

EXCHANGE EQUALISATION ACCOUNT ACT 1979

Presented to Parliament 12 July 2007

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

Exchange Equalisation Account: Report and Accounts 2006–07

ORDERED BY THE HOUSE OF COMMONS TO BE PRINTED 12 July 2007

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Foreword

Introduction

1. The Exchange Equalisation Account (EEA) holds the United Kingdom's reserves of gold, foreign currency assets and International Monetary Fund (IMF) Special Drawing Rights¹ (SDRs). Combined with the UK's Reserve Tranche Position (RTP) at the IMF, these assets comprise the UK's official holdings of international reserves (the "official reserves"). The RTP is held in the National Loans Fund (NLF).

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

3. The Bank also acts as the Treasury's Agent for foreign currency liability management, including the issuance of foreign currency debt to finance some of the reserves. This debt is issued by, and is an obligation of, the NLF under the National Loans Act 1968 since it is that Act (rather than the Exchange Equalisation Account Act 1979) which provides the powers for the Government to issue foreign currency securities. The foreign currency raised by issuing foreign currency debt is transferred to the EEA (see paragraph 16).

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

Origin and Purpose

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

6. The Government's macroeconomic framework is designed to maintain long-term economic stability. This is achieved by maintaining low and steady inflation, steady and sustainable growth and sound public finances. The current macroeconomic framework does not entail management of the exchange rate and the UK has not intervened for the purposes of influencing the sterling exchange rate since 1992.³ Against this background, foreign exchange reserves are largely held on a precautionary basis - to meet any change in exchange rate policy in the future, if required, or in the event of any unexpected shocks. The reserves are also used to provide foreign currency services for government departments and agencies, to provide foreign exchange for making payments abroad and to buy, sell and hold Special Drawing Rights (SDRs) as required by the UK's membership of the IMF. The way the reserve assets are invested, financed and managed is primarily designed to meet these policy objectives.

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

² A summary is included in the Debt and Reserves Management report produced by HM Treasury at the time of the Budget and available via www.hm-treasury.gov.uk.

³ The UK participated in a G7 concerted intervention to support the Euro in 2000.

7. Under the Exchange Equalisation Act 1979, the EEA is permitted to invest its funds in any assets denominated in the currency of any country; to purchase gold; and to acquire SDRs.

Administration and Control

8. The EEA is under the control of the Treasury. The Treasury has appointed the Bank to act as its Agent to carry out dealing in foreign currencies and the investment of the reserves. The Bank also provides advice and analysis to the Treasury on issues relating to the reserves. The Bank's management costs are charged to the EEA; these costs were £9.2million for 2007 (2006: £9.1million).

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

- benchmarks⁴ for investing the reserves, with limits to the Bank's discretion to take currency or interest rate positions relative to these benchmarks;
- the framework for controlling credit, market, liquidity and other risks;
- a target return for active management compared to benchmark positions; and
- the programme for financing the reserves, covering the NLF's foreign currency borrowing and currency swaps out of sterling.

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

10. The Bank reports to the Treasury on investment performance, returns made and risk exposures, including those relating to active management, at regular meetings chaired by the head of the Treasury's Debt and Reserves Management team. Every six months there is a meeting at which the EEA Accounting Officer (currently the Second Permanent Secretary of the Treasury) and the Bank of England's Executive Director for Markets, or delegated senior officials, review investment performance and discuss strategic issues relating to the reserves.

Investment Policy

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

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

- securities issued by other national governments, supranational organisations and selected government and government-sponsored agencies;
- foreign currency spot, forward and swap transactions;
- interest rate swaps;
- bond, interest rate and swap futures;
- sale and repurchase agreements;

⁴ Benchmark is the neutral or passive investment strategy for the reserves portfolio. Active management performance is measured against a target return over the benchmark.

- forward rate agreements;
- gold deposits and swaps - no gold swaps were entered into during the year;
- SDRs;
- deposits with, and certificates of deposits and certain covered bonds issued by, highly rated banks; and
- corporate commercial paper - no such transactions were entered into during the year.

Management Commentary

Reserves

13. The UK official reserves can be divided into two components: reserves that are hedged for currency risk of £11.6bn, (the 'hedged reserves'); and the remaining reserves (£10.9bn) where the currency exposure is unhedged (the 'unhedged reserves').

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

15. The hedged reserves comprise portfolios of eligible dollar, euro and yen denominated bonds. Assets in the hedged reserves are hedged for currency risk either by being denominated in the same currency as the liabilities which finance them or by using currency swaps. In practice the hedged reserves are also hedged against interest rate risk, through the use of swaps (see paragraph 53-55).

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

17. Financing of the hedged reserves in 2006-07 included sterling swapped into foreign currencies of £10.1bn (2005-06: £10.1bn) and outstanding foreign currency securities of £1.5bn (2005-06: £1.7bn) at the end of the year. No new foreign currency securities were issued during the year (2005-06: nil).

Management of the official reserves

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

19. The size of the official reserves assets that are held in the EEA fell over the course of the year by £0.4bn to £28.2bn. This decrease consisted primarily of a reduction in loans and advances to banks of £0.6bn.

20. This fall in the reserve assets in the EEA reflects a drop in liabilities consisting of a reduction in repo transactions of £0.3bn and a decrease of £0.2bn in the liability to the NLF.

21. In the NLF, the value of the RTP fell during the year to SDR 0.8bn (2006: SDR 1.2bn) equating to £0.6bn (2006: £1.0bn). This was the result of sterling repayments from IMF lending programmes that more than offset new disbursements.

22. The foreign currency elements of the total UK official reserves are published in the monthly IMF Reserves Template⁵. The Template shows the net foreign currency position in the official reserves, which at end-March was the equivalent of £10.9bn. The assets and liabilities in the Template differ from those of the EEA balance sheet on page 23 of these accounts. This is for a number of reasons, but principally it is because the Template is designed to reflect the UK's foreign currency position. Therefore it includes foreign currency assets and liabilities of the NLF (notably the RTP and foreign currency debt issuance) and excludes all items denominated in domestic currency (i.e. sterling). The most significant of these are the capital of the EEA, the liability of the EEA to the NLF and the valuation of the sterling leg of foreign currency forwards and cross-currency swaps. These factors coupled with the effects of differing accounting treatment of collateral and unsettled items mean that gross reserve assets shown in the Template (the equivalent of £26.0bn at 31 March 2007) differs by £2.2bn from the official reserves assets held in the EEA. A reconciliation between the EEA's balance sheet and the Template is provided on page 14.

Benchmark asset allocation

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

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

25. The Treasury also sets a benchmark for the currency allocation of the EEA's unhedged reserves excluding gold. This takes into account past patterns of risk and return, as well as other factors such as the currencies likely to be required in any intervention. As in the previous year, this benchmark was 40% US dollar; 40% euro and 20% yen.

26. Each currency bloc within the unhedged reserves has a benchmark for the assets within that bloc. The benchmark for assets denominated in US dollars comprised a combination of US Treasury and other US dollar denominated bonds. The benchmark for euro-denominated assets comprised a combination of euro-denominated sovereign and other eligible securities. For yen, the benchmark was derived from 1-month forward rates against the euro and the

⁵ This can be viewed at: http://www.hm-treasury.gov.uk/media/658/79/reservespn_050406.pdf

dollar. For gold lending, the benchmark portfolio comprised a weighted average of one, three and six month gold deposits.

