

Exchange Equalisation Account: Accounts 1998-99

EXCHANGE EQUALISATION ACCOUNT 1998-1999

Account for the year ended 31 March 1999

Contents

| | Page |
|-------------------------------------------------------|------|
| Foreword | 3 |
| Statement on the System of Internal Financial Control | 14 |
| Financial Statements | 15 |
| Notes to the Financial Statements | 19 |
| Glossary | 22 |
| Audit Certificate for the 1998-99 Accounts | 25 |
| Accounts Direction | 27 |

EXCHANGE EQUALISATION ACCOUNT 1998-1999

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 the purchase of gold; or in the acquisition of 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 2000-2001 onwards. For financial years prior to 2000-2001, 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. These financial statements for the EEA for 1998-99 which the Treasury has prepared using returns supplied by the Bank of England 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 NAO's audit opinion on the 1998-99 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.

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 of England can intervene in support of its monetary policy objective using the Bank's own resources rather than those of the EEA.

EXCHANGE EQUALISATION ACCOUNT 1998-1999

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 14.

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 specifies:

- any change 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,
- it also specifies the National Loans Fund (NLF) foreign currency borrowing programme which is partly used to finance the reserves.

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

8. Every six months the Accounting Officer and the Bank's Executive Director for Financial Market Operations review the Bank's performance in managing the reserves. These meetings are supplemented by monthly meetings between the Treasury's Debt and Reserves Management Team and the Bank's Foreign Exchange Division. The Bank provides the Treasury with a daily report on the level of the reserves.

9. The EEA's assets are held by a range of custodians. US Treasury bonds and bills, and Canadian government bonds, are held on our behalf by Chase Manhattan and the Federal Reserve Bank of New York. Bunds (German government bonds) and most other European government bonds are held by Deutsche Bank but some are held at Euroclear⁴. JGBs (Japanese government bonds) are held at the Bank of Japan. Eurobonds and short term credit instruments such as certificates of deposit and commercial paper are held in Euroclear and Cedel (Clearstream from 3 January 2000). SDRs are entries in the IMF's books. Gold bars and gold coins are held by a number of central bank custodians.

⁴ Euroclear and Cedel are depositories which hold securities on others' behalf and operate a clearing system for the purchase or sales of bonds.

EXCHANGE EQUALISATION ACCOUNT 1998-1999

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 (two such loans were made in 1998-99 under the IMF's General Arrangements to Borrow (GAB) and its New Arrangements to Borrow (NAB) but these do not feature in the table below because they were advanced and repaid within the financial year). Table 1 below summarises the total combined EEA and NLF foreign currency assets and liabilities. Assets and liabilities are valued in Table 1 at their market value at the balance sheet date.

EXCHANGE EQUALISATION ACCOUNT 1998-1999

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

| | 31/3/98 | 31/3/99 |
|---------------------------------|-----------------|---------------|
| | £mns | £mns |
| | Unaudited | Unaudited |
| Assets | | |
| Foreign currency | 16,291 | 15,270 |
| | <i>of which</i> | |
| US Dollar bloc | 6,802 | 6,425 |
| European bloc | 8,704 | 8,476 |
| Yen | 785 | 369 |
| Gold | 4,142 | 3,982 |
| SDRs | 263 | 317 |
| IMF Reserve Tranche (NLF asset) | 1,752 | 3,222 |
| | | |
| Total Assets | <u>22,448</u> | <u>22,791</u> |
| Liabilities | | |
| Foreign Currency Borrowing | 12,352 | 12,696 |
| | <i>of which</i> | |
| US Dollar bloc | 5,227 | 5,296 |
| European bloc | 7,124 | 7,399 |
| Yen | 1 | 1 |
| SDR Allocation | 1,528 | 1,616 |
| | | |
| Total Liabilities | <u>13,880</u> | <u>14,312</u> |
| | | |
| Net Assets | 8,568 | 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 cash flows relating to forwards and other off-balance sheet positions. The asset values shown above differ from those reflected in the EEA Statement of Assets and Liabilities on pages 20 and 21, 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).

