

Management of the Official Reserves

Introduction

1.1 The Government's official holdings of international reserves comprise gold, foreign currency assets and International Monetary Fund (IMF) Special Drawing Rights (SDRs).¹ With the exception of the SDR assets that constitute the UK's Reserve Tranche Position (RTP) at the IMF and other loans to the IMF, these assets are held in the Exchange Equalisation Account (EEA).

Origin and purpose

1.2 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 Government exchange rate intervention would be conducted.

1.3 The Government has not intervened for the purposes of influencing the sterling exchange rate since 1992. Against this background, foreign exchange reserves are 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.

1.4 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 SDRs as required by the UK's membership of the IMF.

Financing of the Reserves

1.5 The reserve assets are partly financed either by sterling financing from issuing gilts or, alternatively, issuing securities denominated in foreign currency; these funds are used to acquire foreign currency assets. The remaining part of the reserves is financed by retained earnings, historic sales of sterling for foreign currency and the EEA's net SDR position. The quantity and method of financing for the reserves has been published in the Debt and Reserves Management Report published annually alongside the Budget and available at:

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/191848/drmr_201314.pdf

1.6 The Bank of England will act as HM Treasury's agent in issuing and managing any foreign currency liabilities associated with the reserves and the Debt Management Office will issue any sterling financing required for the reserves.

Management of the Exchange Equalisation Account

1.7 The EEA is under the control of HM Treasury, which appoints the Bank of England² as its agent to carry out the day-to-day management of the international reserves ('the reserves'). An annual Service Level Agreement (SLA) between HM Treasury and the Bank of England specifies

¹ The SDR is an international reserve asset created by the IMF. Its value is defined in terms of a basket of the US dollar, the euro, the yen and sterling. More information on the SDR can be found at: <http://www.imf.org/external/np/exr/facts/sdr.htm>

² The Bank of England also holds foreign currency reserves on its own balance sheet, including for intervention purposes, in pursuit of the Monetary Policy Committee's monetary policy objective.

the parameters under which the reserves are managed. It remains in force indefinitely and is reviewed annually. The SLA specifies:

- benchmarks³ for investing the reserves, with limits to the Bank of England'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 EEA's foreign currency borrowing and currency swaps out of sterling.

1.8 The SLA is set within the context of all relevant legislation, particularly the *Exchange Equalisation Account Act 1979*, as amended by the *Finance Act 2000*, which provides that the EEA shall be used:

- for checking undue fluctuations in the exchange value of sterling;
- for securing the conservation or disposition in the national interest of the means of making payments abroad;
- for the purpose specified in Section 1(3) of the *International Monetary Fund Act 1979* (payment of charges under Section 8 of Article V of the *Articles of Agreement of the International Monetary Fund*); and
- for carrying out any of the functions of the Government of the United Kingdom under those of the said *Articles of Agreement* which relate to SDRs.

Roles and responsibilities set out in the Service Level Agreement

1.9 The Bank of England will at all times:

- carry out efficiently and cost effectively, in a legal and proper form, foreign currency and gold transactions on behalf of HM Treasury and other government departments, including the issuance of foreign currency debt on behalf of HM Treasury;
- manage the reserves so as to maintain their liquidity and security within limits agreed with HM Treasury and ensure that the public funds entrusted to the Bank of England in the EEA are properly managed and safeguarded.
- advise HM Treasury on the financing of the reserves including, as necessary, the management of foreign currency borrowing;
- monitor and report to HM Treasury on the level of risk and return on holding the reserves and provide accurate and timely accounting and management information and statistical analysis pertaining to the reserves as requested by HM Treasury;
- ensure that effective management systems, including financial monitoring and control systems, are in operation and that proper financial procedures are followed and that accounting records are maintained in a form suited to the requirements of management as well as in the form prescribed for the published accounts; and
- advise HM Treasury as to how to ensure that the EEA assets have the fullest possible protection of sovereign immunity and that the EEA enters into appropriate legal

³ The benchmark is the neutral or passive investment strategy for the reserves portfolio.

agreements with counterparties, nominees, delegates and agents that provide the fullest possible protection for EEA assets, subject to commercial feasibility.

