currencies up to the value of its RTP.

Sale and repurchase agreements (repo) - the sale of an asset with an obligation to repurchase it at a fixed price at some future date: essentially, a form of secured borrowing.

Special Drawing Rights (SDRs) – an international reserve asset created by the IMF in 1969 as a supplement to the then existing reserve assets. It is currently valued in terms of a weighted basket of four currencies (US dollar, sterling, yen and euro).

Spot transaction is an agreement to pay the prevailing market price for a currency or financial instrument for delivery usually in two days time.

Swap is a financial transaction in which two counterparties agree to exchange streams of payments occurring over time according to predetermined rules. Swaps can be used to change the currency or interest rate exposure associated with investments or liabilities.

US dollar bloc - US and Canadian dollar holdings.

Value at Risk (VaR) measures the aggregate market risk on a portfolio. VaR is an estimate of the maximum potential loss in the value of a portfolio. For example, "99% of the time losses will not exceed \$10 million over a two week period".

Yield curve plots the relationship between bonds' maturity and their yield.