EXCHANGE EQUALISATION ACCOUNT ACT 1979

Presented to Parliament 16 January 2003

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

Exchange Equalisation Account: Report and Accounts 2001–02

ORDERED BY THE HOUSE OF COMMONS TO BE PRINTED 16 JANUARY 2003

LONDON: The Stationery Office **16 January 2003**
HC 258 **£8.50**

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Foreword

Introduction

1. The Exchange Equalisation Account (EEA) holds the UK's reserves of gold, foreign currencies and International Monetary Fund (IMF) Special Drawing Rights (SDRs). These holdings, together with the UK's reserve tranche position (RTP)[1] at the IMF and certain other categories of loans made by the United Kingdom to the IMF, make up the UK's official holdings of international reserves (the "official reserves"). The EEA's links to the IMF are explained in paragraphs 31 to 33.

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 exchange rate intervention would therefore be conducted through the EEA[3]. Subsequent legislation extended the possible use of the fund; and, under the consolidating Exchange Equalisation Account Act 1979, it may also be used:

— to secure the conservation or disposition in the national interest of the means of making payments abroad; and

— for certain purposes arising from the UK's membership of the IMF, including the holding, purchase and sale of SDRs.

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

Administration and Control

4. The EEA is under the control of the Treasury, which has appointed the Bank of England (the Bank) to act as its agent. 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.

5. The Treasury sets the Bank an annual Remit for the management of the EEA. The Remit for 2001-02 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, market and other risks;

— the programme for financing the reserves, covering the National Loans Fund's (NLF) foreign currency borrowing and currency swaps out of sterling (involving advances of sterling from the NLF). The links to the NLF are described in paragraphs 27 to 30.

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

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[1] The Glossary explains this and other terms.

[2] Section 24 of the Finance Act 1932.

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

6. The EEA Accounting Officer and the Bank's Executive Director for Financial Market Operations, with senior officials, met every six months to review the Bank's performance in managing the reserves. Monthly meetings between the Treasury's Debt and Reserves Management Team and the Bank's Foreign Exchange, and Risk Analysis and Monitoring, Divisions supplemented this process.

7. The EEA's assets were held by a range of custodians in 2001-02. US Treasury bonds and other US dollar denominated securities were held on the EEA's behalf by Chase Manhattan and the Federal Reserve Bank of New York. Most European government bonds were held at Deutsche Bank but some were held in Euroclear directly. International bonds and short-term credit instruments, such as certificates of deposit and commercial paper, were held in Euroclear and Clearstream[4]. Japanese government bonds were held at the Bank of Japan. SDRs were held as entries in the IMF's books. The gold bars and coin in the reserves were held at the Bank of England.

Operating and Financial Review

Investment Policy

8. EEA investments need to be highly liquid, so they can be made available quickly for intervention purposes, or other permitted uses, if necessary. Inevitably, these investments carry some element of credit risk. In order to reduce this risk and to ensure relative liquidity, the EEA predominantly holds securities issued by the national governments of the United States, euro area countries and Japan, and deposits with highly-rated banks. Taking account of past patterns of risk and return, the Treasury set a benchmark for net currency exposures in 2001-02 of 40% US dollar, 40% euro and 20% yen[5]. The EEA may also use other financial instruments including:

— bonds issued by other national governments, supranational 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;

— SDRs; and

— certificates of deposit and corporate commercial paper.

As in previous years, the EEA did not use options during 2001-02.

[4] Euroclear and Clearstream are international depositories, which hold securities on others' behalves and operate a clearing system for the purchase or sale of bonds.

[5] This 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.

Strategy Positions

9. The Treasury may decide, on advice from the Bank, to set deviations from the 40:40:20 currency exposure benchmark or from the interest rate benchmarks (which are denoted "strategy positions"). No strategy positions were set during 2001-02.

Intervention

10. No use was made of the EEA to intervene in the foreign exchange market during 2001-02.

Provision of Foreign Currency Services to Departments

11. The EEA continued to provide foreign currency services to various Government Departments and Agencies, i.e. sales of foreign currency to Departments with foreign currency obligations and purchases of foreign currency from Departments with foreign currency receipts. These purchases and sales were offset by transactions with the market.

Gold

12. 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 tonnes *(2001: 200 tonnes)* and interest received on gold lending during 2001-02 amounted to £14.0 million *(2001: £11.0 million)*.

13. In March 2002, the Government completed its programme of gold auctions, announced in May 1999. The aim was to restructure the UK's official reserves to achieve a better balance in the portfolio. Proceeds from these sales were retained in the reserves and re-invested in interest-bearing foreign currency assets with a currency exposure broadly in the proportion 40% dollars, 40% euros and 20% yen.

14. During the year ended 31 March 2002 the Bank of England sold, on behalf of HM Treasury, approximately 120 tonnes of gold from the EEA in a series of six auctions, bringing the total sold under the programme to approximately 395 tonnes.

15. The decrease in the market value of the EEA's gold holdings from £2,570 million to £2,181 million over the year mainly reflects a reduction in gold holdings from 14.1 million fine ounces (437 tonnes) at end-March 2001 to 10.1 million fine ounces (314 tonnes) at end-March 2002 because of the programme of gold auctions. The fall in the volume of the gold held by the EEA in this period was partly offset by an increase in the sterling price of gold.

Analysis of Returns for the Period

16. The gross level of the reserves in the EEA fell by £2.6 billion to £26.8 billion over the course of the year. This was largely because of the policy decision in 2000-01 to prefinance maturing foreign currency liabilities, which increased the reserves that year. As these liabilities began to mature in 2001-02, the effect of the prefinancing started to unwind reducing the gross level of reserves. This was partly offset by the positive returns made on the foreign currency reserves during the year.

17. The operating surplus for the year ending 31 March 2002 (see page 18) totalled £116 million *(2001: £1,012 million)*. Broadly speaking this surplus was equal to the sum of gains or losses from

foreign exchange and gold price movements, net interest receipts and dealing profits. The "dealing profits" figure includes realised profit or loss on the disposal of investments during the period and active management, as well as unrealised gains and losses. Exchange gains on foreign currencies and gold during the year contributed £307 million *(2001: £894 million)* towards the operating surplus. Primarily, these gains resulted from movements during the year in the gold price and in the dollar, euro, yen and SDR exchange rates against sterling.

