

EXCHANGE EQUALISATION ACCOUNT ACT 1979

Presented to Parliament 31 January 2002

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

Presented pursuant to Act 1921, s.5(1)

Exchange Equalisation Account: Report and Accounts 2000–01

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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 position¹ 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.

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 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 UK'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.

Administration and Control

4. 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.

5. The Treasury sets the Bank an annual Remit for the management of the EEA. The Remit for 2000-01 specified:

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

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

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

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.

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

Links to the National Loans Fund

8. 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. Because the EEA does not have the power to borrow, the foreign currency debt which funds part of the reserves is a liability of the NLF. In addition, the UK's reserve tranche position at the IMF and certain other loans to the IMF which create reserve assets are also assets and liabilities of the NLF.

9. The exposures on these foreign currency assets and liabilities are managed together, as explained in paragraph 53. 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. A complete picture of the asset and liability position for the UK's official holdings of international reserves is provided in Tables 1 and 2 on pages 7 and 8.

Links to the International Monetary Fund

10. The primary means of financing the IMF is through members' quotas. Each member of the IMF is assigned a quota, part of which is normally 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 reserve tranche position (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.

11. 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. The United Kingdom also holds SDRs, which are an asset of the EEA. Members are credited with interest on their holdings of SDRs and pay interest on their allocation of SDRs at the same rate.

12. 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. It is intended that the NAB should 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.

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

Operating and Financial Review

Investment Policy

13. EEA investments need to be highly liquid, so they can be made available quickly for intervention purposes if necessary, and carry acceptable credit risk. Essentially this means that the bulk of the assets are securities issued by the national governments of the United States, Euro area countries and Japan, and currency deposits with highly rated banks. Taking account of past patterns of risk and return the Treasury set a benchmark for net currency exposures in 2000–01 of 40% US dollar, 40% euro and 20% yen⁵. During 2000–01 the EEA also made use of other financial instruments including:

- bonds issued by 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 2000–01.

Securities

14. The EEA holds a range of bonds and money market securities. Purchases are made on the basis of the investment policy described in paragraph 13 above. The composition of the EEA's holdings of securities and other eligible instruments is structured so that where appropriate they hedge the liabilities, for example where the reserves have been financed by the Government issuing foreign currency debt (see paragraphs 53 and 55). The returns from securities are mainly from interest received and dealing profits. The dealing profits, which totalled £708 million for the year ending 31 March 2001, include profit or loss realised when a holding is disposed of and also unrealised profit or loss arising from changes in the market value of the securities portfolio. The appreciation of the US dollar and the euro against sterling over the financial year increased the unrealised dealing profits in sterling terms, although this was partly offset by the depreciation of the yen against sterling for the period. The EEA also receives an income return when it authorises custodians holding bonds owned by the EEA to use them in their bond lending programmes (see paragraph 7).

Gold

15. 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 200.2 tonnes; interest received on gold lending during 2000–01 amounted to £11.0 million.

⁵This benchmark is applied to currency exposures excluding the EEA's holdings of Gold and SDRs, and the NLF's reserve tranche position at the IMF.

16. In May 1999, the Government announced a restructuring of the UK's official reserves involving a programme of gold auctions to achieve a better balance in the portfolio by increasing the proportion held in currency. Following each auction, the proceeds of the gold sales are reinvested in foreign currency interest-bearing assets—broadly in the proportion 40% dollars, 40% euros and 20% yen—and retained in the reserves.

17. During the year ended 31 March 2001 the Bank of England sold, on behalf of HM Treasury, approximately 150 tonnes of gold from the EEA in a series of six auctions, bringing the total sold under the programme to approximately 275 tonnes. It was announced in March 2001 that HM Treasury planned to sell 120 tonnes of gold during 2001–02 through a further series of six auctions conducted by the Bank of England, of approximately 20 tonnes each.

18. The decrease in the market value of the EEA's gold holdings from £3,299 million to £2,570 million over the year mainly reflects a reduction in gold holdings from 18.9 million fine ounces (588.3 tonnes) at end-March 2000 to 14.1 million fine ounces (437.1 tonnes) at end-March 2001 due to the programme of gold auctions. The fall in the volume of the gold held by the EEA was partly offset by an increase in the sterling price of gold during the same period.

Strategy Positions

19. The Treasury may decide, on advice from the Bank, to set deviations from the 40:40:20 currency benchmark or the one month rate benchmark (which are denoted "strategy positions"). No strategy positions were set during 2000–01.

