HM Treasury

Exchange Equalisation Account:

Report and Accounts 2014-15

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July 2015

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Introduction

1. The Exchange Equalisation Account (EEA) holds the United Kingdom's reserves of gold, foreign currency assets and International Monetary Fund (IMF) Special Drawing Rights[1] (SDRs). Combined with the UK's Reserve Tranche Position (RTP) at the IMF and lending to the IMF under the New Arrangements to Borrow (NAB), these assets comprise the UK's official holdings of international reserves ('the Official Reserves'). The RTP and NAB loans are held in the National Loans Fund (NLF) for which separate accounts are published by HM Treasury (the Treasury).

Origin and Purpose

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

3. Against this background, foreign currency reserves are held on a precautionary basis to meet any change in exchange rate policy in the future, if required, or in the event of any unexpected shocks. The reserves are also used to provide foreign currency services for Government departments and agencies, to provide foreign exchange for making payments abroad and to buy, sell and hold SDRs as required by the UK's membership of the IMF.

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

Administration and Control

5. The EEA is under the control of the Treasury whose prime objective in managing the EEA on behalf of the Government is to ensure the reserves are fit for purpose in order to meet current policy objectives and any potential future changes in policy. In support of that, the Government's objective is to preserve the liquidity and security of the reserves and to ensure that the Government maintains its capability to intervene in the foreign exchange market if required. Subject to this, the aim is to minimise the overall cost of holding the reserves, while ensuring exposure to financial risk is limited through the appropriate choice of portfolio and risk management practices. The Treasury's role is to ensure that its choice for the strategic composition for the benchmark asset allocation of the reserves, including gold, meets these policy objectives. Subject to this, the Treasury will make the benchmark asset allocation choice to trade off risk, return and liquidity in line with its risk preferences.

6. The Treasury has appointed the Bank of England (the Bank) to act as its agent in the day-to-day management of the EEA. The Bank executes foreign exchange transactions and invests the reserves in accordance with an agreed framework (see paragraph 10).

7. The Bank also acts as the Treasury's agent for foreign currency liability management, including the issuance of foreign currency debt to finance some of the reserves. This debt is issued by, and is an obligation of, the NLF under the National Loans Act 1968 since it is that Act (rather than the Exchange Equalisation Account Act 1979) which provides the powers for the Government to issue foreign currency securities. The foreign currency raised by issuing foreign currency debt is transferred to the EEA (see paragraphs 34 and 35). At 31 March 2015

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

there was £329m foreign currency debt outstanding in the NLF relating to the renminbi issuance in October 2014 (*2014: nil*).

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

9. The Bank's management costs are charged to the EEA. The management charge in 2014-15 was £8m *(2014: £8m)*.

10. An annual Service Level Agreement (SLA)[2] between the Treasury and the Bank specifies the parameters within which the reserves are managed. The SLA outlines:

- benchmarks which specify the currency and asset composition of the reserves;
- limits to the Bank's discretion to take currency or interest rate positions relative to those benchmarks ('active management');
- the framework for controlling credit, market, liquidity and other risks;
- a target return for active management; and
- the programme for financing the reserves, covering the NLF's foreign currency borrowing and currency swaps out of sterling.

The terms of the SLA can be reviewed during the year at the Bank's or the Treasury's request. There were no substantive changes made to the SLA for 2014-15.

11. In accordance with the SLA, the Bank manages the reserves so as to ensure adherence to Treasury policy aims and reports against this to the Treasury as described in the Governance Statement.

Benchmark Allocations

12. The Bank and the Treasury agree a series of benchmarks for the assets in which the reserves are invested which are made on the basis of a trade-off between risk, return and liquidity. These represent the high-level asset allocation criteria, reflecting the policy objectives of the reserves, and also form the benchmark against which the Bank's active management is measured.

13. The reserves can be divided into two components: reserves hedged for currency and interest rate risk (the 'hedged reserves') and the remaining reserves which are unhedged (the 'unhedged reserves'). Separate benchmarks are set for each of these two components.

Hedged reserves

14. In order to determine the benchmark asset allocation for the hedged reserves, the Bank uses an asset allocation model, the parameters of which are agreed by the Treasury, which explicitly trades off liquidity and return.

[2] A summary is included in a report produced by the Treasury entitled 'Management of the Official Reserves' available at https://www.gov.uk/government/publications/management-of-the-official-reserves.

Unhedged reserves

15. The Treasury sets a benchmark for the currency allocation of the EEA's unhedged reserves, excluding gold. This takes into account past patterns of risk and return, as well as other factors such as the currencies likely to be required in any intervention. As in the previous year, in 2014-15 this benchmark was 40% US dollar, 40% euro and 20% yen.

16. In the unhedged reserves, the Treasury may decide, with advice from the Bank, to set deviations from the 40:40:20 currency benchmark or the interest rate benchmarks.

17. Each currency within the unhedged reserves has a benchmark for the assets within it. In 2014-15 the benchmark for assets denominated in US dollars comprised of US Treasury bonds. The benchmark for euro denominated assets comprised euro denominated sovereign securities. For yen, the benchmark was derived from 1-3 month forward yen rates against the euro and the dollar.

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

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

Active management

20. Subject to ensuring that the reserves are liquid, secure and properly managed, the Government will seek to minimise the cost to the taxpayer. As part of that, the Bank will actively manage the reserves, taking currency or interest rate positions relative to the benchmark positions, subject to restrictions and limits laid out in the SLA.

21. An active management income target is set each year.

Investment Policy

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

23. In October 2014 the UK issued the world's first non-Chinese sovereign bond denominated in renminbi (RMB) in the offshore renminbi market totalling RMB 3 billion (£304m at the time of issuance) with the proceeds financing the reserves through the purchase of RMB assets. This is in recognition of the increasingly prominent role that renminbi is playing in the global economy, including as a potential future reserve currency.

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

- conventional bonds, bills, discount notes and floating rate notes of any maturity and commercial paper issued by other national Governments, supranational organisations and selected official sector agencies;
- foreign currency spot, forward and swap transactions;
- interest rate and currency swaps;
- overnight indexed swaps;

- bond and interest rate futures, swap notes and swap futures;
- repurchase and reverse repurchase agreements ('repos' and 'reverse repos');
- forward rate agreements;
- SDRs;
- short-term bank deposits; and
- deposits with the Bank.

25. Derivative transactions entered into by the EEA are documented under the Bank's ISDA Master Agreements with counterparties. Swaps and foreign exchange transactions are governed by these agreements. Repos and reverse repos are governed by bespoke foreign currency repo documentation.

26. The terms of ISDA agreements with market counterparties under which the Bank transacts swaps and foreign exchange transactions state that as well as taking collateral when the net present value of transactions is positive, the EEA provides collateral to market counterparties when the net present value to the Treasury becomes negative. This means there is a two-way margining under the ISDA agreements, in line with market standard practice.

Key Performance Indicators

27. The Treasury has agreed a set of Key Performance Indicators (KPIs) with the Bank with the purpose of providing a basket of indicators that can be used to assess the future effectiveness of the management of the EEA. The KPIs selected reflect the overall objectives for holding the reserves, as explained above.

28. The KPIs for 2014-15 specified that:

(i) The foreign currency reserves, while not used in operations to deliver policy objectives, will be invested in assets that are liquid and secure and are monitored daily. Specifically:

- A minimum of 75% of assets will be held in cash or invested in securities on the Bank's Level A collateral list, which comprises securities expected to remain liquid in all but the most extreme circumstances.
- All official reserve assets should be securities that normally trade in liquid markets. Assets must be eligible to be accepted as collateral under the Bank's Level B collateral list and be in the list of assets eligible for the EEA.

(ii) The Bank will observe the limits as set out in the SLA. In line with the SLA, any substantive breaches of the limits and/or any operational errors will be reported to the Treasury as soon as possible, along with advice on how the Bank will deal with them. Any significant breach will be reported publicly (e.g. in the annual accounts).

(iii) In order to aim to at least cover costs, and to ensure the Bank maintains its capability to intervene in the foreign exchange market if required, the Bank will actively manage the EEA portfolio against the benchmark to meet the active management return target set by the Treasury (see paragraph 51 for details), while ensuring compliance with the limits as detailed in the SLA.