18. The EEA continued to hold a range of bonds and securities within the portfolio, based on the investment policy described in paragraph 8 above. The composition of the EEA's holdings of securities and other eligible instruments was structured so that where appropriate they hedged the corresponding liabilities, for example where the reserves have been financed by the Government issuing foreign currency debt (see paragraph 50). The returns from securities, mainly from dealing profits (both realised and unrealised) and interest received, were £533 million *(2001: £851 million)*. The EEA also received income when it authorised custodians holding bonds owned by the EEA to use them in their bond lending programmes (see paragraph 44). Returns on securities are largely driven by changes in bond and swap yields and exchange rates. The relevant yen and dollar bond yields ended the year to March broadly unchanged, but euro bond yields rose leading to a corresponding decrease in unrealised returns on euro securities. Separately the depreciation of the yen and the euro against sterling over the year reduced the sterling value of these holdings; the dollar rate against sterling changed little year on year. In aggregate, these factors reduced the figure for the unrealised component of dealing profits for the current year.

19. The hedges put in place across the portfolio resulted in the lower return from securities being broadly offset by increases in the value of currency swaps of £130 million *(2001: £171 million)* and the increases arising from treasury and other eligible bills £73 million *(2001: £79 million)*. The depreciation of the yen and euro against sterling resulted in a reduction of £37 million *(2001: £143 million increase)* in the unrealised gains on foreign currency transactions for the year.

20. The total interest receivable figure from the EEA's portfolio of assets was £1,012 million *(2001: £964 million)*. Increased bond coupons were the main factor in the rise, offsetting a lower return from money market deposits and margin accounts. However, interest receivable was more than offset by interest payable of £1,232 million *(2001: £1,556 million)*, resulting in a net interest expense figure for the year of -£220 million *(2001: -£592 million)*. The interest payable figure was mainly interest on the UK's SDR allocation, and a notional sterling capital charge for the retained reserves and the EEA's sterling liability to the NLF (which includes sterling swapped into foreign currencies). The notional sterling charge was calculated using the Bank of England repo rate. The deficit on net interest income reflects the fact that during 2001-02, sterling interest rates were on average higher than dollar, euro and yen interest rates.

Bank of England's Active Management

21. The reserves excluding the RTP, were actively managed against a number of benchmarks. These can be split into benchmarks for the "borrowed reserves", on which the currency and interest rate exposure was fully hedged; benchmarks for the "net currency reserves", which are unhedged; and the benchmark for gold lending. In broad terms the benchmarks used were as follows:

(a) <u>Benchmark returns on borrowed reserves:</u> this comprised returns to "hedge portfolios", which are hypothetical portfolios constructed by the Bank consisting of a set of assets with similar risk characteristics to the liabilities that financed them (for example, for the US dollar portfolio, a

hedge would typically comprise US Treasuries with a similar maturity to the corresponding dollar liabilities). The hedge portfolios were held against NLF foreign currency liabilities used to finance reserve assets and returns generated by the sterling swaps programme. The returns to the hedge portfolios in 2001-02 were the returns that would have occurred had the actual assets held been those of the hypothetical hedges. Returns on the sterling swaps programme represented 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 financing cost of 1-month sterling LIBOR less 25 basis points;

(b) Benchmark return on holding foreign currencies and gold lending: this comprised the return on holding the "net currency reserves" in a "neutral" benchmark of 40% US dollars, 40% euros and 20% yen[6] and from gold lending[7]. The "neutral" net currency reserves benchmarks were assumed to earn 1-month LIBOR less 25 basis points in US dollars and yen and 1-month EURIBOR less 25 basis points in euros. Sterling borrowing to finance the net currency reserves was assumed to be raised at 1-month sterling LIBOR less 25 basis points.

22. The total sterling return to active management during 2001-02 was £34 million *(2001 £19 million)*, and the management charge for the administrative costs incurred by the Bank of England for its management of the EEA during 2001-02 was £8 million *(2001 £8 million)*.

Financing

23. The main determinant of whether the foreign currency reserves are to be financed by issuing foreign currency liabilities or by sterling swapped into foreign currencies is cost. The least cost method of financing can be determined by comparing, on a swapped basis, the cost of issuing bonds of a given maturity and nominal amount in dollars, euros and yen with the cost of issuing a similar bond in sterling.

24. The programme to replace the financing of reserves through foreign currency debt issuance by substituting sterling debt swapped into foreign currencies, which commenced in 1999, continued during 2001-02 when £1.1 billion *(2001: £7.8 billion)* was used to finance the acquisition of €1.3 billion nominal of European government bonds, ¥24 billion nominal of Japanese government bonds and $0.1 billion of US government bonds.

25. During 2001-02, £4.3 billion *(2001: £3.2 billion)* of foreign currency liabilities were repaid, comprising the $2 billion July 2001 US dollar bond, $2 billion October 2001 US dollar floating rate note and €2.2 billion January 2002 euro note. At end March 2002 foreign currency liabilities totalled £4.0 billion *(2001 £8.3 billion)*. Of this, £3.6 billion is due to be repaid in 2002-03.

UK Official Holdings of International Reserves and Related Returns

26. As explained in paragraph 1, looking at the EEA in isolation gives an incomplete picture of the overall foreign currency asset and liability position, and returns, in relation to the official holdings of international reserves. The complete picture is derived by consolidating the assets and liabilities of the EEA with those of the NLF and IMF associated with the official reserves. The main effects of this consolidation are the inclusion of the NLF's foreign currency borrowing, the RTP and loans to the IMF. These are described in the sections below. The assets and liabilities included within the official reserves and the related returns are shown in the Tables on pages 8 and 9.

[6] The "neutral" benchmark is set taking into account three factors; the potential requirement to intervene; the possible need to finance trade flows; and the risk-return characteristics of the benchmark.

[7] The gold-lending benchmark portfolio comprises a weighted average of one, three and six month deposits.

Links to the National Loans Fund

27. The Exchange Equalisation Account Act does not permit the EEA to borrow. The National Loans Fund undertakes such transactions. Therefore, where the foreign currency reserves are financed by foreign currency liabilities, the debt is issued and held on the NLF. The foreign currency raised is transferred to the EEA in return for payment in sterling. The sterling used to make this payment is advanced to the EEA from the NLF. Upon consolidation of the two accounts, the inter-account sterling transactions cancel out leaving the NLF with a foreign currency liability to the market hedged by a foreign currency asset on the EEA.

28. In the case of sterling financing of the borrowed foreign currency reserves, the NLF again advances sterling to the EEA but this is then swapped (with market counterparties) for foreign currency assets. Upon consolidation, the inter-account sterling transactions again cancel out leaving a foreign currency asset on the EEA hedging the NLF's sterling liability to the market.

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

30. The NLF in addition holds the UK's RTP at the IMF and may hold certain other loans to the IMF. The exposures on all these foreign currency assets and liabilities are managed together. Table 2 on page 9 provides a complete picture of the asset and liability position of the UK's official reserves.