27. A short-term liquidity portfolio is used to manage cash flows arising from the hedged and unhedged reserves. The size of this portfolio is such that the scope for active management is very small and it does not have an explicit benchmark for this reason.

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

Links between the International Monetary Fund and the official reserves

29. The primary means of financing the IMF is through members' quotas. Each member of the IMF is assigned a quota which is payable in a combination of SDRs and the member's own currency. The difference between a member's quota and the IMF's holdings of its currency is a member's RTP. As explained above, the UK's RTP is an asset of the NLF.

30. The IMF has periodically issued SDRs and allocated them to members in proportion to their quotas. The UK's SDR allocation is a liability of the EEA and the resultant holding of SDRs by the UK is an asset of the EEA. IMF members are credited with interest on their holdings of SDRs and pay interest on their allocation of SDRs at the same rate.

Analysis of returns for the period

31. The EEA's accounts for the year ended 31 March 2007 are given on pages 22 to 39 and show an operating loss for the year of £1.0bn (2005-06: profit of £1.1bn). The operating loss was the result of a net interest expense of £0.4bn (2005-06: net expense of £0.2bn) and a loss on the revaluation of foreign currency holdings into sterling of £1.1bn (2005-06: gain of £0.6bn), offset by a gain in dealing profits of £0.6bn (2005-06: loss of £0.3bn).

32. The significant exchange rate loss was driven by the fall in the sterling value of the US dollar (£0.7bn loss), euro (£0.3bn loss) and yen (£0.2bn loss). The exchange rate loss on these currencies was partially offset by an exchange rate gain on the net SDR liability (£0.1bn gain).

33. The total interest receivable from the EEA's portfolio of assets was £1.4bn (2005-06: £1.3bn). As in the previous year, this consisted primarily of interest received on debt securities (2006-07: £0.6bn) and currency swaps (2006-07: £0.5bn).

34. Interest payable of £1.8bn (2005-06: £1.5bn) exceeded the interest receivable in the year. The interest payable figure consisted primarily of the notional sterling capital charge for the EEA reserves of £1.0bn (2005-06: £0.9bn) and interest expense on currency swaps of £0.4bn (2005-06: £0.4bn), largely offsetting the interest income on these instruments. The notional sterling capital charge is applied to reflect an assumed cost to the NLF of providing sterling advances to finance the reserves held in the EEA. The interest rate is set at the five-year gilt swap rate. The charge is taken through the Income and Expenditure Account for the year and subsequently added back to the Accumulated Income and Expenditure Reserve, as shown in note 13 to the accounts.

35. The deficit on net interest income of £0.4bn (2005-06: £0.2bn) reflects the fact that during the year sterling interest rates continued to be higher, on average, than dollar, euro and yen interest rates.

36. There was a dealing gain for the year of £0.6bn (2005-06: £0.3bn loss). The dealing gain represents the mark-to-market change in value of the assets and liabilities. Dealing gains/losses exclude interest receivable and payable, and so do not represent the entire return on positions. During the year, the main constituents of dealing profits were gains on cross-currency swaps used to hedge the hedged reserves of £0.6bn (2005-06: £0.1bn).

37. Taken together, bonds and related hedges showed a gain of £0.7bn (2005-06: £0.2bn loss). The remaining elements of the dealing profit arose from spot and forward foreign exchange transactions.

38. The Treasury set a target for active management return as part of the annual SLA. This target is confidential as the limits and controls on the managers' ability to take risk within the portfolio are confidential for policy reasons. The return from the Bank's active management of the reserves against the benchmarks during the year was £19.3million (2005-06: £20.1million).

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

Intervention

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

Provision of Foreign Currency Services to Government Departments

41. The EEA continued to provide foreign currency services to various government departments and agencies, i.e. sales of foreign currency to departments with foreign currency obligations and purchases of foreign currency from departments with foreign currency receipts, in aggregate totalling £9.9bn (2005-06: £5.4bn). These purchases and sales both spot and forward were hedged through offsetting trades with the market.

Risk Management and Control

42. Although the reserves are not held primarily to make a profit, the Treasury seeks to minimise the cost of holding the foreign currency reserves whilst avoiding exposing the public purse to unnecessary risk.

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 during the year were as follows:

- An annual Service Level Agreement (SLA) agreed between the Treasury and the Bank, in which the Treasury set out the parameters under which the Bank was to manage the reserves. A summary of the SLA was published in the Debt and Reserves Management Report⁶.
- The Bank produced a quarterly report for the Treasury on risk controls and any breaches of the control framework.
- There is a system of financial reporting. Each month the Bank reported to the Treasury on the returns made and the market and credit risks incurred.
- The EEA Accounting Officer and the Bank's Executive Director, Markets met together with Treasury officials twice in the year to review the Bank's performance in managing the reserves. Monthly meetings between the Treasury's Debt and Reserves Management Team and the Bank's Foreign Exchange and Risk Management Divisions supplemented this process.
- A risk-based internal audit programme (agreed with the Treasury) delivered reports to the Bank's Executive Director, Markets, as well as a quarterly report which was forwarded to the Treasury.
- An organisational structure in the Bank containing clear reporting lines. The Bank's Risk Management Division is independent of the Foreign Exchange Division where trading activities were conducted. Both the Risk Management Division and the Foreign Exchange Division report to the Bank's Executive Director, Markets. Settlements of transactions were carried out by the Customer Banking, Market Services and Notes Divisions, which report to the Executive Director, Banking Services.
- Operational Risk Officers in the Bank's Foreign Exchange and Risk Management Divisions were responsible for co-ordinating and collecting analysis on the operational risk in the Divisions.
- The Bank tested its remote contingency facilities where EEA operations can be carried out in an emergency.
- The limits to credit and market risk exposures are explained in the following paragraphs.

45. Credit risk: The management of the reserves involves exposure to counterparties and to the issuers of securities. The creditworthiness of these counterparties and issuers is subject to

⁶ A summary is included in the Debt and Reserves Management report produced by HM Treasury at the time of the Budget and available via www.hm-treasury.gov.uk.

regular scrutiny by the Bank, both through analysis in the Risk Management Division and review by the Bank's Credit Ratings Advisory Committee. Exposure to each counterparty and issuer is monitored in real time against limits. A report of any limit excesses is sent to the Treasury each month. In addition, there are limits to contain the overall exposure to each relevant country's banking sector.

46. Commercial custodians holding bonds owned by the EEA are authorised to use them in their bond lending programmes. These programmes involve lending the bonds against collateral consisting of either other bonds or cash. The custodians are permitted to invest the cash collateral in money market instruments ranging from US Treasury repo to bank deposits. The credit limits delegated to these custodians for the investment of cash collateral are deducted from the limits available to the Bank for its own EEA management activities. Interest rate mismatches between the collateral held and the corresponding investments are strictly limited. The Bank receives daily reports allowing compliance with the investment limits to be monitored.