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

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

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

Links between the International Monetary Fund and the Official Reserves

29. The primary means of financing the IMF is through members' quotas. Each member of the IMF is assigned a quota, based broadly on its relative size in the world economy, which is payable in a combination of SDRs and the member's own currency. The difference between a member's quota and the IMF's holdings of its currency is a member's RTP. As explained above, the UK's RTP is an asset of the NLF. A portion of the RTP is unremunerated and interest is earned on the remaining balance at the SDR interest rate.

30. While quota subscriptions of member countries are the IMF's main source of financing, the IMF can supplement its resources through borrowing if it believes that resources might fall short of members' needs. Through a standing multilateral borrowing arrangement – the New Arrangements to Borrow (NAB) – a number of member countries and institutions, including the UK, stand ready to lend additional funds to the IMF. Any lending against this facility is an asset of the NLF.

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

32. The SDR market functions through voluntary trading arrangements. Under these arrangements a number of members, including the UK, have volunteered to buy or sell SDRs within limits defined by their respective arrangements. Following the 2009 SDR allocations, the number and size of the voluntary arrangements has been expanded to ensure continued liquidity of the voluntary market. In the event that there is insufficient capacity under the voluntary trading arrangements to ensure the liquidity of the market, the IMF can activate the designated mechanism. Under this mechanism, members with sufficiently strong external positions are designated by the IMF to buy SDRs with freely useable currencies up to certain amounts for members with weak external positions. This arrangement guarantees the liquidity and the reserve asset character of the SDR.

Risk Management and Control

33. In addition to managing the operational risks discussed in the Governance Statement and financial risks discussed in the 'Risk management and control' note to the accounts on page 36, the Bank also conducts regular stress tests for a range of scenarios. A range of historical and theoretical scenarios involving large shifts in interest rates, spreads between securities and changes in yield curve shapes are applied to both the overall EEA holdings and the active management positions/component. These results are reviewed by senior management and the associated risks accepted or actions taken.

Management Commentary of activities in 2014-15

34. At Budget 2011, the Chancellor announced an additional £6 billion of sterling financing for the Official Reserves in 2011-12. The Government envisaged sterling financing being held at a similar level on average over the three years up to, and including 2014-15. In accordance with this plan, at Budget 2014 the Chancellor confirmed an additional £6 billion of sterling financing was to be invested in the reserves in 2014-15. This was then adjusted down to £5.7 billion at Autumn Statement 2014 to factor in the Government's foreign currency bond issuance of RMB 3 billion in October 2014. At Autumn Statement 2014 the Chancellor also announced a further £6 billion of sterling financing for the reserves bringing the total additional sterling financing to £11.7 billion in 2014-15.

35. In addition, at Autumn Statement 2014 and Budget 2015, the Chancellor announced that the Government would provide a further £6 billion of additional sterling financing for the Official Reserves in 2015-16. The Chancellor also announced that the Government planned on the basis of sterling financing for the Official Reserves at a similar level on average over the 4 years from 2016-17 up to, and including, 2019-20. This additional financing is intended to meet potential calls on the reserves that may arise and ensure that the level of foreign currency reserves held is sufficient for the UK to remain resilient to possible future shocks. The option to issue foreign currency denominated securities remains available based on an assessment of market conditions and the likely cost of borrowing. If the option was taken then sterling financing for the reserves would be adjusted accordingly.

36. The actual net sterling funding amount drawn down from the NLF shown in the Statement of Cash Flows was £14.4 billion for the year to 31 March 2015. This amount included the additional sterling financing of £11.7 billion in 2014-15 plus the sterling flows resulting from IMF related transactions. As stated in the "Central Government Net Cash Requirement Outturn 2014-15: Revision to the DMO's Financing Remit 2015-16"[3], it also included an increase of £0.7 billion which will be offset against the £6 billion of additional sterling financing in 2015-16 noted above.

Hedged and unhedged reserves

37. As described above, the UK's Official Reserves, of which £79,500m *(2014: £61,882m)* are held in the EEA and £2,927m *(2014: £4,623m)* are held in the NLF, can be divided into two components: the 'hedged reserves' £57,423m (*2014: £40,158m*), and the 'unhedged reserves' of £25,004m (*2014: £26,347m*). The rise in the hedged reserves is due primarily to the investment of additional financing provided by the NLF. The decrease in unhedged reserves is due primarily to IMF loan repayments.

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

39. The hedged reserves comprise portfolios of eligible US dollar, euro, yen and Canadian dollar denominated assets and holdings of SDRs. Assets in the hedged reserves are hedged for currency risk either by being denominated in the same currency as the liabilities which finance

[3] This can be viewed at: http://www.dmo.gov.uk/documentview.aspx?docname=gilts/press/sa230415.pdf&page=Remit/full_details.

them or by using currency swaps. The hedged reserves are also hedged against interest rate risk, through the use of swaps.

40. The hedged reserves are primarily financed by sterling raised from the sale of gilts. The EEA uses sterling advanced from the NLF to purchase foreign currency assets with, as noted above, swaps used to hedge the resulting currency and interest rate risks. However, the Government retains the option of issuing foreign currency denominated securities taking into account cost, risk, market conditions and consistency with debt management objectives.

41. Financing of the hedged reserves as at 31 March 2015 included sterling swapped into foreign currencies of £44,038m *(2014: £29,702m*) and the SDR allocation of £9,416m *(2014: £9,395m*).

Management of the reserves

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

43. The foreign currency elements of the UK's total Official Reserves are published in the monthly IMF Reserves Template.[4] The Template shows the net foreign currency position in the Official Reserves, which at end-March was the equivalent of £25,004m. The assets and liabilities in the Template differ from those of the EEA Statement of Financial Position on page 22 of these accounts. This is for a number of reasons but principally it is because the Template is designed to reflect the UK's foreign currency position. It therefore includes foreign currency assets and liabilities of the NLF (notably the RTP) and excludes all items denominated in domestic currency (i.e. sterling). The most significant of these are the liability of the EEA to the NLF and the valuation of the sterling leg of foreign currency forwards and currency swaps. These factors, coupled with the effects of differing treatment of unsettled items and short positions in debt securities, mean that gross reserve assets shown in the Template (the equivalent of £82,427m at 31 March 2015) differ by £3,287m from the assets held in the EEA. A reconciliation between the EEA's Statement of Financial Position and the Template is provided on page 11.

44. The size of the Official Reserves assets that are held in the EEA rose over the course of the year by £17,618m to £79,500m. This rise was the result of increases in debt securities (£14,642m), money market instruments (£2,432m) and items in course of settlement (£348m).

45. The reserve liabilities held in the EEA rose over the course of the year by £17,265m to £57,423m. This increase consisted primarily of a rise in the net derivative positions (£15,163m), repurchase agreements (£1,472m) and unsettled trades (£609m).

46. In the EEA Statement of Financial Position shown on page 22, assets increased over the course of the year by £17,519m to £85,714m. This increase consisted primarily of rises in debt securities (£14,280m), money market instruments (£2,432m) and derivative financial assets (£1,042m).

47. A matching increase in EEA liabilities consisted primarily of a rise in the liability to the NLF (£14,969m).

[4] This can be viewed at: https://www.gov.uk/search?q=international+reserves&tab=government-results.

Analysis of returns for the period

48. The EEA's accounts for the year ended 31 March 2015 are given on pages 21 to 49 and show a total comprehensive gain for the year of £549m (*2014: £3,845m loss*).

49. The price of gold rose from £775 to £799 an ounce, an increase of 3%, giving rise to a revaluation gain of £246m.

50. The net trading gain for the year was £313m *(2014: £1,066m loss).* On a financial instrument basis, net trading gains on debt securities (net of short positions) of £752m were the largest contributor to the overall net trading gain. This was partly offset by losses on interest rate swaps (£526m). A full breakdown of net trading income by instrument is provided in note 2.

51. The Treasury sets a target for active management return as part of the SLA, above the cost of managing the reserves. This target is set against the benchmarks for the portfolio (as detailed above), and takes account of the limits on active management set as part of the SLA. This target is confidential for policy reasons. The return from the Bank's active management of the reserves against the benchmarks during the year was £24m (*2014: £23m*).

52. The EEA continued to invest in high credit quality assets throughout the year, and has not crystallised any credit losses.

Performance against Key Performance Indicators

53. All KPIs were met in 2014-15 and there were no significant breaches of the limits in the SLA.

Intervention

54. No intervention was undertaken by the Government in the foreign exchange market during the year. The last intervention was the coordinated G7 yen intervention of March 2011.

