HM Treasury

Management of the Official Reserves

March 2020

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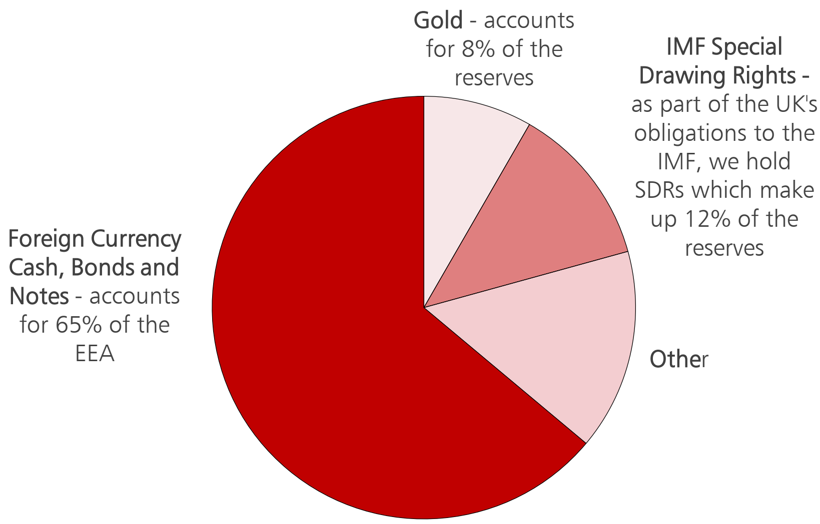
Introduction

Summary

This document provides an overview of the policy objectives of the United Kingdom's official reserves ("the reserves"), the ways in which the reserves are invested, and the policies and controls underpinning the management of the reserves.

The gross official reserves comprise foreign currency assets (cash, bonds and notes), gold assets and net positions of International Monetary Fund (IMF) Special Drawing Rights (SDR)[1], which are held in the Exchange Equalisation Account (EEA). The reserves also include the UK's Reserve Tranche Position[2] at the IMF and lending to the IMF under the New Arrangements to Borrow (NAB).

Box 1.A: What are the reserves?



Source: Bank of England, December 2019

[1] The Special Drawing Right is an international reserve asset, created by the IMF in 1969 to supplement its member countries' official reserves. The value of the SDR is based on a basket of five currencies – the U.S. dollar, the euro, the Chinese Renminbi, the Japanese yen, and the British pound sterling. More information on the SDR can be found in the SDR Factsheet, International Monetary Fund, 8 March 2019

[2] The Reserve Tranche Position is an SDR-denominated asset representing the UK's net lending position with the IMF.

This document provides an update to the UK's approach to managing the reserves, reflecting changes since the previous version of this report was published in May 2013. This document and the investment strategy for the reserves have been approved by HM Treasury ministers.

Background

Following the financial crisis, successive governments have increased the size of the reserves to ensure that all likely calls on the reserves can be met. A total of £72 billion of additional financing has been provided for the reserves since 2008. Over the same period, the gross value of the reserves has increased by £91 billion and stood at over £140 billion in December 2019. The size of the UK's reserves as a percentage of UK GDP has increased from 1.7% in December 2008 to 6.7% in December 2019[3], and now stands in line with other comparable economies. This is a pattern that has been seen in many other countries' reserves since the financial crisis. The current size of the UK's gross reserves is sufficient to deal with the policy objectives of the reserves.

In addition, there have been numerous structural changes to financial markets over the past decade. Global interest rates have fallen, and term premia have been compressed. This was the result of slow recovery from the global financial crisis, which led to a low interest rate environment and quantitative easing programmes by central banks. The yield achieved by large portfolios of high-quality sovereign bonds, such as the reserves, has therefore fallen over recent years. Broader structural changes have included, for example, increased use of clearing, the "electronification" of markets, and the growing presence of algorithmic trading across financial markets.

One of the main objectives of the government's Balance Sheet Review (BSR), launched in 2017, has been to improve returns on assets held on the public sector balance sheet. Changes to the composition of the reserves have been considered to support this objective.

Rationale: review of the investment strategy for the reserves

Taking into account the factors above, HM Treasury and the Bank of England ("the Bank") have jointly undertaken a review of the investment strategy to manage the portfolio of the UK's foreign currency assets. Our holdings of gold and IMF SDR remain unaffected following this review.