47. The arrangements for custody of EEA assets in 2006-07 were as follows:

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

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

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

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

Operational Guidelines

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

52. Where financing was through foreign currency borrowing with assets hedged into the currency of the liability, so that fluctuations in the sterling value of the NLF's foreign currency liabilities were matched by fluctuations in the sterling value of EEA assets. Where financing was through sterling using currency swaps, the foreign currency payments on the swap hedged the foreign currency receipts on the assets purchased.

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

54. The currency and interest rate risk in the unhedged reserves was controlled through the selection of benchmarks. The Bank may incur currency risk by deviating from the benchmark in its operations, within the VaR limit mentioned below. During the year there were no significant deviations from the 40:40:20 currency benchmark, and the currency assets held in the unhedged reserves were invested predominantly in government (or other high quality) bonds.

55. The Treasury may decide, with advice from the Bank, to set deviations from the 40:40:20 currency benchmark or the interest rate benchmarks (which are denoted 'strategy positions'). No currency benchmark deviations were set and no strategy positions were taken during the year. Any intervention to influence the level of sterling or other currency would change the level and possibly the composition of the currency risk. No such intervention was undertaken in the year.

56. Under the SLA, the Bank actively managed the hedged and unhedged reserves, in order to improve the return. The Treasury sets the Bank a VaR limit for active management relative to benchmarks, with the VaR being calculated at close of business each day. In 2006-07 the limit was unchanged at US\$40million, and during the year the Bank's use of it did not exceed US\$4.92million. The average use of VaR during the year was US\$3.79million and the lowest VaR usage at the end of any one day was US\$2.24million.

Performance Measures

57. The Treasury and the Bank have agreed a set of performance measures to be introduced during the course of 2007-08. The intent of the performance measures will be to provide a basket of indicators that can be used to assess the future effectiveness of the management of the EEA.

58. The current macroeconomic framework does not entail management of the exchange rate and the UK has not intervened for the purposes of influencing the sterling exchange rate since 1992.⁷ Against this background, foreign exchange reserves are largely held on a precautionary basis - to meet any change in exchange rate policy in the future, if required, or in the event of any unexpected shocks.

59. The Government's prime objective in managing the EEA is to ensure the reserves are fit for purpose in order to meet current policy objectives and any potential future changes in policy. In support of that, the Government's objective is to preserve the liquidity and security of the reserves and to ensure that the Government maintains its capability to intervene in the foreign exchange market if required. Subject to this, the aim is to minimise the overall cost of holding the reserves, while ensuring exposure to financial risk is limited through the appropriate choice of portfolio and risk management practices.

60. The Treasury's role in this is to:

- ensure that its choice for the strategic composition for the benchmark asset allocation of the reserves, including gold, meets the policy objectives set out above. Subject to meeting those objectives, the Treasury will make that benchmark asset allocation choice to trade off risk, return and liquidity in line with their risk preferences. The performance of the reserves, including financial outturns, will be reported in the annual accounts;
- set an active management return target for the Bank in managing the reserves against the benchmark, subject to the limits detailed in the EEA. This target will be set to at least cover the costs of the Bank in managing the EEA.

61. The foreign currency reserves will be invested in assets that are liquid and secure. Specifically:

- a minimum of 90% will be held in tradeable debt securities and cash;⁸
- a minimum of 90% will be invested in assets that are rated at least AA-;
- all assets must be investment grade.

62. The Treasury has appointed the Bank to act as its agent to carry out the day-to-day management of the reserves; the arrangements are laid out in detail in a Service Level Agreement (SLA). The performance measures listed below should be read in conjunction with the annual SLA.

63. The Bank will observe the limits as set out in the SLA. In line with the SLA, any substantive breaches of the limits and/or any operational errors will be reported to the

⁷ The UK participated in a G7 concerted intervention to support the Euro in 2000.

⁸ Including deposits whose value can be realised within 2 working days and so available for fx intervention.

Treasury as soon as possible, along with advice if necessary as to how best to deal with them. Any significant breach will be reported publicly (e.g. in the annual accounts).

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

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

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

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

66. These performance measures will be introduced during the course of 2007/08 and the Treasury and Bank will report formally against them in the 2007-08 financial accounts.

Accounting Policies

67. The accounts of the EEA for the year are drawn up in accordance with the Accounts Direction, reproduced at Annex A (on page 40) to this report, which reflects UK GAAP and the Companies Act as far as appropriate. In the prior year, the EEA elected to prepare accounts incorporating the requirements of FRS 26 and FRS 29 under early adoption rules. As a result, there are no changes to the accounting policies adopted for the preparation of these accounts in the current year. There was no restatement of prior year positions or returns relating to the adoption of new accounting standards and therefore the prior year figures are fully comparable. Under FRS26, all of the EEA's assets and liabilities, other than gold, are classified as "held for trading". There have been no reclassifications of assets or liabilities during the year.

Jon Cunliffe
Accounting Officer

HM Treasury
26 June 2007

Reconciliation of EEA Balance Sheet to IMF Reserves Template

As at 31 March 2007	Unaudited £ millions	Unaudited \$ millions
Total assets per EEA balance sheet	28,230	
Add Reserve Tranche Position in NLF	617	
<i>Adjustments to reflect IMF Reserves Template presentation:</i>		
Deduct cash collateral and derivatives	(1,396)	
Reclassification between assets and liabilities	(1,325)	
Other adjustments	(85)	
Sterling total assets using Template presentation	26,041	
Dollar equivalent per Template		51,076
Total liabilities per EEA balance sheet	28,230	
Eliminate EEA's Liability to NLF (see note 13)	(22,018)	
Add NLF issued debt	1,506	
<i>Adjustments to reflect IMF Reserves Template presentation:</i>		
Add foreign currency liability on FX trades and swaps	9,551	
Deduct cash collateral and derivatives	(804)	
Reclassification between assets and liabilities	(1,325)	
Other adjustments	(12)	
Sterling total liabilities using Template presentation	15,128	
Dollar equivalent per Template		29,671
Net assets per Template	10,913	21,405

Conversion rate into US dollars is 1.9614 as at close 31 March 2007

The Treasury and Bank of England publish the UK's international reserves figures on a monthly basis. The figures are published in accordance with the methodology developed by the International Monetary Fund in the context of revisions to its Special Data Dissemination Standard (SDDS), and the G10 central banks in their report "Enhancing transparency regarding authorities' foreign currency liquidity position" (IMF Reserves Template presentation). The Bank of England website provides information on the methodology used and definitions of the main conventions employed. The table above reconciles the IMF Reserves Template presentation with the information contained in these accounts.

Statement of the Accounting Officer's Responsibilities

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

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

The Treasury has appointed the Second Permanent Secretary of the Treasury 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 Internal Control can be found on page 16.

Statement on Internal Control

1. Scope of responsibility

1.1 As Accounting Officer for the Exchange Equalisation Account (EEA), I have responsibility for maintaining a sound system of internal control that supports the achievement of the policies, aims and objectives of the Exchange Equalisation Account Act 1979 (as amended by the Finance Act 2000) as well as the targets set by Treasury Ministers, whilst safeguarding the public funds and assets for which I am personally responsible, in accordance with the responsibilities assigned to me in Government Accounting.