Provision of foreign currency services to Government departments

55. The EEA continued to provide foreign currency services to various Government departments and agencies. Sales of foreign currency, to departments with foreign currency obligations, and purchases of foreign currency, from departments with foreign currency receipts, in aggregate totalled £9,258m (*2014: £12,128m*). These purchases and sales, both spot and forward, were hedged through offsetting trades with the market.

David Ramsden
Accounting Officer

HM Treasury
9 July 2015

Directors' Report

The EEA does not have any employees and, therefore, there is nothing to report for pension liabilities and staff sickness absence.

Financial instrument risk

Financial risks related to the EEA are considered in note 18.

Personal data related incidents

The EEA does not hold any protected personal data.

Disclosure to auditors

In accordance with the Accounts Direction issued on 6 January 2012 (on page 50 to the accounts), the EEA accounts for 2014-15 have been prepared in accordance with the requirements of the relevant version of the Government Financial Reporting Manual (FReM).

The EEA account is audited by the Comptroller and Auditor General under the requirements of the Exchange Equalisation Account Act 1979.

The National Audit Office (NAO) bears the cost of all external audit work performed on the EEA. During the financial year, no non-audit work was undertaken by the NAO in relation to the EEA.

As the Accounting Officer, I have taken all the steps that I ought to have taken to make myself aware of any relevant audit information and to establish that the EEA's auditors are aware of that information. So far as I am aware, there is no relevant audit information of which the EEA's auditors are unaware.

David Ramsden	HM Treasury
Accounting Officer	9 July 2015

Reconciliation of EEA Statement of Financial Position to IMF Reserves Template

As at 31 March 2015:

	Unaudited **£ millions**	Unaudited **$ millions**
Total assets per EEA statement of financial position	**85,714**	
Adjustments to reflect IMF Reserves Template presentation:		
Sterling cash balance	(1,372)	
Reclassification between assets and liabilities	(4,520)	
Foreign currency assets not included in Official Reserves	(329)	
Other adjustments[5]	7	
Reserve assets held in the EEA	79,500	
Reserve assets held in NLF	2,927	
Sterling total assets using Template presentation	**82,427**	
Dollar equivalent per Template		**122,383**
Total liabilities per EEA statement of financial position	**85,714**	
EEA's Reserves and liability to the NLF (see note 14)	(67,774)	
Adjustments to reflect IMF Reserves Template presentation:		
Sterling leg of derivative trades	44,038	
Reclassification between assets and liabilities	(4,520)	
Other adjustments	(35)	
Sterling total liabilities using Template presentation	**57,423**	
Dollar equivalent per Template		**85,259**
Net assets per Template	**25,004**	**37,124**

Conversion rate into US dollars is 1.4848 as at close 31 March 2015

[5] Other adjustments include a bid-offer spread provision. Financial accounting assets and liabilities are reported using bid or offer prices as appropriate, whereas the reserves are reported using mid-point prices.

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 a statement of accounts in the form and on the basis considered appropriate by the Treasury. The accounts are prepared on an accruals basis and must give a true and fair view of the state of affairs, of its Comprehensive Income and cash flows for the financial year.

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

- observe the relevant accounting and disclosure requirements of the Government Financial Reporting Manual, in so far as they are relevant to the accounts, and apply suitable accounting policies on a consistent basis;
- make judgements and estimates on a reasonable basis;
- state whether applicable accounting standards have been followed, and disclose and explain any material departures in the accounts; and
- prepare the accounts on a going concern basis.

The Treasury has appointed its Chief Economic Adviser as the Accounting Officer for the Account.

The responsibilities of an Accounting Officer, including responsibility for the propriety and regularity of the public finances for which the Accounting Officer is answerable, for keeping proper records and for safeguarding the Account's assets, are set out in *Managing Public Money*.

Governance Statement

1. Scope of responsibility

1.1 The Exchange Equalisation Account (EEA) is managed within the Treasury's overall risk and governance framework as set out in the Treasury's Annual Report and Accounts 2014-15. This includes the Treasury Board's assessment of its compliance with the *Corporate Governance Code*. The Chancellor of the Exchequer, as Minister in charge of the Treasury, is responsible and answerable to Parliament on all the policies, decisions and actions of the Treasury and ultimately of the EEA.

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

1.3 Overall management of the EEA is the responsibility of the Treasury which delegates day-to-day management to the Bank, which acts as its Agent and Advisor. The Debt and Reserves Management (DRM) team at the Treasury has oversight of the Bank's EEA operations and agrees an Annual Service Level Agreement (SLA) with the Bank that specifies the parameters under which the reserves are managed. The SLA sets out the guidelines for investing the reserves, including risk limits and the associated management information required and is described in more detail in the Strategic Report. The Exchequer Funds and Accounts (EFA) team at the Treasury reports directly to me on operational risk issues and works closely with the Bank to produce the annual accounts.

2. The purpose of the system of internal control

2.1 Although the reserves are not held in order to make a profit, consistent with the KPIs described in the Strategic Report, the Treasury seeks to minimise the cost of holding the foreign currency reserves while avoiding exposing the public purse to unnecessary risk.

2.2 The system of internal control is designed to manage risk to an acceptable level, balancing the impact of potential risks with the resources to manage them, rather than to eliminate all risk. 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 has been in place throughout the year ended 31 March 2015 and up to the date of approval of the annual report and accounts, and accords with Treasury guidance.

3. Capacity to handle risk

3.1 The risk management strategy is set annually via the SLA, which is signed by me as Accounting Officer. There is clear segregation of duties within the Bank and the Treasury for the management of the EEA and the supporting processes.

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

3.3 At the Treasury, management ensures that specific DRM and EFA staff members are trained in risk appraisal and management. Job instructions are maintained for time and business-critical tasks.

4. The risk and control framework

4.1 Within the Bank, the Risk Management Division is responsible for financial risk analysis and risk methodologies. The Financial Risk Operations & Accounting Control Unit is responsible for risk management information and running, developing and streamlining the operations and processes in Markets which underpin risk management, and for reconciling and producing the EEA financial and management accounts. The Markets & Banking Chief Operations Officer Division oversees management of operational risks and undertakes all Markets-wide crisis and contingency planning. Those teams are all separate from the Foreign Exchange Division where transactions are executed. The Risk Management, Financial Risk Operations & Accounting Control, Markets & Banking Chief Operating Officer, and Foreign Exchange Divisions are also separate from the Market Services and Customer Banking Divisions in the Banking Directorate where the transactions are settled and custodian arrangements are managed.

4.2 The Bank has an overarching Risk Management Framework in order to provide consistency and transparency in operational risk management processes across the organisation. This framework is supported by a central Risk Oversight Unit in the Finance Directorate and is ultimately overseen by the Bank's Audit and Risk Committee (ARCo). The framework identifies the roles and responsibilities of the key parties involved in the risk management processes, the policies for how risks are managed, and the reporting outputs that are generated. The risk policies are set out in the Strategic and Policy Risk Statement, the Operational Risk Policy and in a number of Risk Standards. The Standards are a high-level articulation of how key categories of risk are identified, assessed, controlled and monitored within the Bank. Those relevant to the management of the EEA include the following operational risk standards: Business Continuity Risk, Business Practice Risk, Human Resources Risk, Information Technology Risk, Legal Risk, Project Risk and Security Risk. The Executive Directors Committee (EDCo) ensures that these Policy and Risk Standards are fit for purpose, and reviews them on an annual basis prior to approval by the Governors. Risks identified by each Bank Directorate and Risk Standard owner are consolidated into the Bank-wide risk profile reported to EDCo, ARCo and the Bank's Court of Directors. Mitigating actions in response to incidents and exceptions relating to the Bank's risk profile are also reported to ARCo.

