

EXCHANGE EQUALISATION ACCOUNT ACT 1979

Presented to Parliament 19 July 2004

**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 2003-04**

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## Foreword

### Introduction

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

### Origin and Purpose

2. The EEA was established in 1932 to provide a fund that could be used for "checking undue fluctuations in the exchange value of sterling"<sup>2</sup>. Any UK Government exchange rate intervention would therefore be conducted through the EEA<sup>3</sup>. Subsequent legislation extended the possible uses of the fund; and, under the consolidating Exchange Equalisation Account Act 1979, it may also be used:

- to secure the conservation or disposition in the national interest of the means of making payments abroad; and
- for certain purposes arising from the UK's membership of the IMF, including the holding, purchase and sale of SDRs.

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

### Administration and Control

4. The EEA is under the control of the Treasury, which has appointed the Bank of England (the Bank) to act as its agent to carry out day-to-day dealing in foreign currencies and the investment of the reserves. The Bank also provides advice and performance analysis to the Treasury on issues relating to the reserves. The Bank's management costs are charged to the EEA. In restricted circumstances, and with appropriate authorisation and controls, the EEA can transact directly with the Bank.

5. The Treasury sets the Bank an annual Remit for the management of the EEA. The Remit for 2003-04 specified:

- benchmarks for investing the reserves, with limits to the Bank's discretion to take currency or interest rate positions relative to these benchmarks;
- the framework for controlling credit, market and other risks; and

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<sup>1</sup> The Glossary on pages 38 to 39 explains this and other terms.

<sup>2</sup> Section 24 of the Finance Act 1932.

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

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

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

6. The EEA Accounting Officer and the Bank's Executive Director for Markets, met together with senior officials in April and November 2003 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.

7. EEA assets were held by a range of custodians in 2003-04. US Treasury bonds and other US dollar-denominated securities were held on the EEA's behalf by JP Morgan Chase and the Federal Reserve Bank of New York. Euro-denominated bonds were held at Deutsche Bank, whilst international bonds and short-term credit instruments, such as bank certificates of deposit and commercial paper, were held at JP Morgan Chase. Japanese government bonds (JGBs) were held at the Bank of Japan. Other yen-denominated bonds were held at JP Morgan Chase. SDRs were held as entries in the IMF's books. The gold bars in the reserves were held at the Bank. The gold coin in the reserves was held at the Bank and the Royal Mint.

## **Operating and Financial Review**

### **Investment Policy**

8. EEA investments need to be highly liquid in order that they can be made available quickly for intervention purposes, or other permitted uses, if necessary. Inevitably, these investments carry some element of credit risk. In order to reduce this risk and to ensure relative liquidity, the EEA predominantly holds securities issued or guaranteed by the national governments of the United States, euro area countries and Japan, and deposits with highly rated banks. The EEA may also use other authorised investments including:

- bonds issued by other national governments, supranational organisations and selected government and government-sponsored agencies;
- foreign currency spot, forward and swap transactions;
- interest rate and currency swaps;
- bond and interest rate futures;
- sale and repurchase agreements;
- forward rate agreements;
- gold deposits, location swaps and quality swaps;
- SDRs; and
- certificates of deposit and corporate commercial paper.

As in previous years, the EEA did not use options during 2003-04.

## Intervention

9. No use was made of the EEA to intervene in the foreign exchange market during 2003-04.

## Provision of Foreign Currency Services to Departments

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

## Financing

11. Foreign currency reserves not funded out of retained earnings are financed by issuing foreign currency liabilities or by sterling swapped into foreign currencies. This process is described in paragraphs 27 to 30. The main determinant of which financing method to use is cost. 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.

12. The total financing of the reserves at the end of the period was £11.9 billion (2003: £12.5 billion). This was split into sterling swapped into foreign currencies of £10 billion (2003: £12.1 billion) and foreign currency liabilities of £1.9 billion (2003: £0.4 billion). In 2003-04, £1.6 billion (2003: £3.1 billion) of new swaps were entered into; £3.7 billion (2003: £2.2 billion) of currency swaps matured or were unwound by entering into an offsetting swap transaction. In June 2003 the Bank, acting on behalf of the Treasury, issued a US\$3 billion (£1.6 billion) five-year eurobond. No foreign currency liabilities matured during the year (2003: £3.5 billion).

13. When retained earnings are included, the overall size of the reserves in the EEA fell over the course of the year to £24.3 billion (2003: £25.1 billion). This reflected the impacts of financing transactions during the year, described above, and the net returns for the period as described below.

## Analysis of Returns for the Period

14. The EEA continued to hold a range of assets within the portfolio, based on the investment policy described in paragraph 8 above. The EEA's financial statements for the year ended 31 March 2004 are given on pages 21 to 33 and show an operating deficit for the year of £357 million (2003: surplus of £65 million). The change in returns is a result of a number of influences, notably exchange rate movements.

15. The operating deficit (see page 21) represents, in broad terms, the sum of gains or losses in the period arising from foreign exchange rate and gold price movements, interest receipts and expenses (including the notional capital charge described in paragraph 20) and dealing profits. The term "dealing profits" includes realised profit or loss on the maturity or sale of investments, as well as gains and losses resulting from changes to market valuations of the trading portfolios.

16. Overall there was a net exchange rate loss of £365 million (*2003: gain of £355 million*), primarily resulting from the depreciation during the year in the dollar, euro, yen and SDR exchange rates against sterling. However, this was partly offset by the increase in the gold price in sterling terms.

17. The EEA continued to lend part of its gold holdings to market participants. The maximum amount of gold lent at any one time during the year was 123 tonnes (*2003: 153 tonnes*) and interest received on gold lending during 2003-04 amounted to £1.2 million (*2003: £4.2 million*). The reduction in interest received reflected the low gold lending rates that prevailed during the period and the lower volume of lending.

18. Returns on securities held in the EEA are largely driven by changes in bond yields. The relevant yen bond yields increased during the year to March, leading to a fall in bond prices and a corresponding decline in unrealised returns. The dollar bond yields remained broadly unchanged. Euro bond yields fell moderately over the year.

19. The total interest receivable from the EEA's portfolio of assets was £816 million (*2003: £940 million*). The interest returns on debt securities fell to £699 million (*2003: £764 million*). The EEA also received income on money market deposits, on IMF transactions and when it authorised custodians holding bonds owned by the EEA to use them in their bond lending programmes (see paragraph 43).

20. Interest payable of £931 million (*2003: £1,032 million*) more than offset the interest receivable. The interest payable figure was mainly interest on the UK's SDR allocation and a notional sterling capital charge for both the retained reserves<sup>4</sup> and the EEA's sterling liability to the NLF. The notional sterling charge was calculated using the swapped five-year gilt rate as the assumed cost of financing. The deficit on net interest income reflects the fact that during 2003-04, sterling interest rates were on average higher than dollar, euro and yen interest rates. The net interest expense figure for the year was £115 million (*2003: £92 million*).

