

EXCHANGE EQUALISATION ACCOUNT ACT 1979

Presented to Parliament 21 July 2008

**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 2007–08

ORDERED BY THE HOUSE OF COMMONS TO BE PRINTED 21 July 2008

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## Foreword

### Introduction

1. The Exchange Equalisation Account (EEA) holds the United Kingdom's reserves of gold, foreign currency assets and International Monetary Fund (IMF) Special Drawing Rights<sup>1</sup> (SDRs). Combined with the UK's Reserve Tranche Position (RTP) at the IMF, these assets comprise the UK's official holdings of international reserves (the "official reserves"). The RTP is held in the National Loans Fund (NLF).

2. The Bank of England (the Bank) acts as the Treasury's Agent in the day-to-day management of the EEA. The Bank executes foreign exchange transactions and invests the reserves in accordance with a framework set out in a Service Level Agreement (SLA) agreed annually between the Bank and the Treasury (see paragraph 9)<sup>2</sup>.

3. The Bank also acts as the Treasury's Agent for foreign currency liability management, including the issuance of foreign currency debt to finance some of the reserves. This debt is issued by, and is an obligation of, the NLF under the National Loans Act 1968 since it is that Act (rather than the Exchange Equalisation Account Act 1979) which provides the powers for the Government to issue foreign currency securities. The foreign currency raised by issuing foreign currency debt is transferred to the EEA (see paragraph 25).

4. The Bank manages the foreign currency assets and liabilities associated with the official reserves of the NLF in conjunction with those of the EEA as the Treasury's Agent. This allows the foreign currency assets and liabilities associated with the reserves, and the risk exposures therein, to be managed collectively in an efficient way. These are the financial accounts of the EEA only, but where relevant the management commentary covers issues relating to the NLF assets and liabilities that are managed as part of the official reserves.

### Origin and Purpose

5. The EEA was established in 1932 to provide a fund that could be used, when necessary, to regulate the exchange value of sterling, and therefore is the mechanism through which any UK Government exchange rate intervention would be conducted.

6. The Government's macroeconomic framework is designed to maintain long-term economic stability. This is achieved by maintaining low and steady inflation, steady and sustainable growth and sound public finances. The framework does not entail management of the exchange rate and the UK has not intervened for the purposes of influencing the sterling exchange rate since 1992. Against this background, foreign exchange reserves are held on a precautionary basis - to meet any change in exchange rate policy in the future, if required, or in the event of any unexpected shocks. The reserves are also used to provide foreign currency services for government departments and agencies, to provide foreign exchange for making payments abroad and to buy, sell and hold SDRs as required by the UK's membership of the IMF. The Treasury's prime objective in managing the EEA on behalf of the Government is to ensure the reserves are fit for purpose in order to meet current policy objectives and any potential future changes in policy.

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<sup>1</sup> This and other terms are defined in the Glossary at the back of this document.

<sup>2</sup> A summary is included in the Debt and Reserves Management report produced by HM Treasury at the time of the Budget and available via [www.hm-treasury.gov.uk](http://www.hm-treasury.gov.uk).

7. Under the Exchange Equalisation Act 1979, 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**

8. The EEA is under the control of the Treasury, which has appointed the Bank to act as its Agent to carry out dealing in foreign currencies and the investment of the reserves. The Bank also provides advice and analysis to the Treasury on issues relating to the reserves. The Bank's management costs are charged to the EEA; these costs were £9.2million for 2007-08 (2006-07: £9.2 million).

9. An annual Service Level Agreement (SLA) between the Treasury and the Bank specifies the parameters within which the reserves are managed. There were no substantive changes to the SLA this year. The SLA specifies:

- benchmarks<sup>3</sup> which specify the currency and asset composition of the reserves;
- 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;
- a target return for active management compared to benchmark positions; and
- the programme for financing the reserves, covering the NLF's foreign currency borrowing and currency swaps out of sterling.

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

10. The Bank reports to the Treasury on size, composition and liquidity of the reserves and their continued consistency with policy objectives; investment performance; returns made and risk exposures, including those relating to active management, at a quarterly meeting chaired by the head of the Treasury's Debt and Reserves Management team. Every six months there is a meeting at which the EEA Accounting Officer (currently the Managing Director responsible for Macroeconomics and Fiscal Policy) and the Bank of England's Executive Director for Markets, or delegated senior officials, review investment performance and discuss strategic issues relating to the reserves.

### **Key performance indicators**

11. In July 2007, the Treasury agreed with the Bank a set of performance measures, to be introduced during the course of the year. The purpose of these performance measures is to provide a basket of indicators that can be used to assess the future effectiveness of the management of the EEA. The Treasury and the Bank agree that these Key Performance Indicators have been met since monitoring began.

12. The performance measures selected reflect the overall objectives for holding the reserves, as explained in detail above. The Treasury's prime objective in managing the EEA on behalf of the Government is to ensure the reserves are fit for purpose in order to meet current policy objectives and any potential future changes in policy. In support of that, the Government's objective is to preserve the liquidity and security of the reserves and to ensure that the Government maintains its capability to intervene in the foreign exchange market if required. Subject to this, the aim is to minimise the overall cost of holding the reserves, while ensuring

<sup>3</sup> Benchmark is the neutral or passive investment strategy for the reserves portfolio. Active management performance is measured against a target return over the benchmark.

exposure to financial risk is limited through the appropriate choice of portfolio and risk management practices.

13. The Treasury's role in this is to ensure that its choice for the strategic composition for the benchmark asset allocation of the reserves, including gold, meets the policy objectives set out above. Subject to meeting those objectives, the Treasury will make that benchmark asset allocation choice to trade off risk, return and liquidity in line with their risk preferences.

14. The foreign currency reserves, whilst not employed in operations to deliver on policy objectives, will be invested in assets that are liquid and secure. Specifically:

- A minimum of 90% will be held in tradeable debt securities and cash;
- A minimum of 90% will be invested in assets that are rated at least AA-;
- All assets must be investment grade.

15. The Bank will observe the limits as set out in the SLA. In line with the SLA, any substantive breaches of the limits and/or any operational errors will be reported to the Treasury as soon as possible, along with advice if necessary as to how best to deal with them. Any significant breach will be reported publicly (e.g. in the annual accounts).

16. In order to aim to at least cover costs, and to ensure the Bank maintains its capability to intervene in the foreign exchange market if required, the Bank will actively manage the EEA portfolio against the benchmark to meet the active management return target set by the Treasury (see paragraph 44 for details), whilst ensuring compliance with the limits as detailed in the SLA.

17. The Bank will ensure that all transactions related to government departments and the IMF shall be handled efficiently, accurately and in a timely fashion.

18. In carrying out its services, the Bank will as far as possible ensure that:

- its management and staff are of high repute and integrity;
- staff training and experience are appropriate for the tasks they are expected to undertake and consistent with the amount of risk they are authorised to take;
- its internal systems and controls are adequate for the size, nature and complexity of EEA operations and comply with best market practice so far as possible;
- appropriate preparations are made for possible policy deployment of the reserves (e.g. FX intervention).

19. Daily monitoring of the credit risk Key Performance Indicators in paragraph 14 was introduced during 2007.

### **Investment Policy**

20. EEA investments need to be highly liquid in order that they can be made available for use quickly, whilst minimising the costs of holding the reserves. Inevitably, these investments carry some element of credit risk. In order to reduce this risk and to ensure the necessary liquidity, the EEA predominantly holds securities issued or guaranteed by the national governments of the United States, Euro area countries and Japan.

21. The EEA is permitted to use other financial instruments, including:

- securities 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, interest rate and swap futures;
- sale and repurchase agreements;
- forward rate agreements;
- gold deposits;
- SDRs;
- deposits with, and certificates of deposits issued by, highly rated banks; and
- corporate commercial paper – no such transactions were entered into during the year.

## Management Commentary

### Hedged and unhedged reserves

22. The UK's official reserves (held in the EEA and the NLF) can be divided into two components: reserves that are hedged for currency and interest rate risk of £17.2bn, (the 'hedged reserves'); and the remaining reserves (£13.6bn) which are unhedged (the 'unhedged reserves').

23. The unhedged reserves comprise dollar and euro denominated bonds, gold, the RTP (which is part of the NLF) and yen exposure normally obtained largely through forward yen purchases. The unhedged reserves are in the main financed out of sterling through accumulated retained earnings and historic sterling financing provided by the NLF. A small element of the unhedged reserves is financed by the EEA's net SDR position.