1.2 The management of the EEA is divided between the Reserves branch of the Debt and Reserves Management (DRM) team at the Treasury and the Bank of England (the Bank). The EEA is under the control of the Treasury. The Bank is the Treasury's Agent and is responsible for the day-to-day management of the EEA, within the framework set by the Treasury. DRM has oversight of the Bank's EEA operations and reports directly to me on risk issues. An Annual Service Level Agreement (SLA) between the Treasury and the Bank specifies the parameters under which the reserves are managed. The SLA sets out the guidelines for investing the reserves, including risk limits and the associated management information required.

2. The purpose of the system of internal control

2.1 The system of internal control is designed to manage risk to a reasonable level rather than to eliminate all risk of failure to achieve policies, aims and objectives; it can therefore only provide reasonable and not absolute assurance of effectiveness. The system of internal control is based on an ongoing process designed to identify and prioritise the risks to the achievement of the EEA's policies, aims, and objectives; to evaluate the likelihood of those risks being realised and the impact should they be realised; and to manage them efficiently, effectively and economically. The system of internal control in DRM together with the Bank has been in place throughout the year ended 31 March 2007 and up to the date of approval of the annual report and accounts, and accords with Treasury guidance.

3. Capacity to handle risk

3.1 There is a risk management strategy, set via the SLA, and clear segregation of duties within the Bank and the Treasury for the management of the EEA and the supporting processes.

3.2 At the Bank, staff have skills and receive training appropriate to their responsibilities. Those involved in managing financial and other risks have their objectives set accordingly, including responsibility for relevant aspects of the control framework. Policy and procedures manuals as well as job instructions are maintained to ensure staff carry out their responsibilities in a controlled manner. Where there are instances of control failure, staff are required to maintain a record in an incident log. These are reviewed on a regular basis to ensure lessons are learned and control improvements implemented. Control improvements and responses to control failures are summarised in the quarterly Turnbull report from the Bank to DRM described below.

3.3 At the Treasury, specific DRM staff are trained in risk appraisal and management and periodic risk management workshops help to maintain and develop DRM staff's risk awareness. Job instructions are maintained for time and business critical tasks.

4. The risk and control framework

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

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

- Monthly financial reporting detailing, on a management accounting basis, the returns made with respect to the management of the EEA and the market and credit risks incurred.
- The Bank's Executive Director for Markets provides the Accounting Officer with a quarterly assurance that the processes and framework in place are sufficient to identify current and future sources of material risk and meet the Turnbull requirements and that this is evidence which can be relied upon in this Statement on Internal Control. In addition, DRM are provided with quarterly management reports on risk issues and the Bank's compliance with the guidance issued by the Turnbull Report. These reports highlight the Bank's role in identifying, assessing, managing and monitoring the risks relating to its management of the EEA. This process is supported by an Operational Risk Officer in both the Foreign Exchange Division and, with specific responsibility for the co-ordination of the quarterly reporting framework, the Risk Management Division.
- DRM considers and discusses the information provided with the Bank and Treasury Internal Audit and provides the Accounting Officer with quarterly reports that highlight the key risks.
- The Bank's Internal Audit Division conducts an agreed internal audit programme as part of the SLA. The Bank's Executive Director for Markets forwards to the Accounting Officer the Internal Audit quarterly reports on this activity.
- Treasury Internal Audit provides an independent and objective opinion to the Accounting Officer on risk management, control and governance of the EEA. Assurance is provided following reviews of relevant Bank Internal Audit reports and DRM's oversight of the Bank's work, as agreed by the Accounting Officer and the Treasury Audit Committee (Exchequer Funds Audit Committee during 2006-07). Treasury Internal Audit's reviews aim to measure and evaluate the effectiveness of the Treasury in achieving their agreed objectives in respect of the EEA. Treasury Internal Audit also review DRM's quarterly report to the Accounting Officer (mentioned above).
- Bank and Treasury officials met monthly to review performance against the parameters set out in the SLA and to consider wider operational and policy issues. The Accounting Officer and the Bank's Executive Director for Markets attended two of these meetings in May 2006 and November 2006 to discuss overall strategy and governance issues.
- Bank accountancy professionals produced the financial accounts on behalf of the Treasury using Bank IT systems.

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

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

Some of the actions initiated during the year

4.4 The Bank and DRM aim continuously to identify possible areas for operational risk reduction and control improvements. Some of the actions initiated during the year were:

- The Bank has instigated a monthly three-way reconciliation between the financial accounts, the Reserves Template and the monthly management information.
- The Bank conducted a series of successful live tests of its operations at its contingency site. DRM and the Bank also took part in a six-week financial sector wide contingency test based around a flu pandemic scenario.
- The Bank has recruited an additional qualified accountant to reduce key person risk.
- The Treasury Accountant undertook a high-level Review of the 2006-07 financial accounts and advised on preparation of the foreword to the accounts.

Planned action for 2007-08

4.5 The Bank and DRM will continue to review and develop the control environment. This will include implementing recommendations made by both Bank Internal Audit and Treasury Internal Audit. DRM will undertake co-ordinated contingency site tests with the Bank in 2007-08.

5. Review of effectiveness

5.1 As Accounting Officer, I have responsibility for reviewing the effectiveness of the system of internal control. My review is informed by the work of Treasury Internal Audit and Bank Internal Audit, who both provided positive assurance as to the management and control of the EEA in 2006-07 and the executive managers within DRM and in the Bank, who have responsibility for the development and maintenance of the internal control framework, as well as comments made by external auditors in their management letter and other reports. I have been supported by the Audit Committee and risk owners in addressing weaknesses and ensuring continuous improvement of the system is in place. The Exchequer Funds Audit

Committee considered the 2006-07 accounts in draft and provided me with its views before I formally signed the accounts.

Jon Cunliffe
Accounting Officer

HM Treasury
26 June 2007

THE CERTIFICATE AND REPORT OF THE COMPTROLLER AND AUDITOR GENERAL TO THE HOUSES OF PARLIAMENT

I certify that I have audited the financial statements of the Exchange Equalisation Account for the year ended 31 March 2007 under the Exchange Equalisation Account 1979 (as amended by the Finance Act 2000). These comprise the Income and Expenditure Account, the Balance Sheet, the Cash Flow Statement and the related notes. These financial statements have been prepared under the accounting policies set out within them.

Respective responsibilities of the Accounting Officer and auditor

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

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

I report to you my opinion as to whether the financial statements give a true and fair view and whether the financial statements have been properly prepared in accordance with the Exchange Equalisation Account 1979 (as amended by the Finance Act 2000) and HM Treasury directions made thereunder. I report to you whether, in my opinion certain information in the Annual Report, which comprises an Introduction, the Origin and Purpose of the Account, Administration and Control, Investment Policy, Risk Management and Control and Performance Measures is consistent with the financial statements. I also report 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.