The principal outcome of the investment strategy review is a change in approach to the trade-off between policy readiness, financial risk, and investment return. As a result, the reserves will optimise return whilst ensuring policy readiness by setting a minimum requirement for the safest and most liquid assets, and overlaying

[3] Data from the International Monetary Fund

investment constraints to prudently manage financial risks (liquidity, credit, and market risk). Material changes to the investment strategy include:

- extending the investment horizon
- broadening the types of assets in which the reserves are invested
- holding a greater proportion of assets with higher returns and sufficient liquidity
- changing the proportion of the reserves that is hedged

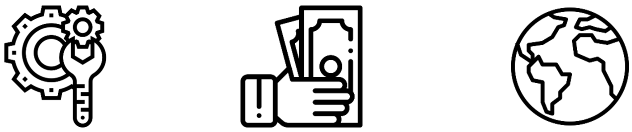
Box 1.B: Overview of the reserves[4]

The purposes of the government's reserves are….

Foreign exchange market activity

Enable payments abroad

Carry out the UK's obligations to the IMF



Three investment principles determine how the reserves are invested…

Ensuring readiness to carry out the three purposes

Limiting the amount of risk and volatility

Maximising returns, within these constraints

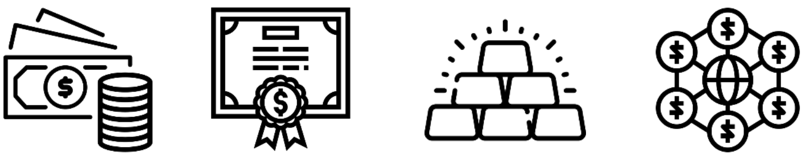
To achieve the purposes and meet the principles, the reserves are invested in…

Foreign currency

Government bonds

Gold

IMF reserves



The government's foreign currency reserves are managed by the Bank of England, on the government's behalf. Strict rules and controls underpin the overall management of the reserves, to ensure value for the taxpayer.

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[4] Icons made by Pixel perfect from www.flaticon.com

Chapter 2
Origin and Purpose

Why were the reserves established?

The reserves are held in the EEA, which was established in 1932 to provide a fund that could be used, when necessary, to regulate the exchange value of sterling and, therefore, is the mechanism through which any government exchange rate intervention would be conducted. The purposes of the reserves were formalised in the EEA Act 1979 and amended by the Finance Act 2000.[1] The EEA Act was introduced following the abolishment of capital controls in the UK in the "post Bretton Woods" era.

What are the policy objectives of the reserves?

The EEA Act 1979, as amended by the Finance Act 2000, provides the purposes for which the EEA shall be used. Those purposes are summarised in Table 2.A along with a non-exhaustive list of the types of activity which might be relevant to that purpose.

The government has not intervened in the sterling exchange rate for domestic policy reasons since 1992. The UK has participated in two G7 co-ordinated interventions in the foreign exchange market since then, in 2000 (for the euro) and 2011 (for the yen). Against this background, foreign exchange reserves are held on a precautionary basis – in the event of any unexpected shocks, or, if required, to meet any change in exchange rate policy in the future. Decisions relating to the management and use of the reserves are the responsibility of the Chancellor of the Exchequer and the Economic Secretary to the Treasury.

The reserves are also used to provide foreign currency services for government departments and agencies to provide foreign exchange for making payments abroad, and to carry out the UK's obligations under its membership of the IMF.

While meeting these policy objectives is the primary purpose of the EEA, HM Treasury ensures the cost for holding reserve assets is minimised. Cost reduction and maximising value to the taxpayer became an important focus of the government following the launch of the Balance Sheet Review (BSR) in 2017. The BSR aims to identify opportunities to dispose of assets that no longer serve a policy purpose, improve returns on retained assets, and reduce the risk and cost of liabilities. This work aims to put the UK at the forefront of the international drive to reduce waste and improve the cost-effective management of public wealth, as recognised by the IMF in its October 2018 Fiscal Monitor. The BSR led to the review of the investment

[1] Exchange Equalisation Account Act 1979

strategy of the reserves, which should result in better returns from these assets while ensuring a dynamic, yet prudent, approach to managing the reserves.

