

Exchange Equalisation Account: Accounts 1999-2000

EXCHANGE EQUALISATION ACCOUNT 1999-2000

Account for the year ended 31 March 2000

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Account for the year ended 31 March 2000

Foreword

Introduction

1. The Exchange Equalisation Account (EEA) holds the United Kingdom's reserves of gold, foreign currencies and International Monetary Fund (IMF) Special Drawing Rights (SDRs). These holdings, together with the United Kingdom's reserve tranche position¹ at the IMF and certain other categories of loans made by the United Kingdom to the IMF, make up the United Kingdom's official reserves.

Origin and purpose

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

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

3. Under the Act the funds in the EEA may be invested in any assets denominated in the currency of any country, in gold, or in SDRs.

Audit and Publication

4. A statutory requirement for financial statements to be prepared and published for the EEA has been introduced through an amendment to the Exchange Equalisation Account Act 1979 which will take effect for financial years 2000-01 onwards. For financial years prior to 2000-01, the Exchange Equalisation Account Act 1979 requires the Comptroller and Auditor General (C&AG) to certify to the House of Commons that the operations on, and transactions in connection with, the EEA have or have not been in accordance with the provisions of the Act. By agreement with the Treasury, the Comptroller and Auditor General also provides a full audit opinion on the accounts. The financial statements for 1999-2000 have been audited by the National Audit Office (NAO) following a recommendation by the Committee of Public Accounts in its 8th Report of 1989-90. The C&AG's audit opinion on the 1999-2000 financial statements can be found on page 25. The financial statements are produced in accordance with the Accounts Direction, which is reproduced at page 27.

¹The Glossary explains this and other terms.

²Section 24 of the Finance Act 1932.

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

Statement of the Accounting Officer's Responsibilities

5. The Treasury have appointed an Accounting Officer for the EEA. His relevant responsibilities as Accounting Officer, including the propriety and regularity of the public finances for which he is answerable and for the keeping of proper records, are set out in the Accounting Officers' Memorandum issued by the Treasury and published in "Government Accounting". The Accounting Officer's Statement on the System of Internal Financial Control can be found on page 12.

Administration and control

6. The EEA is under the control of the Treasury, which has appointed the Bank of England to act as its agent. The Bank carries out the day-to-day dealing in foreign currencies and the investment of the reserves. The Bank's management costs are charged to the EEA.

7. The Treasury set the Bank an annual Remit for the management of the reserves. The Remit for 1999-2000 specified:

- limits on changes in the level of the reserves for the year;
- benchmarks for investing the reserves, with limits to the Bank's discretion to take currency or interest rate positions relative to these benchmarks;
- the framework for controlling credit and market risks;
- the programme for financing the reserves, covering National Loans Fund (NLF) foreign currency borrowing and currency swaps out sterling (involving advances of sterling from the National Loans Fund).

The Remit can be reviewed during the year at the Bank's or the Treasury's request.

8. Every six months the Accounting Officer and the Bank's Executive Director for Financial Market Operations, or delegated senior officials, review the Bank's performance in managing the reserves. This process is supplemented by monthly meetings between the Treasury's Debt and Reserves Management Team and the Bank's Foreign Exchange and Risk Analysis and Monitoring Divisions.

9. The EEA's assets are held by a range of custodians. US Treasury bonds and bills, and Canadian government bonds, are held on its behalf by Chase Manhattan and the Federal Reserve Bank of New York. Bunds (German government bonds) and most other European government bonds are held at Deutsche Bank but some are held at Euroclear⁴. JGBs (Japanese government bonds) are held at the Bank of Japan. International bonds and short term credit instruments such as certificates of deposit and commercial paper are held in Euroclear and Clearstream. SDRs are entries in the IMF's books. Gold bars and gold coins are held by a number of central bank custodians, although the vast majority are held at the Bank of England.

⁴Euroclear and Clearstream (formerly Cedel) are international depositories, which hold securities on others' behalf and operate a clearing system for the purchase or sale of bonds.

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Links to the National Loans Fund

10. Looked at in isolation the EEA gives an incomplete picture of the overall foreign currency asset and liability position in relation to the official reserves. This also includes NLF foreign currency debt which finances reserves, the UK's reserve tranche at the IMF (an NLF asset) and certain other loans to the IMF which create reserve assets (although no such loans existed during 1999-2000). Table 1 below summarises the total combined EEA and NLF foreign currency assets and liabilities, which are valued at their market value at the balance sheet date.

Table 1: Combined EEA and NLF Foreign Currency Assets and Liabilities (£mns)

	31/03/2000	31/03/1999
	£mns	£mns
	Unaudited	Unaudited
Assets		
Foreign Currency	12,834	15,270
	<i>of which:</i>	
US Dollar bloc	6,467	6,425
European bloc	5,686	8,476
Yen	681	369
Gold	3,281	3,982
SDRs	293	317
IMF Reserve Tranche (NLF Asset)	3,231	3,222
Total Assets	19,639	22,791
Liabilities		
Foreign Currency borrowing	9,440	12,696
	<i>of which:</i>	
US Dollar bloc	5,107	5,296
European bloc	4,333	7,399
Yen	0	1
SDR Allocation	1,621	1,616
Total Liabilities	11,061	14,312
Net Assets	8,578	8,479

Note: The above mark-to-market balance sheet has been derived from unaudited internal management information systems. It includes the present value of future cashflows relating to forwards and other off-balance sheet positions including swaps. The asset values shown above differ from those reflected in the EEA Statement of Assets and Liabilities on page 15, which is prepared on a cash basis and therefore excludes the valuation effect of off-balance sheet items and reflects the value of investments in foreign currency securities at average historic cost. In addition, foreign currency assets and gold in the latter statement are translated into sterling on a different basis (i.e. using parity rates and applying a discount to gold).