21. The dealing profit for 2003-04 was £130 million (*2003: loss of £191 million*). The main components are returns on the debt securities held and, where appropriate, the related hedging instruments, mainly currency and interest rate swaps. The bond yield changes (see paragraph 18 above) resulted in a loss of £224 million (*2003: gain of £268 million*). The currency and interest rate swaps hedging these positions made a dealing profit of £300 million (*2003: loss of £444 million*). During the year, swap yields rose in Japan, remained broadly unchanged in the US and fell moderately in Europe. Taken together, bonds and related hedges contributed £76 million (*2003: loss of £176 million*). The remaining elements were from foreign exchange transactions and other instruments.

22. The management charge for the administrative costs incurred by the Bank of England in its management of the EEA during 2003-04 was £8.0 million (*2003: £8.6 million*).

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<sup>4</sup> The component of the EEA funded by retained earnings.

## Bank of England's Active Management

23. The reserves, excluding the RTP, were actively managed against a number of benchmarks. The benchmarks are reviewed regularly and are specified such that they are replicable and represent the Treasury's long-term investment strategy. These can be split into benchmarks for: the "borrowed reserves", on which the currency and interest rate exposure was hedged; the "net currency reserves", which are unhedged against exchange rate and interest rate risk; and gold lending. In broad terms the benchmarks used were as follows:

- (a) Benchmarks for borrowed reserves: The borrowed reserves are hedged against both exchange rate and interest rate risk. The benchmarks in 2003-04 mainly comprised government and other eligible bonds financed out of swapped sterling, as described in paragraph 28 below. For example, in the US dollar element of this portfolio, a benchmark holding might comprise a US Treasury bond and a matching currency swap in which the EEA pays fixed rate dollars and receives floating rate sterling. The benchmark return on this element of the portfolio will represent a combination of capital gain (or loss) on the foreign currency assets purchased and the (generally) offsetting gain (or loss) on the maturing swap. The benchmark return will also include any excess return on the floating rate sterling received compared to an assumed benchmark financing cost of the swapped five-year gilt rate. Where assets in the borrowed reserves were financed by NLF foreign currency liabilities, described in paragraphs 11 and 27, the benchmark was a portfolio of assets with similar risk characteristics to the liabilities that financed them; and
- (b) Benchmarks for net currency reserves and gold lending: The net currency reserves have a benchmark currency allocation<sup>5</sup> of 40% US dollars, 40% euros and 20% yen<sup>6</sup>. Each currency bloc 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 dollar. For gold lending, the benchmark portfolio comprised a weighted average of one, three and six month gold deposits.

24. A short-term liquidity portfolio is used to manage cash flows arising from the borrowed and net currency 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.

25. The return for active management against the benchmarks during 2003-04 was £16.7 million (2003: £11 million).

<sup>5</sup> This benchmark is applied to currency exposures excluding the EEA's holdings of gold and SDRs, and the UK's reserve tranche position at the IMF.

<sup>6</sup> The currency allocation within the benchmark is set taking into account three factors: the potential requirement to intervene; the possible need to finance trade flows; and the risk-return characteristics of the benchmark.

## Strategy Positions

26. The Treasury may decide, on advice from the Bank, to set “strategy positions”, which are deviations from the benchmarks set out in the Remit. Any such positions would be the responsibility of the Treasury and would be separate from active management positions taken by the Bank. No strategy positions were set during 2003-04.

## Links to the National Loans Fund

27. The Exchange Equalisation Account Act does not permit the EEA to borrow outside the government sector. The NLF undertakes such transactions and finances the EEA. Therefore, where the foreign currency reserves are financed by foreign currency liabilities, the debt is issued by and is an obligation of the NLF. The foreign currency raised is transferred to the EEA in return for payment in sterling. The sterling used to make this payment is advanced to the EEA from the NLF. Upon consolidation of the two accounts, the inter-account sterling transactions offset, leaving the NLF’s foreign currency liability to the market hedged by a foreign currency asset on the EEA.

28. In the case of sterling financing of the borrowed foreign currency reserves, the NLF again advances sterling to the EEA but this is then invested in foreign currency assets, with risk exposures hedged via swaps with market counterparties. Upon consolidation, the inter-account sterling transactions again offset, leaving a swapped foreign currency asset on the EEA hedging the NLF’s sterling liability to the market.

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

30. The NLF in addition holds the UK’s reserve tranche position at the IMF and may hold certain other loans to the IMF. All these foreign currency assets and liabilities are managed together. Table 2 on page 10 provides a complete picture of the asset and liability position of the UK’s official reserves.

## Links to the International Monetary Fund

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

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

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

- General Arrangements to Borrow (GAB) – These are long-standing arrangements under which the Group of Ten industrial countries stand ready to lend to the IMF for the purpose of forestalling or coping with a situation that could impair the international monetary system.
  
- New Arrangements to Borrow (NAB) – Since 1998 the Fund has had a SDR 34 billion facility at its disposal, provided by GAB members and other IMF members. The intention is that the NAB would replace the GAB as the primary financial resource for the Fund in the event that it needs additional liquidity.

When the IMF draws on these facilities, the UK's contribution forms part of the official reserves.

### **Loans to the IMF**

34. In sterling terms, the UK's RTP at the IMF fell over the course of the year to £3,407 million (*2003: £3,928 million*). This was because of a fall in the value of the RTP to SDR 4,262 million at end March 2004 (*2003: SDR 4,561 million*). This movement reflected sterling repayments (mainly by Russia and Turkey) from IMF lending programmes more than offsetting new disbursements and a strengthening in sterling against the SDR over the period. There were no increases in the UK's IMF quota during the year and the United Kingdom did not lend to the IMF under the General or New Arrangements to Borrow during the course of the year.

35. The policy of neutralising changes in the level of the RTP on the level of the official reserves continued during 2003-04. Other things being equal, use of the UK's quota in IMF lending or an increase in the quota would lead to a rise in the UK's SDR assets and therefore in the official reserves. Conversely, when countries repay sterling borrowing from the IMF resulting in a decrease in the UK's RTP, other things being equal the official reserves would also fall. To offset a decrease in the reserves arising for this reason during 2003-04, the EEA purchased foreign currency for sterling.

### **UK Official Holdings of International Reserves and Related Returns**

36. As stated in paragraph 29, looking at the EEA in isolation gives an incomplete picture of the overall foreign currency asset and liability position, and returns, in relation to the official holdings of international reserves. Tables 1 and 2 below show the complete picture. Table 2 is derived by consolidating the assets and liabilities of the EEA with those of the NLF associated with the official reserves.

37. There are differences between the returns figures for UK official reserves in Table 1 and those for the Income and Expenditure account for the EEA. The interest payable figure of £1,038 million (*2003: £1,204 million*) includes interest on foreign currency debt securities and loans, which is excluded from the EEA accounts. It also includes a notional charge, calculated at the swapped five-year gilt rate, on the outstanding net assets and the outstanding 'sterling liability to investors' figure. The latter represents the liability side of the RTP and the sterling side of currency swaps, which are used to finance the reserves. This differs from the notional sterling capital charge in the EEA accounts, which is described in the EEA accounting policies on page 24. The foreign exchange losses of £432 million (*2003: gain of £456 million*) differ by £67 million from the EEA Income and Expenditure account because of foreign exchange losses on the RTP, partly offset by gains on the foreign currency debt.