Links to the International Monetary Fund

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

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

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

— General Arrangements to Borrow (GAB) – These are long-standing arrangements under which the Group of Ten industrial countries stand ready to lend to the IMF to finance purchases that aim at forestalling or coping with a situation that could impair the international monetary system.

— New Arrangements to Borrow (NAB) – Since 1998 the Fund has had a SDR 34 billion facility at its disposal, provided by GAB members and other IMF members. The intention is that the NAB would replace the GAB as the primary financial resource for the Fund in the event that it needs additional liquidity.

When the IMF draws on these facilities, the UK's contribution counts towards the official holdings of international reserves.

Loans to the IMF

34. The UK's RTP at the IMF rose over the course of the year to the SDR equivalent of £3,433 million at end March 2002 *(2001: £2,865 million)*. This reflected an increase in the SDR value of the RTP to SDR 3,931 million at end March 2002 *(2001: SDR 3,235 million)*. This movement was due to IMF lending programmes (mainly to Argentina, Brazil and Turkey) being greater than repayments (mainly by Russia and South Korea); partly offset by a strengthening in sterling against the SDR basket over the period. There were no increases in the UK's IMF quota during the year and the United Kingdom did not lend to the IMF under the General or New Arrangements to Borrow during the course of the year.

35. The policy of neutralising changes in the level of the RTP on the level of the official reserves continued during 2001-02. Other things being equal, lending by the IMF 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 offset this increase in the reserves during 2001-02, the EEA used foreign currency to buy back the sterling lent by the IMF to other members. Conversely, when countries repay loans to the IMF in sterling and so reducing the UK's RTP, other things being equal the official reserves would fall. These trades are offset by buying foreign currency with the sterling repayment.

Official Reserves: Returns, Assets and Liabilities

36. The Tables on pages 8 and 9 show the complete picture and are derived by consolidating the assets and liabilities of the EEA with those of the NLF associated with the official reserves.

37. The returns for the figures for the UK official reserves in Table 1 are different from the income and expenditure account for the EEA. The interest payable figure of £1,366 million *(2001: £1,545 million)* includes interest on the foreign currency debt securities and loans, which is excluded from the EEA accounts. It also includes a (notional) charge, calculated at the Bank of England repo rate, on the outstanding sterling liability to investors and the outstanding net assets. This differs from the notional sterling capital charge in the EEA accounts, which is described in the EEA Accounting Policies on page 21. The foreign exchange gains of £317 million (2001: £108 million) differ marginally with the EEA accounts (£307 million) due to the inclusion of gains on the foreign currency debt offset by foreign exchange losses on the RTP.

38. The balance sheet for the official reserves in Table 2 differs on the asset side from the EEA reserves as they include the RTP (an NLF asset) of £3.4 billion *(2001: £2.9 billion)*. The liabilities in the official reserves include £4.0 billion *(2001: £8.3 billion)* equivalent of foreign currency debt (an NLF liability) and the sterling liability to investors £14.6 billion *(2001: £12.6 billion)*. The latter represents the liability side of the RTP and the sterling side of currency swaps, which are used to finance the reserves.

Table 1: UK Official Holdings of International Reserves: Returns

For the year ended 31 March 2002

	2002 £ millions	*2001* *£ millions* *Unaudited*
Interest receivable	1012	*964*
Interest payable	(1,366)	*(1,545)*
Net interest expense	**(354)**	***(581)***
Fees and commissions receivable	6	*11*
Fees and commissions payable	(1)	*(1)*
Dealing profits	32	*708*
Exchange gains and losses on foreign currencies and gold	317	*108*
Management charge	(8)	*(8)*
Operating (deficit)/surplus	**(8)**	***237***

Table 2: UK Official Holdings of International Reserves: Assets and Liabilities[8]

As at 31 March 2002

			2002 £ millions		*2001 £ millions Unaudited*
Assets					
Cash balances at central banks			86		*85*
Holdings of IMF Special Drawing Rights			202		*246*
Reserve Tranche Position			3,433		*2,865*
Items in course of collection from banks			674		*73*
Treasury and other eligible bills			2,170		*1,931*
of which:	USD bloc	773		*1,411*	
	Euro	1,397		*477*	
	Yen and other currencies	–		*43*	
Loans and advances to banks			4,093		*5,998*
of which:	USD bloc	2,480		*4,049*	
	Euro	1,517		*1,647*	
	Yen and other currencies	96		*302*	
Debt securities			16,142		*17,199*
of which:	USD bloc	4,128		*4,465*	
	Euro	8,813		*8,139*	
	Yen and other currencies	3,201		*4,595*	
Gold and gold receivables (net of items in course of transmission)			2,140		*2,547*
Other assets			946		*638*
Prepayments and accrued income			317		*333*
Total assets			30,203		*31,915*
Liabilities					
Items in course of transmission to banks			593		*845*
Deposits by banks			1,971		*561*
Debt securities and loans			3,990		*8,326*
of which:	USD bloc	2,645		*5,604*	
	Euro	1,345		*2,722*	
Sterling liability to investors[9]			14,567		*12,604*
SDR allocation			1,671		*1,695*
Other liabilities			210		*354*
Accruals and deferred income			63		*160*
Total liabilities			23,065		*24,545*
Net assets			**7,138**		***7,370***

[8] This statement has been prepared on a different accounting basis to the IMF template of the UK International Reserves and Foreign Currency Liquidity. As a result total assets shown exceed the gross reserves in the end-March 2002 template by £2.9 billion *(2001: £1.7 billion)*. This is because the template excludes the sterling leg of currency swaps and is adjusted for unsettled items.

[9] The figure from the 2000-01 accounts *(£8,217 million)* has been restated as £12,604 million to reflect the inclusion of the sterling side of currency swaps for that reporting period. This change reduced the net asset figure by an equivalent amount to £7,370 million *(2001: £11,757 million)*.

Risk Management and Control

39. Although the official reserves are not held solely to make a profit, the general need to achieve value for money means that the Treasury and the Bank seek to maximise returns on the foreign currency balance sheet, whilst avoiding exposing the public purse to unnecessary risk.

40. 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

41. The key features of the control framework during 2001-02 were as follows:

— An organisational structure in the Bank containing clear reporting lines, which included the Risk Analysis and Monitoring Division that reported to the Executive Director for Financial Market Operations, and which was independent of the Foreign Exchange Division where trading activities were conducted.

— An annual Remit agreed between the Treasury and the Bank, in which the Treasury set out the parameters under which the Bank shall manage the reserves. A published version of the Remit was contained in the Debt and Reserves Management Report[10].