EXCHANGE EQUALISATION ACCOUNT 1998-1999

11. The EEA's exposures are managed alongside those of the NLF. 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 24, which has been extracted from the Bank's internal management information system, combines EEA and NLF foreign currency exposures.

Investment Policy

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 in limiting the Bank's discretion to manage them actively. 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 the Treasury limits its exposure to fluctuations in sterling. When sterling appreciates the value of the EEA's foreign currency assets falls in sterling terms but the value of the NLF's foreign currency liabilities also falls. As Table 1 illustrates, while assets of foreign currency and gold totalled ,22,791million at the end of 1998-99, exposure to currency movements (and the gold price) was largely limited to the net assets valued at , 8,479 million as a substantial proportion of the currency exposure on the assets is hedged by the foreign currency liabilities valued at ,14,312 million. There is, however, a net currency exposure and this needs to be controlled. Taking account of past patterns of risk and return the benchmark for net currency exposures in 1998-99 was 40% US Dollar, 40% deutsche mark (euro after 1 January 1999) and 20% Yen.⁵ This is reflected in the composition of the net reserves (i.e. the differences between the level of foreign currency assets and liabilities) between the US dollar bloc, European bloc and in yen at the balance sheet dates. The overall currency composition is determined by the "A40:40:20" benchmark for the net reserves combined with the composition of the NLF's foreign currency liabilities.

14. Interest rate risk is controlled by matching the risk characteristics, for example the maturity, of the EEA's assets to the NLF's foreign currency liabilities. The net currency assets are invested in short term money market instruments to control the residual interest rate risk.

15. The "benchmark" for investing the reserves during 1998-99, against which the actual return can be measured, was the return to keeping currency exposures split 40:40:20 between US dollar, deutsche mark/euro and yen and limiting interest rate exposure to 1 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.

⁵ This benchmark 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").

EXCHANGE EQUALISATION ACCOUNT 1998-1999

16. 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"). No such "strategy positions" were in place at the start of 1998-99 but the net reserves were held in the proportion of 44:42:14 at the end of the period. No further positions were run during the year.

17. As part of its active management, the Bank can run currency or interest rate risk on the reserves within the following limits. On currencies, deviations from the 40:40:20 benchmark must be limited to the equivalent of \$300 million for each currency. In 1998-99 the maximum currency divergences were long \$141 million of dollar, long \$139 million of euro and short \$280 million of yen. On interest rates, deviations from a neutral position must be limited to the 4 year equivalent of \$600 million for each of the dollar, deutschemark/euro and yen currency blocks. The maximum month-end interest rate divergences from the benchmark were the 4 year equivalent of \$112 million for the dollar yield curve at the end of August 1998; \$107 million for the deutsche mark/euro curve in July 1998; and \$175 million for the yen yield curve in November 1998. At the end of March, exposures to parallel shifts in the yield curve were the 4 year equivalent of \$1 million for the dollar curve, \$26 million for the euro curve and \$47 million for the yen yield curve.

18. Limits and measuring exposures to parallel shifts in yield curves does not tell the whole picture on interest rate exposures. During 1998-99 the Bank made significant progress in introducing a new management information system to enable value at risk (VAR) limits to be implemented (a system which is now fully in place). Value at Risk measures the aggregate market risk on a portfolio, specifically, the maximum potential change in the value of a portfolio with a given probability over a given time horizon. For example, "95% of the time gains/losses will not exceed \$10million over a two week period." These value-at-risk 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 others held in the portfolio. In addition, regular stress tests are conducted to explore the vulnerability of the portfolio to hypothetical market developments.

19. 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 are securities issued by the national governments of the United States, France, Germany and Japan and currency deposits with highly rated banks. During 1998-99 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),

EXCHANGE EQUALISATION ACCOUNT 1998-1999

- and corporate commercial paper.

The EEA did not use options during 1998-99.

Credit Risk

20. The management of the reserves involves exposure to the creditworthiness of commercial and investment banks. Part of the Bank's reserve management function is to measure and manage these exposures based on an assessment of each bank's creditworthiness. Credit exposures to banks are monitored on a daily basis 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 overall exposure limit excesses is sent to the Treasury each month.

21. 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.