4.3 At the Treasury, EFA is responsible for monitoring the risk environment and providing the Accounting Officer with the assurance to sign off the Governance Statement. DRM are responsible for monitoring the performance of the Bank in managing the reserves. To support these processes, the Bank provides the following management information:

- Monthly reports to the Treasury on the size, composition and liquidity of the reserves, their consistency with policy objectives, investment performance, returns made and risk exposures. The management accounts are reconciled to the financial accounts.
- The Bank's Executive Director for Markets provides me as the Accounting Officer with a quarterly assurance that the processes and framework in place are sufficient to identify current and future sources of material risk and meet the Turnbull requirements. The assurance also states that it is evidence which can be relied upon in making this Governance Statement. In addition, EFA are provided with quarterly management reports on risk issues and the Bank's compliance with the guidance issued by the Turnbull Report. These reports highlight the Bank's role in identifying, assessing, managing and monitoring the risks relating to its management of the EEA and any breaches of the control framework. Any significant breaches are reported as they occur. This process is supported by Operational Risk Officers in the Foreign Exchange Division, the Risk Management Division, Banking Services, Financial Risk Operations & Accounting Control and, with specific responsibility for the co-ordination of the quarterly reporting framework, the Markets & Banking Chief Operating Officer Division.
- EFA considers and discusses the information provided with the Bank and Exchequer Funds Internal Audit and provides me as the Accounting Officer with quarterly reports that highlight the key risks.
- The Bank's Internal Audit Division conducts an agreed internal audit programme. The Bank's Executive Director for Markets forwards the Internal Audit quarterly reports on this activity to me as the Accounting Officer and the results of all relevant internal audits are provided to EFA.
- Exchequer Funds Internal Audit provides an independent and objective opinion to me as the Accounting Officer on risk management, control and governance of the EEA. Assurance is provided following reviews of relevant Bank Internal Audit reports and EFA's oversight of the Bank's work, as agreed by me as the Accounting Officer and the Treasury Group Audit Committee. Exchequer Funds Internal Audit's reviews aim to measure and evaluate the effectiveness of the Treasury in achieving its agreed objectives in respect of the EEA. Exchequer Funds Internal Audit also reviews EFA's quarterly report to me as the Accounting Officer (mentioned above).
- Bank and Treasury officials meet quarterly to review performance against the parameters set out in the SLA and to consider wider operational and policy issues. Additionally, I as the Accounting Officer and the Bank's Executive Director for Markets hold half-yearly meetings to discuss overall strategy and governance issues.

Bank accountancy professionals produce the financial accounts on behalf of the Treasury using Bank IT systems. EFA liaises with the Bank and DRM to produce the annual accounts. The Treasury Accountant in EFA reviewed and approved the 2014-15 financial accounts, Strategic Report and Directors' Report in draft before I approved them formally.

4.4 The Treasury Group Audit Committee is a subcommittee of the Treasury Board and is tasked with supporting the Permanent Secretary, as Principal Accounting Officer, and the Treasury's Additional Accounting Officers in their responsibilities for managing risk, internal control and governance related to the Treasury Group's Annual Report and Accounts, the Central Funds (Consolidated Fund, National Loans Fund, Contingencies Fund and EEA) and the Whole of Government Accounts.

4.5 Members of the Committee are appointed by the Permanent Secretary for periods up to three years, extendable by one additional three-year periods. The Chair of the Committee (Richard Meddings) reports directly to the Permanent Secretary and is also a Non-Executive Member of the Treasury Board. The membership of the Audit Committee at the close of 2014-15 was:

- Richard Meddings (from 1 September 2014). Non-Executive Director, Legal & General PLC (December 2014 to current); Main Board Director (2002-2014) and Group Finance Director (2006-2014) Standard Chartered PLC; Non-Executive Director of 3i Group PLC (2008-2014); Financial Reporting Review Panel in FRC and Board member of International Chambers of Commerce UK (2007 to current).

- Mike Ashley – Non-Executive Director, and Audit Committee Chairman, Barclays PLC; Board membership (and Chair of Audit and Risk Committee) of the Charity Commission and Chair of the Government Internal Audit Agency (GIAA) Board. Previously Head of Quality and Risk Management and Board Member, KPMG Europe LLP.

- Mary Hardy – Audit Committee Member, Institute of Chartered Accountants in England and Wales; Non-Executive Member, Defence Audit Committee; Non-Executive Member of the Board of the Royal Navy, and Chair of its Audit Committee.

- Abhai Rajguru – Non-Executive Director, Leeds Building Society; Chairman, Alexander Rosse; Managing Partner, Pravara Capital LLP; Non-Executive Director, Tollers LLP; Governor, Northampton College.

4.6 The Audit Committee has a robust Conflicts of Interest Policy, which requires members to excuse themselves from discussions where potential conflicts may occur. Members are required to inform the Permanent Secretary about any potential conflicts and highlight these at the start of each meeting as appropriate.

4.7 In addition to the independent members, the appropriate Accounting Officers, the Treasury's Group Director of Finance and the Treasury Accountant also attend Committee meetings. Members have the opportunity for a pre-committee discussion with the National Audit Office, Group Head of Internal Audit for Treasury and Head of Exchequer Funds Internal Audit.

4.8 The Treasury Audit Committee met five times during 2014-15, taking the opportunity for pre-committee discussions with the National Audit Office on each occasion. The Chair of the Committee changed during the reporting period. Richard Meddings took over as Chair from Michael O'Higgins before his departure at the end of his second term in September 2014.

4.9 Apologies were received from Mary Hardy for the May 2014 meeting and Mike Ashley for March 2015.

4.10 Over the course of the year, as well as scrutinising the Treasury's financial management and balance sheet risks, the Audit Committee considered a wide range of issues relating to the system of control governing the department, including: Internal Audit planning and outcomes; analytical models; corporate memory; arm's length bodies; the move to a new IT contract; the delivery of the Whole of Government Accounts; and additional work undertaken by Internal Audit on Purchase to Pay, Data Mining and Correspondence.

4.11 Outside of the planned committee meetings individual members have shared their commercial and professional expertise with key officials across the Treasury.

4.12 The Chair of the Audit Committee is invited to report concerns or issues to the Treasury's Board and its Sub-committee. EFA feeds into the Treasury's Operational Risk Group, which is chaired by a member of the Executive Management Board and gives evidence to the Treasury Board and its Sub-Committee.

5. Risk profile

5.1 A detailed operational risk register is maintained by the Bank. From the Treasury's overall perspective, key high-level risks and associated controls are:

- **Failure to execute trades correctly resulting in financial impact and/or trading with/across the wrong entity**: Controls include checking of all trade confirmations with counterparties; end of day reconciliations; dealer training; senior dealers validating trades input by junior dealers, and assessment of incidents.

- **Inadequate IT infrastructure and provision of IT services impedes delivery of EEA operations; loss of sensitive data or intrusion to IT systems:** Incidents are investigated with appropriate action taken where necessary and reported to Treasury as described above. Locally, processes exist to identify and prioritise system fixes to IT issues as they arise. Mechanisms also exist to address larger scale issues such as improving system resilience. Alternative processes exist in the event of outages.

  During the year, the Bank upgraded key operating and reporting systems used in managing the EEA. These upgrades were carried out in line with the Bank's standard project governance processes. The upgraded systems were fully operational at year end.

- **Failure to comply with legal requirements or regulations including non-UK Tax reporting and/or withholding requirements:** Third party expertise is employed to advise and support on fulfilling requirements. Internally, the Bank operates cross-directorate oversight of tax issues led by the Finance Directorate and the Legal Directorate review legal agreements prior to execution.

- **Static data input and/or loaded into systems incorrectly impacts business processes:** The Bank have agreed principles governing management of static data across Markets and Banking Financial Operations and maintains segregation of static duties between teams along with a minimum of 'four eye checks' for manual inputs and changes and management review and sign off.

- **Insufficient or inadequate resources to deliver EEA objectives:** Markets maintains a plan to ensure that high priority objectives (such as management of the EEA) are resourced. The Markets Senior Management Team reviews workloads and monitors for signed of operational stretch. Contingency planning ensures there are sufficiently experienced staff available to deal with unexpected events such as credit defaults.

- **In executing or settling EEA trades, staff fail to meet compliance obligations:** A Bankwide compliance function and code of staff conduct has recently been introduced. Markets has compliance policies specific to trading activities which are benchmarked and monitored by the Chief Operating Officer Division, who also provide training to staff.

5.2 As I reported last year, the Bank announced on 12 March 2014 that its Oversight Committee had appointed Lord Grabiner QC to lead its investigation into the role of Bank officials in relation to conduct issues in the foreign exchange market. The Bank published conclusions of the independent investigation on 12 November 2014.[6] The Bank has advised no impact on the EEA and that the recommended outcomes are not directly relevant to the EEA.

5.3 As noted above, the risk management strategy is set annually via the SLA, which is signed by me as Accounting Officer. The exposures to credit and market risk are detailed in note 18.