11. The exposures on these foreign currency assets and liabilities are managed together. For example, when the NLF borrows in a foreign currency it assumes the currency and interest rate risk as it sells the foreign currency to the EEA for sterling. Typically through its investments the EEA will take an offsetting currency and interest rate position so that exposures as a whole are controlled. This does, however, mean that the EEA's returns looked at in isolation give an incomplete picture of overall returns on foreign currency assets and liabilities. The return information given below in paragraph 25, which has been extracted from the Bank's internal management information system, combines EEA and NLF foreign currency exposures.

Investment Policy and Market Risk Management

12. Given the uses for which it was set up, the EEA's foreign currency reserves need to be carefully managed to ensure their liquidity and to avoid exposing the public purse to unnecessary risk. Market risk (exposure to movements in either exchange rates or interest rates) is carefully controlled both in financing the EEA's reserves and by setting benchmarks for investing the reserves, with limits on the size of the positions taken against these benchmarks. While the EEA was not set up to make a profit, achieving value for money means that the Treasury and the Bank seek to maximise returns on the foreign currency balance sheet, taking assets and liabilities together, subject to controlling risk and ensuring liquidity.

13. Where it finances the foreign currency reserves through borrowing in foreign currency or by engaging in foreign currency swaps out of sterling, the Treasury avoids exposure to fluctuations in sterling. If financing is through foreign currency borrowing, with assets hedged into the currency of the liability, this happens automatically in that fluctuations in the sterling value of NLF foreign currency liabilities are matched by fluctuations in the sterling value of EEA assets, with the combined fluctuations cancelling each other out. For example, when sterling appreciates the value of the NLF's foreign currency liabilities falls in sterling terms but the sterling value of the EEA's foreign currency assets also falls. If financing is in sterling using currency swaps, the initial swap of sterling for foreign currency involves fully hedging the exchange rate risk. This is done through an initial exchange of sterling principal for foreign currency at the spot rate reversed at the same exchange rate at an agreed future date, and regular exchanges of interest payments on the principal amounts.

14. Similarly, interest rate risk is controlled in two different ways, according to the method chosen for raising foreign currency to finance reserves. Where financing is through the issue of NLF foreign currency liabilities, the EEA seeks to control the interest rate risk by matching the risk characteristics, for example the maturity, of the EEA's assets to those NLF foreign currency liabilities. If instead currency swaps out of sterling are used, interest rate risk is hedged through interest rate swaps. Typically, the EEA will incur a liability to pay floating rate interest on the currency it has acquired through the initial swap out of sterling and will generate fixed interest income in the same currency through the purchase of an asset such as a bond. By swapping the fixed interest receipts for floating interest receipts through an interest rate swap, the EEA will acquire an income stream that matches its interest payment liability and thus eliminate its interest rate exposure.

15. As Table 1 illustrates, while the Treasury's gross reserves of foreign currency and gold totalled £19,639 million at the end of 1999-2000, exposure to currency movements (and the gold price) was largely limited to the net assets valued at £8,578 million, as a substantial proportion of the currency exposure was hedged by foreign currency liabilities valued at £11,061 million. The remaining net currency exposure needs to be controlled. Taking account of past patterns of risk and return the

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benchmark for net currency exposures in 1999-2000 was 40% US Dollar, 40% Euro and 20% Yen.⁵ This is reflected in the composition of the net currency reserves between the US dollar bloc, European bloc and in yen at the balance sheet dates. These net currency assets are also invested in short term money market instruments in order to control the residual interest rate risk. The overall currency composition of the reserves reflects the "40:40:20" benchmark for the net reserves and the composition of the NLF's foreign currency liabilities. It also reflects the Government's preferences after taking into account the need to hold reserves which can be used to fulfil the purposes of the EEA Act, whilst controlling risk and achieving value for money.

16. The "benchmark" for investing the net currency reserves during 1999-2000 was the return to keeping currency exposures split 40:40:20 between US dollar, euro and yen and limiting interest rate exposure to one month on the net currency reserves. The composition of the currency risk can vary from the benchmark, or the Treasury can take on interest rate risk, as a result of decisions taken by the Treasury or the Bank. Any intervention to influence the level of sterling would change the level and possibly the composition of the currency risk.

17. The Treasury may decide, on advice from the Bank, to set deviations from the 40:40:20 currency benchmark or the one month interest rate benchmark (which are denoted "strategy positions"). A strategy position was in place at the start of 1999-2000 when the net reserves were held in the proportion of 44:42:14. This position was closed at the end of July 1999 and no further strategy positions were run during the year.