Intervention

20. Intervention was undertaken on one occasion during the year, on 22 September 2000, when the Bank of England, acting as the Government's agent, purchased €85 million against sterling. This action was taken as part of a concerted intervention by the G7 monetary authorities because of the shared concern about the potential implications of movements in the euro for the world economy.

Provision of Foreign Currency Services to Departments

21. 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.

Analysis of Returns for the Period

22. The level of the reserves in the EEA rose to £29.4 billion over the course of the year. This was mainly as a result of the policy decision to prefinance foreign currency liabilities (see paragraphs 36–41) as well as the positive return made on the holdings of foreign currency reserves.

23. The operating surplus for the year ending 31 March 2001 (see page 17) totalled £1,012 million. Broadly speaking this surplus is equal to the sum of net interest receipts, dealing profits (both realised and unrealised) and gains or losses from foreign exchange movements. The interest receivable figure of £964 million, which is the interest received on the EEA's portfolio of assets, was more than offset by interest payable of £1,556 million, resulting in a net interest figure for the year of –£592 million. The interest payable figure is mainly interest on the borrowed foreign currency reserves, the 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 main drivers of the foreign currency

interest payments are yield levels in US dollars, yen and euro at the time when these assets and liabilities were created. The notional sterling charge is calculated using the Bank of England repo rate.

24. Dealing profits, which totalled £708 million for the year ended 31 March 2001, include realised profit or loss on the disposal of investments and changes in the market value of the portfolio. The largest component, £286 million, related to dealing profits on the bond portfolio. Falls in interest rates increase the unrealised returns in the dealing profits as the price of securities rises. The position is reversed if interest rates increase. During the year dollar yields fell. Yen yields also fell, although by less than dollar yields. Euro yields also fell over the period with the exception of those on short-dated instruments.

25. Other components were dealing profits on foreign exchange, currency swaps and money market instruments. Foreign exchange dealing profits, of £143 million, arose in the course of foreign exchange trading and as a result of fluctuations in the sterling value of the reserves. The return on currency swaps, of £171 million, is the unrealised dealing profit arising from the price movements on swaps yet to mature. However, currency swaps are intended to hedge foreign currency risk on assets held; so dealing profits on these swaps broadly offset losses from price movements elsewhere in the portfolio. Dealing profits on money market instruments totalled £103 million.

26. Exchange gains and losses on foreign currencies and gold during the year contributed £894 million towards the operating surplus. Primarily, these gains resulted from movements in the dollar, euro, yen and SDR exchange rates against sterling. However, there was an offsetting loss of £786 million on foreign currency liabilities held on the NLF (see paragraph 32).

Bank's Management of the Official Holdings of International Reserves

27. The reserves⁶ are actively managed against a number of benchmarks. These can be split into benchmarks for the “borrowed reserves” on which the currency exposure has been hedged, the “net currency reserves” and gold leasing. In broad terms the benchmarks used are:

- (a) benchmark returns on borrowed reserves: this comprises returns to hedge portfolios held against NLF foreign currency liabilities used to finance reserve assets and returns generated by the sterling swaps programme. The hedge portfolios are hypothetical portfolios constructed by the Bank, which consist of a set of assets that have very similar risk characteristics to the liabilities that finance them (for example, for the US dollar portfolio a hedge would typically comprise US Treasuries with a similar maturity to the corresponding dollar liabilities). The returns to the hedge portfolios are the returns that would have occurred had the actual assets held been those of the hypothetical hedges. Returns on the sterling swaps programme represent a combination of capital gain (or loss) on the foreign currency assets purchased and the (generally) offsetting gain or loss on the maturing swaps, plus the excess sterling return compared to an assumed cost of funding of 1-month sterling LIBOR less 25 basis points;
- (b) benchmark return on holding foreign currencies and gold leasing: this comprises the return on holding the “net currency reserves” in a “neutral” benchmark of 40% US dollars, 40% euros and 20% yen⁷ and from gold leasing⁸. The “neutral” net currency reserves benchmark are 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 fund the net currency reserves is assumed to be raised at 1-month sterling LIBOR less 25 basis points.

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

⁷ 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.

⁸ Gold leasing was benchmarked from 1 October 2000. The benchmark portfolio comprises a weighted average of one, three and six month deposits.

28. The total sterling return to active management during 2000–01 was £19 million, including the return on the purchase and sale of euros related to the foreign currency intervention referred to in paragraph 20 above.

29. The management charge for the administrative costs incurred by the Bank of England for its management of the EEA during 2000–01 was £8 million.