6. Review of effectiveness

6.1 In line with Government guidance, set out within the Corporate Governance Code of Good Practice for Central Government departments, I have reviewed the effectiveness of the system of internal control. My review is informed by the work of Exchequer Funds Internal Audit and Bank Internal Audit, who both provided positive assurance as to the management and control of the EEA in 2014-15 and the executive managers within DRM, EFA and in the Bank, who have responsibility for the development and maintenance of the internal control framework, as well as comments made by external auditors in their management letter and other reports. I have been supported by the Treasury Group Audit Committee and risk owners in addressing weaknesses and ensuring continuous improvement of the system is in place. The Treasury Group Audit Committee considered the 2014-15 accounts in draft and provided me with its views before I formally signed the accounts.

6.2 No significant control issues, including personal data related incidents, have been identified in 2014-15, and no significant new risks have been identified in the year. No ministerial directions have been given in 2014-15.

6.3 In my opinion, the system of internal control was effective throughout the financial year, and remains so on the date I sign this statement.

David Ramsden
HM Treasury
Accounting Officer 9 July 2015

[6] This can be viewed at http://www.bankofengland.co.uk/publications/Pages/news/2014/146.aspx.

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

I certify that I have audited the financial statements of the Exchange Equalisation Account for the year ended 31 March 2015 under the Exchange Equalisation Account Act 1979 (as amended by the Finance Act 2000). The financial statements comprise: the Statement of Comprehensive Income, the Statement of Financial Position, the Statement of Cash Flows, and the related notes. These financial statements have been prepared under the accounting policies set out within them.

Respective responsibilities of HM Treasury, the Accounting Officer and auditor

As explained more fully in the Statement of the Accounting Officer's Responsibilities, HM Treasury and the Accounting Officer are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. My responsibility is to audit, certify and report on the financial statements in accordance with the Exchange Equalisation Account Act 1979 (as amended by the Finance Act 2000). I conducted my audit in accordance with International Standards on Auditing (UK and Ireland). Those standards require me and my staff to comply with the Auditing Practices Board's Ethical Standards for Auditors.

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the circumstances of the Exchange Equalisation Account and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the Accounting Officer; and the overall presentation of the financial statements. I read all the financial and non-financial information in the Strategic report, Directors' report, the Reconciliation of EEA Statement of Financial Position to IMF Reserves Template and the Governance Statement to identify material inconsistencies with the audited financial statements and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by me in the course of performing the audit. If I become aware of any apparent material misstatements or inconsistencies I consider the implications for my certificate.

I am required to obtain evidence sufficient to give reasonable assurance that the expenditure and income recorded in the financial statements have been applied to the purposes intended by Parliament and the financial transactions recorded in the financial statements conform to the authorities which govern them.

Opinion on regularity

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

Opinion on financial statements

In my opinion:

- the financial statements give a true and fair view of the state of the Exchange Equalisation Account's affairs as at 31 March 2015 and of its total comprehensive income for the year then ended; and

- the financial statements have been properly prepared in accordance with the Exchange Equalisation Account Act 1979 (as amended by the Finance Act 2000) and HM Treasury directions issued thereunder.

Opinion on other matters

In my opinion the information given in the Strategic report and Directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements.

Matters on which I report by exception

I have nothing to report in respect of the following matters which I report to you if, in my opinion:

- adequate accounting records have not been kept or returns adequate for my audit have not been received from branches not visited by my staff; or
- the financial statements are not in agreement with the accounting records and returns; or
- I have not received all of the information and explanations I require for my audit; or
- the Governance Statement does not reflect compliance with HM Treasury's guidance.

Report

I have no observations to make on these financial statements.

Sir Amyas C E Morse
Comptroller and Auditor General
14 July 2015

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

Statement of Comprehensive Income

For the year ended 31 March 2015:

	Note	2015 £ millions	*2014* *£ millions*
Net trading income	2	313	*(1,066)*
Fair value changes in gold		246	*(2,773)*
Fees and commissions		(2)	*2*
Management charge	3	(8)	*(8)*
Total comprehensive income/(loss) for the year	14	**549**	***(3,845)***

Statement of Financial Position

	Note	31 March 2015 £ millions	*31 March 2014 £ millions*
Assets			
Cash	16	1,920	*1,685*
Items in the course of collection from banks	16	456	*1,131*
Money market instruments	4	3,673	*1,241*
Debt securities	5	53,802	*39,522*
Gold	6	7,974	*7,728*
Reverse repurchase agreements	7	5,677	*5,725*
Derivative financial assets	8	3,245	*2,203*
Other financial assets	9	29	*4*
Holdings of IMF Special Drawing Rights	13	8,938	*8,956*
Total assets		**85,714**	***68,195***
Liabilities			
Items in the course of transmission to banks	16	728	*1,142*
Debt securities - short positions	10	251	*669*
Repurchase agreements	11	5,200	*3,727*
Derivative financial liabilities	12	2,344	*455*
Other financial liabilities		1	*2*
SDR allocation	13	9,416	*9,395*
Liability to the National Loans Fund	14	67,774	*52,805*
Total liabilities		**85,714**	***68,195***

The notes on pages 24 to 49 form an integral part of these accounts.

David Ramsden — HM Treasury
Accounting Officer — 9 July 2015

Statement of Cash Flows

For the year ended 31 March 2015:

	Note	2015 £ millions	*2014* *£ millions*
Net cash outflow from operating activities	15	**(12,815)**	***(8,338)***
Cash flows from financing activities:			
Cash inflow from National Loans Fund	14	18,220	*9,250*
Cash outflow to National Loans Fund	14	(3,800)	*(2,550)*
Net cash inflow from financing activities		**14,420**	***6,700***
Net increase/(decrease) in cash and cash equivalents during the year	16	**1,605**	***(1,638)***
Cash and cash equivalents at the beginning of the year	16	2,202	*3,840*
Cash and cash equivalents at the end of the year	16	**3,807**	***2,202***

Notes to the Accounts

1 Accounting policies

Basis of preparation

The EEA produces accounts under the Exchange Equalisation Account Act 1979, as amended by the Finance Act 2000. These accounts have been prepared in accordance with the Accounts Direction, reproduced in the Annex to this report. The financial statements have been prepared in accordance with the current Government Financial Reporting Manual (FReM) issued by the Treasury. The accounting policies contained in the FReM apply International Financial Reporting Standards (IFRS) as adapted or interpreted for the public sector context. Where the FReM permits a choice of accounting policy, the accounting policy which is judged to be most appropriate to the particular circumstances of the EEA for the purpose of giving a true and fair view has been selected. The particular policies adopted are described below. They have been applied consistently in dealing with items that are considered material to the accounts.

These accounts are prepared on a trade date basis and all assets and liabilities are initially recognised at cost on their trade dates and then subsequently in line with the relevant accounting policy. The EEA is stated in millions of pounds sterling (£m). The net assets of the EEA represent a liability to the NLF.

At 31 March 2015, a number of standards and interpretations and amendments thereto, had been issued by the IASB which are not yet effective for the EEA's financial statements. In particular, IFRS 9 'Financial Instruments' was issued in July 2014, and sets out a single IFRS framework for all financial instruments required or permitted by IFRS. It is effective for annual periods beginning on or after 1 January 2018. The effect of IFRS 9 is not expected to be material on the financial reporting of the EEA.

Recognition of financial assets and financial liabilities

The EEA is managed on a homogeneous basis and, although the reserves are not held primarily to make a profit, the Treasury seeks to minimise the cost of holding the foreign currency reserves while avoiding exposing the public purse to unnecessary risk. The Bank actively manages the EEA portfolio against the benchmark to meet the active management return set by the Treasury. As a result, the financial assets and liabilities of the EEA are all 'held for trading', in accordance with the definition of IAS 39, and therefore all financial assets and liabilities are held at fair value, in line with IFRS 13, with gains and losses taken through the Statement of Comprehensive Income. There have been no reclassifications of financial instruments during the year. Financial assets are derecognised when the rights to receive cash flows from them have expired or where the EEA has transferred substantially all the risks and rewards of ownership. Financial liabilities are derecognised when they are extinguished, that is, when the obligation is discharged, cancelled or expires.