18. As part of its active management, the Bank could run currency or interest rate risk on the reserves within the following limits. On currencies, deviations from the 40:40:20 benchmark were limited to the equivalent of \$300 million for each currency. In 1999-2000 the maximum month-end currency deviations were short \$10 million of dollars, short \$15 million of euros and long \$21 million of yen. On interest rates, limits were agreed at \$200,000 per currency bloc in delta terms. Maximum month-end interest rate delta divergences were \$9,000 in dollars, \$16,000 in euro and \$24,000 in yen.

19. During 1999-2000 the Bank implemented changes to the management reporting system for monitoring and controlling market risk. It uses value at risk (VaR) to measure risk consistently across the different components of the reserves portfolio. VaR predicts, at a specified confidence level, the maximum likely loss for the portfolios over a certain time period. The methodology used for calculating VaR for the EEA is in line with recommended best practice as outlined by the Basle Committee of the Bank for International Settlements. The Bank applies a 99% confidence interval and a two-week holding period, which predicts that in only one two-week period out of a hundred would losses exceed those suggested by the model. These VaR estimates are based on the past volatility of returns on different asset classes and on how the returns on each asset class are correlated with other positions held in the portfolio. Delta, which measures the change in value of the reserves portfolios for each one basis point shift in the relevant yield curve, is also calculated to supplement VaR and is used to help test the sensitivity of the portfolios to changes in interest rates and exchange rates. In addition, regular stress tests are conducted to explore the vulnerability of the portfolio to hypothetical market developments and to estimate potential losses in the extreme 1% of market scenarios.

20. Investments need to be highly liquid, so they can be made available quickly for intervention purposes if necessary, and carry minimal credit risk. Essentially this means that the bulk of the assets

⁵This benchmark is applied to currency exposures excluding the EEA's holdings of Gold and SDRs and the NLF's reserve tranche position at the IMF (because they are not "actively managed").

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are securities issued by the national governments of the United States, Eurozone countries and Japan and currency deposits with highly rated banks. During 1999-2000 the EEA also made use of other financial instruments including:

- bonds issued by supra-national organisations and selected official sector agencies;
- foreign currency spot, forward and swap transactions;
- interest rate and currency swaps;
- bond and interest rate futures;
- sale and repurchase agreements;
- forward rate agreements;
- gold deposits, gold loco and gold quality swaps;
- Special Drawing Rights (SDRs); and
- corporate commercial paper.

The EEA did not use options during 1999-2000.

Credit Risk

21. The management of the reserves involves exposure to the creditworthiness of commercial and investment banks. Part of the Bank's reserves management function is to measure and manage these exposures based on an assessment of each bank's creditworthiness. Credit exposures to banks are monitored real time against set limits. On occasion it may be necessary to exceed limits for operational reasons but the control framework ensures that this is only done with the prior approval of Bank senior management. A report of any limit excesses is sent to the Treasury each month.

22. Limits are set for each type of credit exposure in each country. For instance there are limits for foreign and domestic currency credit exposures for each sovereign issuer. In addition there are limits to reflect the overall exposure to each country's payment systems. Further limits have been established for holdings of commercial paper issued by AAA/Aaa-rated corporates.

23. The bonds held by Chase and Deutsche as custodians are used in their lending programmes. These programmes involve lending the bonds against collateral consisting of either other government bonds or cash. The custodians are permitted to invest cash collateral in money market instruments ranging from US agency repo to bank deposits. The credit limits delegated to the custodians are deducted from the limits available to the Bank for its own EEA management activities. Any maturity mismatch between the collateral held and the corresponding investments is strictly limited. Daily reports are received to check compliance with the investment constraints.

Evaluation of the Bank's Management of the Reserves

24. The Bank's internal unaudited management accounting system is designed to calculate the return earned by the Treasury on its reserves⁶. These can be split into reserves on which the currency exposure has been hedged - those assets financed either by borrowing in foreign currency, or equivalently by a combination of sterling borrowing and a currency swap - and the "net currency reserves", that is, the remaining foreign currency assets (effectively financed by unhedged sterling borrowing reflected in the EEA's Retained Surplus, and by the EEA's net SDR liability), plus the

⁶ Defined as all EEA and NLF foreign currency assets and liabilities except for gold, the reserve tranche at the IMF and other relevant loans to the IMF.

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forward book. The “forward book” comprises outstanding commitments to buy or sell foreign currency for sterling that are unrelated to the sterling swaps programme. The overall return can be split into:

- (a) the return on holding foreign currencies: this identifies the return from holding the “net currency reserves” in the “neutral” 40:40:20 benchmark. Sterling borrowing is assumed to be raised at 1 month sterling LIBOR less 25 basis points, while the “neutral” benchmark is assumed to earn 1 month LIBOR less 25 basis points in US dollars and yen and 1 month EURIBOR less 25 basis points in euro;
- (b) the return to hedged reserves: this combines returns to hedge portfolios held against NLF foreign currency liabilities used to finance reserve assets, with returns generated by the sterling swaps programme. The hedge portfolios are hypothetical portfolios identified by the Bank, which consist of a set of assets that have very similar risk characteristics to the liabilities that finance them (for example, for the US dollar portfolio a hedge would typically comprise US Treasuries with a similar maturity to the corresponding dollar liabilities). These hedges can be regarded as minimum risk portfolios. The returns to the hedge portfolios are the returns that would have occurred had the actual assets held been those of the hypothetical hedges. Returns on the sterling swaps programme represent a combination of capital gain (or loss) on the foreign currency assets purchased and the (generally) offsetting gain or loss on the maturing swaps, plus the excess sterling return compared to an assumed cost of funding of 1 month sterling LIBOR less 25 basis points;
- (c) returns to active management: this is the overall return on the reserves less the “return on holding foreign currencies” and less the “returns to the hedged reserves”.