38. The balance sheet for the official reserves in Table 2 differs on the asset side from the EEA reserves as the former includes the RTP (an NLF asset) of £3.4 billion (*2003: £3.9 billion*). The liabilities in the official reserves include £1.9 billion (*2003: £0.4 billion*) equivalent of foreign currency debt (an NLF liability) and the sterling liability to investors of £13.2 billion (*2003: £15.9 billion*). Accruals and deferred income include £25 million (*2003: £2 million*) equivalent of accrued interest on foreign currency debt.

## Table 1<sup>7</sup>: UK Official Holdings of International Reserves: Returns

For the year ended 31 March 2004

|  | 2004<br>£ millions<br>Unaudited | 2003<br>£ millions<br>Unaudited |
|--|---------------------------------|---------------------------------|
| Interest receivable  | 816                             | 940                             |
| Interest payable   | <u>(1,038)</u>                  | <u>(1,204)</u>                  |
| <b>Net interest expense</b>                                    | <b>(222)</b>                    | <b>(264)</b>                    |
| Fees and commissions receivable                                | 1                               | 2                               |
| Fees and commissions payable                                   | (2)                             | -                               |
| Dealing (losses)/ profits                                      | 130                             | (191)                           |
| Exchange gains and losses on foreign currencies and gold (net) | (432)                           | 456                             |
| Management charge  | <u>(8)</u>                      | <u>(9)</u>                      |
| <b>Operating deficit</b>                                       | <b><u>(533)</u></b>             | <b><u>(6)</u></b>               |

<sup>7</sup> See paragraphs 27 to 30 and 36 to 38 that provide an explanation of this table.

## Table 2<sup>7</sup>: UK Official Holdings of International Reserves: Assets and Liabilities<sup>8</sup>

As at 31 March 2004

|   | 2004<br>£ millions<br>Unaudited | 2003<br>£ millions<br>Unaudited |
|---|---------------------------------|---------------------------------|
| <b>Assets</b>   |                                 |                                 |
| Cash (excluding sterling balance with Paymaster General)              | 101                             | 76                              |
| Holdings of IMF Special Drawing Rights                                | 184                             | 203                             |
| Reserve Tranche Position  | 3,407                           | 3,928                           |
| Items in course of collection from banks                              | 473                             | 742                             |
| Loans and advances to banks   | 3,670                           | 4,272                           |
| of which:- USD bloc   | 2,034                           | 1,463                           |
| Euro  | 1,482                           | 2,625                           |
| Yen and other currencies  | 154                             | 184                             |
| Debt securities   | 16,052                          | 16,759                          |
| of which:- USD bloc   | 5,148                           | 5,029                           |
| Euro  | 7,898                           | 8,639                           |
| Yen and other currencies  | 3,006                           | 3,091                           |
| Gold and gold receivables (net of items in course<br>of transmission) | 2,319                           | 2,138                           |
| Other assets  | 1,037                           | 554                             |
| Prepayments and accrued income  | 247                             | 301                             |
| <b>Total assets</b>   | <b><u>27,490</u></b>            | <b><u>28,973</u></b>            |
| <b>Liabilities</b>  |                                 |                                 |
| Items in course of transmission to banks                              | 481                             | 748                             |
| Deposits by banks   | 2,542                           | 2,855                           |
| Debt securities and loans   | 1,866                           | 372                             |
| of which:- USD bloc   | 1,866                           | 372                             |
| Sterling liability to investors                                       | 13,244                          | 15,904                          |
| SDR allocation  | 1,529                           | 1,648                           |
| Other liabilities   | 1,097                           | 1,261                           |
| Accruals and deferred income  | 37                              | 3                               |
| <b>Total liabilities</b>  | <b><u>20,796</u></b>            | <b><u>22,791</u></b>            |
| <b>Net assets</b>   | <b><u>6,694</u></b>             | <b><u>6,182</u></b>             |

<sup>7</sup> See paragraphs 27 to 30 and 36 to 38 that provide an explanation of this table.

<sup>8</sup> This statement has been prepared on a different accounting basis to the IMF template of the UK International Reserves and Foreign Currency Liquidity. As a result total assets shown exceed the gross reserves in the end-March 2004 template by £2.6 billion (2003: £2.1 billion). This is because the template excludes the sterling leg of currency swaps and is adjusted for unsettled items.

## Risk Management and Control

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

40. Risk is managed through an established control framework, including setting limits to credit risk and market risk exposures, combined with clear operational guidelines.

## Control Framework

41. The key features of the control framework during 2003-04 were as follows:

- An annual Remit 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 published version of the Remit was contained in the Debt and Reserves Management Report<sup>9</sup>.
- A quarterly Turnbull report from the Bank on risk controls and any breaches of the control framework.
- Operational Risk Officers in the Bank's Foreign Exchange and Risk Management Divisions with responsibility for co-ordinating and collecting analysis on the operational risk in the Divisions.
- A system of financial reporting in which the Bank accounted each month to the Treasury for the returns made and the market and credit risks incurred.
- An organisational structure in the Bank containing clear reporting lines. This included the Risk Management Division which reported to the Executive Director, Markets, and was independent of the Foreign Exchange Division where trading activities were conducted. Settlement was carried out by Customer Banking Division, which reported to the Executive Director, Banking Services.
- A risk-based internal audit programme that delivered reports to the Bank's Executive Director, as well as a quarterly report to HMT.
- Trialling of the Bank's remote contingency facilities where EEA operations can be carried out in an emergency.
- Limits to credit and market risk exposures that are explained in the following paragraphs.

42. Credit risk: The management of the reserves involves exposure to banks and to the issuers of sovereign, agency, supranational and commercial paper. The creditworthiness of these banks and issuers was subject to regular scrutiny by the Bank, both through analysis in the Risk Management Division and by review in the Bank's Credit Risk Advisory Committee. Following this process, limits were agreed for the exposure to each bank and issuer, with such exposures being monitored in real time against the limits. A report of any limit excesses was sent to the Treasury each month. In addition, there were limits to contain the overall exposure to each relevant country's banking sector.

<sup>9</sup> Produced by HM Treasury at the time of the Budget for the financial year ahead and available via [www.hm-treasury.gov.uk](http://www.hm-treasury.gov.uk).

43. Custodians holding bonds owned by the EEA were authorised to use them in their bond lending programmes. These programmes involved lending the bonds against collateral consisting of either other bonds or cash. The authorised custodians were permitted to invest the cash collateral in money market instruments ranging from US Treasury repo to bank deposits. The credit limits delegated to the custodians were deducted from the limits available to the Bank for its own EEA management activities. Any maturity mismatch between the collateral held and the corresponding investments was strictly limited. The Bank received daily reports thus allowing compliance with the investment constraints to be checked.

44. 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. In this period, the Bank monitored and controlled market risk primarily by using a Value at Risk (VaR) model, which predicted, at a specified confidence level, the maximum likely loss for the portfolio over a certain time period. The Bank applied a 99% confidence interval and a two-week holding period, which predicted that losses should not exceed those suggested by the model in ninety-nine two-week periods out of a hundred. The VaR estimates were based on the historic volatility of returns on different asset classes and the historic correlation between returns on those asset classes.

45. The Bank measured the EEA's VaR and delta exposures daily. Delta measures the change in value of the portfolio for each one basis point shift in the relevant yield curve. It supplemented the VaR measure, and helped to test the sensitivity of the portfolio to changes in interest rates.