Details of the methodologies used to revalue different instrument classes are given below.

i. Net trading income

Net trading income comprises all gains and losses from changes in the fair value of the EEA financial assets and liabilities, together with related interest income and expense. Realised gains and losses on disposal or maturity are also included.

ii. Special Drawing Rights (SDR) remuneration

The EEA is remunerated (in SDRs) on its holdings of SDRs and pays interest on its SDR allocation. This income is included within net trading income. Remuneration (in SDRs) on loans to the IMF, both the UK's Reserve Tranche Position (RTP) and any lending under the NAB (NLF assets), is also received by the EEA and is recognised in these accounts as net trading income. All SDR remuneration is accounted for on an accruals basis.

iii. Fees and commissions

Fees and commissions are not material and are recognised in the Statement of Comprehensive Income as incurred.

iv. Foreign currency translation

Transactions denominated in foreign currencies are recorded in sterling using the rate prevailing at the date of the transaction. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation of monetary assets and liabilities at the Statement of Financial Position date are recognised in the Statement of Comprehensive Income within net trading income.

v. Cash and cash equivalents

For the purpose of the Statement of Cash Flows, cash comprises balances at central banks and loans and advances to banks. Cash equivalents comprise highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of change in value. Such investments normally have maturities of less than three months from the date of acquisition and include settlement balances and money market instruments. Longer term deposits have maturities of more than three months from the date of acquisition and are classified as other financial assets. Repos and reverse repos are excluded from cash and cash equivalents.

vi. Loans and advances to banks

Loans and advances to banks comprise short-term deposits and cash held at commercial banks. These are initially recorded at the cost of funds advanced and are then revalued using a discounted cash flow valuation technique. All inputs into the pricing model are externally sourced and assumptions used are supported by observable market prices. Changes in the fair value of loans and advances are recognised in the Statement of Comprehensive Income, within net trading income, when they arise.

vii. Items in course of collection from or transmission to other banks

Money market instruments, debt securities, loans and advances to banks, reverse repos, deposits by banks, debt security short positions and repos are recorded on a trade date basis. For these financial assets and liabilities, between trade date and settlement date, any amounts payable to or receivable from bank counterparties are recorded separately on the Statement of Financial Position, within items in the course of collection from banks or items in the course of transmission to banks, until settlement occurs.

viii. Money market instruments

Money market instruments are reported at fair value. Money market instruments are initially recognised at cost, as the best estimate of fair value and are subsequently revalued to their market price daily. Changes in the fair value of money market instruments are recognised in the Statement of Comprehensive Income, within net trading income, when they arise.

Fair values are either determined by reference to quoted market prices, or by using internal models where no market price is readily obtainable. All inputs into the pricing models are externally sourced and assumptions used are supported by observable market prices. Money market instruments are priced at bid prices.

ix. Debt securities (including short positions)

All debt securities are reported at fair value. Debt securities are initially recognised at cost, as the best estimate of fair value and are subsequently revalued to their market price daily. Changes in the fair value of debt securities are recognised in the Statement of Comprehensive Income, within net trading income, when they arise.

All bonds are valued directly by reference to published price quotations at 31 March 2015. Certificates of deposit are valued using a discounted cash flow valuation technique. All inputs into this pricing model are externally sourced and assumptions used are supported by observable market prices. Bonds and certificates of deposit are priced at bid prices.

x. Gold

Gold is treated as being similar to a financial asset and, as such, is reported at fair value. Gold holdings on deposit are valued at the sterling equivalent of the London Bullion Market Association (LBMA) dollar denominated spot bid price as at 31 March 2015. Revaluation gains and losses on gold assets are recognised within fair value changes in gold in the Statement of Comprehensive Income.

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

Securities which have been sold with an agreement to repurchase remain on the Statement of Financial Position and the sale proceeds are recorded as a repo. Securities acquired in reverse sale and repurchase agreements are not recognised on the Statement of Financial Position and the purchase amount is recorded as a reverse repo.

Repurchase and reverse repurchase agreements are initially recognised at cost as the best estimate of fair value and subsequently revalued daily. These are valued using a discounted cash flow valuation technique. All inputs into the pricing model are externally sourced and assumptions used are supported by observable market prices. Changes in the fair value of repos and reverse repos are recognised in the Statement of Comprehensive Income, within net trading income, when they arise. Repos and reverse repos are marked to bid or offer prices, as appropriate.

xii. Derivative transactions

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

Derivatives with positive fair values are recognised on the Statement of Financial Position within derivative financial assets. Derivatives with negative fair values are included within derivative financial liabilities.

Any cash flow receipts and payments relating to derivative transactions are recognised in net trading income as they occur.

xiii. International Monetary Fund Special Drawing Rights (SDRs)

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

xiv. Collateral and netting

The EEA enters into ISDA Master Agreements with counterparties requiring collateral to be pledged by both parties as appropriate. An ISDA Master Agreement contains close-out netting provisions which provide that, if an event of default occurs and a party chooses to close out its transaction(s) with its counterparty, all transactions documented under the ISDA Master Agreement with such counterparty will be closed-out at the same time and netted off against each other. A single resulting cash-flow will be owed from or to the Bank. The EEA also enters into Foreign Currency Repo Agreements with all repo counterparties, featuring close-out netting provisions.

Collateral is received in the form of cash or securities. Collateral received in the form of securities is not recorded on the Statement of Financial Position. Collateral received in the form of cash is recorded on the Statement of Financial Position with a corresponding liability, assigned to deposits by banks. Any interest arising on collateral received is recorded within net trading income. Collateral pledged remains on the Statement of Financial Position within Debt Securities.

Although master netting agreements are in place, the lack of intention to settle on a net basis results in the related assets and liabilities being reported gross in the Statement of Financial Position.

Critical accounting judgements and key sources of estimation uncertainty

The preparation of financial statements in conformity with IFRS requires the use of certain critical accounting estimates. It also requires management to exercise its judgement in the process of applying the entity's accounting policies.

Judgement would be necessary in the valuation of financial instruments and gold should there be no readily available market prices. Further information about how financial instruments are valued in such circumstances is provided in the 'Debt securities' and 'Derivative transactions' accounting policies above. At 31 March 2015 there were no valuations which are not supported by observable market prices or rates (*2014: £nil*). Gold and gold assets are treated as being similar to a financial asset and are reported at fair value as described in the 'Gold' accounting policy. The valuation of gold at 31 March 2015 was £7,974m (*2014: £*7,728m).

The financial assets and financial liabilities of the EEA are classified as held for trading, as they all form part of a portfolio that is managed as a whole and for which there is evidence of a recent pattern of short-term profit taking.

2 Net trading income

	2015 £ millions	*2014* *£ millions*
Money market instruments	(54)	*(143)*
Debt securities	769	*(2,541)*
Debt securities – short positions	(17)	*102*
Reverse repurchase agreements	(215)	*(263)*
Repurchase agreements	152	*216*
Futures	–	*1*
Foreign exchange transactions	103	*(195)*
Currency swaps	82	*1,670*
Interest rate swaps	(526)	*(25)*
Loans and deposits	23	*1*
Reserve Tranche Position	2	*4*
Special Drawing Rights	(6)	*107*
Total	**313**	***(1,066)***

3 Management charge

The management charge of £8m represents the cost of the Bank’s management of the EEA during the year (*2014: £8m*).

4 Money market instruments

	2015 £ millions	*2014* *£ millions*
Treasury bills	2,235	*92*
Commercial paper	1,438	*1,149*
Total	**3,673**	***1,241***

	2015 £ millions	*2014* *£ millions*
Amounts maturing:		
In not more than 3 months	2,159	*528*
In 1 year or less but over 3 months	1,514	*713*
Total	**3,673**	***1,241***

5 Debt securities

	2015	*2014*
	£ millions	*£ millions*
Issued by:		
Government	52,398	*37,992*
Other Public Sector	1,404	*1,530*
Total	**53,802**	***39,522***

	2015	*2014*
	£ millions	*£ millions*
Amounts maturing:		
Current	2,785	*3,726*
Non-current	51,017	*35,796*
Total	**53,802**	***39,522***

6 Gold

	2015	*2014*
	£ millions	*£ millions*
Gold Stock	7,974	*7,728*
Total	**7,974**	***7,728***

There were no gold loan/deposit or swap trades undertaken during the year *(2014: nil)*.

7 Reverse repurchase agreements

	2015	*2014*
	£ millions	*£ millions*
Amounts maturing:		
Current	5,677	*5,725*
Total	**5,677**	***5,725***

An analysis of reverse repos together with their backing collateral is provided in note 18.