Returns in 1999-2000

25. The management information system disclosed a total sterling return on all of the Treasury’s reserves of -£52 million, made up as follows:

£ million

	1999-2000
(a) return on holding foreign currencies	-109
(b) return to hedged reserves	35
(c) return to active management	22
Total	-52

26. The negative return on holding foreign currencies largely reflected the appreciation of sterling against the euro during 1999-2000. The return to active management includes the return to the strategy position referred to in paragraph 17 above.

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Gold

27. The EEA continued its practice of lending part of its gold holdings to market participants. The maximum amount of gold lent at any one time during the year was 200.4 tonnes; interest received on gold lending during 1999-2000 amounted to £15.6 million.

REVIEW OF ACTIVITIES DURING 1999-2000

Intervention

28. There was no intervention in the foreign exchange market during 1999-2000 to influence the level of sterling.

Provision of foreign currency services to Departments

29. 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. Over the year these purchases and sales were offset by transactions with the market.

Loans to the IMF

30. At various times during the year the IMF called on the UK's Quota at the Fund to finance its lending programmes. There was little overall change in the UK's reserve tranche position at the Fund, which stood at the SDR equivalent of £3,231 million at end-March 2000 compared to the SDR equivalent of £3,222 million at end-March 1999. There were no increases in the UK's IMF Quota during the year. Other things being equal, lending by the Fund in sterling or an increase in the Quota would lead to a rise in the UK's SDR assets and therefore in the official reserves. To avoid the UK's foreign currency exposures increasing as a result of this activity the EEA uses foreign currency to buy back the sterling lent by the Fund to other members and funds the reserve tranche portion of the Quota increase from its foreign currency holdings.

Foreign currency borrowing programme

31. The foreign currency borrowing programme comprises NLF foreign currency liabilities. The foreign currency receipts are sold to the EEA for sterling and partly finance the reserves. The Treasury discontinued its regular auction programme in euro bills in September 1999. This followed an announcement by the Government in January 1999 of its intention to replace this part of the financing of the Government's foreign exchange reserves through the issue of sterling debt swapped into foreign currency (see paragraph 33 below). At the same time the Bank of England announced it would take over as issuer of euro bills. Thus all euro bills issued after September 1999 have been Bank of England bills.

32. A rolling euro note issuance programme was continued and it was announced in January 2000 that regular tranches of €500 million would be auctioned each quarter in calendar 2000. The outstanding €2billion 2000 note was repaid in January 2000. These changes meant that at the financial year end the total of euro notes outstanding stood at €4.5 billion. The proceeds from these euro note issues were swapped into fixed rate instruments giving the highest yield from a range of options, within set cost limits. In March 2000 the Government announced its intention to withdraw from the

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euro note issuance programme. At the same time the Bank of England announced arrangements for it to take over from HM Treasury as the issuer of 3-year euro notes with effect from January 2001.

Sterling Swaps Programme

33. A programme to replace funding of reserves through the euro bill programme by substituting sterling debt swapped into foreign currencies was begun in April 1999 and completed during the financial year. Over this period a total of £2.25 billion was used to fund the acquisition of €2.5 billion nominal of European government bonds and yen 62.5 billion nominal of Japanese government bonds.

Level of the Reserves

34. The overall level of gross reserves in sterling terms, as shown in Table 1 (paragraph 10), decreased over the year. This reflects the replacement of the Government's euro bill programme by sterling debt swapped into foreign currency. The euro bills are included as liabilities on the mark-to-market balance sheet, whereas the (negative) net present value of future cash flows relating to currency swaps is reflected under foreign currency assets. The gross value of the reserves, excluding the mark-to-market value of foreign currency forwards, swaps and repo transactions, was £22,403 million at the end of March 2000.

Gold Auctions

35. In May 1999, the Government announced a restructuring of the United Kingdom's official reserves involving a programme of gold auctions. During the year ended 31 March 2000 the Bank of England sold, on behalf of HM Treasury, approximately 125 tonnes of gold from the EEA in a series of five auctions. A further 150 tonnes of gold was sold in a series of six auctions during the financial year 2000-01, and it was announced in March 2001 that HM Treasury planned to sell a further 120 tonnes of gold during 2001-02 through another series of six auctions conducted by the Bank of England, of approximately 20 tonnes each.

36. The decrease in the market value of the EEA's gold holdings from £3,982 million to £3,281 million over the year almost entirely reflects a reduction in gold holdings from 23.0 million ounces at end-March 1999 to 18.9 million ounces at end-March 2000 due to the programme of gold auctions. Note that in these financial statements gold is valued at a discount to its market value (Accounting policy 1 (c) on page 16).