— A system of financial reporting where the Bank accounted each month to the Treasury for the returns made and the market and credit risks incurred.

— A risk-based internal audit programme that delivered reports to the Bank's Executive Director who reported their content to the Treasury.

— Limits to credit and market risk exposures that are explained in the following paragraphs.

42. *Credit risk:* The management of the reserves involves exposure to the creditworthiness of banks and of the issuers of sovereign, supranational or commercial paper. The creditworthiness of these banks and issuers was subject to regular scrutiny by the Bank, both through analysis in the Risk Analysis and Monitoring Division and by review in the Bank's Credit Risk Advisory Committee. Following this process, limits were agreed for the exposure to each bank and issuer. Such exposures were monitored in real time against the limits. A report of any limit excesses was sent to the Treasury each month.

43. In addition, there were limits to contain the overall exposure to each country's banking system.

44. Where bonds were owned by the EEA, but held by custodians, they could be authorised to use them in their bond lending programmes. These programmes involved lending the bonds against collateral consisting of either other bonds or cash. The authorised custodians were permitted to invest cash collateral in money market instruments ranging from US Treasury repo to bank deposits. The credit limits delegated to the custodians were 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 was strictly limited. Daily reports were received by the Bank, allowing compliance with the investment constraints to be checked.

[10] Produced by HM Treasury, usually at the time of the Budget, for the financial year ahead.

45. Market risk: Market risk is the exposure to movements in market variables. For the EEA, the main market variables are primarily interest rates and exchange rates. In this period the Bank monitored and controlled market risk primarily by using a Value at Risk (VaR) model, which predicted, at a specified confidence level, the maximum likely loss for the portfolio over a certain time period. The Bank applied a 99% confidence interval and a two-week holding period, which predicted that in ninety-nine two-week periods out of a hundred, losses should not exceed those suggested by the model. The VaR estimates were 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.

46. The Bank measured the EEA's VaR exposure daily. It also calculated the Delta exposure at the same frequency. Delta measures the change in value of the portfolio for each one basis point shift in the relevant yield curve. It supplemented the VaR measure, and helped to test the sensitivity of the portfolio to changes in interest rates.

47. Furthermore, the Bank conducted 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

48. In addition to the limits to the controls in the above framework, risk was further managed by the following operational guidelines.

49. Whether the Treasury financed the foreign currency reserves through borrowing in foreign currency or by engaging in foreign currency swaps out of sterling, it looked to minimise the exposure to fluctuations in the value of currencies.

50. Where financing was through foreign currency borrowing with assets hedged into the currency of the liability, this happened automatically in that fluctuations in the sterling value of the NLF's foreign currency liabilities were matched by fluctuations in the sterling value of EEA assets, with the combined fluctuations cancelling each other out.

51. Where financing was through sterling using currency swaps, the initial swap of sterling for foreign currency fully 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.

52. Similarly, interest rate risk was controlled in two main ways, according to the method chosen for raising foreign currency to finance reserves. Where financing was through the issue of NLF foreign currency liabilities the interest rate risk was controlled by matching the risk characteristics, for example the maturity, of the EEA's assets to those NLF foreign currency liabilities. Where currency swaps out of sterling were used, interest rate risk was hedged through interest rate swaps. Typically, the EEA paid floating rate interest on the currency it acquired through the initial swap out of sterling and generated fixed interest income in the same currency through purchasing an asset such as a bond. By swapping the fixed interest receipts for floating interest receipts through an interest rate swap, the EEA acquired an income stream that matched its interest payment liability and thus minimised its interest rate exposure.

53. The above arrangements produced a portfolio of assets that closely hedged the obligations to repay the NLF's foreign currency liabilities. The currency and interest rate risk in the net reserves was controlled through the selection of benchmarks. For most of the 2001-02 period, the net currency assets were invested in short-term money market instruments. During the period it was decided that the average maturity of the benchmark for the net reserves should be increased. This process started in early 2002. The Bank may incur currency risk by deviating from the benchmark in its operations, within the VaR limit mentioned below. In 2001-02 the maximum deviation from the 40:40:20 currency benchmark was 37:42:21.

54. The Treasury may decide, on advice from the Bank, to set deviations from the 40:40:20 currency benchmark or the interest rate benchmark (which are denoted 'strategy positions'). As detailed in paragraph 9, no strategy positions were taken in 2001-02. Any intervention to influence the level of sterling or other currency would change the level and possibly the composition of the currency risk.

55. Under the Remit, the Bank actively managed the borrowed and net reserves, in order to improve the return. The Treasury set the Bank a VaR limit, with the VaR being calculated at close of business each day. In 2001-02 the limit was US$40 million, and during the year the Bank's use of it did not exceed US$11 million on any day.

Accounting Policies

56. The accounts of the EEA for the year are drawn up on a UK GAAP basis as far as appropriate, to reflect best accounting practice in reporting on the EEA's activities. The accounts primarily reflect the results of transactions in activities that are carried out in ways and for purposes (though without an overriding aim to make a profit) that make them comparable to those of a banking entity.

57. Accordingly, accounting requirements for banking entities form the basis of the EEA's Accounts Direction (page 30) and are reflected in its accounting policies. The effect is that, for example, securities held for trading purposes are marked to market and the related unrealised gains and losses are recognised as income and expenditure in the year.

Audit and Publication

58. The accounts have been prepared in accordance with a direction given by HM Treasury in pursuance of section 5(1) of the Exchange Equalisation Act 1979 as amended by the Finance Act 2000. The text of the direction is reproduced on page 30 of this document. The accounts and supporting notes relating to the EEA for the year ending 31 March 2002 have been audited by the Comptroller and Auditor General.

Jon Cunliffe
Accounting Officer

HM Treasury
13 January 2003

Statement of the Accounting Officer's Responsibilities

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

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

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

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

a observe the relevant accounting and disclosure requirements, and apply suitable accounting policies on a consistent basis;

b make judgements and estimates on a reasonable basis;

c state whether applicable accounting standards have been followed, and disclose and explain any material departures in the accounts; and

d prepare the accounts on a going-concern basis.

The responsibilities of an Accounting Officer, including responsibility for the propriety and regularity of the public finances for which an Accounting Officer is answerable, for keeping proper records and for safeguarding the Department's assets, are set out in the Accounting Officers' Memorandum issued by HM Treasury and published in "Government Accounting". The Accounting Officer's Statement on the System of Internal Control can be found on page 14.

Statement on the System of Internal Control

This statement is given in respect of the Exchange Equalisation Account (EEA) for 2001-02. The internal control systems for the EEA are informed by those set by the Principal Accounting Officer as contained in the Resource Account Statement of Internal Control (SIC) covering the whole framework of resource allocation, utilisation and management of risks across Treasury's business.