24. The hedged reserves comprise portfolios of eligible dollar, euro and yen denominated bonds. Assets in the hedged reserves are hedged for currency risk either by being denominated in the same currency as the liabilities which finance them or by using currency swaps. The hedged reserves are also hedged against interest rate risk, through the use of swaps.

25. The hedged reserves are primarily financed either by issuing securities denominated in foreign currency or by sterling advanced from the NLF to the EEA. As explained in paragraph 3, the issuance of foreign currency securities is effected through the NLF and the resulting foreign currency proceeds are treated as being sold for sterling to the EEA, with the NLF advancing the EEA the sterling required as necessary. Where hedged reserves are financed out of sterling, the EEA uses sterling from the NLF to purchase foreign currency assets with, as noted above, asset swaps used to hedge the resulting currency and interest rate risks. The main determinant of which currency to finance out of is cost. The least cost method of financing is determined by comparing, on a swapped basis, the estimated cost of issuing bonds in foreign currency of a given maturity and nominal amount, with the cost of issuing in sterling.

26. Financing of the hedged reserves in 2007-08 included sterling swapped into foreign currencies of £10.0bn (2006-07: £10.1bn) and outstanding foreign currency securities of £1.5bn (2006-07: £1.5bn) at the end of the year. No new foreign currency securities were issued during the year (2006-07: nil).

### **Management of the official reserves**

27. As noted above, the relevant foreign currency assets and liabilities of the NLF are managed together with the EEA to enable integrated management of the overall UK official foreign exchange reserves.

28. The size of the official reserves assets that are held in the EEA rose over the course of the year by £4.2bn to £32.4bn. This increase primarily consisted of rises in the sterling value of debt securities (£1.4bn rise); gold (£1.3bn rise); and loans and advances to banks (£1.0bn rise).

29. This rise in the reserve assets in the EEA is matched largely by a rise in the liability to the National Loans Fund of £2.8bn and a rise in the marked to market value of currency swaps of £1.3bn.

30. The foreign currency elements of the total UK's official reserves are published in the monthly IMF Reserves Template<sup>4</sup>. The Template shows the net foreign currency position in the official reserves, which at end-March was the equivalent of £13.6bn. The assets and liabilities in the Template differ from those of the EEA balance sheet on page 21 of these accounts. This is for a number of reasons, but principally it is because the Template is designed to reflect the UK's foreign currency position. Therefore it includes foreign currency assets and liabilities of the NLF (notably the RTP and foreign currency debt issuance) and excludes all items denominated in domestic currency (i.e. sterling). The most significant of these are the liability of the EEA to the NLF and the valuation of the sterling leg of foreign currency forwards and currency swaps. These factors, coupled with the effects of differing accounting treatment of collateral and unsettled items, mean that gross reserve assets shown in the Template (the equivalent of £30.9bn at 31 March 2008) differ by £1.6bn from the assets held in the EEA. A reconciliation between the EEA's balance sheet and the Template is provided on page 12.

### **Benchmark asset allocation**

31. In accordance with the SLA, the Bank manages the official reserves so as to ensure adherence to Treasury policy aims and thereby maintain their liquidity and security and, subject to that, so as to minimise the cost of holding the reserves. The Bank and the Treasury agree in the SLA a series of benchmarks for the assets in which the reserves are invested. These represent the high-level asset allocation decision, reflecting the policy objectives of the reserves, and also form the benchmark against which the Bank's active management is measured.

32. In order to determine the benchmark asset allocation for the hedged reserves of the EEA, the Bank employs an asset allocation model, the parameters of which are agreed by the Treasury, which explicitly trades off liquidity and return; the model determines an asset mix that maximises expected return for given estimated levels of expected liquidation costs.

33. The Treasury also sets a benchmark for the currency allocation of the EEA's unhedged reserves excluding gold. This takes into account past patterns of risk and return, as well as

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<sup>4</sup> This can be view at: [http://www.hm-treasury.gov.uk/newsroom\\_and\\_speeches/press/press\\_index.cfm](http://www.hm-treasury.gov.uk/newsroom_and_speeches/press/press_index.cfm)

other factors such as the currencies likely to be required in any intervention. As in the previous year, in 2007-08, this benchmark was 40% US dollar; 40% euro and 20% yen.

34. Each currency bloc within the unhedged reserves 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.

35. A short-term liquidity portfolio is used to manage cash flows arising from the hedged and unhedged 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.

36. There is no benchmark for the RTP in the NLF given that there is no discretion, under IMF membership rules, to alter this holding.

### **Links between the International Monetary Fund and the official reserves**

37. The primary means of financing the IMF is through members' quotas. Each member of the IMF is assigned a quota which is payable in a combination of SDRs and 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 explained above, the UK's RTP is an asset of the NLF.

38. The IMF has periodically issued SDRs and allocated them to members in proportion to their quotas. The UK's 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.

### **Analysis of returns for the period**

39. The EEA's accounts for the year ended 31 March 2008 are given on pages 20 to 37 and show an operating surplus for the year of £2.1bn (2006-07: loss of £1.0bn). The operating surplus was driven by substantial gains made on the revaluation of gold positions (£1.3bn) and the revaluation of other currency positions (£2.3bn), this was partially offset by dealing losses of £1.1bn explained later in paragraph 43.

40. The significant exchange rate gain was driven by a substantial rise in the value against sterling of the euro (£2.1bn gain), a gain on yen (£0.3bn) and a small loss resulting from the fall in value of the US dollar (£0.1bn loss).

41. The total interest receivable from the EEA's portfolio of assets was £1.5bn (2006-07: £1.4bn). As in previous years, this consisted primarily of interest received on debt securities of £0.7bn (2006-07: £0.6bn) and sterling legs of currency swaps of £0.6bn (2006-07: £0.5bn).

42. Total interest payable of £2.0bn (2006-07: £1.8bn) led to a net interest expense of £0.5bn (2006-07: 0.4bn). The interest payable figure consisted primarily of the notional sterling capital charge for the EEA reserves of £1.3bn (2006-07: £1.0bn) and interest expense on the foreign currency legs of currency swaps of £0.4bn (2006-07: £0.4bn). The notional sterling capital charge is applied to reflect an assumed cost to the NLF of providing sterling advances to finance the reserves held in the EEA. The interest rate is set at the five-year gilt swap rate. The charge is taken through the Income and Expenditure Account for the year and subsequently added back to the Accumulated Income and Expenditure Reserve, as shown in

note 13 to the accounts. The net interest expense position reflects the fact that during the year sterling interest rates were higher, on average, than dollar, euro and yen interest rates.

43. There was a dealing loss for the year of £1.1bn (2006-07: £0.6bn gain), consisting primarily of a loss on currency swaps of £1.7bn, slightly offset by gains on debt securities of £0.5bn. The dealing profit or loss represents the marked-to-market change in value of the assets and liabilities held arising from movements in market variables. The majority of this balance arises from the revaluation of foreign currency security and currency swap positions. Dealing gains and losses exclude interest receivable and payable, and so do not represent the entire return on positions, nor do they reflect active management of the reserves. The dealing result on its own does not represent how successful dealing strategies have been as the dealing gains or losses arise in large part because of the swapping programme undertaken to hedge the currency reserves. The dealing result is therefore expected to be in the opposite direction to the revaluation gains or losses on foreign currencies. The swapping programme is explained in paragraphs 59 to 61.

44. The Treasury sets a target for active management return as part of the SLA. This target is set against the benchmark for the portfolio (as detailed above), and takes account of the limits on active management set as part of the SLA. This target is confidential for policy reasons. The return from the Bank's active management of the reserves against the benchmarks during the year was £16.1million (2006-07: £19.3 million).

45. The returns on assets held in the EEA represent the vast majority of returns on the overall official reserves. The main additional item for the official reserves is the impact of exchange rate movements between SDRs, in which the RTP is denominated, and sterling. For the current year, this generated an unrealised exchange rate gain.

### **Intervention**

46. No intervention was undertaken by the Government in the foreign exchange market during the year.

### **Provision of Foreign Currency Services to Government Departments**

47. 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 £2.7bn (2006-07: £9.9bn). These purchases and sales both spot and forward were hedged through offsetting trades with the market.