Financial Statements

37. The financial statements of the EEA comprise a Receipts and Payments Account, a Statement of Assets and Liabilities and supporting Notes. The Receipts and Payments Account is a cash account which measures the level of the EEA's turnover for the year. The Statement of Assets and Liabilities records the EEA's (but not the NLF's) assets and liabilities, including its sterling balance at the Paymaster General. Assets are valued at their weighted average historic cost in their original currency of issue but for balance sheet purposes this historic cost is converted to a sterling equivalent using year-end exchange rates.

38. Before drawing any inferences from the attached financial statements the reader should remember that they only cover the EEA's assets and liabilities. As explained above, the exposures on EEA foreign currency assets are managed together with those NLF foreign currency liabilities. Currency or interest rate movements that generate a gain or loss to the EEA may well therefore have an equal and

EXCHANGE EQUALISATION ACCOUNT 1999-2000

offsetting impact on the NLF. The management accounting data presented in paragraphs 24 to 27 above combines EEA and NLF foreign currency assets and liabilities. Furthermore, the EEA's financial statements are constructed on a cash rather than an accruals basis and assets are valued using a modified historic cost basis rather than at their open market values. This means, for example, that these financial statements make no allowance for variations in the prices of bonds the EEA holds until such time as they are sold. In particular, no allowance is made for any "mark-to-market" gains or losses on uncompleted contracts such as forward commitments to purchase foreign currency.

39. The Treasury has instituted a new accounting system for the financial year 2000-01 based on UK Generally Accepted Accounting Practice (UK GAAP). As well as reporting the EEA's returns on a UK GAAP basis the Treasury intends to show in the Financial Statements the relationship between the EEA and the NLF with regard to foreign currency assets and liabilities. This should generate meaningful profit/loss figures for combined EEA and NLF foreign currency exposures, which will be audited by the NAO. For more information about the NLF see the "Consolidated Fund and National Loans Fund Accounts 1999-2000 Supplementary Statements" (HC 55) published on 14 December 2000 by The Stationery Office.

40. The high level of reported turnover on the Receipts and Payments account reflects the accounting methodology. In the case of a deposit in dollars, for example, the initial placement of a deposit is scored as a sale of dollars (cash) and a purchase of dollars (deposit). When the deposit matures another sale and receipt is scored. Each of these transactions is converted into sterling at the market exchange rate ruling at the time of the transaction. Rolling over short-term deposits contributes to the level of turnover. For example an overnight deposit of \$100 million rolled over throughout the year would contribute \$50 billion (plus interest) to turnover. "Payments" of interest represent the accrued interest element of bonds purchased by the EEA in the year. The use of swaps for liquidity management and for rolling the forward book is also significant. In addition, certain transactions continued to be denominated in the legacy currencies of countries which had entered Stage 3 of Economic and Monetary Union, reflecting the decisions of individual counterparties not to re-denominate certain assets into euro.

41. Gold lending transactions make up a significant proportion of the recorded "purchases" and "sales" of gold. These transactions are distinct from the sale proceeds of gold auctions (referred to above in paragraph 35). Fluctuations in the sterling price of gold between the dates gold was placed on deposit (sales) and the dates that deposits matured (purchases), combined with changes to the maturity profile of the EEA's gold deposits, affect recorded "sales" and "purchases" of gold in the same kind of way that turnover in currencies is affected by the placing of currency deposits: thus gold auction proceeds represented in 1999-2000 only 8% of recorded total "sales."

G O'Donnell
Accounting Officer

H M Treasury
15 June 2001

Statement on the System of Internal Financial Control: Exchange Equalisation Account: Accounts 1999-2000

This statement is given in respect of the accounts of the Exchange Equalisation Account for 1999-2000. As Accounting Officer for this Account, I acknowledge my responsibility for ensuring that an effective system of internal financial control is maintained and operated in respect of the Exchange Equalisation Account.

The system can provide only reasonable and not absolute assurance that assets are safeguarded, transactions authorised and properly recorded, and that material errors or irregularities are either prevented or would be detected within a timely period.

The system of internal financial control is based on a framework of regular management information, periodic audit, administrative procedures including segregation of duties, and a system of delegation and accountability. In particular it includes:

- the existence of an appropriate control environment, such as clearly defined management responsibilities and evidence of reaction to control failures;
- regular monitoring of financial activity, on a daily basis at middle management level by the Bank of England as agents for HM Treasury, and at monthly meetings between Bank and Treasury middle and senior management;
- the preparation of daily, weekly and monthly reports on the level of transactions.

The Bank of England has an internal audit function, which operates to standards defined in the Government Internal Audit Manual. The work of the internal audit unit in respect of the Exchange Equalisation Account is informed by an analysis of the risks to which HM Treasury is exposed and annual internal audit plans are based on this analysis. The analysis of risk and the internal audit plans are endorsed by the Bank's Audit Committee and approved by me.

The Bank of England's Executive Director for Financial Market Operations provides me with regular reports through the Head of Internal Audit (HIA) covering internal audit activity in respect of the Exchange Equalisation Account. Two biannual reports provide me with the HIA's independent opinion on the adequacy and effectiveness of the system of internal financial control.