UK Official Holdings of International Reserves and Related Returns

30. As explained in paragraphs 8 and 9, looked at in isolation the EEA 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 shown in Tables 1 and 2, which have been derived by consolidating the assets and liabilities of the EEA with those of the NLF associated with the official reserves.

31. The key differences between the EEA's assets and liabilities and those for the UK official reserves are the inclusion of the RTP (a NLF asset) with the associated sterling liability and the inclusion of £8.3 billion equivalent of foreign currency securities and loans (a NLF liability) replacing an element of the retained reserves shown in the EEA balance sheet.

32. Likewise, there are a number of differences between the income and expenditure account for the EEA and the returns for the UK official reserves. The changed composition of liabilities resulting from consolidation is reflected in interest payable, as is the inclusion of the sterling liability associated with the RTP. However, the most significant difference is the reduction in foreign exchange gains from £894 million on the EEA to £108 million on the consolidated account. This is also due to the inclusion, upon consolidation, of the foreign currency debt securities and loans on the NLF. As explained in paragraph 53, the foreign currency assets and liabilities associated with the official reserves are managed together in order to minimise exposure to fluctuations in the value of currencies. During 2000–01 foreign exchange losses on the NLF's foreign currency liabilities associated with the official reserves were offset by foreign exchange gains on the related foreign currency assets held on the EEA.

Table 1: UK Official Holdings of International Reserves: Returns

For the year ended 31 March 2001

| | Year ended 31 March 2001 £ millions Unaudited |
|-----------------------------------|--|
| Interest receivable | 964 |
| Interest payable | (1,545) |
| Net interest income | (581) |
| Fees and commissions receivable | 11 |
| Fees and commissions payable | (1) |
| Dealing profits | 708 |
| Foreign exchange gains and losses | 108 |
| Management charge | (8) |
| Operating surplus | 237 |

Table 2: UK Official Holdings International Reserves: Assets and Liabilities

As at March 2001

31 March 2001
£ millions
Unaudited**Assets**

| | | | |
|--|---------------------------------|-------|---------------------------|
| Cash (excluding sterling balance with Paymaster General) | | | 85 |
| Holdings of IMF Special Drawing Rights | | | 246 |
| Reserve Tranche Position | | | 2,865 |
| Items in course of collection from banks | | | 73 |
| Treasury and other eligible bills | | | 1,931 |
| | <i>of which:-</i> | | |
| | <i>US dollar bloc</i> | 1,411 | |
| | <i>Euro</i> | 477 | |
| | <i>Yen and other currencies</i> | 43 | |
| Loans and advances to banks | | | 5,998 |
| | <i>of which:-</i> | | |
| | <i>US dollar bloc</i> | 4,049 | |
| | <i>Euro</i> | 1,647 | |
| | <i>Yen and other currencies</i> | 302 | |
| Debt securities | | | 17,199 |
| | <i>of which:-</i> | | |
| | <i>US dollar bloc</i> | 4,465 | |
| | <i>Euro</i> | 8,139 | |
| | <i>Yen and other currencies</i> | 4,595 | |
| Gold and gold receivables (net of items in course of transmission) | | | 2,547 |
| Other assets | | | 638 |
| Prepayments and accrued income | | | 333 |
| Total assets | | | 31,915⁹ |
| Liabilities | | | |
| Items in course of transmission to banks | | | 845 |
| Deposits by banks | | | 561 |
| Debt securities and loans | | | 8,326 |
| | <i>of which:-</i> | | |
| | <i>US dollar bloc</i> | 5,604 | |
| | <i>Euro</i> | 2,722 | |
| Sterling liability to investors | | | 8,217 |
| SDR allocation | | | 1,695 |
| Other liabilities | | | 354 |
| Accruals and deferred income | | | 160 |
| Total liabilities | | | 20,158 |
| Net assets | | | 11,757 |

⁹ This statement has been prepared on a different accounting basis to the monthly template of UK International Reserves and Foreign Currency Liquidity. As a result, the total assets shown exceed the gross reserves in the March 2001 template by £1.7 billion. In contrast to the figure shown here, the template excludes the sterling leg of currency swaps and is adjusted for unsettled items.

Loans to the IMF

33. The UK's RTP at the Fund fell over the course of the year to the SDR equivalent of £2,865 million at end-March 2001 compared to the SDR equivalent of £3,231 million at end-March 2000. This reflected a fall in the SDR value of the RTP from SDR 3,813 million at end-March 2000 to SDR 3,235 million at end-March 2001. This movement was due to repayments of IMF lending programmes (including Brazil, Korea and Mexico) being greater than new lending (to Argentina and Turkey); offset in part by a weakening in sterling against the SDR basket over the period. There were no increases in the UK's IMF quota during the year.