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

The management of the EEA is divided between the Bank of England who carry out the day-to-day dealings and the Debt and Reserves Management (DRM) team of HM Treasury.

The system of internal control is designed to manage rather than eliminate the risk of failure to achieve policies, targets, aims and objectives; it can therefore only provide reasonable assurance and not absolute assurance of effectiveness.

The system of internal control is based on an ongoing process designed to identify the principal risks to the achievement of the EEA's purposes, to evaluate the nature and extent of these risks and to manage them efficiently, effectively and economically. I consider that I will have procedures in place by March 2003 necessary to implement Treasury guidance. This takes account of the time needed to fully embed the processes, which the Treasury and the Bank have agreed should be established, and improve their robustness.

Arrangements in place during 2001-02

The performance against the parameters agreed in the annual Remit was reviewed in monthly meetings between the Bank and HM Treasury. Wider operational and policy issues were also considered at these meetings; and overall strategy and governance was discussed when the Accounting Officer and Director of Financial Market Operations attended these meetings every six months. Senior Treasury officials were delegated to represent the Accounting Officer in his absence.

Clear delegation of responsibilities and reporting lines are in place in both the Bank and HM Treasury. In the Bank, the Risk Analysis and Monitoring Division (or Middle Office) monitored and reported management information, including credit and market risk, independently from the Foreign Exchange Division where trading was carried out.

The Bank compiled a central register of risks inherent in managing the EEA, classified under generic headings with the controls and management monitoring processes separately identified and ratings given to the impact and probability of a control failure. The internal audit programme conducted by the Bank's Audit Division was based on this database and other relevant information. The programme, endorsed by the Bank's Audit Committee and sent to the Accounting Officer, was included in the annual Remit. Quarterly audit reports were made to the Executive Director for Financial Market Operations at the Bank, and sent to Accounting Officer. The audit reporting included opinions on the controls over each of the generic risk headings and on the overall control environment, based on the internal audit work conducted during the year under review.

A team from HM Treasury's Internal Audit (TIA) conducted a programme of internal audit within the Treasury based on an analysis of the risks to which the Treasury is exposed in relation to the EEA. The programme is endorsed by the Treasury's Audit Committee, of which the Accounting Officer is a member. Reports on the TIA audit programme were made to the Committee and include an independent view on the adequacy and effectiveness of the Treasury's system of internal control. The Treasury's internal audit team operates to the standards defined in the Government Internal Audit Manual.

Actions initiated during the year

DRM convened risk management workshops, facilitated by Treasury Internal Audit and attended by staff at all levels. A register of risks that could militate against DRM attaining its objectives in relation to the EEA was compiled. DRM have also adopted control strategies for each of the significant risks, based on their impact and likelihood. The Bank developed its use of 'incident logs' to enhance the reporting and monitoring of errors and to help formulate corrective action.

A new protocol for alerting the Treasury to control issues and the escalation procedures was agreed with the Bank. The Bank now provides the Treasury with a quarterly management report on risk issues. This report highlighted the Bank's role in managing, monitoring and evaluating the risks relating to the EEA as well as indicating the processes that management employed to ensure that the risks were being properly controlled.

DRM formalised contingency and business continuity arrangements for staff in the event of an unforeseen disruption to work. The Bank's Management Committee also conducted a review of business continuity planning as part of a broader assessment of operational risk.

Planned action for 2002-03

The Bank is improving co-ordination of its operational risk management by appointing Operational Risk Officers in the Front and Middle offices.

DRM will hold quarterly risk management reviews from 2003 onwards to discuss emerging issues in risk management, evaluate the system of internal control and to update the risk register. A quarterly report to the Accounting Officer will review the key risk indicators and give assurances on the effectiveness of the controls in place. DRM will review regularly the incident log recording any control failures. TIA will assess the DRM risk and control environment in 2003 and will plan to conduct a peer review of the Bank's Internal Audit.

My review of the effectiveness of the system of internal controls that has operated over the year 2001-2002 has been informed by the reports I have received under the above framework, from executive managers within the department with responsibility for the development and maintenance of the internal control framework, and comments made by external auditors.

Jon Cunliffe
Accounting Officer

HM Treasury
13 January 2003

Certificate and Report by the Comptroller and Auditor General

Exchange Equalisation Account 2001-02

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

I certify that I have audited the financial statements on pages 18 to 29 under the Exchange Equalisation Account Act 1979 (as amended by the Finance Act 2000). These financial statements have been prepared under the historical cost convention as modified by the revaluation of certain investments and the accounting policies set out on pages 21 to 22.

Respective Responsibilities of the Accounting Officer and the Auditor

As described on page 13 the Accounting Officer is responsible for the preparation of the financial statements in accordance with the Exchange Equalisation Account Act 1979 (as amended by the Finance Act 2000) and Treasury directions made thereunder and for ensuring the regularity of financial transactions. The Accounting Officer is also responsible for the preparation of the other contents of the Annual Report. My responsibilities as independent auditor are guided by the Auditing Practices Board and the auditing profession's ethical guidance.

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

I 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 certificate if I become aware of any apparent misstatements or material inconsistencies with the financial statements.

I review whether the statement on pages 14 to 15 reflects compliance with the Treasury's guidance "Corporate Governance: statement on the system of internal control". I report if it does not meet the requirements specified by the Treasury, or if the statement is misleading or inconsistent with other information I am aware of from my audit of the financial statements.

Basis of Audit 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 financial transactions included in the financial statements. It also includes an assessment of the significant estimates and judgements made by the Accounting Officer in the preparation of the financial statements and of whether the accounting policies are appropriate to the 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 error, or by fraud or other irregularity and that, in all material respects, the expenditure and income have been applied to the purposes intended by Parliament and conform to the authorities which govern them. In forming my opinion I also evaluated the overall adequacy of the presentation of information in the financial statements.

Opinion

In my opinion:

— the financial statements give a true and fair view of the state of affairs of the Exchange Equalisation Account at 31 March 2002, and of the operating surplus, total recognised gains and losses and cash flows for the year then ended, and have been properly prepared in accordance with the Exchange Equalisation Account Act 1979 (as amended by the Finance Act 2000) and directions made thereunder by Treasury; and

— in all material respects the expenditure and income have been applied to the purposes intended by Parliament and the financial transactions conform to the authorities which govern them.

I have no observations to make on these financial statements.