My review of the effectiveness of the system of internal financial control is informed by the work of the internal auditors and of the managers who have responsibility for the development and maintenance of the financial control framework, and comments made by the National Audit Office in relevant reports.

As Accounting Officer, I am aware of the recommendations of the Turnbull Committee and I am taking reasonable steps to comply with the requirement for a statement on internal control to be prepared for the year ending 2001-02 in accordance with Treasury guidance.

G O'Donnell
Accounting Officer

HM Treasury
15 June 2001

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Account of Receipts and Payments in the year ended 31 March 2000

	£million 1999-2000	<i>£million</i> <i>1998-99</i>
Balance with Paymaster General as at 1 April	960	428
Receipts		
Transfers from National Loans Fund	1,275	1,250
Sales of Gold	9,145	8,856
Sales of securities and currency		
Eurosystème currencies		
Euro	105,474	99,413
Deutschmarks	1,414	71,800
French Francs	7	16,206
Netherlands Guilder	7	7,314
Italian Lire	37	1,202
Other	6	440
	106,945	196,375
Non Eurosystème currencies		
US dollars	437,327	385,834
Japanese yen	34,024	71,620
Other	3,289	1,111
	474,640	458,565
Sales of IMF Special Drawing Rights	363	751
Interest, etc. on gold and currencies	2,079	2,299
Interest, etc. from IMF	10	59
Charges for exchange guarantees	2	2
Total receipts	594,459	668,157

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**Account of Receipts and Payments in the year ended 31 March 2000
(continued)**

	£million 1999-2000	£million 1998-99
Payments		
Transfers to National Loans Fund	2,250	3,130
Purchases of Gold	8,443	9,673
Purchases of securities and currency		
Eurosystem currencies		
Euro	105,998	95,779
Deutschemarks	1,368	70,462
French Francs	7	17,566
Netherlands Guilder	13	7,225
Italian Lire	37	1,234
Other	6	404
	107,429	192,670
Non Eurosystem currencies		
US dollars	437,757	385,480
Japanese yen	34,284	73,540
Other	3,351	1,039
	475,392	460,059
Purchases of IMF Special Drawing Rights	341	788
Interest, etc. on gold and currencies	1,027	1,242
Interest, etc. from IMF	56	54
Bank of England management charges	6	9
Total payments	<u>594,944</u>	<u>667,625</u>
Balance with Paymaster General as at 31 March	<u>475</u>	<u>960</u>

G O'Donnell
Accounting Officer

H M Treasury
15 June 2001

EXCHANGE EQUALISATION ACCOUNT 1999-2000

Statement of Assets and Liabilities

	£million 31/03/2000	<i>£million</i> 31/03/99
Assets		
Balance with Paymaster General	475	960
Gold (Note 1(c))	2,459	2,989
Securities and Currencies		
Denominated in Eurosystem currencies		
Euro	6,922	7,263
Deutschemarks	110	169
Netherlands Guilder	6	-
Italian Lire	3	3
Other	2	3
	7,043	7,438
Denominated in non Eurosystem currencies		
US dollars	6,173	5,710
Japanese yen	3,004	2,468
Other	94	35
	9,271	8,213
IMF Special Drawing Rights	292	317
Total Assets	<u>19,540</u>	<u>19,917</u>
Liabilities		
National Loans Fund (Note 2)	475	-
IMF Special Drawing Rights	1,615	1,612
Total Liabilities	2,090	1,612
FINANCED BY:		
Retained Surplus (Note 3)	17,450	18,305
	<u>19,540</u>	<u>19,917</u>

G O'Donnell
Accounting Officer

H M Treasury
15 June 2001

Notes to the Financial Statements for the year ended 31 March 2000**1 Accounting Policies**

- (a) The financial statements are prepared on a cash basis with all transactions being accounted for on settlement. Purchases and sales of securities and currencies include purchases of foreign currencies with sterling, but they also include inter alia:
- purchases of foreign currency with another foreign currency;
 - placing (purchasing) foreign currency deposits with foreign currency and the maturity of foreign currency deposits for foreign currency;
 - purchases of securities denominated in foreign currency with foreign currency and the sale of such securities for foreign currency.
- (b) Transactions in foreign currency, gold and IMF Special Drawing Rights are translated at the market price or exchange rate ruling at the date of the transactions.
- (c) Stocks of gold held at the year-end are valued at 75 per cent of the final London fixing price as at 31 March 2000, the balance sheet date. This policy has resulted in gold balances at 31 March 2000 being valued at £130.003 per troy ounce.

Foreign currency and IMF Special Drawing Rights deposits are translated into sterling at the year-end using market rates ruling on the last working day in March.

- (d) Investments are not revalued at the balance sheet date, but are carried at their average historic cost unless determined to have suffered a permanent loss of value in which case they are written off. No write-offs occurred during 1999-2000. Holdings of foreign currencies are primarily invested in securities.