34. The policy of neutralising changes in the level of the RTP on the level of the international reserves was continued during 2000–01. 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 contain its foreign exchange exposure during 2000–01, 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 the UK's RTP falls, other things being equal the official reserves would fall. These trades are offset in the market by buying foreign currency with the sterling repayment.

35. The United Kingdom did not lend to the IMF under the General or New Arrangements to Borrow during the course of the year.

Financing

36. The Exchange Equalisation Account Act does not permit the EEA to borrow. Therefore, where the foreign currency reserves have been 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 leaving the NLF with a foreign currency liability to the market hedged by a foreign currency asset on the EEA. More information on the management of interest rate and currency exposure by the combined management of assets and liabilities can be found in paragraphs 53 and 55.

37. In the case of sterling funding 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 leaving a synthetic foreign currency asset on the EEA hedging the NLF's sterling liability to the market. More information on the management of interest rate and currency exposure through the use of swaps can be found in paragraphs 54 and 55.

38. The main determinant of whether the foreign currency reserves are to be funded by issuing foreign currency liabilities or by sterling swapped into foreign currencies is cost. The least cost method of funding 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.

39. During 2000–01, £3.2 billion of foreign currency liabilities were repaid, comprising the €2.2 billion January 2001 euro note and €2.75 billion February 2001 euro bond. At end-March 2001 foreign currency liabilities totalled £8.3 billion. Of this, £4.3 billion is due to be repaid in 2001–02 and £3.6 billion in 2002–03.

40. A rolling euro note issuance programme was continued and it was announced in January 2000 that regular tranches of €500 million would be auctioned each quarter in calendar year 2000. The proceeds from these euro note issues were reinvested in fixed rate instruments giving the highest yield from a

range of securities, within set risk limits. In March 2000 the Government announced its intention to withdraw from the euro note issuance programme. At the same time the Bank of England announced arrangements for it to take over from HM Treasury as the issuer of 3-year euro notes with effect from January 2001, which it has now done.

41. The programme to replace the financing of reserves through foreign currency debt issuance by substituting sterling debt swapped into foreign currencies continued during 2000–01. Over this period a total of £7.8 billion was used to finance the acquisition of €7.5 billion nominal of European government bonds, ¥352 billion nominal of Japanese government bonds and \$0.9 billion of US government bonds.

Risk Management and Control

42. Although the 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.

43. 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

44. The key features of the control framework are as follows:

- An organisational structure in the Bank containing clear reporting lines, which includes a Risk Analysis and Monitoring Division that reports to the Executive Director for Financial Market Operations at the Bank, and which is independent of the Foreign Exchange Division where trading activities are conducted.
- An annual Remit that is agreed between the Treasury and the Bank, in which the Treasury sets out the parameters under which the reserves shall be managed by the Bank. A published version of the remit is contained in the Debt and Reserves Management Report¹⁰.
- A system of financial reporting that requires the Bank to account each month to the Treasury for the returns made and the market and credit risks incurred.
- An internal audit programme that is risk-based and which delivers reports to the Bank's Executive Director who reports their content to the Treasury.
- Limits to credit and market risk exposures that are explained in the following paragraphs.

45. *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 is 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 are agreed for the exposure to each bank and issuer. Such exposures are monitored in real time against the limits. A report of any limit excesses is sent to the Treasury each month.

¹⁰Produced by HM Treasury at the time of the Budget for the financial year ahead.

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

47. Where bonds are owned by the EEA, but held by custodians, they may be authorised to use them in their bond lending programmes. These programmes involve lending the bonds against collateral consisting of either other bonds or cash. The authorised custodians are permitted to invest cash collateral in money market instruments ranging from US agency repo to bank deposits. The credit limits delegated to the custodians are deducted from the limits available to the Bank for its own EEA management activities. Any maturity mismatch between the collateral held and the corresponding investments is strictly limited. Daily reports are received by the Bank, which allows compliance with the investment constraints to be checked.