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

### **Operational Guidelines**

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

48. Whether the Treasury financed the borrowed foreign currency reserves either through borrowing in foreign currency or by engaging in foreign currency swaps out of sterling, it did so in a way which minimised the exposure to fluctuations in the value of currencies.

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

50. Where financing was through sterling using currency swaps, the initial swap of sterling for foreign currency hedged the exchange rate risk. This was done through an initial exchange of sterling principal for foreign currency at the spot rate, receiving back the same amount of sterling principal at maturity, and regular exchanges of interest payments on the principal amounts.

51. 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 liabilities, 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 liabilities. Where currency swaps out of sterling were used, interest rate risk was hedged through interest rate swaps. Typically, the EEA paid floating rate interest on the currency it acquired through the initial swap out of sterling and generated fixed interest income in the same currency through purchasing an asset such as a bond. By swapping the fixed interest receipts for floating interest receipts through an interest rate swap, the EEA acquired an income stream that matched its interest payment liability and thus minimised its interest rate exposure.

52. The above arrangements produced a portfolio of assets that closely hedged the obligations to repay the NLF's foreign currency liabilities. The currency and interest rate risk in the net reserves was controlled through the selection of benchmarks. The Bank may incur currency risk by deviating from the benchmark in its operations, within the VaR limit mentioned below. In 2003-04 there were no significant deviations from 40:40:20 currency benchmark. For most of the 2003-04 period, the net currency assets were invested in long-term government (or other high quality) debt.

53. The Treasury may decide, on advice from the Bank, to set deviations from the 40:40:20 currency benchmark or the interest rate benchmarks (which are denoted 'strategy positions'). As detailed in paragraph 26, no strategy positions were taken in 2003-04. 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 2003-04.

54. Under the Remit, the Bank actively managed the borrowed and net reserves, in order to improve the return. The Treasury sets the Bank a VaR limit, with the VaR being calculated at close of business each day. In 2003-04 the limit was US\$40 million, and during the year the Bank's use of it did not exceed US\$4.32 million measured at the end of any one day. The average use of VaR during the year was US\$3.19 million and the lowest VaR usage at the end of any one day was US\$ 1.54 million.

### **Accounting Policies**

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

56. Accordingly, accounting requirements for banking entities form the basis of the EEA's Accounts Direction (page 34) and are reflected in its accounting policies. The effect is that, for example, securities held for trading purposes are marked to market and the related unrealised gains and losses are recognised as income and expenditure in the year.

## **Audit and Publication**

57. The accounts have been prepared in accordance with a direction given by HM Treasury in pursuance of section 5(1) of the Exchange Equalisation Account Act 1979 (as amended by the Finance Act 2000). The text of the direction is reproduced on page 34 of this document. The accounts and supporting notes relating to the EEA for the year ending 31 March 2004 have been audited by the Comptroller and Auditor General.

Jon Cunliffe  
Accounting Officer

HM Treasury  
14 July 2004

## Statement of the Accounting Officer's Responsibilities

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

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

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

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

- a** observe the relevant accounting and disclosure requirements, and apply suitable accounting policies on a consistent basis;
- b** make judgements and estimates on a reasonable basis;
- c** state whether applicable accounting standards have been followed, and disclose and explain any material departures in the accounts; and
- d** prepare the accounts on a going-concern basis.

The responsibilities of an Accounting Officer, including responsibility for the propriety and regularity of the public finances for which an Accounting Officer is answerable, for keeping proper records and for safeguarding the Department's assets, are set out in the Accounting Officers' Memorandum issued by HM Treasury and published in "Government Accounting". The Accounting Officer's Statement on Internal Control can be found on page 16.

## Statement on Internal Control

### 1. Scope of responsibility

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 policy 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.

The management of the EEA is divided between the Bank of England (the Bank) and the Reserves branch of the Debt and Reserves Management (DRM) team at the Treasury. This relationship is formalised by an annual Remit, which sets out the guidelines for investing the reserves, including risk limits and the associated management information. The Bank is responsible for the day-to-day management of the EEA. DRM has oversight of the Bank's EEA operations and reports directly to me on risk issues.

### 2. The purpose of the system of internal control

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 for the year ended 31 March 2004 and up to the date of approval of the annual report and accounts, and accords with Treasury guidance.

### 3. Capacity to handle risk

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

At the Bank, staff are trained in a way 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. Control improvements and responses to control failures are summarised in the quarterly Turnbull report from the Bank to DRM described below.

At the Treasury, the Treasury Internal Audit Team facilitates risk management workshops to maintain and develop DRM's risk awareness.

#### 4. The risk and control framework

Within the Bank, risk analysis and measurement is undertaken by the Risk Management Division, which is independent from the Foreign Exchange Division where the trading was carried out. Both the Risk Management and Foreign Exchange Divisions are independent from the Customer Banking Division where the trades are settled.

At the Treasury, DRM is 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 the returns made with respect to the management of the EEA and the market and credit risks incurred.
- Quarterly management reports on risk issues and the Bank's compliance with the guidance issued by the Turnbull Report (*Internal Control: Guidance for Directors on the Combined Code issued by the Institute of Chartered Accountants in England and Wales*) These reports highlight the Bank's role in identifying, assessing, managing and monitoring the risks relating to its management of the EEA. This process was 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, in the Risk Management Division.
- The Bank's Internal Audit Division conducted an agreed internal audit programme as part of the Remit and the Executive Director, Markets area forwarded to the Accounting Officer the Internal Audit quarterly reports on this activity.
- Bank and Treasury officials meet at monthly reserves meetings to review the performance against the parameters set out in the annual Remit and to consider wider operational and policy issues. The Accounting Officer and the Bank's Executive Director for Markets met in April and November 2003 to discuss overall strategy and governance issues.

Using this information, as well as the Treasury's risk register and risk workshops, DRM provided quarterly reports to the Accounting Officer on the key risk indicators giving assurance on the overall effectiveness of the controls in place.

#### **Some of the actions initiated during the year**

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 are:

- The establishment of a Risk Committee in the Bank's Markets area to review and take decisions on issues relating to risk management policy and its implementation. The committee met monthly.
- The Bank enhanced the coverage, frequency and reporting of reconciliation processes, in particular those relating to accounting and the associated management information.

- Further enhancements were made to the change control process for new product procedures and for developments to the trading and risk management system.
- The Bank conducted a series of successful live tests of its operations at its contingency site.
- The Treasury Internal Audit (TIA) Team reviewed the adequacy and effectiveness of DRM's controls in place over the Remit to determine whether the Remit provides management with a satisfactory level of internal control to manage risk and whether the systems and controls promote efficient, economical and effective use of resources. DRM received full assurance from this review.

### **Planned action for 2004-05**

The Bank and DRM will continue to build on work carried out to date to engender a "Turnbull" compliant control environment. Some of the planned actions for the coming year are:

- DRM developing an incident/error log to record instances of control failures. This will be reviewed monthly to ensure lessons are learned.
- The Bank will conduct an upgrade of its trading and risk management system.
- The Bank will continue to improve its framework for analysing operational risk, including introducing enhanced management information outputs.