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

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

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

Basis of audit opinion

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

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

Opinions

Audit Opinion

In my opinion:

- the financial statements give a true and fair view, in accordance with the Exchange Equalisation Account 1979 (as amended by the Finance Act 2000) and directions made thereunder by HM Treasury, of the state of the Exchange Equalisation Account's affairs as at 31 March 2007 and of its deficit for the year then ended;
- the financial statements have been properly prepared in accordance with the Exchange Equalisation Account 1979 (as amended by the Finance Act 2000) and HM Treasury directions made thereunder; and
- information given within the Annual Report, which comprises an Introduction, the Origin and Purpose of the Account, Administration and Control, Investment Policy, Risk Management and Control and Performance Measures is consistent with the financial statements.

Audit Opinion on Regularity

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

Report

I have no observations to make on these financial statements.

*John Bourn
Comptroller and Auditor General
National Audit Office
157-197 Buckingham Palace Road
Victoria
London
SW1W 9SP
5 July 2007*

Income and Expenditure Account

For the year ended 31 March:

	Notes	2007 £ millions	2006 £ millions
Interest receivable and similar income arising from debt securities	2	613	634
Other interest receivable and similar income	2	792	645
Interest payable	3	<u>(1,818)</u>	<u>(1,504)</u>
Net interest expense		(413)	(225)
Fees and commissions		(1)	(1)
Dealing profits / (losses)	4	568	(312)
Gains on revaluation of gold		18	1092
Exchange (losses) / gains on foreign currencies	5	(1,179)	605
Management charge	6	<u>(9)</u>	<u>(9)</u>
(Deficit) / profit on ordinary activities		<u>(1,016)</u>	<u>1,150</u>
(Deficit) / profit for the financial year	13	<u>(1,016)</u>	<u>1,150</u>

All income and expenditure arose from continuing operations.

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

The notes on pages 25 to 39 form an integral part of these accounts.

Balance Sheet

As at 31 March:

	Notes	2007 £ millions	2006 £ millions
Assets			
Cash and balances at central banks and Paymaster General	19	170	180
Holdings of IMF Special Drawing Rights		192	182
Settlement balances		518	239
Treasury bills	7	111	291
Loans and advances to banks	8	2,512	3,073
Debt securities	9	20,086	20,398
Gold and gold receivables	10	3,365	3,347
Other financial assets	11	1,030	624
Prepayments and accrued income		246	270
Total assets		28,230	28,604
Liabilities			
Settlement balances		454	286
Deposits by banks	12	3,369	3,641
SDR allocation	14	1,473	1,589
Other financial liabilities	15	890	863
Accruals		26	27
Liability to the National Loan Fund	13	22,018	22,198
Total liabilities		28,230	28,604

The notes on pages 25 to 39 form an integral part of these accounts.

Jon Cunliffe
Accounting Officer

HM Treasury
26 June 2007

Cash Flow Statement

For the year ended 31 March:

	Notes	2007 £ millions	2006 £ millions
Net cash inflow/(outflow) from operating activities	18	187	(1,220)
<i>Financing</i>			
Net (outflow) / inflow from National Loans Fund	13	(200)	1,095
Decrease in cash in the year	19	<u>(13)</u>	<u>(125)</u>

The notes on pages 25 to 39 form an integral part of these accounts.

Notes to the Accounts

1 Accounting policies

Basis of accounting

These accounts have been prepared in accordance with the Accounts Direction, reproduced in the Annex to this report, and according to United Kingdom Generally Accepted Accounting Principles and, where appropriate, although not subject to the Companies Act 1985 and technically not being the accounts of a bank, the special provisions of Schedule 9 of the Companies Act 1985 relating to banking companies.

These accounts applied FRS26 (Financial Instruments: Recognition and Measurement) and FRS29 (Financial Instruments: Disclosures) for the first time for the year ended 31 March 2006 under the early adoption rules for these standards. There have been no changes to accounting policies in the current year. The disclosures pertaining to Appendix E (capital disclosures) of FRS29, have not been adopted at this stage, as allowed for by the standard.

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

Recognition of financial assets and financial liabilities

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

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

Interest receivable and payable

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

A notional sterling capital charge is included within interest payable. There is no cash movement in respect of this charge, which is intended to reflect an assumed cost of sterling capital used by the EEA. The charge is calculated on the outstanding reserves of the EEA (including the income and expenditure account) and the EEA’s outstanding liability to the NLF, less cash balances with the Paymaster General, at the 5-year gilt swap rate, calculated on a daily basis. This charge is subsequently added back to the Accumulated Income and Expenditure Reserve (see note 13).

Special Drawing Rights (SDR) remuneration

The EEA is remunerated (in SDRs) on its holdings of SDRs. This income is included within interest receivable. Remuneration of the UK’s Reserve Tranche Position (RTP) at the IMF

(an NLF asset) is also received in the form of SDRs and is recognised in these accounts as interest receivable. Interest paid on SDRs is accounted for on an accruals basis.

Dealing profits

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

Fees and commissions

Fees and commissions are recognised in the income and expenditure account as incurred.

Exchange gains on foreign currencies

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

Debt securities

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

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

Treasury bills

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

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

Loans and advances

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

Repurchase (repo) and reverse repurchase (reverse repo) agreements

Securities which have been sold with an agreement to repurchase remain on the balance sheet and the sale proceeds are recorded as a deposit. Securities acquired in reverse sale and repurchase agreements are not recognised on the balance sheet and the purchase price is treated as a loan. The difference between the sale and repurchase price is accrued evenly over the life of the transaction and credited or charged to the income and expenditure account as interest receivable or payable. Repos and reverse repos are marked to bid or offer prices, as appropriate.

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

Gold

Gold holdings and gold assets on deposit, although not falling within the FRS 25 definition of financial instruments, are held at fair value and changes in the market value of gold assets are recognised in the income and expenditure account when they arise. Changes in the fair values of gold lending transactions are recognised within dealing profits and changes to the balance sheet valuation of gold holdings are recognised in a separate line in the income and expenditure account.

International Monetary Fund Special Drawing Rights (SDRs)

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

Derivative transactions

Derivative transactions are used in trading activities to manage risk in the trading portfolios. Such instruments include exchange rate forwards, currency swaps, interest rate swaps and interest rate and bond futures. Derivatives are carried at fair value and changes in the fair values are reported within dealing profits in the income and expenditure account. Fair values are either determined by reference to quoted market prices, or by using internal models where no market price is readily obtainable. All inputs into the pricing models are externally sourced and assumptions used are supported by observable market prices. Derivatives are marked to bid or offer prices, as appropriate.

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

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

2 Interest receivable and similar income

	2007 £ millions	2006 £ millions
Interest receivable and similar income arising from debt securities:		
Bonds	558	593
Certificates of deposit	55	41
Sub-total	613	634
Other interest receivable and similar income:		
Currency swaps	514	485
Interest rate swaps	141	32
Money market deposits	72	49
Reverse repos	41	36
Reserve Tranche Position	13	34
Special Drawing Rights	7	5
Securities lending	4	3
Gold deposits	-	1
Sub-total	792	645
Total	1,405	1,279

3 Interest payable

	2007 £ millions	2006 £ millions
Notional sterling capital charge	1,036	873
Currency swaps	391	420
Interest rate swaps	174	48
Repos	114	85
SDR allocation	58	44
Interest on short positions in bonds	24	22
Interest on cash collateral taken	21	12
Total	1,818	1,504

4 Dealing profits/(losses)

	2007	2006
	£ millions	£ millions
Currency swaps	619	147
Debt securities	66	(360)
Interest rate swaps	33	6
Other instruments	1	(2)
Futures	(3)	(2)
Foreign exchange transactions	<u>(148)</u>	<u>(101)</u>
Total	<u>568</u>	<u>(312)</u>

All dealing losses relate to financial instruments that are held for trading purposes, in accordance with the FRS 26 definition.