48. *Market risk:* Market risk is the exposure to movements in market variables. For the EEA, these variables are primarily interest rates and exchange rates. The Bank monitors and controls market risk by using a Value at Risk (VaR) model, which predicts, at a specified confidence level, the maximum likely loss for the portfolios over a certain time period. The Bank applies a 99% confidence interval and a two-week holding period, which predicts that in ninety-nine two-week periods out of a hundred, losses should not exceed those suggested by the model. These VaR estimates are based on the past volatility of returns on different asset classes and on how the returns on each asset class are correlated with other positions held in the portfolio.

49. The Bank measures the EEA's VaR exposure on a regular basis throughout the day. It also calculates the Delta exposure at the same frequency. Delta measures the change in value of the portfolios for each one basis point shift in the relevant yield curve. It supplements the VaR measure, and helps to test the sensitivity of the portfolios to changes in interest rates.

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

Operational Guidelines

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

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

53. If financing is through foreign currency borrowing with assets hedged into the currency of the liability, this happens automatically in that fluctuations in the sterling value of the NLF's foreign currency liabilities are matched by fluctuations in the sterling value of EEA assets, with the combined fluctuations cancelling each other out. For example, when sterling appreciates, the values of both the NLF's foreign currency liabilities and of the EEA's foreign currency assets fall in sterling terms.

54. If financing is in sterling using currency swaps, the initial swap of sterling for foreign currency fully hedges the exchange rate risk. This is 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.

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

56. The above arrangements produce a portfolio of assets that closely hedges the obligations to repay the NLF's foreign currency liabilities.

57. The currency and interest rate risk in the net reserves needs to be controlled as well, and this is done as follows.

58. The net currency assets are invested in short-term money market instruments in order to control the residual interest rate risk. The Bank can, and does, incur currency risk by deviating from the benchmark in its operations. The Bank is limited in these deviations by the VaR limit mentioned below. In 2000-01 the maximum deviation from 40:40:20 was 37:42:21.

59. 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 19, no strategy positions were taken in 2000–01. Any intervention to influence the level of sterling or other currency would change the level and possibly the composition of the currency risk. This happened once in 2000-01, as mentioned in paragraph 20.

60. Under the Remit the Bank actively manages the borrowed and net reserves, in order to improve the return. The Treasury sets the Bank a VaR limit in the Remit each year. In 2000-01 it was US\$40 million, and during the year the Bank's use did not exceed US\$14 million at any one time.

Accounting Policies

61. 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.

62. Accordingly, accounting requirements for banking entities form the basis of the EEA's Accounts Direction (page 29) 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.

63. The EEA's accounts for previous years were prepared on the basis of quite different accounting policies, under which transactions were reported on in cash terms only and most balances were not revalued to reflect market values. Because of this difference, the EEA's accounts for 2000–01 do not include comparative figures drawn from its accounts for 1999–2000. Additional information is given on assets and liabilities as at 31 March 2000 (see page 28) calculated on bases consistent with those applying to the accounts for 2000–01, other than in that other assets and other liabilities are shown on a net, not a gross, basis.

Audit and Publication

64. The accounts have been prepared in accordance with a direction given by HM Treasury in pursuance of section 5(1) as amended by the Finance Act 2000. The text of the direction is reproduced on page 29 of this document. The accounts and supporting notes relating to the EEA for the year ending 31 March 2001 have been audited by the Comptroller and Auditor General.

G O'Donnell
Accounting Officer

HM Treasury
18 January 2002

Statement of the Accounting Officer's Responsibilities

Under the Exchange Equalisation 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 Financial Control can be found on page 15.

Statement on the System of Internal Financial Control

This statement is given in respect of the accounts of the Exchange Equalisation Account for 2000–01. 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 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; and
- the work of the internal audit unit at the Bank of England, which operates broadly to the 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 the Account is exposed and annual internal audit plans are based on this analysis. The Bank's Audit Committee endorses the framework for the analysis of risk and the internal audit plans and these are approved by me.

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

The Treasury has an internal audit team which operates to the standards defined in the Government Internal Audit Manual. The work of the Treasury's internal audit (TIA) team is informed by an analysis of the risk to which the department is exposed in relation to the EEA and internal audit plans for the EEA are informed by this analysis. The analysis of risk and the work of the TIA team is endorsed by the department's Audit Committee of which I am a member. The Head of TIA provides the Audit Committee with reports on internal audit activity in the department and include her independent views on the adequacy of the Treasury's system of internal control including internal financial controls.

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

As Accounting Officer, I am aware of the recommendations of the Turnbull Committee and I am taking reasonable steps to comply with the Treasury's requirement for a statement of internal control to be prepared for the year ending 31 March 2002, in accordance with DAO (GEN) 13/2000.