#### 5. Review of effectiveness

As Accounting Officer, I have responsibility for reviewing the effectiveness of the system of internal control. My review is informed by the work of the internal auditors and the executive managers within the DRM and in the Bank, who have responsibility for the development and maintenance of the internal control framework, and comments made by external auditors in their management letter and other reports. I have been advised on the implications of the result of my review of the effectiveness of the system of internal control by DRM and Bank officials and a plan to address continuous improvement of the system is in place. In June 2004 the Treasury Audit Committee agreed to include the Exchange Equalisation Account within its remit; the intention is that the committee will consider key aspects of my review for the 2004-05 accounts.

Jon Cunliffe  
Accounting Officer

HM Treasury  
14 July 2004

## **Certificate and Report by the Comptroller and Auditor General**

### **Exchange Equalisation Account 2003-04**

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

I certify that I have audited the financial statements on pages 21 to 33 under the Exchange Equalisation Account Act 1979 (as amended by the Finance Act 2000). These financial statements have been prepared under the historical cost convention as modified by the revaluation of certain investments and the accounting policies set out on pages 24 to 25.

#### **Respective Responsibilities of the Accounting Officer and the Auditor**

As described on page 15 the Accounting Officer is responsible for the preparation of the financial statements in accordance with the Exchange Equalisation Account Act 1979 (as amended by the Finance Act 2000) and Treasury directions made thereunder and for ensuring the regularity of financial transactions. The Accounting Officer is also responsible for the preparation of the other contents of the Annual Report. My responsibilities as independent auditor are guided by the Auditing Practices Board and the auditing profession's ethical guidance.

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

I read the other information contained in the Annual Report, and consider whether it is consistent with the audited financial statements. I consider the implications for my certificate if I become aware of any apparent misstatements or material inconsistencies with the financial statements.

I review whether the statement on pages 16 to 18 reflects compliance with the Treasury's guidance "Corporate Governance: statement on the system of internal control". I report if it does not meet the requirements specified by the Treasury, or if the statement is misleading or inconsistent with other information I am aware of from my audit of the financial statements.

I am not required to consider, nor have I considered, whether the Accounting Officer's Statement on Internal Control covers all risks and controls. I am also not required to form an opinion on the effectiveness of the Agency's corporate governance procedures or its risk control procedures.

## **Basis of Audit Opinion**

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

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

## **Opinion**

In my opinion:

- the financial statements give a true and fair view of the state of affairs of the Exchange Equalisation Account at 31 March 2004, and of the operating deficit, total recognised gains and losses and cash flows for the year then ended, and have been properly prepared in accordance with the Exchange Equalisation Account Act 1979 (as amended by the Finance Act 2000) and directions made thereunder by Treasury; and
- in all material respects the expenditure and income have been applied to the purposes intended by Parliament and the financial transactions conform to the authorities which govern them.

I have no observations to make on these financial statements.

*Sir John Bourn  
Comptroller and Auditor General*

*16 July 2004*

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

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The maintenance and integrity of the Treasury's website is the responsibility of the Accounting Officer; the work carried out by the auditors does not involve consideration of these matters and accordingly the auditors accept no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the web site.

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## Income and Expenditure account

For the year ended 31 March 2004

|   | Notes | 2004<br>£ millions | 2003<br>£ millions |
|---|-------|--------------------|--------------------|
| Interest receivable and similar income arising from debt securities | 2a    | 699                | 764                |
| Other interest receivable and similar income                        | 2b    | 117                | 176                |
| Interest payable  | 3     | (931)              | (1,032)            |
| <b>Net interest expense</b>   |       | <b>(115)</b>       | <b>(92)</b>        |
| Fees and commissions receivable                                     |       | 1                  | 2                  |
| Dealing profits/(losses)  | 4     | 130                | (191)              |
| Exchange gains and losses on foreign currencies and gold (net)      |       | (365)              | 355                |
| Management charge   | 5     | (8)                | (9)                |
| <b>Operating (deficit)/surplus</b>                                  |       | <b>(357)</b>       | <b>65</b>          |
| <b>Retained (deficit)/surplus for the financial year</b>            | 15    | <b>(357)</b>       | <b>65</b>          |

All income and expenditure arose from continuing operations.

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

The notes on pages 24 to 33 form an integral part of these accounts.

## Balance Sheet

As at 31 March 2004

|  | Notes | 2004<br>£ millions   | 2003<br>£ millions   |
|--|-------|----------------------|----------------------|
| <b>Assets</b>  |       |                      |                      |
| Cash balances at central banks and Paymaster General | 17    | 267                  | 158                  |
| Holdings of IMF Special Drawing Rights               |       | 184                  | 203                  |
| Items in course of collection from banks             |       | 473                  | 742                  |
| Loans and advances to banks                          | 6     | 3,670                | 4,272                |
| Debt securities                                      | 7     | 16,052               | 16,759               |
| Gold and gold receivables                            | 8     | 2,334                | 2,138                |
| Other assets   | 9     | 1,037                | 554                  |
| Prepayments and accrued income                       |       | 247                  | 301                  |
| <b>Total assets</b>                                  |       | <b><u>24,264</u></b> | <b><u>25,127</u></b> |
| <b>Liabilities</b>                                   |       |                      |                      |
| Items in course of transmission to banks             |       | 496                  | 748                  |
| Deposits by banks                                    | 10    | 2,542                | 2,854                |
| Liability to NLF                                     | 11    | 670                  | 30                   |
| SDR allocation                                       | 12    | 1,529                | 1,648                |
| Other liabilities                                    | 13    | 1,097                | 1,262                |
| Accruals and deferred income                         |       | 12                   | 1                    |
| Retained reserves                                    | 15    | 17,918               | 18,584               |
| <b>Total liabilities</b>                             |       | <b><u>24,264</u></b> | <b><u>25,127</u></b> |

The notes on pages 24 to 33 form an integral part of these accounts.

*Jon Cunliffe*  
Accounting Officer

HM Treasury  
14 July 2004

# Cash Flow Statement

For the year ended 31 March 2004

|  | Notes | 2004<br>£ millions | 2003<br>£ millions |
|--|-------|--------------------|--------------------|
| <b>Net cash inflow from operating activities</b>     | 16    | <u>434</u>         | <u>4,611</u>       |
| <b>Financing</b>                                     |       |                    |                    |
| Net inflow from/(outflow to) the National Loans Fund | 11    | 640                | (801)              |
| Capital repayments                                   | 15    | <u>(970)</u>       | <u>(3,819)</u>     |
| <b>Increase/(Decrease) in cash in the year</b>       | 17    | <u><b>104</b></u>  | <u><b>(9)</b></u>  |

The notes on pages 24 to 33 form an integral part of these accounts.

# Notes to the Accounts

## 1 Accounting policies

### **Basis of accounting**

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

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

### **Interest**

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

### **SDR remuneration**

The EEA is remunerated (in SDRs) on its holdings of SDRs. This income is reflected in 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.

### **Dealing profits**

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

### **Sterling capital charge**

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

### **Fee and commission income and expense**

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

**Foreign currencies**

The financial statements of the EEA have been compiled in sterling. Transactions denominated in foreign currencies are recorded at the rate of exchange at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies at the balance sheet date are reported at the rates of exchange prevailing at that date. Any gain or loss from a change in exchange rates subsequent to the date of transaction is included as an exchange gain or loss in the income and expenditure account.