Sir John Bourn
Comptroller and Auditor General

15 January 2003

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

Income and Expenditure account

For the year ended 31 March 2002

	Notes	2002 £ millions	*2001* *£ millions*
Interest receivable and similar income arising from debt securities	2a	705	*541*
Other interest receivable and similar income	2b	307	*423*
Interest payable	3	(1,232)	*(1,556)*
Net interest expense		**(220)**	*(592)*
Fees and commissions receivable		6	*11*
Fees and commissions payable		(1)	*(1)*
Dealing profits	4	32	*708*
Exchange gains and losses on foreign currencies and gold		307	*894*
Management charge	5	(8)	*(8)*
Operating surplus		**116**	*1,012*
Retained surplus for the financial year	16	**116**	*1,012*

All income and expenditure arose from continuing operations.

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

The notes on pages 21 to 29 form an integral part of these accounts.

Balance Sheet

As at 31 March 2002

	Notes	2002 £ millions	*2001* *£ millions*
Assets			
Cash balances at central banks and Paymaster General	18	90	*414*
Holdings of IMF Special Drawing Rights		202	*246*
Items in course of collection from banks		674	*73*
Treasury and other eligible bills	6	2,170	*1,931*
Loans and advances to banks	7	4,093	*5,998*
Debt securities	8	16,142	*17,199*
Gold and gold receivables	9	2,181	*2,570*
Other assets	10	946	*638*
Prepayments and accrued income		317	*333*
Total assets		**26,815**	*29,402*
Liabilities			
Items in course of transmission to banks		634	*868*
Deposits by banks	11	1,971	*561*
Liability to NLF	12	831	*5,680*
SDR allocation	13	1,671	*1,695*
Other liabilities	14	210	*354*
Accruals and deferred income		2	*1*
Retained reserves	16	21,496	*20,243*
Total liabilities		**26,815**	*29,402*

The notes on pages 21 to 29 form an integral part of these accounts.

Jon Cunliffe
Accounting Officer

HM Treasury
13 January 2003

Cash Flow Statement

For the year ended 31 March 2002

	Notes	2002 £ millions	*2001* *£ millions*
Net cash inflow/(outflow) from operating activities	17	4,518	*(5,326)*
Financing			
Net (outflow)/inflow from the National Loans Fund	12	(4,849)	*5,205*
Decrease in cash in the year	18	**(331)**	*(121)*

The notes on pages 21 to 29 form an integral part of these accounts.

Notes to the Accounts

1 Accounting policies

Basis of accounting

The accounts have been prepared under the historical cost convention modified to include certain investments at valuation and in accordance with applicable accounting standards and where appropriate, although not subject to the Companies Act 1985 and technically not being the accounts of a bank, the special provisions of Schedule 9 of the Companies Act 1985 relating to banking companies and the Statements of Recommended Practice issued by the British Bankers Association and Irish Bankers Federation.

Interest

Interest receivable and payable have been accounted for on an accruals basis.

SDR remuneration

The EEA is remunerated on its holdings of SDRs. This income is reflected in interest receivable. Remuneration of the UK's RTP at the IMF (a NLF asset) is also received in the form of SDRs and is therefore recognised in these accounts as interest receivable.

Dealing profits

Dealing profits include realised profit or loss on the disposal of current investments, including active management and changes in the market value of the trading portfolio.

Sterling capital charge

A notional charge, reflecting the cost of sterling capital used by the EEA, is included in interest payable. The charge is calculated using the Bank of England repo rate on the outstanding reserves (including the income and expenditure account) and the EEA's outstanding liability to the NLF less cash balances with the Paymaster General.

Fee and commission income and expense

Fees and commissions are recognised in the income and expenditure account when they are received and paid.

Foreign currencies

The financial statements of the EEA have been compiled in sterling. Transactions denominated in foreign currencies (other than sterling) are recorded at the rate of exchange at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies at the balance sheet date are reported at the rates of exchange prevailing at that date. For the year ending 31 March 2002, the dollar and euro closing prices were taken on 28 March and yen closing prices on 29 March. Any gain or loss from a change in exchange rates subsequent to the date of transaction is included as an exchange gain or loss in the income and expenditure account.

Debt securities

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

Loans and advances

Loans and advances are recorded at the amount advanced.

Repurchase agreements

Where securities are sold subject to a commitment to repurchase them at a predetermined price, they remain on the balance sheet and a liability is recorded in Note 11 in respect of the consideration received. Conversely, securities purchased under analogous commitments to resell are not recognised on the balance sheet and the consideration paid is recorded in 'Loans and advances to banks'.

Gold

Gold assets are recorded in the balance sheet at market value. Changes in the market value of gold assets are recognised in the income and expenditure account when they arise.

Derivatives

Derivatives are used in trading activities both for direct trading purposes and to manage risk in the trading portfolios. Such instruments include exchange rate forwards, currency swaps, interest rate swaps and interest rate futures. They are carried at fair value and all changes in fair value are reported within dealing profits in the income and expenditure account. Fair values are normally determined by reference to quoted market prices; internal models are used to determine fair value in instances where no market price is available. The unrealised gains and losses on trading activities are included within other assets and liabilities respectively.

Accounting entries

Income and expenditure transactions and assets and liabilities are recognised in the financial statements on a trade date basis.

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

	2002 £ millions	*2001* *£ millions*
Bonds	696	*526*
Certificates of deposit	9	*15*
Total	**705**	*541*

2b. Other interest receivable and similar income

	2002	*2001*
	£ millions	*£ millions*
Money market deposits and margin accounts	128	*232*
Reverse repos	33	*47*
Reserve Tranche Position	75	*98*
Special Drawing Rights	8	*12*
Currency swaps	42	*12*
Gold deposits	14	*11*
Securities lending	3	*4*
Other	4	*7*
Total	**307**	*423*

3 Interest payable

	2002	*2001*
	£ millions	*£ millions*
Notional sterling capital charge	1,137	*1,435*
SDR allocation	55	*77*
Repos	6	*33*
Interest rate swaps	27	*5*
Other	7	*6*
	1,232	*1,556*

4 Dealing profits

	2002	*2001*
	£ millions	*£ millions*
Debt Securities	(172)	*310*
Foreign exchange transactions	(37)	*143*
Currency swaps	130	*171*
Interest rate swaps	10	*(3)*
Futures	31	*2*
Treasury and other eligible bills	73	*79*
Other instruments	(3)	*6*
Total	**32**	*708*

5 Management charge

The management charge of £8 million represents the administrative costs attributed to the Bank of England for EEA management during 2001-02 *(2000-01: £8 million)*.