### **Risk Management and Control**

48. Although the reserves are not held primarily to make a profit, consistent with the Key Performance Indicators (see paragraphs 11 to 19), the Treasury seeks to minimise the cost of holding the foreign currency reserves whilst avoiding exposing the public purse to unnecessary risk.

49. 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

50. The key features of the control framework during the year were as follows:

- An annual Service Level Agreement (SLA) was 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 Report<sup>5</sup>.
- The Bank produced a quarterly report for the Treasury on risk controls and any breaches of the control framework.
- There is a system of financial reporting. Each month the Bank reported to the Treasury on the returns made and the market and credit risks incurred.
- The EEA Accounting Officer and the Bank's Executive Director, Markets met together with Treasury officials twice in the year to review the management of the reserves. Quarterly meetings between the Treasury's Debt and Reserves Management Team and the Bank's Foreign Exchange and Risk Management Divisions supplemented this process.
- A risk-based internal audit programme (agreed with the Treasury) that delivered reports to the Bank's Executive Director, Markets, as well as a quarterly report which is forwarded to the Treasury.
- There is an organisational structure in the Bank containing clear reporting lines. The Bank's Risk Management Division is independent of the Foreign Exchange Division where trading activities were conducted. Both the Risk Management Division and the Foreign Exchange Division report to the Bank's Executive Director, Markets. Settlements of transactions were carried out by the Customer Banking and Market Services Divisions, which report to the Executive Director, Banking Services.
- Operational Risk Officers in the Bank's Foreign Exchange and Risk Management Divisions were responsible for co-ordinating and collecting analysis on the operational risk in the Divisions.

The Bank tested its remote contingency facilities where EEA operations can be carried out in an emergency.

The limits to credit and market risk exposures are explained in the following paragraphs.

51. Credit risk: the management of the reserves involves exposure to counterparties and to the issuers of securities. 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.

52. 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 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

<sup>5</sup> Produced by HM Treasury at the time of the Budget available via [www.hm-treasury.gov.uk](http://www.hm-treasury.gov.uk).

the corresponding investments are strictly limited. The Bank receives daily reports allowing compliance with the investment limits to be checked.

53. The arrangements for custody of EEA assets in 2007-08 were as follows. US Treasury bonds and other US dollar-denominated securities were held in custody at either the Federal Reserve Bank of New York or at JP Morgan Chase Bank NA. Euro denominated securities were held in custody at State Street Bank and Trust Company. Japanese government bonds were held in custody at the Bank of Japan. Other yen denominated bonds were held at JP Morgan Chase. The gold bars and gold coin in the reserves were stored physically at the Bank's premises.

54. 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.

55. The Bank measures the VaR on active management positions on a daily basis. Estimates of the VaR arising from the choice of benchmark asset allocation are also produced, and reported to the Treasury on a regular basis. The Bank undertakes regular back-testing of the VaR model. The Bank also measures the delta exposures on active management positions. Delta measures the change in value of the portfolio for each one basis point shift in the relevant yield curve.

56. 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**

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

58. The Treasury's financing of the hedged foreign currency reserves, whether through borrowing directly in foreign currency or by engaging in foreign currency swaps out of sterling (see paragraph 25), was done in a way that minimised the exposure to fluctuations in the value of currencies.

59. Where financing was through foreign currency borrowing with assets hedged into the currency of the liability, 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.

60. 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.

61. 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 securities, the interest rate risk was controlled by entering into interest rate swaps on both the EEA assets and the NLF foreign currency securities. 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.

62. 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 unhedged 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. During the year 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.

63. The Treasury may decide, with advice from the Bank, to set deviations from the 40:40:20 currency benchmark or the interest rate benchmarks (which are denoted 'strategy positions'). No currency benchmark deviations were set and no strategy positions were taken during the year. 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 the year.

64. Under the SLA, the Bank actively managed the hedged and unhedged reserves, in order to improve the return. The Treasury sets the Bank a VaR limit for active management relative to benchmarks, with the VaR being calculated at close of business each day. In 2007-08 the VaR limit for active management was reduced from US\$40 million to US\$20 million. This decision was taken because VaR usage has been substantially below the VaR limit in recent years. During the year the Bank's use of VaR did not exceed US\$4.35 million. The average use of VaR during the year was US\$3.31 million and the lowest VaR usage at the end of any one day was US\$2.09million.

65. During the year, the Treasury agreed with the Bank on a number of actions in order to better align the risks to which the EEA is exposed with the Treasury's risk preferences, responding to changed perceptions of risk as a consequence of market turbulence.

### **Accounting Policies**

66. The accounts of the EEA for the year are drawn up in accordance with the Accounts Direction, reproduced at Annex A (on page 38) to this report, which reflects UK GAAP and the Companies Act as far as appropriate. Detailed accounting policies are provided in the notes to the accounts.

*David Ramsden*  
Accounting Officer

HM Treasury  
15 July 2008

## Reconciliation of EEA Balance Sheet to IMF Reserves Template

As at 31 March 2008	Unaudited £ millions	Unaudited \$ millions
<b>Total assets per EEA balance sheet</b>	<b>32,442</b>	
Add Reserve Tranche Position in NLF	561	
<i>Adjustments to reflect IMF Reserves Template presentation:</i>		
Deduct cash collateral and derivatives	(778)	
Reclassification between assets and liabilities	(1,123)	
Other adjustments	(230)	
<b>Sterling total assets using Template presentation</b>	<b>30,872</b>	
<b>Dollar equivalent per Template</b>		<b>61,354</b>
<b>Total liabilities per EEA balance sheet</b>	<b>32,442</b>	
Eliminate EEA's Liability to NLF (see note 13)	(24,857)	
Add NLF issued debt	1,533	
<i>Adjustments to reflect IMF Reserves Template presentation:</i>		
Add foreign currency liability on FX trades and swaps	11,381	
Deduct cash collateral and derivatives	(2,179)	
Reclassification between assets and liabilities	(1,123)	
Other adjustments	38	
<b>Sterling total liabilities using Template presentation</b>	<b>17,235</b>	
<b>Dollar equivalent per Template</b>		<b>34,253</b>
<b>Net assets per Template</b>	<b>13,637</b>	<b>27,101</b>

*Conversion rate into US dollars is 1.9874 as at close 31 March 2008*

## 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 the Managing Director of Macroeconomic and Fiscal Policy 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 Chapter 3 of "Managing Public Money". The Accounting Officer's Statement on Internal Control can be found on page 14.

## **Statement on Internal Control**

### **1. Scope of responsibility**

1.1 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 'Managing Public Money'.

1.2 The management of the EEA is divided between the Treasury and the Bank of England (the Bank). The EEA is under the control of the Treasury. The Bank is the Treasury's Agent and is responsible for the day-to-day management of the EEA, within the framework set by the Treasury. The Debt and Reserves Management (DRM) team at the Treasury has oversight of the Bank's EEA operations and agrees an Annual Service Level Agreement (SLA) with the Bank that 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. The Exchequer Funds and Accounts (EFA) Team at the Treasury reports directly to me on operational risk issues and works closely with the Bank to produce the annual accounts.

### **2. The purpose of the system of internal control**

2.1 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 has been in place throughout the year ended 31 March 2008 and up to the date of approval of the annual report and accounts, and accords with Treasury guidance.

### **3. Capacity to handle risk**

3.1 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.

3.2 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 and control improvements implemented. Control improvements and responses to control failures are summarised in the quarterly Turnbull (Risk) report from the Bank to DRM described below.

3.3 At the Treasury, specific DRM and EFA staff are trained in risk appraisal and management. Job instructions are maintained for time and business-critical tasks.

#### 4. The risk and control framework

4.1 Within the Bank, risk analysis and measurement is undertaken by the Risk Management Division, which is independent from the Foreign Exchange Division where transactions are executed. Both the Risk Management and Foreign Exchange Divisions are independent from the Banking Services Directorate where the transactions are settled.