**Debt securities**

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

**Loans and advances**

Loans and advances are recorded at the amount advanced.

**Repurchase agreements**

Where securities are sold subject to a commitment to repurchase them at a predetermined price, they remain on the balance sheet and a liability is recorded in Note 10 in respect of the consideration received. Conversely, securities purchased under analogous commitments to resell are not recognised on the balance sheet and the consideration paid is recorded in 'Loans and advances to banks'.

**Gold**

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

**Derivatives**

Derivatives are used in trading activities to manage risk in the trading portfolios. Such instruments include exchange rate forwards, currency swaps, interest rate swaps and interest rate futures. They are carried at fair value and changes in fair value are reported within dealing profits in the income and expenditure account. Fair values are normally determined by reference to quoted market prices; internal models are used to determine fair value in instances where no market price is available.

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

|                         | 2004              | 2003              |
|-------------------------|-------------------|-------------------|
|                         | £ millions        | <i>£ millions</i> |
| Bonds                   | 699               | 763               |
| Certificates of deposit | <u>-</u>          | <u>1</u>          |
| <b>Total</b>            | <b><u>699</u></b> | <b><u>764</u></b> |

**2b Other interest receivable and similar income**

|                          | 2004              | 2003              |
|--------------------------|-------------------|-------------------|
|                          | £ millions        | <i>£ millions</i> |
| Reserve Tranche Position | 57                | 63                |
| Money market deposits    | 34                | 90                |
| Reverse repos            | 18                | 9                 |
| Special Drawing Rights   | 4                 | 5                 |
| Securities lending       | 3                 | 3                 |
| Gold deposits            | 1                 | 4                 |
| Other                    | <u>-</u>          | <u>2</u>          |
| <b>Total</b>             | <b><u>117</u></b> | <b><u>176</u></b> |

**3 Interest payable**

|                                      | 2004              | 2003                |
|--------------------------------------|-------------------|---------------------|
|                                      | £ millions        | <i>£ millions</i>   |
| Notional sterling capital charge     | 661               | 842                 |
| Currency swaps                       | 142               | 81                  |
| Interest rate swaps                  | 69                | 50                  |
| SDR allocation                       | 30                | 36                  |
| Repos                                | 15                | 14                  |
| Interest on short positions in bonds | 12                | -                   |
| Interest on cash collateral taken    | <u>2</u>          | <u>9</u>            |
|                                      | <b><u>931</u></b> | <b><u>1,032</u></b> |

**4 Dealing profits /(losses)**

|                               | 2004              | 2003                |
|-------------------------------|-------------------|---------------------|
|                               | £ millions        | £ millions          |
| Debt Securities               | (224)             | 268                 |
| Moneymarket instruments       | -                 | 25                  |
| Other instruments             | (1)               | (3)                 |
| Futures                       | 2                 | (6)                 |
| Foreign exchange transactions | 53                | (31)                |
| Interest rate swaps           | 20                | (62)                |
| Currency swaps                | <u>280</u>        | <u>(382)</u>        |
| <b>Total</b>                  | <b><u>130</u></b> | <b><u>(191)</u></b> |

**5 Management charge**

The management charge of £8.0 million represents the administrative costs attributed to the Bank of England for EEA management during 2003-04 (2002-03: £8.6 million).

**6 Loans and advances to Banks**

|  | 2004                | 2003                |
|--|---------------------|---------------------|
|  | £ millions          | £ millions          |
| Repayable on demand                            | 4                   | 9                   |
| Other loans and advances – remaining maturity: |                     |                     |
| 3 months or less                               | 3,000               | 3,569               |
| 1 year or less but over 3 months               | <u>666</u>          | <u>694</u>          |
| <b>Total</b>                                   | <b><u>3,670</u></b> | <b><u>4,272</u></b> |
| Of which, reverse repo transactions are :      | 1,854               | 2,030               |

## 7 Debt securities

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

|                                | 2004                             |                        |                     | 2003                             |                        |                     |
|--------------------------------|----------------------------------|------------------------|---------------------|----------------------------------|------------------------|---------------------|
|                                | Listed<br>overseas<br>£ millions | Unlisted<br>£ millions | Total<br>£ millions | Listed<br>overseas<br>£ millions | Unlisted<br>£ millions | Total<br>£ millions |
| <b>Issued by Public Bodies</b> |                                  |                        |                     |                                  |                        |                     |
| Government Securities          | 13,121                           | -                      | 13,121              | 13,972                           | -                      | 13,972              |
| Other Public Sector            | <u>2,798</u>                     | <u>80</u>              | <u>2,878</u>        | <u>2,370</u>                     | <u>96</u>              | <u>2,466</u>        |
|                                | <u>15,919</u>                    | <u>80</u>              | <u>15,999</u>       | <u>16,342</u>                    | <u>96</u>              | <u>16,438</u>       |
| <b>Issued by Other Issuers</b> |                                  |                        |                     |                                  |                        |                     |
| Other debt securities          | <u>53</u>                        | <u>-</u>               | <u>53</u>           | <u>321</u>                       | <u>-</u>               | <u>321</u>          |
| <b>Total</b>                   | <u>15,972</u>                    | <u>80</u>              | <u>16,052</u>       | <u>16,663</u>                    | <u>96</u>              | <u>16,759</u>       |

|                       | 2004<br>£ millions | 2003<br>£ millions |
|-----------------------|--------------------|--------------------|
| Due within one year   | 3,091              | 2,395              |
| Due one year and over | <u>12,961</u>      | <u>14,364</u>      |
| <b>Total</b>          | <u>16,052</u>      | <u>16,759</u>      |

## 8 Gold and gold receivables

|               | 2004<br>£ millions | 2003<br>£ millions |
|---------------|--------------------|--------------------|
| Gold stock    | 2,098              | 1,459              |
| Gold deposits | <u>236</u>         | <u>679</u>         |
| <b>Total</b>  | <u>2,334</u>       | <u>2,138</u>       |

**9 Other assets**

|   | 2004                | 2003              |
|---|---------------------|-------------------|
|   | £ millions          | £ millions        |
| Margin accounts                                   | 2                   | 2                 |
| Balances arising from other financial instruments |                     |                   |
| - Currency swaps                                  | 745                 | 405               |
| - Interest rate swaps                             | 36                  | 34                |
| - Foreign exchange transactions                   | 254                 | 104               |
| - Futures   | -                   | 9                 |
| <b>Total</b>                                      | <b><u>1,037</u></b> | <b><u>554</u></b> |

**10 Deposits by Banks**

|                          | 2004                |                      |                     | 2003                |                      |              |
|--------------------------|---------------------|----------------------|---------------------|---------------------|----------------------|--------------|
|                          | £ millions          | £ millions           | £ millions          | £ millions          | £ millions           | £ millions   |
|                          |                     | 1 year<br>or less    |                     |                     | 1 year<br>or less    |              |
|                          | 3 months<br>or less | but over<br>3 months | Total               | 3 months<br>or less | but over<br>3 months | Total        |
| Repo transactions        | 2,095               | 80                   | 2,175               | 2,447               | 305                  | 2,752        |
| Cash collateral received | <u>367</u>          | -                    | <u>367</u>          | <u>102</u>          | -                    | <u>102</u>   |
|                          | <u>2,462</u>        | <u>80</u>            | <b><u>2,542</u></b> | <u>2,549</u>        | <u>305</u>           | <u>2,854</u> |

There were no deposits by banks repayable on demand as at 31 March 2004 (2003: nil).