22. The bonds held by Chase and Deutsche participate 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 fund management activities. Any maturity mismatch of 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

23. The Bank's internal unaudited management accounting system is designed to calculate the sterling return earned by the Treasury on its reserves⁶. By convention these have been split into the "borrowed reserves" - the assets financed by borrowing in foreign currency (or equivalently by a combination of sterling borrowing and a currency swap) - and the "net currency reserves" - the remaining foreign currency assets (effectively financed by sterling borrowing and the EEA's net SDR liability), plus the forward book. The "forward book" comprises outstanding commitments to buy or sell foreign currency for sterling. 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. The 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, Deutschemarks/euro and Yen; and
- (b) the return to the hedges: the hedges are hypothetical portfolios identified by the Bank consisting of a set of assets which have very similar risk characteristics to the liabilities that finance the "borrowed reserves" (for the US Dollar portfolio a hedge would typically comprise US

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

EXCHANGE EQUALISATION ACCOUNT 1998-1999

Treasuries with a similar maturity to the corresponding dollar liabilities). The hedges can be regarded as minimum risk portfolios. The returns to the hedges are the returns that would have occurred had the actual assets held been those of the hypothetical hedges.

(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 hedges”.

Returns in 1998-99

24. The management information system disclosed a total sterling return on the Treasury's reserves of £164 million, made up as follows:

| £ million | 1998-99 |
|------------------------------------------|----------------|
| (a) return on holding foreign currencies | 121 |
| (b) return to hedges | 15 |
| (c) return to active management | 28 |
| Total | 164 |

25. The positive return on holding foreign currencies reflected the depreciation of sterling during 1998-99.

Gold

26. The EEA continued its practice of lending part of its gold holdings to market participants. 161.5 tonnes was the maximum amount of gold lent at any one time during the year; interest received on gold lending during 1998-99 amounted to £7.34 million.

27. The market value of the EEA's holdings of 23 million ounces decreased from £4,142 million to £3,982 million over the year. Note that in the financial statements gold is valued at a discount to its market value (Accounting policy 1 (c) on page 18).

EXCHANGE EQUALISATION ACCOUNT 1998-1999

Review of Activities during 1998-99

Intervention

28. There was no intervention in the foreign exchange market during 1998-99 to influence the level of sterling.

Redenomination

29. On 1 January 1999 following the commencement of Stage 3 of Economic and Monetary Union, the Bank redenominated into euro those assets of the EEA which were denominated in the legacy currencies of participating member states with the exception of those deposits and securities maturing shortly after this date and a number of outstanding foreign currency loans granted to public sector bodies under the Exchange Cover Scheme.

Provision of foreign currency services to Departments.

30. 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

31. At various times during the year the IMF called on the UK's Quota at the Fund to finance its lending programmes. In addition, the UK's IMF Quota was increased as part of the General Quota Increase in February 1999. These transactions resulted in an increase in the UK's reserve tranche position at the Fund from the SDR equivalent of £1,752million at end-March 1998 to the SDR equivalent of £3,222million by end-March 1999. 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. To avoid the UK's foreign currency exposures increasing as a result of this activity the EEA used foreign currency to buy back the sterling lent by the Fund and funded the reserve tranche portion of the Quota increase from its foreign currency holdings.

32. The UK also participated in IMF lending made under the General Arrangements to Borrow (GAB) and the New Arrangements to Borrow (NAB) during the year, by making advances totalling the SDR equivalent of £318 million in July and November 1998 which were repaid before the financial year end in March 1999. The temporary increase in the UK's foreign currency exposures which this would have produced was also offset by purchases of sterling using some of the foreign currency reserves.

Foreign currency borrowing programme

33. 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 continued with its regular auction programme in ECU bills (Euro Bills for those bills maturing after 1 January 1999) and maintained the total outstanding at €3.5bn (excluding bills issued to the EEA for use in sale and repurchase transactions). However, in January 1999 the Government announced its intention to replace this part of the financing of the Government's

EXCHANGE EQUALISATION ACCOUNT 1998-1999

foreign exchange reserves through the issue of sterling debt swapped into foreign currency. At the same time, the Bank of England announced that it would take over as issuer of Euro Bills. The proceeds of the Bank of England Euro Bills will be available to the Bank to finance the provision of intra-day liquidity, on a secured basis, to participants in CHAPS Euro, as part of the arrangements for TARGET. This process started in April 1999 and all Euro Bills maturing after September 1999 have been Bank of England bills.