6 Treasury and other eligible bills

	2002 £ millions	*2001 £ millions*
Treasury bills and similar securities	68	*–*
Other eligible bills	2,102	*1,931*
Total	**2,170**	*1,931*

7 Loans and advances to Banks

	2002 £ millions	*2001 £ millions*
Repayable on demand	86	*93*
Other loans and advances – remaining maturity:		
3 months or less	3,835	*5,781*
1 year or less but over 3 months	172	*124*
5 years or less but over 1 year	–	*–*
Over 5 years	–	*–*
Total	**4,093**	*5,998*
Of which, reverse repo transactions are:	590	*1,298*

8 Debt Securities

All debt securities are held in the trading book and recorded at market value.

	2002			*2001*
Issued by Public Bodies	Listed overseas £ millions	Unlisted £ millions	Total £ millions	*Total £ millions*
Government Securities	12,285	–	12,285	*14,221*
Other Public Sector	2,632	101	2,733	*2,124*
	14,917	101	15,018	*16,345*
Issued by Other Issuers				
Bank and building society certificates of deposit	926	–	926	*854*
Other debt securities	198	–	198	*–*
	1,124	–	1,124	*854*
Total	16,041	101	**16,142**	17,199

	2002 £ millions	*2001 £ millions*
Due within one year	4,440	*4,157*
Due one year and over	11,702	*13,042*
Total	**16,142**	*17,199*

9 Gold and gold receivables

	2002 £ millions	*2001* *£ millions*
Gold stock	1,103	*1,398*
Gold deposits	1,078	*1,172*
Total	**2,181**	*2,570*

10 Other assets

	2002 £ millions	*2001* *£ millions*
– Futures Margin	6	–
Balances arising from other financial instruments		
– Currency swaps	860	*487*
– Interest rate swaps	32	*30*
– Foreign exchange transactions	32	*110*
– Futures	16	*11*
Total	**946**	638

11 Deposits by Banks

			2002			*2001*
	£ millions	£ millions	£ millions	*£ millions*	*£ millions*	*£ millions*
	3 months or less	1 year or less but over 3 months	Total	*3 months or less*	*1 year or less but over* 3 months	*Total*
Repo transactions	1,152	281	1,433	*561*	–	*561*
Cash collateral received	538		538	–	–	–
	1,690	281	**1,971**	*561*	–	*561*

There were no deposits by banks repayble on demand as at 31 March 2002 *(2001: nil)*.

12 Liability to National Loans Fund

When the sterling balance held by the EEA at the Paymaster General falls, it can be increased by a fresh issue of capital from the NLF under the terms of section 7 of the National Loans Act 1968. This creates a liability on the EEA's balance sheet to the NLF. Conversely, when foreign currency is sold for sterling with the result that the sterling balance is in excess of the EEA's requirements, the Treasury can decide that some reduction should be made by a transfer from the EEA to the NLF. If there is no outstanding liability at the time of a sterling transfer from the EEA to the NLF the transfer is treated as a 'capital repayment' and used to reduce the retained reserves. No capital repayments were made during the year ended 31 March 2002. The sterling transfers to and from the NLF during the year were:

	2002 £ millions	*2001* *£ millions*
Liability to NLF at 1 April	5,680	*475*
Transfers to NLF	(5,349)	*(3,300)*
Transfers from NLF	500	*8,505*
Liability to NLF at 31 March	**831**	*5,680*

13 SDR allocation

The EEA has a liability to the IMF for those SDRs that have been allocated since the United Kingdom became a participant in the Special Drawing Rights Agreement. If the United Kingdom withdrew from participation or the Agreement was wound up, payment to the IMF would be required at current exchange rates. The market value of this liability as at 31 March 2002 was £1,671 million *(2001 £1,695 million)*.

14 Other liabilities

	2002 £ millions	*2001* *£ millions*
Net liability under the Exchange Cover Scheme	–	*2*
Futures Margin	–	5
Balances arising from other financial instruments		
– Currency swaps	136	*212*
– Interest rate swaps	38	47
– Foreign exchange transactions	36	*88*
Total	**210**	*354*

Under the Exchange Cover Scheme, Local Authorities and Public Corporations borrowed foreign currency and sold it to the EEA for sterling. The EEA is committed to sell the foreign currency back to the borrowing bodies for sterling at the same rate of exchange as when the initial borrowing took place. The amounts included above represent the foreign currency commitments outstanding at the balance sheet date, net of the sterling due to be received in respect of those commitments.

15 Financial instruments

Derivatives

The EEA uses derivatives as part of its trading activities and to reduce its exposure to interest rate and exchange risks in the trading portfolio. Because all derivative instruments are marked to market, carrying values are equal to mark-to-market values. Mark-to-market values, or fair values, are determined by reference to market rates prevailing on the date of valuation or by discounting future cash flows. The notional principal amounts of these instruments indicate the volume of transactions outstanding at the balance sheet date and are not a representation of the amount of risk.

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

			2002			*2001*
	£ millions Notional Principal Amount	£ millions Assets at Fair value	£ millions Liabilities at Fair value	*£ millions Notional Principal Amount*	*£ millions Assets at Fair value*	*£ millions Liabilities at Fair value*
Exchange rate contracts:						
Spot and forwards	7,204	32	36	*6,695*	*110*	*88*
Currency Swaps	11,953	860	136	*11,598*	*487*	*212*
	19,157	892	172	*18,293*	*597*	*300*
Interest rate contracts:						
Interest rate swaps	2,882	32	38	*3,343*	*30*	*47*
Interest rate futures	2,893	16	–	*7,100*	*11*	*–*
	5,775	48	38	*10,443*	*41*	*47*
Total	24,932	940	210	*28,736*	*638*	*347*

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

				2002
	£ millions Under 1 Year	£ millions 1 to 5 Years	£ millions Over 5 Years	£ millions Total
Exchange rate contracts:				
– Notional Principal Amount	10,144	9,013	–	19,157
– Net replacement cost	387	333	–	720
Interest rate contracts:				
– Notional Principal Amount	2,961	2,690	124	5,775
– Net replacement cost	27	(17)	–	10

15 Financial instruments *(continued)*

				2001
	£ millions	*£ millions*	*£ millions*	*£ millions*
	Under 1 Year	*1 to 5 Years*	*Over 5 Years*	*Total*
Exchange rate contracts:				
– Notional Principal Amount	*7,401*	*10,882*	*10*	*18,293*
– Net replacement cost	*(17)*	*314*	*–*	*297*
Interest rate contracts:				
– Notional Principal Amount	*1,675*	*8,540*	*228*	*10,443*
– Net replacement cost	*1*	*(3)*	*(4)*	*(6)*

The maximum credit exposure with financial institutions on cross currency and interest rate swaps after taking account of netting agreements was £747 million. The exposure, net of collateral held, was £208 million.

16 Retained reserves

All gains and losses are taken to retained reserves together with the notional sterling capital charge.