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

- Monthly financial reporting detailing, on a management accounting basis, the returns made with respect to the management of the EEA and the market and credit risks incurred.
- The Bank's Executive Director for Markets provides the Accounting Officer with a quarterly assurance that the processes and framework in place are sufficient to identify current and future sources of material risk and meet the Turnbull requirements. It also states that it is evidence which can be relied upon in making this Statement on Internal Control. In addition, the Treasury are provided with quarterly management reports on risk issues and the Bank's compliance with the guidance issued by the Turnbull Report. 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.
- EFA considers and discusses the information provided with the Bank and Exchequer Funds Internal Audit and provides the Accounting Officer with quarterly reports that highlight the key risks.
- The Bank's Internal Audit Division conducts an agreed internal audit programme as part of the SLA. The Bank's Executive Director for Markets forwards to the Accounting Officer the Internal Audit quarterly reports on this activity.
- Exchequer Funds Internal Audit provides an independent and objective opinion to the Accounting Officer on risk management, control and governance of the EEA. Assurance is provided following reviews of relevant Bank Internal Audit reports and EFA's oversight of the Bank's work, as agreed by the Accounting Officer and the Exchequer Funds Audit Committee. Exchequer Funds Internal Audit's reviews aim to measure and evaluate the effectiveness of the Treasury in achieving their agreed objectives in respect of the EEA. Exchequer Funds Internal Audit also review EFA's quarterly report to the Accounting Officer (mentioned above).
- Bank and Treasury officials met quarterly to review performance against the parameters set out in the SLA and to consider wider operational and policy issues. Additionally the Accounting Officer and the Bank's Executive Director for Markets held half yearly meetings to discuss overall strategy and governance issues.

- Bank accountancy professionals produce the financial accounts on behalf of the Treasury using Bank IT systems. EFA liaise with the Bank and DRM to produce the annual accounts. The Treasury Accountant (EFA Team Leader) reviewed and approved the 2007-08 financial accounts and the foreword to the accounts.
- The Treasury agreed with the Bank on a number of actions in order to better align the risks to which the EEA is exposed with the Treasury's risk preferences, responding to changed perceptions of risk as a consequence of market turbulence.
- DRM undertook co-ordinated contingency site tests with the Bank in 2007-08.

4.3 The Exchequer Funds Audit Committee is responsible for supporting me as Accounting Officer in matters relating to oversight of the governance, internal control and risk management processes. The Exchequer Funds Audit Committee performs this role for the Accounting Officers of each of the Exchequer Funds, which are the Debt Management Account, Public Works Loan Board, Commissioners for the Reduction of the National Debt, Exchange Equalisation Account, National Loans Fund, Consolidated Fund and the Contingencies Fund. Members of the Committee are appointed for periods of up to three years, extendable by no more than one additional three-year period. The Chair of the Committee reports directly to me. The current membership of the Committee is:

- Colin Price, Chair, non-executive member of the Debt Management Office's Managing Board, until December 2006 Chair of the Lord Chancellor's Strategic Investment Board and formerly Global Pension Fund Adviser/Finance Director at Shell Pensions Management Services Limited;
- Brian Larkman, non-executive member of the Debt Management Office's Managing Board and formerly Global Head of Money Markets at the Royal Bank of Scotland PLC; and
- Mark Clarke, until June 2008 Director General - Finance & Strategy at the Department for Business, Enterprise and Regulatory Reform.

#### **Planned action for 2008-09**

4.4 The Bank and the Treasury will continue to review and develop the control environment. This will include implementing recommendations made by routine audit reports.

### **5. Review of effectiveness**

5.1 As Accounting Officer, I have responsibility for reviewing the effectiveness of the system of internal control. My review is informed by the work of Exchequer Funds Internal Audit and Bank Internal Audit, who both provided positive assurance as to the management and control of the EEA in 2007-08 and the executive managers within DRM, EFA and in the Bank, 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 Exchequer Funds Audit Committee and risk owners in addressing weaknesses and ensuring continuous improvement of the system is in place. The Exchequer Funds Audit Committee considered the 2007-08 accounts in draft and provided me with its views before I formally signed the accounts.

5.2 In my assessment, the system of internal control was effective with no significant control events identified in 2007-08.

*David Ramsden*  
Accounting Officer

HM Treasury  
15 July 2008

## **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 Exchange Equalisation Account for the year ended 31 March 2008 under the Exchange Equalisation Account Act 1979 (as amended by the Finance Act 2000). These comprise the Income and Expenditure Account, the Balance Sheet, the Cash Flow Statement and the related notes. These financial statements have been prepared under the accounting policies set out within them.

### **Respective responsibilities of the Accounting Officer and auditor**

The Accounting Officer is responsible for preparing the Foreword and the financial statements in accordance with the Exchange Equalisation Account Act 1979 (as amended by the Finance Act 2000) and HM Treasury directions made thereunder and for ensuring the regularity of financial transactions. These responsibilities are set out in the Statement of the Accounting Officer's Responsibilities.

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

I report to you my opinion as to whether the financial statements give a true and fair view and have been properly prepared in accordance with the Exchange Equalisation Account Act 1979 (as amended by the Finance Act 2000) and HM Treasury directions made thereunder. I report to you whether, in my opinion certain information in the Annual Report, which comprises an Introduction, the Origin and Purpose of the Account, Administration and Control, Investment Policy, Management Commentary and Risk Management and Control is consistent with the financial statements. I also report whether, all material respects, the expenditure and income have been applied to the purposes intended by Parliament and the financial transactions conform to the authorities which govern them.

In addition I report to you if the Accounting Officer has not kept proper accounting records, if I have not received all the information and explanations I require for my audit, or if information specified by relevant authorities is not disclosed.

I review whether the Statement on Internal Control reflects compliance with HM Treasury's guidance, and I report if it does not. I am not required to consider whether this statement covers all risks and controls, or form an opinion on the effectiveness of the Exchange Equalisation Account's corporate governance procedures or its risk and control procedures.

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

### **Basis of audit opinion**

I conducted my audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. My audit includes examination, on a test basis, of evidence relevant to the amounts, disclosures and regularity of financial transactions included in the financial statements. It also includes an assessment of the significant estimates and judgments made by the Accounting Officer in the preparation of the financial statements, and of whether the accounting policies are most appropriate to the Exchange Equalisation Account's circumstances, consistently applied and adequately disclosed.

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

## **Opinions**

### **Audit Opinion**

In my opinion:

- the financial statements give a true and fair view, in accordance with the Exchange Equalisation Account Act 1979 (as amended by the Finance Act 2000) and directions made thereunder by HM Treasury, of the state of the Exchange Equalisation Account's affairs as at 31 March 2008 and of its surplus for the year then ended; and
- the financial statements have been properly prepared in accordance with the Exchange Equalisation Account Act 1979 (as amended by the Finance Act 2000) and HM Treasury directions made thereunder; and
- information given within the Annual Report, which comprises an Introduction, the Origin and Purpose of the Account, Administration and Control, Investment Policy, Management Commentary and Risk Management and Control is consistent with the financial statements.

### **Audit 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 conform to the authorities which govern them.

## **Report**

I have no observations to make on these financial statements.

*TJ Burr  
Comptroller and Auditor General  
National Audit Office  
151 Buckingham Palace Road  
Victoria  
London  
SW1W 9SS  
17 July 2008*

## Income and Expenditure Account

### For the year ended 31 March:

	Notes	2008 £ millions	2007 £ millions
Interest receivable and similar income arising from debt securities	2	668	613
Other interest receivable and similar income	2	849	792
Notional sterling capital charge	13	(1,250)	(1,036)
Interest payable	3	<u>(751)</u>	<u>(782)</u>
Net interest expense		<b>(484)</b>	<b>(413)</b>
Fees and commissions		(1)	(1)
Dealing (losses) / profits	4	(1,084)	568
Gains on revaluation of gold		1,319	18
Exchange gains / (losses) on foreign currencies	5	2,323	(1,179)
Management charge	6	<u>(9)</u>	<u>(9)</u>
<b>Surplus / (deficit) on ordinary activities</b>		<b><u>2,064</u></b>	<b><u>(1,016)</u></b>
<b>Surplus / (deficit) for the financial year</b>	13	<b><u><u>2,064</u></u></b>	<b><u><u>(1,016)</u></u></b>

All income and expenditure arose from continuing operations.

There are no recognised gains and losses other than those included above.

The notes on pages 23 to 37 form an integral part of these accounts.