## 11 Liability to National Loans Fund

When the sterling balance held by the EEA at the Paymaster General falls, it can be increased by a fresh issue of capital from the NLF under the terms of section 7 of the National Loans Act 1968. This creates a liability on the EEA's balance sheet to the NLF. Conversely, when foreign currency is sold for sterling with the result that the sterling balance is in excess of the EEA's requirements, the Treasury can decide that some reduction should be made by a transfer from the EEA to the NLF. If there is no outstanding liability at the time of a sterling transfer from the EEA to the NLF the transfer is treated as a 'capital repayment' and used to reduce the retained reserves. Capital repayments made during the year ended 31 March 2004 amounted to £1.0 billion (2003:£3.8 billion). The sterling transfers to and from the NLF during the year were:

|                              | 2004              | 2003             |
|------------------------------|-------------------|------------------|
|                              | £ millions        | £ millions       |
| Liability to NLF at 1 April  | 30                | 831              |
| Transfers to NLF             | (2,900)           | (5,075)          |
| Of which Capital Repayments  | <u>970</u>        | <u>3,819</u>     |
| Transfers from NLF           | <u>2,570</u>      | <u>455</u>       |
| Liability to NLF at 31 March | <u><b>670</b></u> | <u><b>30</b></u> |

## 12 SDR allocation

The EEA has a liability to the IMF for those SDRs that have been allocated since the United Kingdom became a participant in the Special Drawing Rights Agreement. If the United Kingdom withdrew from participation or the Agreement was wound up, payment to the IMF would be required at current exchange rates. On this basis the SDR liability as at 31 March 2004 was £1,529 million (2003 £1,648 million).

## 13 Other liabilities

|   | 2004                | 2003                |
|---|---------------------|---------------------|
|   | £ millions          | £ millions          |
| Net liability under the Exchange Cover Scheme     | -                   | 2                   |
| Short positions in securities                     | 434                 | 227                 |
| Balances arising from other financial instruments |                     |                     |
| - Currency swaps                                  | 379                 | 820                 |
| - Interest rate swaps                             | 79                  | 104                 |
| - Foreign exchange transactions                   | <u>205</u>          | <u>109</u>          |
| <b>Total</b>                                      | <u><b>1,097</b></u> | <u><b>1,262</b></u> |

Short positions in securities relate to the the sale of bonds acquired through reverse repo transactions. All bonds are Government securities listed overseas and are due in one year or over. (*The same applies to 2003*).

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

## 14 Financial instruments

### Derivatives

The EEA uses derivatives to manage its exposure to interest rate and exchange risks in the trading portfolio. A description of the use of derivatives in 2003-04 is given in the Operating and Financial Review on pages 2 to 6. All derivative instruments are marked to market. Mark-to-market values, or fair values, are determined by reference to market rates prevailing on the date of valuation or by discounting future cash flows. The notional principal amounts of these instruments indicate the volume of transactions outstanding at the balance sheet date and are not a representation of the amount of risk.

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

|                                 | 2004  |                                       |   | 2003  |                                       |   |
|---------------------------------|---|---------------------------------------|---|---|---------------------------------------|---|
|                                 | £ millions<br>Notional<br>Principal<br>Amount | £ millions<br>Assets at<br>Fair value | £ millions<br>Liabilities<br>at<br>Fair value | £ millions<br>Notional<br>Principal<br>Amount | £ millions<br>Assets at<br>Fair value | £ millions<br>Liabilities<br>at<br>Fair value |
| <b>Exchange rate contracts:</b> |   |                                       |   |   |                                       |   |
| Spot and forwards               | 10,266  | 254                                   | 205   | 5,522   | 104                                   | 109   |
| Currency swaps                  | <u>11,029</u>                                 | <u>745</u>                            | <u>379</u>                                    | <u>11,440</u>                                 | <u>405</u>                            | <u>820</u>                                    |
|                                 | <u>21,295</u>                                 | <u>999</u>                            | <u>584</u>                                    | <u>16,962</u>                                 | <u>509</u>                            | <u>929</u>                                    |
| <b>Interest rate contracts:</b> |   |                                       |   |   |                                       |   |
| Interest rate swaps             | 4,950   | 36                                    | 79  | 3,480   | 34                                    | 104   |
| Interest rate futures           | <u>1,212</u>                                  | <u>2</u>                              | <u>-</u>                                      | <u>436</u>                                    | <u>9</u>                              | <u>-</u>                                      |
|                                 | <u>6,162</u>                                  | <u>38</u>                             | <u>79</u>                                     | <u>3,916</u>                                  | <u>43</u>                             | <u>104</u>                                    |
| <b>Total</b>                    | <u><b>27,457</b></u>                          | <u><b>1,037</b></u>                   | <u><b>663</b></u>                             | <u><b>20,878</b></u>                          | <u><b>552</b></u>                     | <u><b>1,033</b></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.

|                                 | 2004            |                 |                 |            |
|---------------------------------|-----------------|-----------------|-----------------|------------|
|                                 | £ millions      | £ millions      | £ millions      | £ millions |
|                                 | Under 1<br>Year | 1 to 5<br>Years | Over 5<br>Years | Total      |
| <b>Exchange rate contracts:</b> |                 |                 |                 |            |
| - Notional Principal Amount     | 10,735          | 10,560          | -               | 21,295     |
| - Net replacement cost          | 170             | 245             | -               | 415        |
| <b>Interest rate contracts:</b> |                 |                 |                 |            |
| - Notional Principal Amount     | 1,065           | 4,785           | 312             | 6,162      |
| - Net replacement cost          | (17)            | (22)            | (2)             | (41)       |

|                                 | 2003            |                 |                 |            |
|---------------------------------|-----------------|-----------------|-----------------|------------|
|                                 | £ millions      | £ millions      | £ millions      | £ millions |
|                                 | Under 1<br>Year | 1 to 5<br>Years | Over 5<br>Years | Total      |
| <b>Exchange rate contracts:</b> |                 |                 |                 |            |
| - Notional Principal Amount     | 8,168           | 8,794           | -               | 16,962     |
| - Net replacement cost          | (72)            | (348)           | -               | (420)      |
| <b>Interest rate contracts:</b> |                 |                 |                 |            |
| - Notional Principal Amount     | 1,325           | 2,391           | 200             | 3,916      |
| - Net replacement cost          | (4)             | (54)            | (3)             | (61)       |

As at 31 March 2004, the maximum exposure with financial institutions on cross currency and interest rate swaps, after taking account of netting agreements, was £390 million (2003: £123 million). The exposure, net of collateral held, was £23 million (2003: £21 million).