	2002	*2001*
	£ millions	*£ millions*
At 1 April	20,243	*17,796*
Retained surplus for the year	116	*1,012*
Notional sterling capital charge	1,137	*1,435*
At 31 March	**21,496**	*20,243*

17 Reconciliation of operating profit to net cash inflow/(outflow) from operating activities

	2002 £ millions	*2001* *£ millions*
Operating surplus	116	*1,012*
Notional sterling capital charge	1,137	*1,435*
Net decrease/increase in prepayments and accrued income	16	*(111)*
Net increase/(decrease) in accruals and deferred income	1	*(1)*
Net cash inflow from trading activities	**1,270**	*2,335*
Net decrease in IMF Special Drawing Rights	44	*47*
Net (increase)/decrease in items in course of collection	(601)	*64*
Net increase in treasury and other eligible bills	(239)	*(61)*
Net decrease/(increase) in loans and advances to banks	1,898	*(3,286)*
Net decrease/(increase) in debt securities	1,057	*(5,773)*
Net decrease in gold and gold receivables	389	*729*
Net (increase)/decrease in other assets	(308)	*367*
Net (decrease)/increase in items in course of transmission to banks	(234)	*482*
Net increase/(decrease) in deposits by banks	1,410	*(306)*
Net (decrease)/increase in SDR allocation	(24)	*71*
Net (decrease)/increase in other liabilities	(144)	*5*
Net cash inflow/(outflow) from operating activities	**4,518**	*(5,326)*

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

	At 1 April 2001 *£ millions*	Cashflow £ millions	At 31 March 2002 £ millions
Balance with Paymaster General	*329*	(325)	4
Balances at Central Banks	*85*	1	86
	414	(324)	90
Loans and advances to other banks (Note 7) repayable on demand	*93*	(7)	86
Total	*507*	**(331)**	**176**

Accounts Direction given by HM Treasury under the Exchange Equalisation Account Act 1979[11]

1. The Treasury shall prepare accounts for the Exchange Equalisation Account ("the Account") for the year ending 31 March 2001 and each subsequent financial year comprising:
   - a) A foreword
   - b) A statement of Accounting Officer's responsibilities
   - c) A statement on the system of internal financial control[12]
   - d) An income and expenditure account
   - e) A statement of total recognised gains and losses
   - f) A balance sheet
   - g) A cash flow statement
   - h) Notes to the accounts

2. The accounts shall give a true and fair view of the state of affairs of the Account at the balance sheet date and of its income and expenditure, total recognised gains and losses and cash flows for the year then ended. The accounts shall be prepared under the historical cost convention modified to include certain investments at valuation and in accordance with applicable accounting standards and where appropriate, although not subject to the Companies Act and technically not being the accounts of a bank, the special provisions of Schedule 9 of the Companies Act 1985 relating to banking companies and the Statements of Recommended Practice issued by the British Bankers' Association and the Irish Bankers' Federation.

3. The accounts shall also be consistent with relevant requirements of the Resource Accounting Manual, except to the extent set out in Appendix A and shall meet the extra information requirements set out in Appendix B.

4. This Accounts Direction shall be reproduced as an Appendix to the Accounts.

David Loweth
Head of Central Accountancy Team

HM Treasury
19 December 2001

[11] As amended by the Finance Act 2000.
[12] From 2001-02, a statement on the system of internal control.

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

Appendix A

APPLICATION OF THE RESOURCE ACCOUNTING MANUAL

Background

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

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

Income and expenditure account

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

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

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

Balance sheet

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

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

8. Investment securities, being securities held for use on a continuing basis in the activities in the Account, shall be carried at cost as adjusted for:

a) The amortisation of the premium or discount representing the premium or discount between cost and the redemption proceeds, for redeemable securities;

b) Any diminution in their value that is expected to be other than temporary;

c) Translation differences where the investment securities are denominated in foreign currencies.

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

10. All movements in values of investments shall be reflected in the income and expenditure account, including translation differences arising in relation to investment securities denominated in foreign currencies.

Cash flow statement

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

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

Appendix B

EXTRA INFORMATION REQUIRED TO BE DISCLOSED

1. In addition to meeting appropriate requirements of the Companies Act, the banking SORPs and the Resource Accounting Manual, the following extra information shall be disclosed, including to facilitate the preparation and consistency of Whole of Government Accounts.

Foreword

2. The foreword shall include:

   a) A brief history of the Account, and its statutory background;

   b) An outline of the scope of the Account, its status in relation to HM Treasury and other central funds, and its management arrangements;

   c) An operating and financial review:

      i) meeting relevant requirements of the Accounting Standards Board's Statement and the narrative disclosure requirements of FRS 13, "Derivatives and other financial instruments – disclosures" for banks and similar institutions; and

      ii) including appropriate information on financial performance and position reflecting the relationship between the Account and other relevant central funds, and information on targets set by HM Treasury and their achievement.

Notes to the accounts

3. The notes to the accounts shall include the following:

   a) Analyses of assets, between fixed and current assets.

   b) Analyses of debtors and creditors, between those falling due within and after one year.

   c) Where not separately disclosed on the face of the income and expenditure accounts, analyses of income and expenditure giving totals for the following:

      i) Interest receivable and similar income;

      ii) Interest payable and similar charges, separately identifying any notional cost of capital charge;

      iii) Other operating income, including income derived from the provision of services;

      iv) Operating costs.

d) Disclosure of income and expenditure, and assets and liabilities, relating to other central government funds, including the National Loans Fund, including analyses by funding purpose where appropriate.

e) Disclosures meeting the requirements of FRS 13, “Derivatives and other financial instruments – disclosures” as applying to banks and similar institutions, including numerical disclosures about interest risk, currency risk, fair values, and financial instruments used for trading (including information on the market price risk of the trading book).

Glossary

Active management 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 is a 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 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, warrants and convertible bonds.

Euribor is the euro area inter-bank offered rate for the euro.

Euro area is the area of 12 nations which have adopted the euro as a single currency, and which started using euro notes and coins from January 2002.

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 – 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. 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 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.

LIBOR stands for London Interbank Offer Rate and is the benchmark interest rate banks charge each other on short-term money.

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

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

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

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

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

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, it is the amount of the UK's subscription the IMF has called. The RTP is a reserve asset as in the event of need the United Kingdom 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.

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 in two days time for most major currencies.

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 or liabilities.

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 e.g. 'Fannie Mae'.

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, "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.

Printed in the UK by The Stationery Office Limited on behalf of the
Controller of Her Majesty's Stationery Office
Id XXXXX 01/03 XXXXX XXXXXX

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and available from:

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