G O'Donnell
Accounting Officer

HM Treasury
18 January 2002

Certificate and Report of the Comptroller and Auditor General to the Houses of Parliament

I certify that I have audited the financial statements on pages 17 to 28 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 20 to 21.

Respective Responsibilities of the Accounting Officer and the Auditor

As described on page 14 the Accounting Officer is responsible for the preparation of the financial statements in accordance with the Exchange Equalisation 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 Accounts. My responsibilities as independent auditor are established by statute and 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 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 page 15 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 Audit Opinion

I conducted my audit in accordance with United Kingdom Auditing Standards issued by the Auditing Practices Board. An audit includes an examination on a test basis of evidence relevant to the amounts, disclosures and regularity of financial transactions included in the 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 2001, 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 Act 1979 (as amended by the Finance Act 2000) and directions made thereunder by Treasury; and
- in all material respects the income, expenditure and resources 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.

John Bourn
Comptroller and Auditor General

23 January 2002

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

Income and Expenditure Account

For the year ended 31 March 2001

| | Notes | Year ended 31 March 2001 £ millions |
|--|-------|---|
| Interest receivable | 2 | 964 |
| Interest payable | 3 | <u>(1,556)</u> |
| Net interest income | | (592) |
| Fees and commissions receivable | | 11 |
| Fees and commissions payable | | (1) |
| Dealing profits | 4 | 708 |
| Exchange gains and losses on foreign currencies and gold | | 894 |
| Management charge | 5 | <u>(8)</u> |
| Operating surplus | | <u>1,012</u> |
| Retained surplus for the financial year | 16 | <u>1,012</u> |

All income and expenditure arose from continuing operations.

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

The notes on pages 20 to 28 form part of these accounts.

Balance Sheet

As at 31 March 2001

| | Notes | 31 March 2001 £ millions |
|--|-------|-----------------------------|
| Assets | | |
| Cash | 18 | 414 |
| Holdings of IMF Special Drawing Rights | | 246 |
| Items in course of collection from banks | | 73 |
| Treasury and other eligible bills | 6 | 1,931 |
| Loans and advances to banks | 7 | 5,998 |
| Debt securities | 8 | 17,199 |
| Gold and gold receivables | 9 | 2,570 |
| Other assets | 10 | 638 |
| Prepayments and accrued income | | 333 |
| Total assets | | 29,402 |
| Liabilities | | |
| Items in course of transmission to banks | | 868 |
| Deposits by banks | 11 | 561 |
| Liability to NLF | 12 | 5,680 |
| SDR allocation | 13 | 1,695 |
| Other liabilities | 14 | 354 |
| Accruals and deferred income | | 1 |
| Retained reserves | 16 | 20,243 |
| Total liabilities | | 29,402 |

The notes on pages 20 to 28 form part of these accounts.

G O'Donnell
Accounting Officer

HM Treasury
18 January 2002

Cash Flow Statement

For the year ended 31 March 2001

| | Notes | Year ended 31 March 2001 £ millions |
|---|-------|---|
| Net cash outflow from operating activities | 17 | <u>(5,326)</u> |
| Financing | | |
| Net inflow from the National Loans Fund | 12 | <u>5,205</u> |
| Decrease in cash in the year | 18 | <u>(121)</u> |

The notes on pages 20 to 28 form part of these accounts.

Notes to the Accounts

1 Accounting policies

A summary of the accounting policies, all of which have been applied consistently throughout the year, is set out below. These represent a significant change from those adopted in the prior year under which transactions were recorded on a cash basis and investments were carried at average historic cost. A decision was made to change the basis to mark-to-market and accrual accounting in order to provide a fairer representation of the trading activities of the EEA and to produce financial statements that comply with UK Generally Accepted Accounting Principles.

Given the impact of the change to mark-to-market and accrual accounting, it would not be informative to compare current year figures to the prior year's and it is not practicable to restate all the prior year under the new accounting policies. Consequently no comparable figures for the prior year are provided in the main accounts. However, additional information is given on assets and liabilities as at 31 March 2000 (see note 19) calculated on bases consistent with those applying to the accounts for 2000-01, other than in that other assets and other liabilities are shown on a net, rather than a gross, basis.

Basis of accounting

The accounts are 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.

Interest receivable

Interest receivable has 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 reserve tranche 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 investments 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. 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.

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.