## Balance Sheet

### As at 31 March:

	Notes	2008 £ millions	2007 £ millions
<b>Assets</b>			
Cash and balances at central banks and Paymaster General	19	778	170
Holdings of IMF SDRs		176	192
Settlement balances		284	518
Treasury bills	7	475	111
Loans and advances to banks	8	3,477	2,512
Debt securities	9	21,485	20,086
Gold and gold receivables	10	4,686	3,365
Other financial assets	11	775	1,030
Prepayments and accrued income		306	246
<b>Total assets</b>		<b>32,442</b>	<b>28,230</b>
<b>Liabilities</b>			
Settlement balances		403	454
Deposits by banks	12	3,024	3,369
SDR allocation	14	1,583	1,473
Other financial liabilities	15	2,560	890
Accruals		15	26
Liability to the National Loans Fund	13	24,857	22,018
<b>Total liabilities</b>		<b>32,442</b>	<b>28,230</b>

The notes on pages 23 to 37 form an integral part of these accounts.

David Ramsden  
Accounting Officer

HM Treasury  
15 July 2008

## Cash Flow Statement

**For the year ended 31 March:**

	Notes	2008 £ millions	2007 £ millions
<b>Net cash inflow from operating activities</b>	18	1,081	187
<i>Financing:</i>			
Net outflow from National Loans Fund	13	(475)	(200)
<b>Increase / (decrease) in cash in the year</b>	19	<b>606</b>	<b>(13)</b>

The notes on pages 23 to 37 form an integral part of these accounts.

## Notes to the Accounts

### 1 Accounting policies

#### Basis of accounting

These accounts have been prepared in accordance with the Accounts Direction, reproduced in the Annex to this report, and according to United Kingdom Generally Accepted Accounting Principles 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.

These accounts apply FRS29 (Financial Instruments: Disclosures), excluding the disclosures pertaining to Appendix E (capital disclosures) which are not considered relevant to this entity and are specifically excluded from the Accounts Direction.

These accounts are prepared on a trade date basis and all assets and liabilities are recognised on their trade dates.

#### Recognition of financial assets and financial liabilities

The EEA is managed on an homogeneous basis, and although the reserves are not held primarily to make a profit, the Treasury seeks to minimise the cost of holding the foreign currency reserves whilst avoiding exposing the public purse to unnecessary risk. As a result, the financial assets and liabilities of the EEA are all “held for trading”, in accordance with the definition of FRS 26, and therefore all financial assets and liabilities are held at fair value with gains and losses being taken through the Income and Expenditure Account. There have been no reclassifications of financial instruments during the year.

Financial assets and liabilities are recognised at fair value. Details are given below of the methodologies used to revalue different instrument classes.

#### Interest receivable and payable

Interest receivable and payable on financial instruments that are held for trading is accrued on a straight line basis.

A notional sterling capital charge is included within the Income and Expenditure Account. 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 the Accumulated Income and Expenditure Reserve (see note 13). The charge is a requirement of the Accounts Direction set out in Annex A of this report.

#### 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, by the EEA, in the form of SDRs and is recognised in these accounts as interest receivable. Interest is paid on the EEA’s SDR Allocation. All SDR remuneration is accounted for on an accruals basis.

**Exchange gains on foreign currencies**

The accounts of the EEA have been presented in sterling. Transactions denominated in foreign currencies are recorded in sterling at the rates of exchange applicable on the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are subsequently retranslated into sterling at the rates of exchange prevailing on the balance sheet date. Resulting exchange differences are recognised in the Income and Expenditure Account within exchange gains on foreign currencies.

**Dealing profits**

Dealing profits includes unrealised gains and losses resulting from changes in the fair value of the portfolio and realised gains and losses on disposal or maturity. Included within dealing profits are the gains and losses on foreign exchange trading, when denominated in the currencies of the transaction involved. Subsequent gains or losses on translation into sterling for reporting purposes are included within exchange gains and losses on foreign currencies.

**Fees and commissions**

Fees and commissions are recognised in the Income and Expenditure Account as incurred.

**Debt securities**

All debt securities are held for trading purposes and are reported at fair value. Debt securities are initially recognised at cost, as the best estimate of fair value and are subsequently revalued to their market price daily. Changes in the fair value of debt securities are recognised in the Income and Expenditure Account, within dealing profits, when they arise.

The majority of bonds are valued directly by reference to published price quotations from trade date. Other bonds and certificates of deposit are valued using a discounted cash flow valuation technique. All inputs into this pricing model are externally sourced and assumptions used are supported by observable market prices. Bonds and certificates of deposit are priced at bid prices.

**Treasury bills**

Treasury bills are held for trading purposes and are reported at fair value. Treasury bills are initially recognised at cost, as the best estimate of fair value and are subsequently revalued to their market price daily. Changes in the fair value of treasury bills are recognised in the Income and Expenditure Account, within dealing profits, when they arise.

Treasury bills are valued directly by reference to quoted bid prices.

**Loans and advances**

Loans and advances are initially recorded at the cost of funds advanced and are then revalued using a discounted cash flow valuation technique. All inputs into the pricing model are externally sourced and assumptions used are supported by observable market prices. Loans and advances are marked to bid prices.

**Repurchase (repo) and reverse repurchase (reverse 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. Repos and reverse repos are marked to bid or offer prices, as appropriate.

Repurchase and reverse repurchase agreements are initially recognised at cost as the best estimate of fair value and subsequently revalued daily. These are valued using a discounted cash flow valuation technique. All inputs into the pricing model are externally sourced and assumptions used are supported by observable market prices.

### **Gold**

Gold holdings and gold assets on deposit, although not falling within the definition of financial instruments, are held at fair value and changes in the market value of gold assets are recognised in the Income and Expenditure Account when they arise.

### **International Monetary Fund Special Drawing Rights (SDRs)**

SDRs are an international reserve asset created by the IMF. These consist of a weighted basket of the US dollar, euro, yen and sterling. SDR exchange rates are published by the IMF and SDRs are recognised on the balance sheet at their closing sterling value.

### **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 either determined by reference to quoted market prices, or by using internal models where no market price is readily obtainable. All inputs into the pricing models are externally sourced and assumptions used are supported by observable market prices. Derivatives are marked to bid or offer prices, as appropriate.

Derivatives with positive fair values are recognised on the balance sheet within other assets. Derivatives with negative fair values are included within other liabilities.

Interest receipts and payments relating to derivative transactions are recognised in the Income and Expenditure Account within interest income or interest payable (as appropriate) as they are incurred. The receipt or payment of interest on a derivative will affect the fair value of the derivative, with change in fair value being recognised within dealing profits. It is therefore appropriate to consider interest income, interest expense and dealing profits or losses on derivatives when considering the total return on these transactions.

**2 Interest receivable and similar income**

	2008 £ millions	2007 £ millions
<b>Interest receivable and similar income arising from debt securities:</b>	<u>668</u>	<u>613</u>
<b>Other interest receivable and similar income:</b>		
Nostro Accounts	9	-
Currency swaps	644	514
Interest rate swaps	112	141
Money market deposits	23	72
Reverse repos	47	41
Reserve Tranche Position	1	13
Special Drawing Rights	7	7
Securities lending	6	4
<b>Sub-total</b>	<u>849</u>	<u>792</u>
<b>Total</b>	<u>1,517</u>	<u>1,405</u>

**3 Interest payable**

	2008 £ millions	2007 £ millions
Currency swaps	421	391
Interest rate swaps	154	174
Repos	95	114
SDR allocation	56	58
Interest on short positions in bonds	16	24
Interest on cash collateral taken	9	21
<b>Total</b>	<u>751</u>	<u>782</u>

**4 Dealing (losses)/profits**

	2008 £ millions	2007 £ millions
Currency swaps	(1,675)	619
Debt securities	536	66
Interest rate swaps	36	33
Other instruments	2	1
Futures	-	(3)
Foreign exchange transactions	17	(148)
<b>Total</b>	<u>(1,084)</u>	<u>568</u>

All dealing losses relate to financial instruments that are held for trading purposes.

## 5 Exchange gains / (losses) on foreign currencies

The EEA's accounts are presented in sterling. A gain or loss equivalent to the change in the sterling value of a foreign currency asset or liability, from the date of recognition of the position (or the previous balance sheet date, if earlier) to the current balance sheet date, is incurred on translation. For the current year there was a translation gain of £2,323 million (2006-07: £1,179 million loss).

Gains and losses relating to trades in foreign currency are included within dealing profits.

## 6 Management charge

The management charge of £9.2 million represents the cost of the Bank of England's management of the EEA during the year (2006-07: £9.2 million).