34. A rolling Euro Note issuance programme was continued and it was announced in January 1999 that regular tranches of €500 million would be auctioned each quarter in calendar 1999. The outstanding ECU 2 billion 1999 Note was repaid in January and ECU 2 billion of 2000 Notes were redenominated as €2 billion of 2000 Notes in January 1999. 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.

Level of the Reserves

35. The overall level of reserves in sterling terms (see Table 1 in paragraph 10) rose slightly over the year with an increase in the level of the UK's reserve tranche position at the IMF largely offset by a corresponding fall in currency assets.

Financial Statements

36. 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.

37. 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 EEA's exposures are managed together with the NLF's. Currency or interest rate movements that generate a gain or loss to the EEA may well therefore have an equal and offsetting impact on the NLF. The management accounting data presented above combines the EEA and the NLF's foreign currency assets and liabilities. Furthermore, because 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 "marked-to-market" gains or losses on uncompleted contracts such as forward commitments to purchase foreign currency.

38. The Bank 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 Accounts the relationship between 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 as a whole, which can be audited by the NAO. For more information about the NLF see the 'Consolidated Fund and National Loans Fund Accounts 1998-99 Supplementary Statements' (HC 55) published January 2000 by The Stationery Office.

EXCHANGE EQUALISATION ACCOUNT 1998-1999

39. 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 \$100million rolled over throughout the year would contribute \$50 billion (plus interest) to the turnover. The use of swaps for liquidity management and for rolling the forward book is also significant.

40. As a member of the European Monetary System the UK swapped 20 per cent of its gold holdings and 20 per cent of its gross dollar reserves with the European Monetary Institute (later the European Central Bank) during 1998-99 in return for an equivalent value of official ECUs. Each swap was for three months, at the end of which the swap was unwound and a new swap entered into. The swaps reduced the level of gold and dollars on the EEA's statement of assets and liabilities and increased the holdings of ECUs. This arrangement was unwound just ahead of the start of Stage 3 of Economic and Monetary Union (EMU) on 1 January 1999 and has now ceased.

41. "Payments" of interest represent the accrued interest element of bonds purchased by the EEA in the year. Gold lending transactions account for most of the recorded purchases and sales of gold. The difference between the two figures reflects fluctuations in the sterling price of gold between the dates gold was placed on deposit (sales) and when the deposit matured (purchases) combined with changes to the maturity profile of the EEA's gold deposits.

EXCHANGE EQUALISATION ACCOUNT 1998-1999

Statement on the System of Internal Financial Control: Exchange Equalisation Account Accounts 1998-99

6 February 2001

This statement is given in respect of the accounts of the Exchange Equalisation Account for 1998-99. 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.

Gus O'Donnell
Accounting Officer

EXCHANGE EQUALISATION ACCOUNT 1998-1999

Financial Statements

Account of Receipts and Payments

| £ million | £ million | |
|-------------------------------------------|----------------|------------------|
| | 1998-99 | 1997-98 |
| Balance with Paymaster General at 1 April | <u>428</u> | <u>326</u> |
| Receipts | | |
| Transfer from National Loans Fund | 1,250 | 2,800 |
| Sales of gold | 8,856 | 8,850 |
| Sales of securities and currency | | |
| Eurosystem currencies | | |
| -Euros | 99,413 | 156,923 |
| - Deutschemarks | 71,800 | 105,209 |
| -French Francs | 16,206 | 11,455 |
| -Netherlands Guilder | 7,314 | 10,333 |
| -Italian Lire | 1,202 | 1,392 |
| -Other | 440 | 1,551 |
| | 196,375 | 286,863 |
| Non Eurosystem currencies | | |
| - US dollars | 385,834 | 733,662 |
| -Japanese yen | 71,620 | 72,953 |
| -Other | 1,111 | 1,482 |
| | 458,565 | 808,097 |
| Sales of IMF Special Drawing Rights | 751 | 720 |
| Interest, etc on gold and currencies | 2,299 | 3,845 |
| Interest, etc from IMF | 59 | 33 |
| Charges for exchange guarantees | 2 | 5 |
| Total receipts | 668,157 | 1,111,213 |