The EEA is permitted under the terms of its reverse repo transactions to sell debt securities held as collateral. The carrying amount of short positions in debt securities arising as a result of selling collateral held is given in note 10.

8 Derivative financial assets

	2015 £ millions	*2014* *£ millions*
Foreign exchange transactions	797	*359*
Currency swaps	2,111	*1,569*
Interest rate swaps	337	*275*
Total	**3,245**	***2,203***

An analysis of derivative financial assets together with their backing collateral is provided in note 18.

9 Other financial assets

	2015 £ millions	*2014* *£ millions*
Margin accounts	1	*1*
Prepayments and accrued income	1	*3*
Longer term deposits	27	*–*
Total	**29**	***4***

10 Debt securities - short positions

	2015 £ millions	*2014* *£ millions*
Debt securities – short positions	251	*669*
Total	**251**	***669***

Short positions in securities relate to the sale of bonds acquired as collateral through reverse repurchase transactions (see note 7).

11 Repurchase transactions

	2015 £ millions	*2014* *£ millions*
Amounts maturing:		
Current	5,200	*3,727*
Total	**5,200**	***3,727***

An analysis of repos together with the collateral pledged is provided in note 18.

12 Derivative financial liabilities

	2015 £ millions	*2014* *£ millions*
Foreign exchange transactions	771	*336*
Currency swaps	1,260	*19*
Interest rate swaps	313	*100*
Total	**2,344**	***455***

An analysis of derivative financial liabilities together with the collateral pledged is provided in note 18.

13 SDR Allocation and SDR Holdings

The EEA has a liability to the IMF for those SDRs that have been allocated since the UK became a participant in the Special Drawing Rights Agreement. If the UK withdraws from participation or the Agreement is wound up, payment to the IMF would be required at current exchange rates. The SDR liability as at 31 March 2015 was £9,416m *(2014:* £9,395m*)*.

The SDR holdings of the EEA as at 31 March 2015 was £8,938m (*2014:* £8,956m). These holdings result from SDR allocations made by the IMF, any subsequent purchases and sales of SDRs from or to other IMF members and fair value changes. SDR holdings may include SDR denominated promissory notes received by the IMF in return for the advance of SDRs via the Poverty Reduction and Growth Facility. At 31 March 2015 £14m worth of such notes were held by the EEA (*2014: £11m*). During 2014-15, the EEA sold £40m worth of SDRs (*2014: sold £42m*).

Further detail on the SDRs is provided in the Strategic Report.

14 Liability to the National Loans Fund

The net assets of the EEA represent a liability to the NLF. There are two elements of the Liability to the NLF: a specific liability, recognised in accordance with the National Loans Act 1968 of £40,305m (*2014:* £25,885m) that represents the balance of advances made by the NLF and not repaid; and a separate amount that represents the EEA's total assets, less recognised liabilities. This second element consists of the capital contribution reserve and the accumulated income and expenditure reserve.

The EEA is funded by Central Government through the NLF. Over time, the NLF has advanced sterling to the EEA in order to finance the reserves. Similarly, when the NLF issues foreign currency securities in order to raise foreign currency finance, that would subsequently be transferred to the EEA. As a result, the EEA's net assets, having been derived from initial NLF financing, are ultimately due to the NLF, and are recognised as such on the Statement of Financial Position. If a policy decision is taken to reduce the assets of the EEA, the sterling excess raised via sale of foreign currency assets would be paid to the NLF, at the direction of the Treasury.

Specific liability to the NLF

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

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

If there is no outstanding specific liability to the NLF at the time of a sterling transfer from the EEA to the NLF, then the transfer is treated as a 'capital repayment' and is used to reduce the capital contribution reserve. The effect on the combined liability to the NLF, recognised in the Statement of Financial Position, is identical.

The remainder of the liability to the NLF consists of the capital contribution reserve and the accumulated income & expenditure reserve. These items are described in detail below.

Capital contribution reserve

When UK GAAP compliant accounts were prepared for the first time for the EEA, being for the year ended 31 March 2001, an amount equivalent to the total recognised assets, less liabilities, less the balance on the specific liability to the NLF in the opening Statement of Financial Position of that year, was taken to be the opening balance for the capital contribution reserve. The amount of the capital contribution reserve is periodically reduced, as explained above, because when there is no outstanding specific liability to the NLF, sterling repayments by the EEA to the NLF are taken to the capital contribution reserve. There were no reductions during the year (*2014: nil*).

Accumulated comprehensive income reserve

All gains and losses of the EEA, since UK GAAP compliant accounts were first prepared in 2001, have been taken to the accumulated comprehensive income reserve.

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

All amounts in £ millions	Accumulated comprehensive income reserve	Capital contribution reserve	Specific liability to the NLF	2015 Overall liability to the NLF
Balance at 1 April 2014	17,683	9,237	25,885	52,805
Transfers from the NLF	–	–	18,220	18,220
Repayments to the NLF	–	–	(3,800)	(3,800)
Total comprehensive income/(loss)	549	–	–	549
Balance at 31 March 2015	**18,232**	**9,237**	**40,305**	**67,774**

All amounts in £ millions	*Accumulated comprehensive income reserve*	*Capital contribution reserve*	*Specific liability to the NLF*	*2014 Overall liability to the NLF*
Balance at 1 April 2013	*21,528*	*9,237*	*19,185*	*49,950*
Transfers from the NLF	–	–	*9,250*	*9,250*
Repayments to the NLF	–	–	*(2,550)*	*(2,550)*
Total comprehensive income/(loss)	*(3,845)*	–	–	*(3,845)*
Balance at 31 March 2014	***17,683***	***9,237***	***25,885***	***52,805***

15 Reconciliation of Statement of Comprehensive Income to net cash outflow from operating activities

	2015 £ millions	*2014 £ millions*
Total comprehensive income/(loss) for the year	549	*(3,845)*
Net (increase) in money market instruments	(801)	*(554)*
Net (increase) in debt securities	(14,280)	*(2,494)*
Net (increase)/decrease in gold	(246)	*2,773*
Net decrease/(increase) in reverse repurchase agreements	48	*(2,029)*
Net (increase) in derivative financial assets	(1,042)	*(1,240)*
Net (increase) in other assets	(25)	*(2)*
Net decrease in holding of SDRs	18	*538*
Net (decrease) in debt securities - short positions	(418)	–
Net increase/(decrease) in repurchase agreements	1,473	*(475)*
Net increase/(decrease) in derivative financial liabilities	1,889	*(406)*
Net (decrease)/increase in other financial liabilities	(1)	*1*
Net increase/(decrease) in SDR allocation	21	*(605)*
Net cash (outflow) from operating activities	**(12,815)**	***(8,338)***

16 Cash and cash equivalents

	1 April 2014 £ millions	Cash flow £ millions	31 March 2015 £ millions
Cash at Central Banks	1,552	120	1,672
Loans and advances to banks	133	115	248
	1,685	235	1,920
Amounts with original maturity less than 3 months:			
Items in the course of collection from banks	1,131	(675)	456
Money market instruments	528	1,631	2,159
Items in the course of transmission to banks	(1,142)	414	(728)
	517	1,370	1,887
Total	**2,202**	**1,605**	**3,807**

	1 April 2013 £ millions	*Cash flow £ millions*	*31 March 2014 £ millions*
Cash at Central Banks	*1,380*	*172*	*1,552*
Loans and advances to banks	*6*	*127*	*133*
	1,386	*299*	*1,685*
Amounts with original maturity less than 3 months:			
Items in the course of collection from banks	*608*	*523*	*1,131*
Money market instruments	*2,153*	*(1,625)*	*528*
Items in the course of transmission to banks	*(307)*	*(835)*	*(1,142)*
	2,454	*(1,937)*	*517*
Total	***3,840***	***(1,638)***	***2,202***

17 Related Party Transactions

The Royal Bank of Scotland Group plc is regarded as a related party of the EEA. On 1 December 2008, the UK Government, through the Treasury[7], became the ultimate controlling party of The Royal Bank of Scotland Group plc. At 31 March 2015, the Government's holding is 79%. During the year the EEA entered into various transactions with The Royal Bank of Scotland Group plc, which were all conducted on an arm's length basis and were part of the EEA's normal activity. The net outstanding exposure at 31 March 2015 was £54m *(2014: nil)*.