## 7 Treasury and other eligible bills

	2008	2007
	£ millions	£ millions
Maturing in not more than 3 months	261	100
Maturing in 1 year or less but over 3 months	<u>214</u>	<u>11</u>
<b>Total</b>	<b><u>475</u></b>	<b><u>111</u></b>

## 8 Loans and advances to Banks

	2008	2007
	£ millions	£ millions
Repayable on demand	1	3
Repayable in not more than 3 months	3,432	2,509
Repayable in 1 year or less but over 3 months	<u>44</u>	<u>-</u>
<b>Total</b>	<b><u>3,477</u></b>	<b><u>2,512</u></b>

Of which, reverse repo transactions are: 3,476 1,120

Collateral with a carrying value of £3.5bn (2006-07: £1.1bn) is held in respect of reverse repo transactions. Cash collateral held is recognised within Deposits by Banks (see note 12). Other collateral held is not recognised by the EEA. The EEA is permitted under the terms of its reverse repo transactions to sell debt securities held as collateral. The carrying amount of short positions in debt securities arising as a result of selling collateral held is given in note 15.

**9 Debt securities**All amounts in £  
millions

	2008			2007		
	Listed overseas	Unlisted	Total	Listed overseas	Unlisted	Total
<b>Issued by Public Bodies:</b>						
Government Securities	16,890	-	16,890	13,763	-	13,763
Other Public Sector	3,387	177	3,564	1,683	162	1,845
	<u>20,277</u>	<u>177</u>	<u>20,454</u>	<u>15,446</u>	<u>162</u>	<u>15,608</u>
<b>Other Issuers:</b>						
Bank and building society certificates of deposit	1,031	-	1,031	4,478	-	4,478
	<u>1,031</u>	<u>-</u>	<u>1,031</u>	<u>4,478</u>	<u>-</u>	<u>4,478</u>
<b>Total</b>	<u>21,308</u>	<u>177</u>	<u>21,485</u>	<u>19,924</u>	<u>162</u>	<u>20,086</u>
<b>Amounts maturing:</b>						
Within less than one year			3,839			5,401
In one year and over			17,646			14,685
<b>Total</b>			<u>21,485</u>			<u>20,086</u>

**10 Gold and gold receivables**

	2008 £ millions	2007 £ millions
Gold stock	4,596	3,300
Gold deposits maturing in:		
Not more than 3 months	60	43
1 year or less but over 3 months	30	22
<b>Total</b>	<u>4,686</u>	<u>3,365</u>

Three gold deposit trades were undertaken during the year (2006-07: 3), all of which were outstanding at the year-end. No gold swaps were entered into (2006-07: nil). There were no changes in the quantity of gold owned by the EEA in 2007-08 or in 2006-07.

**11 Other financial assets**

	2008 £ millions	2007 £ millions
Margin accounts	1	5
Balances arising from other financial instruments:		
- Currency swaps	32	644
- Interest rate swaps	33	49
- Foreign exchange transactions	709	332
<b>Total</b>	<u>775</u>	<u>1,030</u>

A maturity analysis of derivatives classified within 'Other financial assets' is provided in note 16.

## 12 Deposits by Banks

Deposits by banks consists of repo transactions and cash collateral held by the EEA.

All amounts in £ millions

Maturing in:	2008			2007		
	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	2,894	38	2,932	2,968	36	3,004
Cash collateral received	92	-	92	365	-	365
	<u>2,986</u>	<u>38</u>	<u>3,024</u>	<u>3,333</u>	<u>36</u>	<u>3,369</u>

There were no deposits by banks repayable on demand as at 31 March 2008 (2007: nil).

The EEA pledges collateral to counterparties in repo transactions. Collateral pledged remains on the balance sheet of the EEA within Debt Securities. The total carrying amount of collateral pledged as at 31 March 2008 was £2.8bn (2007: £2.9bn).

## 13 Liability to the National Loans Fund

There are two elements of the Liability to the NLF: a specific liability, recognised in accordance with the National Loans Act (1968) of £1.3bn (2007: £1.8bn) that represents the balance of advances made by the NLF and not repaid; and a separate amount that represents the EEA's total assets, less recognised liabilities. This second element consists of the Capital Contribution Reserve and the Accumulated Income and Expenditure Reserve.

The EEA is funded by central government through the NLF. Over time, the NLF has advanced sterling to the EEA in order to finance the reserves. Similarly, the NLF has issued foreign currency securities in order to raise foreign currency finance that is subsequently transferred to the EEA. As a result, the EEA's net assets, having been derived from initial NLF financing, are considered to be an amount ultimately due to the NLF, and are recognised as such on the balance sheet. If a policy decision is taken to reduce the assets of the EEA, the sterling excess raised via sale of foreign currency assets would be paid to the NLF, at the direction of the Treasury.

### Specific liability to the NLF

The specific element of the liability to the NLF, described in the National Loans Act (1968), is the mechanism through which the EEA's day to day sterling cash flows are managed.

The sterling balance held by the EEA at the Paymaster General is maintained within a range, agreed by management. When the balance falls below the minimum level, 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 of the EEA 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 specific liability to the NLF at the time of a sterling transfer from the EEA to the NLF, then the transfer is treated as a 'capital repayment' and is used to reduce the Capital Contribution Reserve. The effect on the combined liability to the NLF, recognised in the balance sheet, is identical.

The remainder of the liability to the NLF consists of the Capital Contribution Reserve and the Accumulated Income & Expenditure Reserve. These items are described in detail below.

### Capital Contribution Reserve

When UK GAAP compliant accounts were prepared for the first time for the EEA, being for the year ended 31 March 2001, an amount equivalent to the total recognised assets, less liabilities, less the balance on the specific liability to the NLF in the opening balance sheet of that year, was taken to be the opening balance for the Capital Contribution Reserve. The amount of the Capital Contribution Reserve is periodically reduced, as explained above, 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.

### Accumulated Income & Expenditure Reserve

All gains and losses of the EEA, since UK GAAP compliant accounts were first prepared in 2001, have been taken to the Accumulated Income and Expenditure Reserve, except the notional sterling capital charge. As described in the interest receivable and payable accounting policy in note 1, the notional sterling capital charge is charged to the Income & Expenditure Account and subsequently credited to the Accumulated Income & Expenditure Reserve.

The following table shows the movements in each of the elements described above, and the overall liability to the NLF, during the year.

All amounts in £ millions	Accumulated I&E Reserve	Capital Contribution Reserve	Specific liability to the NLF	2008 Overall liability to the NLF
Balance at 1 April 2007	7,306	12,907	1,805	22,018
Transfers from the NLF	-	-	1,125	1,125
Repayments to the NLF	-	-	(1,600)	(1,600)
Surplus for the year	2,064	-	-	2,064
Notional sterling capital charge	1,250	-	-	1,250
Balance at 31 March 2008	<b>10,620</b>	<b>12,907</b>	<b>1,330</b>	<b>24,857</b>

<i>All amounts in £ millions</i>	<i>Accumulated I&amp;E Reserve</i>	<i>Capital Contribution Reserve</i>	<i>Specific liability to the NLF</i>	<i>2007 Overall liability to the NLF</i>
<i>Balance at 1 April 2006</i>	7,286	12,907	2,005	22,198
<i>Transfers from the NLF</i>	-	-	2,500	2,500
<i>Repayments to the NLF</i>	-	-	(2,700)	(2,700)
<i>Surplus for the year</i>	(1,016)	-	-	(1,016)
<i>Notional sterling capital charge</i>	1,036	-	-	1,036
<i>Balance at 31 March 2007</i>	<u>7,306</u>	<u>12,907</u>	<u>1,805</u>	<u>22,018</u>

#### 14 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 2008 was £1.6bn (2007: £1.5bn).

#### 15 Other financial liabilities

	2008 £ millions	2007 £ millions
Short positions in securities	475	450
Balances arising from other financial instruments:		
- Currency swaps	1,340	42
- Interest rate swaps	13	47
- Foreign exchange transactions	732	348
- Futures	-	3
<b>Total</b>	<u>2,560</u>	<u>890</u>

Short positions in securities relate to the sale of bonds acquired as collateral through reverse repo transactions (see note 8). All bonds are government or other public sector securities listed overseas (*the same applied to 2006-07*). The maturity analysis of short positions in securities is given below:

	2008 £ millions	2007 £ millions
<b>Amounts maturing:</b>		
In one year and over	475	450
<b>Total</b>	<u>475</u>	<u>450</u>

#### 16 Risk management and control

A detailed review of the risks to which the EEA is exposed, how these risks arise and how they are managed is given in the Foreword. The Foreword also details management's objectives and policies for managing risks.