2 Transfers of sterling between the EEA and the National Loans Fund

The sterling balance at the EEA is held in cash at the Paymaster General. When the sterling balance falls it can always be increased by a fresh issue of capital from the NLF under the terms of section 7 of the National Loans Act 1968. This in turn creates a liability on the EEA to the NLF. No interest is charged on these liabilities. Conversely, when foreign currency is sold for sterling with the result that the sterling balance is in excess of the EEA's requirement, the Treasury can decide that some reduction should be made by transfer from the EEA to the NLF. This reduces any outstanding liability of the EEA to the NLF. If there is no outstanding liability the sterling transfer is a "capital repayment". During 1999-2000 there was a capital repayment to the NLF of £1,450 million (see Note 3 below). In addition, there were further transfers between the EEA and the NLF as shown below. The net effect left a liability to the NLF of £475 million at the year-end.

	£million
Liability to NLF at 1 April 1999	-
Transfers to NLF	(800)
Transfers from NLF	1,275
Liability to NLF at 31 March 2000	475

EXCHANGE EQUALISATION ACCOUNT 1999-2000

3 Retained Surplus

The retained surplus represents the difference between the EEA's total assets and liabilities. The movement in that surplus during the year was as follows:

	£million
Balance at 1 April 1999	18,305
Unrealised valuation losses - see Note 4	(407)
Net receipts during year	1,002
EEA Capital to NLF	(1,450)
Balance at 31 March 2000	17,450

4 Unrealised valuation gains (losses) during the year

Unrealised valuation gains and losses result from movements in sterling against the associated foreign currencies in which the bulk of the EEA's assets and liabilities are denominated. Such gains and losses result from movements in exchange rates between the date of the original transaction and the balance sheet date.

	£million
Position at 1 April 1999:	
Unrealised valuation gains on assets	689
Unrealised valuation loss on SDR liability	(704)
Net unrealised valuation gains (losses)	(15)
Position at 31 March 2000:	
Unrealised valuation gains on assets	285
Unrealised valuation loss on SDR liability	(707)
Net unrealised valuation gains (losses)	(422)
 Change in net unrealised valuation gains (losses) during the year	 (407)

EXCHANGE EQUALISATION ACCOUNT 1999-2000

5 Uncompleted contracts

At 31 March 2000 there were outstanding commitments valued at £1,526 million for sale of holdings, resulting from forward sales and unsettled spot transactions.

	£million	£million
Gold		5
Foreign currencies		
US Dollars	2	
Euro	494	
Japanese Yen	(2,027)	
Other	-	
		(1,531)
Total		(1,526)

6 Exchange Cover Scheme

The EEA reserves have been partly financed through the Exchange Cover Scheme (ECS). Under the ECS, Local Authorities and Public Corporations borrowed in foreign currency and sold the foreign currency to the EEA for sterling. The EEA is committed to sell back to the Local Authorities the foreign currency that they require to repay their borrowing at the same rate of exchange as when the initial borrowing took place.

For this “exchange cover” the EEA receives as premium all or a greater part of the difference between the rate of interest charged on the foreign currency borrowing and the rate which would have been charged on normal borrowing from the NLF by the body concerned. Until 1987 borrowers received a percentage of the interest rate difference as a benefit. If the foreign currency was borrowed at a floating rate of interest, and the rate at any time exceeds the appropriate NLF rate, the EEA pays the difference to the borrower. No foreign currency borrowing has received exchange cover since 1987 and none is planned.

7 Administration costs

The following table sets out the administrative costs of EEA management. The figure given below is the actual amount attributed for the Bank of England’s management charges for 1999-2000. This differs from the cash payments made in the year, as shown in the Account of Receipts and Payments, which exclude payments of £2 million in respect of management costs for 1999-2000 which were made during the financial year 1998-99.

	Bank of England management charges	Value of reserves at end of period*	Costs as % of funds managed	Staff employed
	£million	£million		
1999-2000	8.055	19,540	0.041	59

* Total EEA assets at 31 March 2000 as shown in the EEA annual statement of account.

8 SDRs

The EEA has a liability to pay the IMF for those SDRs that were allocated to the UK when the UK became a participant in the Special Drawing Rights Agreement. Payment would be required at current exchange rates if the UK withdrew from participation or the Agreement was wound up. This liability was valued at £1,615 million at 31 March 2000.

Glossary

AAA/Aaa rated the highest rating that can be assigned by the credit rating agencies. It rates the issuer's capacity to pay interest and repay principal extremely strongly.

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

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

Benchmark a neutral or passive investment strategy which can be easily monitored to compare against actual performance.

Corporate Commercial Paper short term debt issued by companies.

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 the reserves portfolios for each one basis point shift in the relevant yield curve.

ECU was the European Currency Unit, a weighted basket of EU currencies such as Sterling, Deutschmark and French Franc (now replaced by the euro).

ECU Notes three year marketable debt denominated in ECU issued by HM Treasury (now redenominated into euro).

Eurosystem is the area of 11 nations which adopted the Euro as a single currency on 1st January 1999, and which will start using Euro notes and coins three years later.

EXCHANGE EQUALISATION ACCOUNT 1999-2000

European Bloc Eurosystem currencies plus the Danish krone, the Swedish krona, the Norwegian krone, the Greek drachma and the Swiss franc.

Forward Book the difference between aggregate forward commitments to sell sterling for foreign currency and forward commitments to buy sterling with foreign 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 future floating rate (e.g. LIBOR).