EXCHANGE EQUALISATION ACCOUNT 1998-1999

Account of Receipts and Payments (cont)

| Payments | £ million | £ million |
|--------------------------------------------|----------------|------------------|
| | 1998-99 | 1997-98 |
| Transfers to National Loans Fund | 3,130 | 6,450 |
| Purchases of gold | 9,673 | 9,965 |
| Purchases of securities and currency | | |
| Eurosystem currencies | | |
| -Euros | 95,779 | 154,578 |
| -Deutschemarks | 70,462 | 104,544 |
| -French Francs | 17,566 | 11,767 |
| -Netherlands Guilder | 7,225 | 10,314 |
| -Italian Lire | 1,234 | 1,321 |
| -Other | 404 | 1,528 |
| | 192,670 | 284,052 |
| Non Eurosystem currencies | | |
| - US dollars | 385,480 | 732,754 |
| -Japanese yen | 73,540 | 73,023 |
| -Other | 1,039 | 1,459 |
| | 460,059 | 807,236 |
| Purchases of IMF Special Drawing Rights | 788 | 726 |
| Interest, etc on gold and currencies | 1,242 | 2,618 |
| Interest, etc to IMF | 54 | 57 |
| Bank of England management charges | 9 | 7 |
| Total payments | 667,625 | 1,111,111 |
| Balance with Paymaster General at 31 March | 960 | 428 |

EXCHANGE EQUALISATION ACCOUNT 1998-1999

Statement of Assets and Liabilities

| | £ million 31/3/99 | £ million 31/03/98 |
|----------------------------------------|-----------------------------|------------------------------|
| Assets | | |
| Balance with Paymaster General | 960 | 428 |
| Gold (Note 1(c)) | 2,989 | 2,468 |
| Securities and Currencies | | |
| Denominated in Euroland currencies | | |
| -Euro currency Units | 7,263 | 7,188 |
| -Deutschemarks | 169 | 2,675 |
| -French Francs | 0 | 440 |
| -Netherlands Guilder | 0 | 118 |
| -Italian Lire | 3 | 80 |
| -Other | <u>3</u> | <u>80</u> |
| | <u>7,438</u> | <u>10,581</u> |
| Denominated in non Euroland currencies | | |
| - US dollars | 5,710 | 5,810 |
| -Japanese yen | 2,468 | 482 |
| -Other | <u>35</u> | <u>115</u> |
| | <u>8,213</u> | <u>6,407</u> |
| IMF Special Drawing Rights | <u>317</u> | <u>261</u> |
| Total Assets | <u>19,917</u> | <u>20,145</u> |
| Liabilities | | |
| National Loans Fund (Note 2) | 0 | 0 |
| IMF Special Drawing Rights | 1,612 | 1,521 |
| Total Liabilities | <u>1,612</u> | <u>1,521</u> |
| Financed by | | |
| Retained Surplus (Note 3) | <u>18,305</u> | <u>18,624</u> |
| | <u>19,917</u> | <u>20,145</u> |

G O'Donnell
Accounting Officer

EXCHANGE EQUALISATION ACCOUNT 1998-1999

Notes to the Financial Statements for the year ended 31 March 1999

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 1999, the balance sheet date. This policy has resulted in gold balances at 31 March 1999 being valued at £129.985 per troy oz.

Foreign currency, and IMF SDRs deposits are translated into sterling at the year end using market exchange 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 1998-99. Holdings of foreign currencies are primarily invested in securities.

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

The sterling balance in 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 a 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 1998-99 there was a capital repayment to the NLF of £1,880 million (see Note 3 below) and hence there was no liability at the year end.