Quantitative data is given below in respect of the financial risks faced by the EEA, the most relevant of which are considered to be market and credit risk. In each case, the data provided reflects the year end position unless stated otherwise.

Derivative transactions entered into by the EEA are documented under market-standard Master Legal Agreements with counterparties. Swaps transactions are governed by the ISDA Master Agreement. Foreign exchange transactions are governed either by the ISDA Master or by the BBA International Foreign Exchange Master Agreement (IFEMA). Repo and reverse repo transactions are governed by the PSA/ISMA Global Master Repo Agreement (GMRA).

### **Market risk**

Market risk is the risk arising from exposure to movement on market variables. The main market variables to which the EEA is exposed are interest rates and exchange rates. The risks arising from each of these factors, and how those risks are managed, are detailed below. Further details are also provided in the Foreword.

The benchmark asset allocation for the reserves is determined by the Treasury given the EEA's policy objectives. VaR is the primary market risk management tool employed in relation to the active management of the EEA against these benchmarks. A summary of the method of calculation of VaR is given in the Foreword in paragraphs 54 and 55. Active management usage of VaR during the year, (calculated at the close of business each day in US dollars), was as follows:

	\$ millions	<i>\$ millions</i>
	2008	2007
VaR usage as at 31 March	2.11	3.30
Maximum VaR usage during the year	4.35	4.92
Minimum VaR usage during the year	2.09	2.24
VaR limit during the year	20.0	40.0

### **Interest Rate Risk**

Methods employed for hedging interest rate risk in the EEA are described in detail in the Foreword. 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.

### **Foreign Exchange Risk**

As explained in the Foreword, the official reserves (i.e. reserves of the EEA plus those foreign currency assets and liabilities of the NLF that are managed together with the EEA) can be divided into two categories; the reserves that are hedged for foreign exchange and interest rate risk (the 'hedged' reserves) and those reserves that are not hedged for foreign exchange and interest rate risk (the 'unhedged' reserves).

Assets and liabilities in the hedged reserves are funded by either: sterling swapped into foreign currency, via asset swap packages; or through foreign currency issuances on the NLF. In either of these cases, the future cashflows from the assets invested in are swapped back into the currency and interest rate profile of the originating liability. Any residual foreign exchange risk is immaterial.

Assets and liabilities in the unhedged reserves are held in a benchmark foreign currency allocation of 40% US dollar; 40% Euro and 20% Yen. This is a structural benchmark position and reflects Treasury investment policy. Further detail on the policy processes for determining benchmark asset allocations is given in the Foreword.

## Credit risk

The reserves are exposed to credit risk through exposures to counterparties and to the issuers of securities. Details of the risk management processes undertaken to limit this exposure to credit risk, and to ensure the creditworthiness of counterparties and issuers, is provided in the Foreword.

The changes in value of any instruments held by the EEA resulting from changes in credit quality are immaterial because of the high credit quality of all counterparties and issuers.

## Credit Risk Limits and Measurement

The creditworthiness of 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 (CRAC). Credit risk is controlled by counterparty and issuer limits and collateralisation. Exposure to issuers and counterparties is monitored against limits in real time. Counterparty credit limits are set in terms of "Credit Equivalent Amounts". In the case of derivatives contracts, exposure is measured as the marked-to-market value plus an estimate of the potential future exposure calculated using a parametric approach and volatility and correlation data. Limits are set for both individual entities and groups of related entities, and on certain instruments traded. In addition, there are limits to contain the overall exposure to each relevant country's banking sector. Limits are also set on the maturity of unsecured deposits with counterparties. A report of any limit excesses is sent to the Treasury each month.

The majority of the EEA is invested in high quality sovereign bonds or highly rated commercial counterparties. There are no significant concentrations of credit risk to issuers or counterparties.

### Other risk mitigation policies

In addition to the use of credit limits, exposure to credit risk is managed through other mitigation measures, as outlined below:

#### a) Netting Agreements

The EEA's exposure to credit losses is restricted by entering into master netting arrangements with counterparties. Netting agreements normally incorporate collateral terms, including provision for additional margin to be called in response to changes in market values of underlying transactions.

#### b) Collateral

For funds advanced under reverse repo, the EEA takes collateral in the form of high quality securities, which must be of a type that the EEA is authorised to hold as an investment.

For interest rate and cross currency swaps and forward foreign exchange transactions transacted under ISDA Master Agreements, collateral can take the form of US Dollar denominated cash or high quality securities.

At 31 March 2008, credit exposure to issuers stood at £20.8bn (2007: 15.5bn). Net credit exposure to counterparties stood at £1.5bn (2007: £7.3bn). £6.4bn (2007: £4.4bn) of collateral was held. The EEA is fully collateralised within its margin arrangements.

## c) Settlement processes

Wherever possible, trades are settled as Delivery versus Payment, with simultaneous exchange of cash and stock, or settlement whereby the EEA receives cash or stock from the counterparty before delivering stock or cash in return.

Settlement limits are used to control FX settlement risk.

**Liquidity risk**

The funding structure of the EEA and the EEA's relationship with the NLF is described in detail in the Foreword. As described there, the NLF provides sterling funding to the EEA when required, and therefore the EEA, as an individual entity, is not exposed to sterling liquidity risk. The EEA's sterling liquidity requirements are consolidated into the Exchequer Pyramid, which mechanism monitors liquidity requirements for the UK government as a whole, and is ultimately managed by H M Treasury and the Debt Management Office. Further details of this operation can be found in the annual Debt & Reserves Management Report via [www.hm-treasury.gov.uk](http://www.hm-treasury.gov.uk)

The EEA maintains a sterling account with the NLF that is used as the mechanism via which funding is transferred to the EEA, and excess cash is repaid to the NLF. This account is monitored daily and is maintained within a range. Forward looking cashflow forecasts are used to predict likely demand for cash in the EEA. Requests for funding from the NLF, and for repayments to be made, are processed when the account is forecasted to fall below, or to exceed, the range.

**Undiscounted contractual cash flows of non-derivative financial liabilities**

The table below presents the cashflows payable by the EEA arising from non-derivative financial liabilities until their contractual maturity date. The amounts disclosed in the table are the contractual undiscounted cash outflows, whereas amounts are presented in the balance sheet at their carrying values, as detailed in note 1 – Accounting Policies. Undiscounted contractual cash outflows for derivatives are described in the subsequent section of this note on derivatives

<b>As at 31 March 2008:</b>	<b>Up to 1 month</b>	<b>1 to 3 months</b>	<b>3 to 12 months</b>	<b>Undated</b>	<b>Total</b>	<b>Carrying value</b>
<b>All amounts in £ millions</b>						
Settlement balances	(403)	-	-	-	<b>(403)</b>	(403)
Deposits by banks	(2,307)	(682)	(38)	-	<b>(3,027)</b>	(3,024)
SDR Allocation	-	-	-	(1,583)	<b>(1,583)</b>	(1,583)
Short positions in securities	(453)	-	-	-	<b>(453)</b>	(475)
Liability to the NLF	-	-	-	(24,857)	<b>(24,857)</b>	(24,857)
<b>Total</b>	<b>(3,163)</b>	<b>(682)</b>	<b>(38)</b>	<b>(26,440)</b>	<b>(30,323)</b>	<b>(30,342)</b>

<i>As at 31 March 2007:</i>	<i>Up to 1 month</i>	<i>1 to 3 months</i>	<i>3 to 12 months</i>	<i>Undated</i>	<i>Total</i>	<i>Carrying value</i>
<b>All amounts in £ millions</b>						
<i>Settlement balances</i>	(454)	-	-	-	(454)	(454)
<i>Deposits by banks</i>	(2,020)	(639)	(36)	-	(2,695)	(3,369)
<i>SDR Allocation</i>	-	-	-	(1,473)	(1,473)	(1,473)
<i>Short positions in securities</i>	(448)	-	-	-	(448)	(450)
<i>Liability to the NLF</i>	-	-	-	(22,018)	(22,018)	(22,018)
<b>Total</b>	<b>(2,922)</b>	<b>(639)</b>	<b>(36)</b>	<b>(23,491)</b>	<b>(27,088)</b>	<b>(27,764)</b>