5 Exchange (losses) / gains on foreign currencies

The EEA's accounts are presented in sterling. A gain or loss equivalent to the change in the sterling value of a foreign currency asset or liability, from the date of recognition of the position (or the previous balance sheet date, if earlier) to the current balance sheet date, is incurred on translation. For the current year there was a translation loss of £1,179 million (2005-06: £605 million gain).

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

6 Management charge

The management charge of £9.2 million represents the cost of the Bank of England's management of the EEA during the year (2005-06: £9.1 million).

7 Treasury and other eligible bills

	2007	2006
	£ millions	£ millions
Treasury bills and similar securities	<u>111</u>	<u>291</u>

8 Loans and advances to Banks

	2007	2006
	£ millions	£ millions
Repayable on demand	3	6
Repayable in not more than 3 months	<u>2,509</u>	<u>3,067</u>
Total	<u>2,512</u>	<u>3,073</u>

Of which, reverse repo transactions are:	1,120	1,989
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Collateral with a carrying value of £1.1bn (2006: £2.0bn) is held in respect of reverse repo transactions. Cash collateral held is recognised within Deposits by Banks (see note 12). Other collateral held is not recognised by the EEA. The EEA is permitted under the terms of its reverse repo transactions to sell debt securities held as collateral. The carrying amount of short positions in debt securities arising as a result of selling collateral held is given in note 15.

9 Debt securities

All amounts in £ millions

	2007			2006		
	Listed overseas	Unlisted	Total	Listed overseas	Unlisted	Total
Issued by Public Bodies:						
Government Securities	13,763	-	13,763	15,532	-	15,532
Other Public Sector	1,683	162	1,845	1,772	47	1,819
	<u>15,446</u>	<u>162</u>	<u>15,608</u>	<u>17,304</u>	<u>47</u>	<u>17,351</u>
Other Issuers:						
Bank and building society certificates of deposit	4,478	-	4,478	2,946	-	2,946
Other debt securities	-	-	-	101	-	101
	<u>4,478</u>	<u>-</u>	<u>4,478</u>	<u>3,047</u>	<u>-</u>	<u>3,047</u>
Total	<u>19,924</u>	<u>162</u>	<u>20,086</u>	<u>20,351</u>	<u>47</u>	<u>20,398</u>
Amounts maturing:						
Within less than one year			5,401			4,898
In one year and over			<u>14,685</u>			<u>15,500</u>
Total			<u>20,086</u>			<u>20,398</u>

10 Gold and gold receivables

	2007	2006
	£ millions	£ millions
Gold stock	3,300	3,047
Gold deposits	<u>65</u>	<u>300</u>
Total	<u>3,365</u>	<u>3,347</u>

11 Other financial assets

	2007	2006
	£ millions	£ millions
Margin accounts	5	5
Balances arising from other financial instruments:		
- Currency swaps	644	408
- Interest rate swaps	49	89
- Foreign exchange transactions	332	122
Total	1,030	624

12 Deposits by Banks

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

All amounts in £ millions

	2007			2006		
	3 months or less	Over 3 months but less than 1 year	Total	3 months or less	Over 3 months but less than 1 year	Total
Repo transactions	2,968	36	3,004	3,158	137	3,295
Cash collateral received	365	-	365	346	-	346
	<u>3,333</u>	<u>36</u>	<u>3,369</u>	<u>3,504</u>	<u>137</u>	<u>3,641</u>

There were no deposits by banks repayable on demand as at 31 March 2007 (2006: nil).

The EEA pledges collateral to counterparties in repo transactions. Collateral pledged remains on the balance sheet of the EEA within Debt Securities. The total carrying amount of collateral pledged as at 31 March 2007 was £2.9bn (2006: £3.2bn).

13 Liability to National Loans Fund

There are two elements of the Liability to the NLF: a specific liability, recognised in accordance with the National Loans Act (1968) of £1.8bn (2006 £2.0bn) that represents the balance of advances made by the NLF and not repaid; and a separate amount that represents the EEA's total assets, less recognised financial liabilities.

The EEA is funded by central government through the NLF. Over time, the NLF has advanced sterling to the EEA in order to finance the reserves. Similarly, the NLF has issued foreign currency securities in order to raise foreign currency finance that is subsequently transferred to the EEA. As a result, the EEA's net assets, having been derived from initial

NLF financing, are considered to be an amount ultimately due to the NLF, and are recognised as such on the balance sheet. If a policy decision is taken to reduce the assets of the EEA, the sterling excess raised via sale of foreign currency assets would be paid to the NLF, at the direction of the Treasury.

Specific liability to the NLF

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

The sterling balance held by the EEA at the Paymaster General is maintained within a range, agreed by management. When the balance falls below the minimum level, it can be increased by a fresh issue of capital from the NLF under the terms of section 7 of the National Loans Act 1968. This creates a liability of the EEA to the NLF. Conversely, when foreign currency is sold for sterling with the result that the sterling balance is in excess of the EEA's requirements, the Treasury can decide that some reduction should be made by a transfer from the EEA to the NLF.

If there is no outstanding specific liability to the NLF at the time of a sterling transfer from the EEA to the NLF, then the transfer is treated as a 'capital repayment' and is used to reduce the Capital Contribution Reserve. The effect on the combined liability to the NLF, recognised in the balance sheet, is identical.

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

Capital Contribution Reserve

When UK GAAP compliant accounts were prepared for the first time for the EEA, being for the year ended 31 March 2001, an amount equivalent to the total recognised assets, less liabilities, less the balance on the specific liability to the NLF in the opening balance sheet of that year, was taken to be the opening balance for the Capital Contribution Reserve. The amount of the Capital Contribution Reserve is periodically reduced, as explained above, because when there is no outstanding specific liability to the NLF, sterling repayments by the EEA to the NLF are taken to the Capital Contribution Reserve.

Accumulated Income & Expenditure Reserve

All gains and losses of the EEA, since UK GAAP compliant accounts were first prepared in 2001, have been taken to the Accumulated I&E Reserve, except the notional sterling charge, which is charged to the Income & Expenditure Account and subsequently credited to the Accumulated Income & Expenditure Reserve, as shown in the table below.