Table 2.A: Policy objectives of the EEA

Policy objective (as set out in the EEA Act 1979)	Examples (non-exhaustive)
Checking undue fluctuations in the exchange value of sterling	• short-term action to mitigate or reduce market disruption or improve functioning of the sterling foreign exchange market • participation in coordinated foreign exchange market intervention to assist other central banks' interventions • providing medium-term support for sterling if required to assist broader macroeconomic policy
Securing the conservation or disposition in the national interest of the means of making payments abroad	• providing foreign exchange payment services to the government, on request • making investments to further broader economic policy aims
For the purpose specified in Section 1(3) of the International Monetary Fund Act 1979 and carrying out any of the functions of the government of the United Kingdom under those of the said Articles of Agreement which relate to SDR	• maintaining the UK's Reserve Tranche Position with the IMF, thereby supporting IMF lending programmes • participating in the purchase and sale of IMF SDR, as necessary

Source: The Exchange Equalisation Account Act 1979

Chapter 3
Investment Policy

Investment Principles

In light of the policy objectives, the Investment Principles of the EEA are:

- **Investment Principle 1 (readiness)** – The EEA must be ready to meet its policy objectives at all times, at an acceptable cost and high degree of certainty
- **Investment Principle 2 (risk tolerance) -** The EEA must not take on risk that compromises the ability to meet Principle 1 or that could unduly influence fiscal metrics
- **Investment Principle 3 (return) -** Subject to meeting Principles 1 and 2, the EEA should seek to optimise risk-adjusted return

The Investment Principles are set out in an order that ensures the EEA's investment strategy is clearly and primarily linked to the policy objectives of the EEA. An assessment of the scale and likelihood of the EEA's policy objectives over the investment horizon is used to set initial parameters and constraints on the EEA's investments.

While taking into account the need to meet the policy objectives, the EEA's investment strategy also involves taking on financial risk. The EEA does so on the condition that it does not infringe the policy objectives, while ensuring the associated volatility does not in turn create undue volatility in the government's fiscal measures (such as Public Sector Net Debt). This risk tolerance is also used to set constraints on the EEA's investments.

Finally, and subject to those parameters and constraints, the EEA should make investments which ensure that the best possible return is made for the level of risk taken.

Parameters and constraints

Readiness: liquidity

In line with Investment Principle 1, the ability to sell assets with negligible impact on their price is of primary importance, even during stressed conditions. The portfolio holds enough of the highest liquidity assets and cash to meet large but all plausible policy objectives. Assets will be assessed by the Bank for market liquidity using a range of qualitative and quantitative metrics.

The portfolio should hold a low proportion of the amount in issue, across individual issuers or individual securities. Additionally, the EEA must target holding a minimum of amount of cash in order ensure efficient settlement.

Readiness: currency holdings

The majority of the EEA's investments is in those currencies most likely to be used in meeting the EEA's policy objectives (Investment Principle 1).

The most likely currencies to be used in either FX market action are the US dollar and euro, which are the two most traded currencies globally. The euro area and the US are also the UK's two largest trading partners.

It is also important to ensure holdings of assets in other advanced economy currencies, so a minimum holding in Japanese yen and Canadian dollar is maintained.

Risk tolerance: credit risk

Exposure to credit risk does not typically improve the ability to meet the EEA's policy objectives (Investment Principle 1). However, provided that credit risk is adequately compensated for, credit exposures should improve portfolio returns (Investment Principle 3). Overall, the EEA has a very low tolerance for taking credit risk.

To ensure this, the Bank maintains a framework of issuer credit limits, which favours holding higher credit quality assets, gradually limits exposures to lower credit quality issuers, and prohibits the purchase of securities from issuers with an unacceptably high probability of default.

A similar limit framework applies to counterparty risk, which also considers the relative riskiness of the trading activity with the counterparty.

Risk tolerance: market risk

The need to liquidate assets to meet large calls on the reserves, in order to meet policy objectives, is likely to be infrequent. Therefore, the EEA has capacity to withstand volatility of mark-to-market movements. The EEA's market risk is primarily driven by interest rate risk and foreign exchange rate risk.

To limit any undue influence of the EEA on fiscal metrics, market risk as a whole is tolerated up to a limit. This limit is set out in the Investment Policy Statement (IPS), which is discussed further in Chapter 4.

Eligible currencies and assets

Under the EEA Act 1979, the EEA may invest in securities (including cash), gold and IMF SDR.