1.10 The Bank of England will ensure that all transactions that relate to the Government 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 that they are expected to undertake and consistent with the amount of risk that 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; and
- appropriate preparations are made for possible policy deployment of the reserves (e.g. foreign exchange intervention).

1.11 HM Treasury's role is to:

- ensure that its choice for the strategic composition for the benchmark asset allocation of the reserves, including gold, meets the policy objectives of the EEA. Subject to meeting those objectives, HM Treasury will make that benchmark asset allocation choice to balance risk, return and liquidity in line with its risk preferences, taking advice from the Bank of England as required. The performance of the reserves, including financial outturns, will be reported in the annual accounts; and
- set an active management return target for the Bank in managing the reserves against the benchmark, subject to the limits detailed in the Service Level Agreement. This target will be set to at least cover the costs of the Bank in managing the EEA.

1.12 HM Treasury is responsible for monitoring the risk environment and performance of the Bank of England in managing the reserves. To support this process, the Bank of England provides the following management information:

- monthly financial reporting, detailing the returns made with respect to the management of the EEA and the market and credit risks incurred;
- quarterly management reports on operational risk issues and the Bank of England's compliance with the guidance issued by the Turnbull Report (*Internal Control: Guidance for Directors on the Combined Code*)⁴ issued by the Institute of Chartered Accountants in England and Wales. These reports highlight the Bank of England's role in identifying, assessing, managing and monitoring the risks relating to its management of the EEA;
- quarterly reports from the Bank of England's Internal Audit Division on the internal audit programme agreed for the EEA; and
- Bank of England and HM Treasury officials meet at regular reserves meetings to review the performance against the parameters set out in the SLA and to consider wider operational and policy issues. The EEA Accounting Officer and the Bank of England's Executive Director for Markets meet twice each year to discuss overall strategy and governance issues.

⁴ <http://www.icaew.com/en/library/subject-gateways/corporate-governance/codes-and-reports/turnbull-report>

Authorised financial instruments

1.13 The reserves can be invested in a specified range of financial instruments:

- conventional bonds, bills, discount notes and floating rate notes of any maturity and commercial paper issued by other national governments, supranational organisations and selected official sector agencies;
- foreign currency spot, forward and swap transactions;
- interest rate and currency swaps;
- overnight indexed swaps;
- bond and interest rate futures, swap notes and swap futures;
- sale and repurchase agreements;
- forward rate agreements;
- SDRs;
- short-term deposits; and
- deposits with the Bank of England.

Active management

1.14 The Bank of England will actively manage the reserves against a number of benchmarks. The benchmarks will be reviewed regularly and constructed so that they are replicable and represent HM Treasury's long-term investment strategy. They are split into benchmarks for the currency-hedged reserves (on which currency and interest rate exposures are hedged) and the unhedged reserves which are not hedged against exchange rate and interest rate risk. The Bank of England's scope to deviate from the benchmarks through active management will be constrained by agreed risk limits.

Risk management

1.15 The Bank of England will:

- ensure that the risks associated with its management of the EEA are properly identified, evaluated and mitigated and that exposures comply with the detailed credit risk, market risk and operational risk framework and limits agreed with HM Treasury at the start of the year;
- monitor the EEA's credit exposures on a daily basis, applying the credit risk framework agreed with HM Treasury. The Bank of England will review this framework and the credit limits it provides in the light of market or institutional developments, and changes in the nature of the EEA's activities. The Bank of England will assess the credit rating of each counterparty, issuer and banking sector;
- monitor the exposure of the EEA to market risk and ensure that it complies with the limits agreed with HM Treasury using Value at Risk (VaR) which provides a means of aggregating risk consistently across the components of the portfolio, and stress tests to quantify the potential loss from particular scenarios;
- confirm to HM Treasury, on a quarterly basis, that sufficient controls were in place to mitigate the operational risks affecting the EEA during that quarter, that appropriate mechanisms were in place to identify and address new risks and that the processes and framework in place adequately meet the 'Turnbull' requirements

relating to the Bank of England's management of the EEA. If appropriate, exceptions to such confirmation will be listed; and

- liaise closely with the DMO with respect to managing sterling flows relating to EEA operations and, so far as is possible, aim to manage the EEA so as to avoid conflict with the DMO's sterling cash management operations while in no way disadvantaging the EEA.