## Derivatives

The EEA uses derivatives to manage its exposure to interest rate and exchange rate risks. A description of the use of derivatives is given in the Foreword. All derivative instruments are held at their fair values. Fair values are determined by reference to market rates prevailing on the date of valuation or by discounting future cashflows. 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

	2008			2007		
	Notional Principal Amounts	Fair values Assets	Liabilities	Notional Principal Amounts	Fair values Assets	Liabilities
<b>Exchange rate contracts:</b>						
Spot and forwards	674	709	(732)	9,913	332	(348)
Currency Swaps	10,653	34	(1,340)	11,055	644	(42)
	<u>11,327</u>	<u>743</u>	<u>(2,072)</u>	<u>20,968</u>	<u>976</u>	<u>(390)</u>
<b>Interest rate contracts:</b>						
Interest rate swaps	834	33	(13)	1,344	49	(47)
Interest rate futures	2,479	-	-	6,983	-	(3)
	<u>3,313</u>	<u>33</u>	<u>(13)</u>	<u>8,327</u>	<u>49</u>	<u>(50)</u>
<b>Total</b>	<b><u>14,640</u></b>	<b><u>776</u></b>	<b><u>(2,085)</u></b>	<b><u>29,295</u></b>	<b><u>1,025</u></b>	<b><u>(440)</u></b>

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 fair value of derivatives after netting positive and negative fair values where there is legal right of offset.

	2008			
	£ millions	£ millions	£ millions	£ millions
	Under 1 Year	1 to 5 Years	Over 5 Years	Total
<b>Exchange rate contracts:</b>				
- Notional Principal Amount	3,632	7,695	-	11,327
- Net replacement cost	(532)	(797)	-	(1,329)
<b>Interest rate contracts:</b>				
- Notional Principal Amount	2,580	454	279	3,313
- Net replacement cost	22	-	(2)	20
	2007			
	£ millions	£ millions	£ millions	£ millions
	Under 1 Year	1 to 5 Years	Over 5 Years	Total
<b>Exchange rate contracts:</b>				
- Notional Principal Amount	6,962	14,006	-	20,968
- Net replacement cost	300	288	-	588
<b>Interest rate contracts:</b>				
- Notional Principal Amount	3,699	4,520	108	8,327
- Net replacement cost	21	(22)	-	(1)

At 31 March 2008 the exposure to financial institutions on derivative positions, after taking account of netting, where ISDA netting Master Agreements permit was £147mn (2007: £462mn). Net of collateral held, the exposure was £56mn (2007: £97mn).

The table below presents the cashflows payable by the EEA under derivative contracts that are settled gross by remaining contractual periods at the balance sheet date. The amounts disclosed in the table are the contractual undiscounted cashflows, or the undiscounted cashflows predicted by current forward rates for the floating legs of currency swaps. Note that net settled derivatives are not presented as the cash outflows on these instruments are not material.

As at 31 March 2008:	Up to 1 month	1 to 3 months	3 to 12 months	1 to 5 years	Total
<b>All amounts in £ millions</b>					
Currency swaps	(585)	(746)	(3,685)	(7,676)	(12,692)
Foreign exchange transactions	0	(536)	(4,485)	(7,738)	(12,759)
<b>Total</b>	(585)	(1,282)	(8,170)	(15,414)	(25,451)
	As at 31 March 2007:				
	Up to 1 month	1 to 3 months	3 to 12 months	1 to 5 years	Total
<b>All amounts in £ millions</b>					
Currency swaps	(46)	(472)	(2,995)	(7,648)	(11,161)
Foreign exchange transactions	(3,014)	(1,020)	(4,365)	(12,593)	(20,992)
<b>Total</b>	(3,060)	(1,492)	(7,360)	(20,241)	(32,153)

**17 Related Party Transactions**

There were no related party transactions, within the definition of FRS 8, during the year.

**18 Reconciliation of operating surplus to net cash outflow from operating activities**

	2008	2007
	£ millions	£ millions
Operating surplus / (deficit)	2,064	(1,016)
Notional sterling capital charge	1,250	1,036
Net (increase) / decrease in accrued income	(60)	24
Net (decrease) in accruals	(11)	(1)
Net decrease / (increase) in SDRs	16	(10)
Net decrease / (increase) in settlement balances	183	(111)
Net (increase) / decrease in treasury and other eligible bills	(364)	180
Net (increase) / decrease in loans and advances to banks	(967)	558
Net (increase) / decrease in debt securities	(1,399)	312
Net increase in gold and gold receivables	(1,321)	(18)
Net decrease / (increase) in other assets	255	(406)
Net (decrease) in deposits by banks	(345)	(272)
Net increase / (decrease) in SDR allocation	110	(116)
Net increase in other liabilities	1,670	27
<b>Net cash inflow from operating activities</b>	<b><u>1,081</u></b>	<b><u>187</u></b>

**19 Cash and similar balances**

	1 April 2007	Cash flow	31 March 2008
	£ millions	£ millions	£ millions
Balance at the Office of HM Paymaster General	87	105	192
Balances at Central Banks	<u>83</u>	<u>503</u>	<u>586</u>
	170	608	778
Loans and advances to banks repayable on demand (Note 8)	<u>3</u>	<u>(2)</u>	<u>1</u>
<b>Total</b>	<b><u>173</u></b>	<b><u>606</u></b>	<b><u>779</u></b>

## ANNEX A

**ACCOUNTS DIRECTION GIVEN BY HM TREASURY UNDER THE EXCHANGE EQUALISATION ACCOUNT ACT 1979<sup>6</sup>**

1. The Treasury shall prepare accounts for the Exchange Equalisation Account (“the Account”) for the year ending 31 March 2006 and each subsequent financial year that 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.
2. The accounts shall also be consistent with relevant requirements of the Government Financial Reporting Manual, except to the extent set out in sub-paragraphs a., b. and c. below, and shall meet the extra information requirements set out in Appendix A:
  - a. 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 (Statement of Parliamentary Supply) and Schedule 5 (Statement of Operating Costs by Departmental Aim and Objectives), are also not relevant;
  - b. The accounts shall follow the requirements of FRS 23 (IAS 21) *The Effects of Changes in Foreign Exchange Rates* (instead of SSAP 20, *Foreign Currency Translation*), FRS 25 (IAS 32) *Financial Instruments: Presentation*, FRS 26 (IAS 39) *Financial Instruments: Measurement*, and FRS 29 (IFRS 7) *Financial Instruments: Disclosures* (instead of FRS 13 *Derivatives and other financial instruments: disclosures*) other than Appendix E, *Capital Disclosures*;
  - c. A notional cost of capital charge shall apply at a rate to be determined by the Treasury. The cost shall be included in the Income and Expenditure Account and credited direct to the reserve at the year-end.
3. This Accounts Direction shall be reproduced as an Appendix to the Accounts.
4. This Accounts Direction supersedes that issued on 19 December 2001.

Ian Carruthers  
Director, Government Reporting  
HM Treasury  
26 May 2006

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<sup>6</sup> As amended by the Finance Act 2000

## EXTRA INFORMATION REQUIRED TO BE DISCLOSED

1. In addition to meeting appropriate requirements of the Companies Act and the Financial Reporting Manual, the following extra information shall be disclosed, including in order to facilitate the preparation and consistency of Whole of Government Accounts.

### Annual Report

2. The Annual Report 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) A Management Commentary:
  - i) Taking into consideration the recommendations outlined in the Accounting Standards Board's Reporting Statement 1, *Operating and Financial Review*; and
  - ii) Including appropriate information on financial performance and position reflecting the relationship between the Account and other relevant central funds reflected in the UK's official holdings of international reserves, and information on targets for the EEA 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) Management costs
- d) Disclosure of income and expenditure, and assets and liabilities, relating to other central government funds, including the National Loans Fund.

## Glossary

**Active management** is the difference between actual returns and the returns which would have been achieved from a passive investment strategy (see “Benchmark” below).

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

**Benchmark** is the neutral or passive investment strategy for the reserve portfolio. Active management performance is measured against a target return over the benchmark.

**Hedged reserves** refers to that part of the reserves, financed by sterling swapped into foreign currencies or foreign currency securities, 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 15 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. Hedge refers to the economic purpose of an instrument and is not used in the accounting sense to imply the use of hedge accounting.

**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.

**Mark to market** - recording the price or fair value of a security, portfolio or account to reflect its current market value rather than its book value.

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

**Unhedged 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)** is 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.







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