Forward transaction is 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 time. Futures differ from forward contracts in that they are traded on a futures exchange. Initial and variation margin is also paid or received to eliminate any counterparty credit risk.

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

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

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

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

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

Liquidity risk is the risk of financial loss that could occur should the reserves require restructuring.

EXCHANGE EQUALISATION ACCOUNT 1999-2000

Liquidity is the ease with which one financial claim can be exchanged for another as a result of the willingness of third parties to transact in these assets.

Long is to buy an asset on the expectation that its price will rise. In the case of bonds this implies an expectation that interest rates will fall.

Market Risk is the risk of financial loss arising from movements in interest rates or currencies.

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

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

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

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

Short is to sell on the expectation that the price of the asset will drop below its prevailing market price. In the case of bonds this implies an expectation that interest rates will rise.

Special Drawing Rights (SDRs) an international reserve asset created by the IMF. It is valued in terms of a weighted basket of four currencies (US dollar, yen, sterling and euro).

Spot transaction is an agreement to pay the prevailing market price for a currency or financial instrument for immediate delivery which for example means two days time for most major currencies.

EXCHANGE EQUALISATION ACCOUNT 1999-2000

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

US Dollar bloc US and Canadian dollar holdings.

US Government Agencies US entities carrying out public policy functions in the US which issue their own debt eg. Fannie Mae. Typically their debt is not formally guaranteed by the US Government but they are usually considered to be very creditworthy.

Value at Risk (VAR) measures the aggregate market risk on a portfolio. VAR is an estimate of the maximum potential change in the value of a portfolio given the historic pattern of movements in financial markets. For example, “95% 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.

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

I certify that I have examined transactions on the Exchange Equalisation Account (“the Account”) for 1999-2000 in accordance with the Exchange Equalisation Account Act 1979.

Respective Responsibilities of the Accounting Officer and the Auditor

As described on page 3, the Accounting Officer is responsible for the preparation of the financial statements and for ensuring the regularity of financial transactions. The Accounting Officer is also responsible for the preparation of the foreword and the Statement on the System of Internal Financial Control on page 12.

Under the Exchange Equalisation Account Act 1979 it is my responsibility to form an independent opinion, based on my examination, as to whether or not the operations and transactions have been in accordance with the provisions of the Act, and to report my opinion to you. By agreement with the Treasury it is also my responsibility to form an independent opinion, based on my examination, as to whether the financial statements properly present the receipts and payments of the Account and the balances held at the year-end, and to report my opinion to you. My responsibilities, as independent auditor, are established by statute and guided by the Auditing Practices Board and the auditing profession’s ethical guidance.

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

I review whether the statement on page 12 reflects compliance with the Treasury’s guidance: “Corporate Governance: statement on the system of internal financial control.” I report if it does not meet the requirements specified by the Treasury, or if the statement is misleading or inconsistent with other information I am aware of from my audit of the financial statements.

Basis of Opinion

I conducted my audit in accordance with Auditing Standards issued by the Auditing Practices Board. An audit includes an examination, on a test basis, of evidence relevant to the amounts, disclosures and regularity of transactions included in the financial statements. It also includes an assessment of the judgements made by the Accounting Officer in the preparation of the financial statements.

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

EXCHANGE EQUALISATION ACCOUNT 1999-2000

Opinion

In my opinion:

- the financial statements set out on pages 13 to 19 properly present the payments and receipts of the Exchange Equalisation Account for the year ended 31 March 2000 and the balances as at that date, and have been properly prepared in the form, and applying accounting policies, determined by the Treasury; and
- in all material respects the payments and receipts have been applied for the purposes intended by Parliament and conform to the authorities which govern them.

I have no observations to make on these financial statements.

John Bourn
Comptroller and Auditor General

9 July 2001

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

Accounts Direction given by HM Treasury

1. The Treasury shall prepare accounts for the Exchange Equalisation Account (“the Account”) for the financial year ended 31 March 1998 and subsequent financial years comprising:
 - (a) a foreword, which inter alia, incorporates a statement of the Accounting Officer’s responsibilities and provides information on the origins and purpose of the Account, the audit and publication requirements, administration and control, links to the National Loans Fund, investment policy, credit risk, an evaluation of the Bank of England’s management of the Account and a review of activities during the financial year,
 - (b) a receipts and payments account,
 - (c) a statement of assets and liabilities; and
 - (d) notes which set out the accounting policies for the Account and provide details of transfers between the Account and the National Loans Fund; returns on surpluses; unrealised valuation of gains/losses during the year resulting from movements in sterling against the associated foreign currencies in which the bulk of the Account’s assets and liabilities are denominated; uncompleted contracts; the Exchange Cover Scheme (ECS); administrative costs; Special Drawing Rights (SDRs) and any other details as may be necessary.
2. The accounts shall properly present the receipts and payments for the period and the assets and liabilities of the Account as at the end of the financial year.
3. The foreword, the Account and the assets and liabilities statement shall be signed by the Accounting Officer and dated.
4. The accounts direction shall be reproduced as an annex to the Account.

Jamie Mortimer
Treasury Officer of Accounts

24 March 1999