Audit arrangements and accounting requirements

1.16 The Bank of England will agree the annual programme of work of the Bank of England's Internal Audit Division pertaining to the EEA with HM Treasury by the beginning of the year. The Bank of England's internal audit arrangements will follow the standards set by the Institute of Internal Auditors – UK and Ireland, and will accord with the objectives, standards and practices set out in HM Treasury's *Government Internal Audit Standards*. The Bank of England will maintain the EEA's accounts drawn up in accordance with International Financial Reporting Standards (IFRS) as far as appropriate and in accordance with the relevant Accounts Direction.

National Audit Office access

1.17 For the purposes of:

- the examination and certification of the EEA accounts; or
- any examination pursuant to Section 6(1) of the *National Audit Act 1983* or any re-enactment thereof of the economy, efficiency and effectiveness with which the Bank of England has managed the EEA;

The National Audit Office (NAO) may examine such documents as it may reasonably require which are owned, held, or are otherwise within the control of the Bank of England, have access to Bank of England buildings, and may require the Bank of England to produce such oral or written factual explanations as it considers necessary. However, the NAO will address substantive questions on the management of the reserves to HM Treasury and not the Bank of England.

Performance evaluation

1.18 In accordance with the SLA, the Bank of England manages the Official Reserves consistently to ensure that the reserves are fit for purpose in order to meet the Government's current policy objectives and any potential future changes in policy.

1.19 The prime objective is to preserve the liquidity and security of the reserves and 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.

1.20 HM Treasury and the Bank of England agreed a set of performance measures including setting a target active management return as part of the annual SLA. The intent of the performance measures is to provide a basket of indicators that can be used to assess the effectiveness of the management of the EEA.

Key performance indicators

1.21 To help gauge the effectiveness of the Bank of England's management of the reserves, HM Treasury and the Bank of England use a set of key performance indicators. Performance against these indicators is published annually in the EEA accounts.

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

- a minimum of 75 per cent of assets will be held in cash or invested in securities on the Bank of England's narrow OMO (Open Market Operations) collateral list, which comprises securities expected to remain liquid in all but the most extreme circumstances; and
- all assets should be securities that normally trade in liquid markets. Assets must be eligible to be accepted as collateral under the Bank of England's wider OMO collateral list and be in the list of assets eligible for the EEA.

Disclosure of financial data

1.23 Since April 2000, the UK has published reserves data in accordance with the IMF/G10's Special Data Dissemination Standard (SDDS). These monthly releases set out the value and composition of the UK's foreign currency and gold assets, liabilities and derivatives on a marked-to-market basis (that is, using current market valuations).

1.24 The format for this Press Notice will be in accordance with the requirements of the IMF's Special Data Dissemination Standard and will be aligned with the conventions of the G10/IMF reserves template published on the Bank of England's web site.

- <https://www.gov.uk/government/organisations/hm-treasury/series/statistical-release-uk-official-holdings-of-international-reserves>

1.25 Reserve data from July 1999 onwards is available on the Bank of England's website.

- <http://www.bankofengland.co.uk/statistics/reserves>

1.26 HM Treasury publishes the financial accounts for the EEA as part of the statutory obligations set out in the *Exchange Equalisation Account Act 1979* (as amended by the *Finance Act 2000*). The financial accounts for 2012-13, audited by the National Audit Office, were published and laid before both Houses of Parliament on 15 July 2013.

- https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/212510/EEA_accounts_2012-13__web_.pdf

Intervention

1.27 Specific prior authority from Treasury Ministers is required for intervention designed to influence sterling exchange rates using the EEA, or for EEA participation in concerted intervention in support of any other currency.

1.28 The Government will publish details of any intervention undertaken to influence exchange rates in the subsequent monthly press release. This will provide details of the amount and date of any official intervention during the month and an explanation of why it was undertaken.