The EEA may invest in cash or securities denominated in the foreign currencies represented in the IMF SDR basket (US dollar, euro, Japanese yen and Chinese renminbi), as well as other advanced economy currencies (Canadian dollar, Swiss francs, Danish krone, Swedish krona, Norwegian krone, Australian dollar and New Zealand dollar).

In line with Investment Principle 1, the liquidity resilience of assets held is of primary importance. Therefore, the universe of eligible securities is those eligible under the Basel III Liquidity Coverage Ratio (LCR).[1]

The Bank maintains a list of eligible issuers and instruments eligible for purchase. Currently, debt issued by the following types of entity will be considered for eligibility, subject to credit, liquidity and non-financial risk assessment:

- central governments or central banks
- regional governments
- supranational agencies (multilateral development banks and international organisations)
- national public agencies (either guaranteed or otherwise)

Gold

The reserves include the EEA's holdings of gold. The gold bars and gold coin in the reserves are stored physically at the Bank's premises.

IMF "Special Drawing Rights"

The reserves also contain the UK's holdings of International Monetary Fund (IMF) Special Drawing Rights (SDR). The SDR is an interest-bearing reserve asset created by the IMF to supplement IMF members' reserve assets.

The SDR is neither a currency nor a claim on the IMF. Instead, it is a potential claim on the freely usable currencies of IMF members.[2] The UK can exchange its SDR holdings with other IMF members for their freely usable currencies and routinely does so.

The SDR value is determined daily by the exchange rates of a basket of currencies, which is reviewed every five years to ensure that the SDR reflects the relative importance of currencies in the global financial system.

[1] Level 1 LCR securities with 100% weighting will ordinarily be eligible. Level 2 LCR securities may be considered on the recommendation of the Bank of England and subject to approval by HM Treasury.

[2] Definition taken from the Glossary of Selected Financial Terms, International Monetary Fund

Strategic asset allocation

Each year, the Bank will propose a strategic asset allocation for the EEA's currency reserves, for HM Treasury to review and agree. The proposed allocation must comply with the portfolio constraints and risk tolerance (Investment Principles 1 and 2). Beyond that, the objective of the allocation is to optimise risk-adjusted return (Investment Principle 3).

The proposed strategic asset allocation is informed by an asset allocation model. The asset allocation model chooses an allocation with the optimal return relative to the overall market risk tolerance. A fully unhedged portfolio is likely to breach this tolerance, so foreign exchange and interest rate hedging is required to ensure overall market risk remains within tolerance (Investment Principle 2).

The asset allocation model sets out portfolio weights by currency, issuer and maturity. A number of factors are considered in determining the proposed strategic asset allocation, including statistical analyses of risk and return input estimates, the operational feasibility of the allocation, and a broader set of financial and macroeconomic indicators. Important judgements are made in running the asset allocation model and any judgements to override the results of the model are explicit and agreed annually.

Active management

The Bank will seek to improve returns for the EEA through active management trading strategies beyond the strategic asset allocation. Active management must not compromise the portfolio constraints.

An annual active management return target is set each year in consultation between the Bank and HM Treasury. This target is set against the benchmark set by the strategic asset allocation and takes account of the limits on active management set as part of the Service Level Agreement (SLA), which is discussed further in Chapter 4. For policy reasons, the annual active management target is confidential.

Active management returns are reported in the EEA's annual accounts and have ranged between £17 million and £71 million per year in the past 5 years.

Risk management

The risk management strategy for the reserves is set annually via the SLA which details the responsibilities of the Bank and HM Treasury. Within the Bank, the Financial Risk Management Division is responsible for financial risk analysis, risk methodologies, risk management information and the reconciliation of the EEA financial and management accounts.

The Bank's Middle Office is responsible for running, developing and streamlining the operations and processes which underpin risk management. Operational risk management and crisis and contingency planning are the responsibility of the Markets & Banking Chief Operating Officer Division. These teams are all separate from the Foreign Exchange Division where transactions are executed. HM Treasury monitors the risk environment and the performance of the Bank.