2 Interest receivable

| | 2000–01 £ millions |
|---|-----------------------|
| Interest on bonds | 526 |
| Interest on money market deposits and margin accounts | 232 |
| Interest on reverse repos | 47 |
| Interest on Reserve Tranche Position | 98 |
| Interest on money market instruments | 15 |
| Interest on Special Drawing Rights | 12 |
| Interest on currency swaps | 12 |
| Interest on gold deposits | 11 |
| Interest on securities lending | 4 |
| Other interest receivable | 7 |
| Total | 964 |

3 Interest payable

| | 2000–01 £ millions |
|--|-----------------------|
| Sterling capital charge (notional) | 1,435 |
| Interest on allocation of Special Drawing Rights | 77 |
| Interest on repos | 33 |
| Interest on interest rate swaps | 5 |
| Other interest payable | <u>6</u> |
| Total | <u>1,556</u> |

4 Dealing profits

| | 2000–01 £ millions |
|-------------------------------|-----------------------|
| Bonds | 286 |
| Foreign exchange transactions | 143 |
| Currency swaps | 171 |
| Money market instruments | 103 |
| Other instruments | <u>5</u> |
| Total | <u>708</u> |

5 Management charge

The management charge of £8 million represents the administrative costs incurred by the Bank of England for EEA management during 2000–01.

6 Treasury and other eligible bills

| | 31 March 2001 £ millions |
|---------------------------------------|-----------------------------|
| Treasury bills and similar securities | — |
| Other eligible bills | <u>1,931</u> |
| Total | <u>1,931</u> |

7 Loans and advances to Banks

| | 31 March 2001 £ millions |
|--|-----------------------------|
| Repayable on demand | 93 |
| Other loans and advances—remaining maturity: | |
| 3 months or less | 5,781 |
| 1 year or less but over 3 months | 124 |
| 5 years or less but over 1 year | — |
| Over 5 years | — |
| Total | <u>5,998</u> |
| Of which, reverse repo transactions | 1,298 |

8 Debt Securities

All debt securities are held in the trading book and recorded at market value. At 31 March 2001, all debt securities were listed overseas.

Issued by Public Bodies

| | 31 March 2001 £ millions |
|-----------------------|-----------------------------|
| Government Securities | 16,111 |
| Other Public Sector | 234 |
| Total | <u>16,345</u> |

Issued by Other Issuers

| | 31 March 2001 £ millions |
|---|-----------------------------|
| Bank/Building Society certificates of deposit | 854 |
| Total | <u>854</u> |
| | 31 March 2001 £ millions |
| Due within one year | 4,157 |
| Due one year and over | 13,042 |
| Total | <u>17,199</u> |

9 Gold and gold receivables

This comprises gold stock and gold deposits at market value.

| | 31 March 2001 £ millions |
|---------------|-----------------------------|
| Gold stock | 1,398 |
| Gold deposits | 1,172 |
| Total | <u>2,570</u> |

10 Other assets

| | 31 March 2001 |
|-------------------------------|---------------|
| | £ millions |
| Currency swaps | 487 |
| Interest rate swaps | 30 |
| Foreign exchange transactions | 110 |
| Futures | 11 |
| Total | 638 |

11 Deposits by Banks

All deposits by Banks, totaling £561 million at 31 March 2001, had remaining maturity of 3 months or less.

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 in 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 is used to reduce the retained reserves. No capital repayments were made during the year ended 31 March 2001. The sterling transfers to and from the NLF during the year were:

| | £ millions |
|--|--------------|
| <i>Liability to NLF at 1 April 2000</i> | 475 |
| Transfers to NLF | (3,300) |
| Transfers from NLF | 8,505 |
| Liability to NLF at 31 March 2001 | 5,680 |

13 SDR allocation

The EEA has a liability to pay the IMF for those SDRs, which were allocated 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 the Agreement was wound up. This liability at market value as at 31 March 2001 was £1,695 million.

14 Other liabilities

| | 31 March 2001 |
|---|-------------------|
| | £ millions |
| Net liability under the Exchange Cover Scheme | 2 |
| Futures Margin | 5 |
| | <u>7</u> |
| Currency swaps | 212 |
| Interest rate swaps | 47 |
| Foreign exchange transactions | 88 |
| | <u>347</u> |
| Total | <u>354</u> |