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

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

<i>All amounts in £ millions</i>	<i>Accumulated I&E Reserve</i>	<i>Capital Contribution Reserve</i>	<i>Specific liability to the NLF</i>	<i>2006 Overall liability to the NLF</i>
<i>Balance at 1 April 2005</i>	<i>5,263</i>	<i>12,907</i>	<i>910</i>	<i>19,080</i>
<i>Transfers from the NLF</i>			<i>3,245</i>	<i>3,245</i>
<i>Repayments to the NLF</i>			<i>(2,150)</i>	<i>(2,150)</i>
<i>Profit for the year</i>	<i>1,150</i>			<i>1,150</i>
<i>Notional sterling charge</i>	<i>873</i>			<i>873</i>
<i>Balance at 31 March 2006</i>	<i>7,286</i>	<i>12,907</i>	<i>2,005</i>	<i>22,198</i>

14 SDR allocation

The EEA has a liability to the IMF for those SDRs that have been allocated since the UK became a participant in the Special Drawing Rights Agreement. If the UK withdraws from participation or the Agreement is wound up, payment to the IMF would be required at current exchange rates. The SDR liability as at 31 March 2007 was £1.5bn (2006 £1.6bn).

15 Other financial liabilities

	2007 £ millions	2006 £ millions
Short positions in securities	450	541
Balances arising from other financial instruments:		
- Currency swaps	42	81
- Interest rate swaps	47	100
- Foreign exchange transactions	348	138
- Futures	3	3
Total	890	863

Short positions in securities relate to the sale of bonds acquired as collateral through reverse repo transactions (see note 8). All bonds are government or other public sector securities listed overseas (*the same applied to 2005-06*). The maturity analysis of short positions in securities is given below:

	2007 £ millions	2006 £ millions
Amounts maturing:		
Within less than one year	-	57
In one year and over	450	484
Total	<u>450</u>	<u>541</u>

16 Risk management and control

A detailed review of the risks to which the EEA is exposed, how these risks arise and how they are managed is given in the Foreword to the accounts (paragraphs 42 to 56). The Foreword also details management's objectives and policies for managing risks.

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

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

Market risk

Market risk is the exposure to movements in market variables. For the EEA, the main market variables are interest rates and exchange rates. The Bank monitors and controls market risk primarily by using a Value at Risk (VaR) model, which predicts, at a specified confidence level, the maximum likely loss for the portfolio over a certain time period. The Bank applies a 99% confidence interval and a two-week holding period, implying that losses should not exceed those suggested by the model in ninety-nine two-week periods out of a hundred. The VaR estimates are based on the historic volatility of returns on different asset classes and the historic correlation between returns on those asset classes.

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

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

	\$ millions 2007	\$ millions 2006
VaR usage as at 31 March	3.30	3.76
Maximum VaR usage during the year	4.92	8.05
Minimum VaR usage during the year	2.24	3.76
VaR limit during the year	40.0	40.0

Interest Rate Risk

The majority of the assets and liabilities of the EEA, after taking account of the effect of derivatives that alter the interest rate risk profile of instruments, are floating rate. Indices used to set floating rates are typically current 3-month LIBOR rates.

Interest rate risk on the hedged reserves 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 securities, the interest rate risk is controlled by matching the risk characteristics, for example, the maturity of the EEA's assets to those of the NLF foreign currency securities. Where currency swaps out of sterling are used, interest rate risk is hedged through interest rate swaps. Typically, the EEA pays floating rate interest on the currency it acquires through the initial swap out of sterling and generates fixed interest income in the same currency through purchasing an asset such as a bond. By swapping the fixed interest receipts for floating interest receipts through an interest rate swap, the EEA acquires an income stream that matches its interest payment liability and thus minimises its interest rate exposure.

The interest rate risk on the unhedged reserves is a policy decision taken by HMT and is embedded in the benchmark given to the Bank.

The Bank may take active management decisions to deviate from its benchmarks within the VaR limit that has been set (see Market Risk above).

Derivatives

The EEA uses derivatives to manage its exposure to interest rate and exchange risks. A description of the use of derivatives is given in the Management Commentary on pages 5 to 8. All derivative instruments are held at their fair values. Fair values are determined by reference to market rates prevailing on the date of valuation or by discounting future 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:

All amounts in £ millions

	2007			2006		
	Notional Principal Amounts	Fair values Assets	Fair values Liabilities	Notional Principal Amounts	Fair values Assets	Fair values Liabilities
Exchange rate contracts:						
Spot and forwards	9,913	332	(348)	5,590	122	(138)
Currency Swaps	11,055	644	(42)	10,725	408	(81)
	<u>20,968</u>	<u>976</u>	<u>(390)</u>	<u>16,315</u>	<u>530</u>	<u>(219)</u>
Interest rate contracts:						
Interest rate swaps	1,344	49	(47)	1,761	89	(100)
Interest rate futures	6,983	-	(3)	4,120	-	(3)
	<u>8,327</u>	<u>49</u>	<u>(50)</u>	<u>5,881</u>	<u>89</u>	<u>(103)</u>
Total	<u>29,295</u>	<u>1,025</u>	<u>(440)</u>	<u>22,196</u>	<u>619</u>	<u>(322)</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.

	2007			
	£ millions Under 1 Year	£ millions 1 to 5 Years	£ millions Over 5 Years	£ millions Total
Exchange rate contracts:				
- Notional Principal Amount	6,962	14,006	-	20,968
- Net replacement cost	300	288	-	588
Interest rate contracts:				
- Notional Principal Amount	3,699	4,520	108	8,327
- Net replacement cost	21	(22)	-	(1)
	2006			
	£ millions Under 1 Year	£ millions 1 to 5 Years	£ millions Over 5 Years	£ millions Total
Exchange rate contracts:				
- Notional Principal Amount	6,979	9,336	-	16,315
- Net replacement cost	144	167	-	311
Interest rate contracts:				
- Notional Principal Amount	3,306	2,355	220	5,881
- Net replacement cost	15	(34)	5	(14)

At 31 March 2007 the exposure to financial institutions on derivative positions, after taking account of netting, where ISDA netting Master Agreements permit was £462mn (2006: £436mn). Net of collateral held, the exposure was £97mn (2006: £90mn).

Credit risk

The EEA incurs credit risk to the issuers of securities it holds; and to its counterparties in financial transactions.

Activities that give rise to credit risk include:

- Placing cash deposits with banks
- Investment in certificates of deposits and commercial paper issued by banks
- Holdings of securities issued by sovereigns and other high quality issuers
- Entering into derivatives contracts

Methods used to measure and manage credit risk in the year ended 31 March 2007 were the same as in the prior year.

Credit Risk Limits and Measurement

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

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

Other risk mitigation policies

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

a) Netting Agreements

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

b) Collateral

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

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

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

c) Settlement processes

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

Settlement limits are used to control FX settlement risk.

Liquidity Risk

To preserve the general liquidity of the reserves to meet policy objectives, the EEA is invested mostly in tradeable debt securities, the majority of which are liquid high-quality government bonds. The EEA also manages liquidity risk arising from repayments of its financial liabilities. The financial liabilities of the EEA comprise funding by central government through the NLF and foreign currency liabilities arising from swaps and repurchase agreements undertaken with the market.

The EEA manages funding repayments mostly by matching the maturity of its assets with the maturity of its liabilities, as explained above. A short-term liquidity portfolio of short-term cash deposits is used to manage cash flows arising from any remaining mismatches in maturity between assets and liabilities.