Portfolio performance and ongoing risk exposures of the EEA are monitored regularly by both the Bank and HM Treasury. The measures used include:

- the sterling-denominated mark-to-market value of the EEA and the 12-monthly rolling standard deviation of changes. This is also monitored excluding repurchase agreements and IMF obligations in order to monitor against the market risk tolerance

- the strategic asset allocation represents a benchmark for the portfolio. Performance of the portfolio, in terms of mark-to-market values, return and market risk, is regularly compared to that of the strategic asset allocation. In addition, the proportion of asset holdings is compared to the asset weights set by the strategic asset allocation

- market risk is also measured using backward-looking portfolio market risk measures, including value-at-risk and expected shortfall, as well as forward-looking scenario-based stress testing

- ongoing issuer credit and counterparty risk exposures are also monitored, relative to the credit risk limit framework

Chapter 4
Management of the EEA

The EEA belongs to the Exchequer, and HM Treasury is the department responsible for controlling the EEA on behalf of the Exchequer. HM Treasury appoints the Bank as its agent to carry out the day-to-day management of the reserves.

The EEA's investment policy and strategic asset allocation are set out in an Investment Policy Statement (IPS). This, together with a Service Level Agreement (SLA) between HM Treasury and the Bank, specifies the parameters under which the reserves are managed. The SLA and IPS are both confidential documents which remain in force indefinitely and are reviewed annually. They are set within the context of all relevant legislation, particularly the EEA Act 1979, as amended by the Finance Act 2000.

Responsibilities of the Bank and HM Treasury

A Memorandum of Understanding (MoU) between HM Treasury and the Bank published in June 2018[1] describes the financial arrangements for the provision of agency services by the Bank to HM Treasury. Specifically, the MoU sets out that "The Treasury acts as a customer of the Bank for the management of the EEA, rather than as the Bank's shareholder". The obligations for how these EEA services are delivered are set out in the SLA between the Bank and HM Treasury.

HM Treasury's role is to:

- ensure that its choice of strategic asset allocation for the reserves, including gold, meets the policy objectives of the EEA. Subject to meeting those objectives, HM Treasury will make an asset allocation choice to balance readiness, risk and return, in line with the investment principles, taking advice from the Bank as required
- set an active management return target for the Bank in managing the reserves against the strategic asset allocation, subject to the limits detailed in the SLA. This target will be set to at least cover the costs of the Bank in managing the EEA

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

- accounting and statistical information

1 Financial relationship between HM Treasury and the Bank of England, HM Treasury and the Bank of England, June 2018

- operational risk reporting
- portfolio composition and analysis

The Bank will ensure that all transactions that relate to its management of the official reserves shall be handled efficiently, accurately and in a timely fashion. In carrying out its services, the Bank will, as far as possible, ensure that:

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

Key Performance Indicators

To help gauge the effectiveness of the Bank's management of the reserves, HM Treasury and the Bank use a set of Key Performance Indicators (KPIs). The current KPIs and the Bank's performance against these indicators, are published annually in the EEA Annual Report & Accounts.[2]

Reporting

Monthly reporting

Since April 2000, the UK has published reserves data in accordance with the IMF/G10's Special Data Dissemination Standard (SDDS)[3] and aligned with the conventions of the G10/IMF reserves template.[4] These monthly releases set out the value and composition of the UK's foreign currency and gold assets, liabilities and derivatives on a marked-to-market basis (that is, using current market valuations).

Every month HM Treasury will publish a press notice showing details of movements in the reserves over the previous month.[5]

Reserve data from July 1999 onwards is available on the Bank of England's website.[6]

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2 HMT Exchange Equalisation Accounts, HM Treasury, 2013

3 IMF Standards for Data Dissemination, International Monetary Fund, 25 March 2019

4 Guidelines for Data Template, International Monetary Fund, 2013

5 HMT Statistical Release: UK official holdings of international reserves, HM Treasury

6 Further details about UK International reserves data, Bank of England

Annual reporting

HM Treasury publishes the financial accounts for the EEA as part of the statutory obligations set out in the EEA Act 1979 (as amended by the Finance Act 2000).[7]

Intervention

The government will publish details of any intervention undertaken in the foreign exchange market in the subsequent monthly press notice. This will provide details of the amount and date of any official intervention during the month and an explanation of why it was undertaken.

Specific prior authority from HM Treasury ministers is required for intervention in the foreign exchange market using the EEA, or for EEA participation in coordinated intervention in support of any other currency.

Governance: audit & accounting

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

National Audit Office access

For the purposes of:

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

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

[7] HMT Exchange Equalisation Accounts, HM Treasury

HM Treasury contacts

This document can be downloaded from www.gov.uk

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