Under the Exchange Cover Scheme, Local Authorities and Public Corporations borrowed foreign currency and sold the foreign currency 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 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:

| | 31 March 2001 | | |
|---------------------------------|---------------------------------|-------------------------|------------------------------|
| | £ millions | £ millions | £ millions |
| | Notional Principal Amount | Assets at Fair Value | Liabilities at Fair Value |
| Exchange rate contracts: | | | |
| Spot and forwards | 6,695 | 110 | 88 |
| Currency Swaps | 11,598 | 487 | 212 |
| | 18,293 | 597 | 300 |
| Interest rate contracts: | | | |
| Interest rate swaps | 3,343 | 30 | 47 |
| Interest rate futures | 7,100 | 11 | — |
| | <u>10,443</u> | <u>41</u> | <u>47</u> |
| Total | <u>28,736</u> | <u>638</u> | <u>347</u> |

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

| | 31 March 2001 | | | |
|---------------------------------|-------------------------------|-------------------------------|-------------------------------|---------------------|
| | £ millions Under 1 Year | £ millions 1 to 5 Years | £ millions Over 5 Years | £ millions 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) |

Other financial instruments

Other financial instruments are included at fair value.

16 Retained reserves

The retained reserves represent the total reserve balance as at the date of transition to the new accounting methodology (1 April 2000). It was set to equal the opening net asset balance as determined in accordance with the new accounting policies. Subsequent gains and losses are also taken to retained reserves together with the notional sterling capital charge.

| | 2000–01 £ millions |
|------------------------------------|-----------------------|
| At 1 April 2000 | 17,796 |
| Retained surplus for the year | 1,012 |
| Sterling capital charge (notional) | 1,435 |
| At 31 March 2001 | 20,243 |

17 Reconciliation of operating surplus to net cash outflow from operating activities

| | 2000-01 |
|---|----------------|
| | £ millions |
| Operating surplus | 1,012 |
| Sterling capital charge (notional) | 1,435 |
| Net increase in prepayments and accrued income | (111) |
| Net decrease in accruals and deferred income | (1) |
| Net cash inflow from trading activities | 2,335 |
| Net decrease in SDRs | 47 |
| Net decrease in items in course of collection | 64 |
| Net increase in treasury and other eligible bills | (61) |
| Net increase in loans and advances to banks | (3,286) |
| Net increase in debt securities | (5,773) |
| Net decrease in gold and gold receivables | 729 |
| Net decrease in other assets | 367 |
| Net increase in items in course of transmission | 482 |
| Net decrease in deposits by banks | (306) |
| Net increase in SDR allocation | 71 |
| Net increase in other liabilities | 5 |
| Net cash outflow from operating activities | (5,326) |

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

| | At 1 April 2000 | At 31 March 2001 | |
|---|-----------------|------------------|------------|
| | £ millions | Cashflow | |
| | £ millions | £ millions | £ millions |
| Balance with Paymaster General | 475 | (146) | 329 |
| Balances at Central Banks | 73 | 12 | 85 |
| | 548 | (134) | 414 |
| Loans and advances to other banks repayable on demand | 80 | 13 | 93 |
| Total | 628 | (121) | 507 |

19 Exchange Equalisation Account Balance Sheet as at 31 March 2000

| | 31 March 2000 |
|--|----------------------|
| | £ millions |
| Assets | |
| Cash | 548 |
| Holdings of IMF Special Drawing Rights | 293 |
| Items in course of collection from banks | 137 |
| Treasury and other eligible bills | 1,870 |
| Loans and advances to banks | 2,699 |
| Debt securities | 11,426 |
| Gold and gold receivables | 3,299 |
| Other assets | 1,005 |
| Prepayments and accrued income | 222 |
| Total assets | <u>21,499</u> |
| Liabilities | |
| Items in course of transmission to banks | 386 |
| Deposits by banks | 867 |
| Liability to NLF | 475 |
| SDR allocation | 1,624 |
| Other liabilities | 349 |
| Accruals and deferred income | 2 |
| Retained reserves | 17,796 |
| Total liabilities | <u>21,499</u> |

The rights and obligations of the Exchange Equalisation Account in relation to certain financial instruments have been recognised within other assets and other liabilities on a net basis, as it was not considered practicable to analyse these balances further. Accordingly the figures for other assets and other liabilities are not directly comparable to those in the balance sheet at 31 March 2001.

Accounts Direction given by HM Treasury under the Exchange Equalisation Account Act 1979¹¹

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 control¹²
- (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 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.

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

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

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 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 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.

LIBOR stands for London Interbank Offer Rate and is the 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 domestic currency by central banks or governments with the intention of influencing the exchange rate.

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

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

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

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

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

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

Special Drawing Right (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 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'. Typically their debt is not formally guaranteed by the US Government but they are usually considered to be very creditworthy.

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

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

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