EXCHANGE EQUALISATION ACCOUNT 1998-1999

Sterling transfers during the year were as follows:

| | £million |
|----------------------------------|-----------------|
| Liability to NLF at 1 April 1998 | 0 |
| Transfers to the NLF | (3,130) |
| Transfers from the NLF | 1,250 |
| Balance at 31 March 1999 | - |

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 1998 | 18,624 |
| Unrealised valuation gains (losses) see Note 4 | 507 |
| Net receipts during year | 1,054 |
| EEA Capital to NLF | (1,880) |
| Balance at 31 March 1999 | 18,305 |

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 1998 | |
| Un realised valuation gains on assets | 91 |
| Unrealised valuation loss on SDR liability | (613) |
| Net unrealised valuation gains (losses) | (522) |
| Position at 31 March 1999 | |
| Unrealised valuation gains on assets | 689 |
| Unrealised valuation loss on SDR liability | (704) |
| Net unrealised valuation gains (losses) | (15) |
| Change in net valuation gains (losses) during the year | 507 |

EXCHANGE EQUALISATION ACCOUNT 1998-1999

5. Uncompleted contracts

At 31 March 1999 there were outstanding commitments valued at £752m for sale of holdings, resulting from forward sales and unsettled spot transactions.

| | | £million |
|---------------------------|---------|------------|
| Gold | | 3 |
| Currencies | | |
| Eurosystem currencies | | |
| -Euros | 4,848 | |
| -Deutschemarks | (1,014) | |
| -French Francs | (1,705) | |
| -Other | 0 | |
| | | 2,129 |
| Non Eurosystem currencies | | |
| -US dollars | 387 | |
| -Japanese yen | (1,836) | |
| -Other | 69 | (1,380) |
| Total | | 752 |

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.

EXCHANGE EQUALISATION ACCOUNT 1998-1999

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 1998-99. This differs from the cash payments made in the year, as shown in the Account of Receipts and Payments, which include payments of £2 million in respect of management costs for 1999-2000.

| | Bank of England management charges | Value of reserves at end of period * | Costs as % of funds managed | Staff employed |
|-------------|---------------------------------------------------|---------------------------------------------------------|----------------------------------------|---------------------------|
| | £millions | £millions | | |
| 1998- 99 | 7.029 | 19,917 | 0.035 | 59 |

* Total EEA assets at 31 March 1999 as shown in the EEA annual statement of account.

8. SDRs

The EEA has a liability to pay the IMF for those SDRs which were allocated to the United Kingdom when the United Kingdom became a participant in the Special Drawing Rights Agreement. Payment would be required at current exchange rates if the United Kingdom withdrew from participation or if the Agreement were wound up. This liability was valued at £1,612 million at 31 March 1999.

9. Post-Balance Sheet Events

On 7 May 1999, HM Treasury announced a restructuring of the United Kingdom's official reserves involving a programme of gold auctions. Over the medium term the Treasury has stated that it is planning to reduce its gold holdings to around 300 tonnes. In the financial year 1999-2000, the Bank of England sold approximately 125 tonnes on behalf of HM Treasury in a programme of five auctions of 25 tonnes. On 3 March 2000 HM Treasury announced the sale of a further 150 tonnes of gold during the financial year 2000-01 in a programme of six auctions of 25 tonnes each. Detailed plans for sales in later years will be announced nearer the time.

EXCHANGE EQUALISATION ACCOUNT 1998-1999

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.

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

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.

EXCHANGE EQUALISATION ACCOUNT 1998-1999

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.

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

EXCHANGE EQUALISATION ACCOUNT 1998-1999

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.

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 e.g. Fannie Mae. Typically their debt is not formally guaranteed by the US Government but they are usually considered to be very credit worthy.

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 with a given probability over a defined time horizon given the historic pattern of movements in financial markets. For example, A95% of the time losses will not exceed \$10mn over a two week period@.

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

EXCHANGE EQUALISATION ACCOUNT 1998-1999

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 1998-99 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 14.

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 14 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 1998-1999

Opinion

In my opinion:

- the financial statements set out on pages 15 to 17 properly present the payments and receipts of the Exchange Equalisation Account for the year ended 31 March 1999 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
National Audit Office
Comptroller and Auditor General
157-197 Buckingham Palace Road
Victoria
London SW1W 9SP

28 February 2001

EXCHANGE EQUALISATION ACCOUNT 1998-1999

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
24 March 1999

Treasury Officer of Accounts