## 15 Retained reserves

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

|   | 2004                 | 2003                 |
|---|----------------------|----------------------|
|   | £ millions           | £ millions           |
| At 1 April                              | 18,584               | 21,496               |
| Capital Repayments                      | (970)                | (3,819)              |
| Retained (deficit)/surplus for the year | (357)                | 65                   |
| Notional sterling capital charge        | 661                  | 842                  |
| <b>At 31 March</b>                      | <b><u>17,918</u></b> | <b><u>18,584</u></b> |

**16 Reconciliation of operating surplus to net cash inflow from operating activities**

|  | 2004              | 2003                |
|--|-------------------|---------------------|
|  | £ millions        | <i>£ millions</i>   |
| Operating (deficit)/surplus                                | (357)             | 65                  |
| Notional sterling capital charge                           | 661               | 842                 |
| Net decrease in prepayments and accrued income             | 54                | 16                  |
| Net increase/(decrease) in accruals and deferred income    | <u>11</u>         | <u>(1)</u>          |
| <b>Net cash inflow from trading activities</b>             | <b>369</b>        | <b>922</b>          |
| Net decrease/(increase) in SDRs                            | 19                | (1)                 |
| Net decrease/(increase) in items in course of collection   | 269               | (68)                |
| Net decrease in treasury and other eligible bills          | -                 | 2,170               |
| Net decrease/(increase) in loans and advances to banks     | 597               | (256)               |
| Net decrease/(increase) in debt securities                 | 707               | (617)               |
| Net (increase)/decrease in gold and gold receivables       | (196)             | 43                  |
| Net (increase)/decrease in other assets                    | (483)             | 392                 |
| Net (decrease)/increase in items in course of transmission | (252)             | 114                 |
| Net (decrease)/increase in deposits by banks               | (312)             | 883                 |
| Net decrease in SDR allocation                             | (119)             | (23)                |
| Net (decrease)/increase in other liabilities               | <u>(165)</u>      | <u>1,052</u>        |
| <b>Net cash inflow from operating activities</b>           | <b><u>434</u></b> | <b><u>4,611</u></b> |

**17 Analysis of the balances of cash as shown in the balance sheet**

|   | <i>At 1 April</i> | Cashflow          | At 31 March       |
|---|-------------------|-------------------|-------------------|
|   | 2003              | £ millions        | 2004              |
|   | <i>£ millions</i> | £ millions        | <i>£ millions</i> |
| Balance with Paymaster General  | 82                | 84                | 166               |
| Balances at central banks   | <u>76</u>         | <u>25</u>         | <u>101</u>        |
|   | 158               | 109               | 267               |
| Loans and advances to other banks<br>repayable on demand (see note 6) | <u>9</u>          | <u>(5)</u>        | <u>4</u>          |
| <b>Total</b>  | <b><u>167</u></b> | <b><u>104</u></b> | <b><u>271</u></b> |

## **Accounts Direction given by HM Treasury under the Exchange Equalisation Account Act 1979<sup>10</sup>**

1. The Treasury shall prepare accounts for the Exchange Equalisation Account (“the Account”) for the year ending 31 March 2001 and each subsequent financial year comprising:

- a) A foreword
- b) A statement of Accounting Officer’s responsibilities
- c) A statement on the system of internal financial control<sup>11</sup>
- d) An income and expenditure account
- e) A statement of total recognised gains and losses
- f) A balance sheet
- g) A cash flow statement
- h) Notes to the accounts

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

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

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

David Loweth  
Head of Central Accountancy Team

HM Treasury  
19 December 2001

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<sup>10</sup> As amended by the Finance Act 2000.

<sup>11</sup> From 2001-02, a statement on the system of internal control.

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

## Appendix A

### APPLICATION OF THE RESOURCE ACCOUNTING MANUAL

#### Background

1. The Exchange Equalisation Account reflects activity that more closely resembles that of a bank than that of an entity covered by the Resource Accounting Manual (RAM). Accordingly, an income and expenditure account shall be prepared instead of Schedule 2, the operating cost statement, and both it and the balance sheet shall be prepared in the same format as those required by Schedule 9 of the Companies Act 1985. Schedule 1 (Summary of Resource Outturn) and Schedule 5 (Resources by Departmental Aim and Objective), are also not relevant.
2. In other respects, the accounts shall be consistent with relevant requirements of the RAM except in so far as is necessary to reflect the special requirements stated below.

#### Income and expenditure account

3. Such management costs as are debited to the Account shall be disclosed on the face of the income and expenditure account as an identifiable component of other operating charges.
4. A notional cost of capital charge shall apply at a rate determined by the Treasury. The cost shall be disclosed in the income and expenditure account and credited direct to the reserve at the year-end.
5. Segmental information shall be given where appropriate, including of separate classes of business.

#### Balance sheet

6. Subject to paragraphs 7 to 10 below, investments shall be valued at market price or at an appropriate estimate of market or fair value.
7. Interests in securities maintained for the purposes of hedging shall be carried at a value that properly reflects the hedge.
8. Investment securities, being securities held for use on a continuing basis in the activities in the Account, shall be carried at cost as adjusted for:
  - a) The amortisation of the premium or discount representing the premium or discount between cost and the redemption proceeds, for redeemable securities;
  - b) Any diminution in their value that is expected to be other than temporary;
  - c) Translation differences where the investment securities are denominated in foreign currencies.

9. Advances and loans shall be carried at cost less appropriate provision for doubtful debts.
10. All movements in values of investments shall be reflected in the income and expenditure account, including translation differences arising in relation to investment securities denominated in foreign currencies.

**Cash flow statement**

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

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

## Appendix B

### EXTRA INFORMATION REQUIRED TO BE DISCLOSED

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

#### Foreword

2. The foreword shall include:

- a) A brief history of the Account, and its statutory background;
- b) An outline of the scope of the Account, its status in relation to HM Treasury and other central funds, and its management arrangements;
- c) An operating and financial review:
  - i) meeting relevant requirements of the Accounting Standards Board's Statement and the narrative disclosure requirements of FRS 13, "Derivatives and other financial instruments - disclosures" for banks and similar institutions; and
  - ii) including appropriate information on financial performance and position reflecting the relationship between the Account and other relevant central funds, and information on targets set by HM Treasury and their achievement.

#### Notes to the accounts

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

- a) Analyses of assets, between fixed and current assets.
- b) Analyses of debtors and creditors, between those falling due within and after one year.
- c) Where not separately disclosed on the face of the income and expenditure accounts, analyses of income and expenditure giving totals for the following:
  - i) Interest receivable and similar income;
  - ii) Interest payable and similar charges, separately identifying any notional cost of capital charge;
  - iii) Other operating income, including income derived from the provision of services;
  - iv) Operating costs.
- d) Disclosure of income and expenditure, and assets and liabilities, relating to other central government funds, including the National Loans Fund, including analyses by funding purpose where appropriate.
- e) Disclosures meeting the requirements of FRS 13, "Derivatives and other financial instruments – disclosures" as applying to banks and similar institutions, including numerical disclosures about interest risk, currency risk, fair values, and financial instruments used for trading (including information on the market price risk of the trading book).

## Glossary

**Active management** is the difference between actual returns and the returns which would have been achieved from a passive investment strategy.

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

**Benchmark** is a neutral or passive investment strategy, against which actual performance is measured.

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

**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.

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

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

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

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

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

**Net reserves** refer to the part of the reserves that is financed by retained earnings, which are unhedged.

**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 United Kingdom could exchange sterling for useable foreign currencies up to the value of its RTP.

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

**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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