17 Related Party Transactions

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

18 Reconciliation of operating profit to net cash outflow from operating activities

	2007	2006
	£ millions	£ millions
Operating (deficit)/profit	(1,016)	1,150
Notional sterling capital charge	1,036	873
Net decrease/(increase) in prepayments and accrued income	24	(34)
Net (decrease)/increase in accruals and deferred income	(1)	9
Net increase in SDRs	(10)	(5)
Net (increase)/decrease in settlement balances	(111)	99
Net decrease/(increase) in treasury and other eligible bills	180	(291)
Net decrease/(increase) in loans and advances to banks	558	(678)
Net decrease/(increase) in debt securities	312	(1,785)
Net increase in gold and gold receivables	(18)	(1,068)
Net (increase)/decrease in other assets	(406)	270
Net (decrease)/increase in deposits by banks	(272)	287
Net (decrease)/increase in SDR allocation	(116)	54
Net increase/(decrease) in other liabilities	27	(101)
Net cash inflow/(outflow) from operating activities	187	(1,220)

19 Cash and similar balances

	1 April 2006	Cash flow	31 March 2007
	£ millions	£ millions	£ millions
Balance with Paymaster General	63	24	87
Balances at Central Banks	117	(34)	83
	180	(10)	170
Loans and advances to banks (Note 8) repayable on demand	6	(3)	3
Total	186	(13)	173

20 Events after the Balance Sheet Date

Jon Cunliffe was replaced as the EEA Accounting Officer on 27 June because he has left the Treasury to become the Head of International Economic Affairs and Europe in the Cabinet Office. The Treasury's Permanent Secretary Nicholas Macpherson has appointed Dave Ramsden as Managing Director of the new Macroeconomic and Fiscal Policy Directorate and Accounting Officer of the Exchange Equalisation Account.

ANNEX A

ACCOUNTS DIRECTION GIVEN BY HM TREASURY UNDER THE EXCHANGE EQUALISATION ACCOUNT ACT 1979⁹

1. The Treasury shall prepare accounts for the Exchange Equalisation Account (“the Account”) for the year ending 31 March 2006 and each subsequent financial year that give a true and fair view of the state of affairs of the Account at the balance sheet date and of its income and expenditure, total recognised gains and losses and cash flows for the year then ended. The accounts shall be prepared under the historical cost convention modified to include certain investments at valuation and in accordance with applicable accounting standards and where appropriate, although not subject to the Companies Act and technically not being the accounts of a bank, the special provisions of Schedule 9 of the Companies Act 1985 relating to banking companies.
2. The accounts shall also be consistent with relevant requirements of the Government Financial Reporting Manual, except to the extent set out in sub-paragraphs a., b. and c. below, and shall meet the extra information requirements set out in Appendix A:
 - a. An income and expenditure account shall be prepared instead of Schedule 2, the operating cost statement, and both it and the balance sheet shall be prepared in the same format as those required by Schedule 9 of the Companies Act 1985. Schedule 1 (Statement of Parliamentary Supply) and Schedule 5 (Statement of Operating Costs by Departmental Aim and Objectives), are also not relevant;
 - b. The accounts shall follow the requirements of FRS 23 (IAS 21) *The Effects of Changes in Foreign Exchange Rates* (instead of SSAP 13, *Foreign Currency Translation*), FRS 25 (IAS 32) *Financial Instruments: Presentation*, FRS 26 (IAS 39) *Financial Instruments: Measurement*, and FRS 29 (IFRS 7) *Financial Instruments: Disclosures* (instead of FRS 13 *Derivatives and other financial instruments: disclosures*) other than Appendix E, *Capital Disclosures*;
 - c. A notional cost of capital charge shall apply at a rate to be determined by the Treasury. The cost shall be included in the Income and Expenditure Account and credited direct to the reserve at the year-end.
3. This Accounts Direction shall be reproduced as an Appendix to the Accounts.
4. This Accounts Direction supersedes that issued on 19 December 2001.

Ian Carruthers
Director, Government Reporting
HM Treasury
26 May 2006

⁹ As amended by the Finance Act 2000

EXTRA INFORMATION REQUIRED TO BE DISCLOSED

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

Annual Report

2. The Annual Report shall include:

- a) A brief history of the Account, and its statutory background;
- b) An outline of the scope of the Account, its status in relation to HM Treasury and other central funds, and its management arrangements;
- c) A Management Commentary:
 - i) Taking into consideration the recommendations outlined in the Accounting Standards Board's Reporting Statement 1, *Operating and Financial Review*; and
 - ii) Including appropriate information on financial performance and position reflecting the relationship between the Account and other relevant central funds reflected in the UK's official holdings of international reserves, and information on targets for the EEA set by HM Treasury and their achievement.

Notes to the accounts

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

- a) Analyses of assets, between fixed and current assets;
- b) Analyses of debtors and creditors, between those falling due within and after one year;
- c) Where not separately disclosed on the face of the income and expenditure accounts, analyses of income and expenditure giving totals for the following:
 - i) Interest receivable and similar income
 - ii) Interest payable and similar charges, separately identifying any notional cost of capital charge
 - iii) Other operating income, including income derived from the provision of services
 - iv) Management costs
- d) Disclosure of income and expenditure, and assets and liabilities, relating to other central government funds, including the National Loans Fund.

Glossary

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

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

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

Corporate commercial paper is a short-term debt issued by companies.

Custodian is a bank or other financial institution that keeps custody of assets of the EEA.

Credit risk is the risk of financial loss arising from a counterparty to a transaction defaulting on its financial obligations under that transaction.

Currency risk is the risk of financial loss arising from fluctuations in exchange rates.

Delta measures the change in the value of a portfolio for each one basis point shift in the relevant yield curve.

Derivatives are a collective name for contracts whose value is derived from the prices of another (underlying) investment. The main derivatives are futures, options, and swaps.

Euro area is the area of 12 nations which have adopted the euro as a single currency.

Forward rate agreement - a contract obligating two parties to exchange the difference between two interest rates at some future date; one rate being fixed now and the other being a rate to be fixed in the future.

Forward transaction - an agreement to pay a specific amount at a specific time in the future for a currency or financial instrument.

Futures - a contract to buy or sell a specified asset at a fixed price at some future point in time.

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

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

Hedge - an asset or derivative whose market risk offsets the risk in another asset held or liability. Hedge refers to the economic purpose of an instrument and is not used in the accounting sense to imply the use of hedge accounting.

Hedged reserves refers to that part of the reserves, financed by sterling swapped into foreign currencies or foreign currency securities, on which currency and interest rate exposure is hedged.

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

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

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

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

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

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

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

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

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

Special Drawing Rights (SDRs) – an international reserve asset created by the IMF in 1969 as a supplement to the then existing reserve assets. It is currently valued in terms of a weighted basket of four currencies (US dollar, sterling, yen and euro).

Spot transaction is an agreement to pay the prevailing market price for a currency or financial instrument for delivery usually in two days time.

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

Unhedged reserves refer to the part of the reserves where the currency and interest rate exposure is not hedged.

US dollar bloc - US and Canadian dollar holdings.

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

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

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