The UK Government, through the Treasury[8], owned 22% of the ordinary share capital of the Lloyds Banking Group at 31 March 2015. As a result, the Lloyds Banking Group is a related party of the EEA. During the year the EEA entered into transactions with the Lloyds Banking Group, which were all conducted on an arm's length basis and were part of the EEA's normal activity. There was no outstanding exposure at 31 March 2015, *(2014: nil).*

During the year, the EEA has not entered into transactions with any other financial institutions in which the UK Government has an investment.

The EEA has provided foreign currency services for a number of government departments and agencies during the year.

18 Risk management and control

A summary of the key features of the control framework for the EEA during the year and management's objectives and policies for managing risks is provided in the Governance Statement (page 13).

A detailed review of the financial risks to which the EEA is exposed and how they are managed is given below, along with quantitative data in respect of those risks. In each case, the data provided reflects the year-end position unless stated otherwise.

a. Market risk

Market risk is the risk arising from exposure to movement on market variables. The main market variables to which the EEA is exposed are interest rates and exchange rates.

The Official Reserves comprise two components: reserves that are hedged for currency and interest rate risk (the 'hedged reserves') and the remaining reserves which are unhedged for currency and interest rate risk (the 'unhedged reserves').

The composition of both elements of the reserves is determined by the benchmark allocations set out by the Treasury and market risk is taken into account when determining those benchmarks. Further detail on the policy processes for determining benchmark asset allocations is given in the Strategic Report (paragraphs 12 to 19).

[7] Details of HM Treasury's holdings can be found on UK Financial Investments Ltd's website at http://www.ukfi.co.uk.
[8] Details of HM Treasury's holdings can be found on UK Financial Investments Ltd's website at http://www.ukfi.co.uk.

Active Management (where positions are taken relative to the benchmarks set for the reserves) may involve exposure to market risk over and above that of the benchmark positions.

Hedged reserves

Assets and liabilities in the hedged reserves are funded by either sterling swapped into foreign currency or through foreign currency issuances on the NLF. In either of these cases, the future cash flows from the assets held are swapped back into the currency and interest rate profile of the originating liability.

Currency swaps are used to hedge exchange rate risk, through an initial exchange of sterling for foreign currency at the spot rate, receiving back the same amount of sterling principal at maturity, and regular exchanges of floating interest payments on the principal amounts. Any residual foreign exchange risk is immaterial.

Interest rate risk is then hedged through interest rate swaps. Typically, this arrangement results in the EEA paying fixed rate interest on the foreign currency it has acquired, hedging the fixed interest income being earned in the same currency earned through the asset held. By swapping those fixed interest receipts for floating interest receipts in the same currency, the EEA acquires an income stream that matches its interest payment liability on the currency swap and thus minimises interest rate exposure.

The majority of the assets and liabilities of the EEA, after taking account of the effect of derivatives that alter the interest rate risk profile of instruments, earn/pay interest on a floating rate.

Unhedged reserves

The unhedged reserves are comprised of holdings of gold, cash, fixed income securities and the net of the SDR allocation and holdings. The benchmark currency position of the unhedged reserves is 40% US dollar, 40% euro, and 20% yen. The liability is in sterling.

Value at Risk

The Bank monitors and controls market risk primarily by using a Value at Risk (VaR) model, which estimates the maximum expected loss for the portfolio, at a specified confidence level, over a defined period of time.

For the calculation of the VaR on the hedged EEA portfolio and the active management of the EEA against the benchmarks, the Bank applies a 99% confidence interval and a two-week holding period (i.e. it is expected that losses will not exceed the VaR figure in ninety nine out of a hundred two-week periods). The VaR estimates are based on the historic volatility of returns on different asset classes and the historic correlation between returns on those asset classes.

For the unhedged EEA portfolio, a simplified value-at-risk calculation gives an estimate of the level of losses not expected to be exceeded in ninety nine out of a hundred two-week periods.

Benchmark Reserves

The Bank reports the VaR on the benchmark reserves on a six-monthly basis. The values for the benchmark reserves are based on marked-to-market prices at the end of the period.

Hedged Reserves

	$ millions 2015	*$ millions 2014*
VaR as at 31 March	68	*56*
VaR as at 30 September	50	*54*

Unhedged Reserves

	$ millions 2015	*$ millions 2014*
VaR as at 31 March	1,228	*1,293*
VaR as at 30 September	1,309	*1,475*

Active Management

The Bank uses two VaR measures as part of its active management: an unweighted VaR where an equal weight is assigned to all historic market data, and an exponentially-weighted VaR which gives greater weight to more recent historic market data. The higher of these two numbers is then reported as the VaR.

The Bank measures the VaR on active management positions on a daily basis and undertakes regular back-testing of the VaR models. Assuming that both models are appropriate, and that the volatility and correlation inputs are an accurate reflection of current market conditions, losses greater than the VaR figure are expected to occur with a probability of 1%. The Bank reports its back-testing to the Treasury and losses significantly greater than would be expected or can be explained by unusual market movements trigger a review of the VaR models. As part of good risk management practice, the Bank intends to review the VaR models for effectiveness and, in conjunction with the Treasury, make improvements as thought appropriate.

Under the SLA, the Treasury sets the Bank a VaR limit for active management relative to benchmarks, with the VaR being calculated at close of business each day. In 2014-15 the VaR limit for active management was $20m. During the year the Bank's use of VaR did not exceed $4.19m. The average VaR during the year was $3.07m and the lowest VaR at the end of any one day was $2.17m.

Active management VaR during the year, (calculated at the close of business each day in US dollars), was as follows:

	$ millions 2015	*$ millions 2014*
VaR as at 31 March	3.61	*3.54*
Average during the year	3.07	*4.47*
Maximum VaR during the year	4.19	*6.88*
Minimum VaR during the year	2.17	*2.15*
VaR limit during the year	20.00	*20.00*

The minimum VaR is the higher of unweighted and exponentially weighted, which for 2014-15 was unweighted (*2014: unweighted*).

The Bank also measures the delta exposures on active management positions which measures the change in value of the portfolio for each one basis point shift in the relevant yield curve.

b. Credit risk

The reserves are exposed to credit risk through exposures to trading counterparties and to the issuers of securities. The creditworthiness of these counterparties and issuers is subject to regular scrutiny by the Bank, through analysis in the Risk Management Division (RMD) and review by the Bank's Credit Ratings Advisory Committee (CRAC) chaired by the Head of RMD. Assessments are performed both routinely, and dynamically, in response to market or specific entity conditions. CRAC makes recommendations to the Executive Director for Markets, who is responsible for decisions on credit ratings.

Credit risk is controlled by counterparty and issuer limits and collateralisation. Exposure to issuers and counterparties is monitored against limits in real time. In the case of derivatives contracts, exposure is measured as the marked-to-market value plus an estimate of the potential future exposure calculated using a parametric approach, volatility and correlation data. Limits are set for both individual entities and groups of related entities, and on certain instruments traded. In addition, there are limits to contain the overall exposure to each relevant country's banking sector. Limits are also set on the maturity of repo and foreign exchange transactions with counterparties. Any limit excesses are reported to the Treasury each month.

The arrangements for custody of EEA assets in 2014-15 were as follows: US Treasury bonds and other US dollar denominated securities were held in custody at the Federal Reserve Bank of New York and Canadian dollar denominated securities were held in custody at Bank of Canada. Euro and Renminbi denominated securities were held in custody at Clearstream. Japanese bonds were held in custody at the Bank of Japan. The gold bars and gold coin in the reserves were stored physically at the Bank's premises.

The EEA continued to invest in high credit quality assets throughout the year. Foreign currency assets held in the EEA inevitably carry some element of credit risk. In order to keep this risk at a low level, the funds of the EEA are predominantly invested in securities issued, or guaranteed by the national Governments of the United States, euro-zone countries and Japan. The majority of the EEA funds are invested in high quality sovereign or supranational bonds. The amount that best represents the EEA's maximum exposure to credit risk at the end of the reporting period without taking account of any collateral held or other credit enhancements is the carrying value of the EEA's assets.

Concentration of Exposure

Concentration of credit risk arises when a number of issuers or counterparties have comparable economic characteristics, or are engaged in similar activities or operate in the same geographical areas, so that their collective ability to meet contractual obligations is similarly affected by changes in economic, political or other conditions.

The tables below illustrate the concentration of the assets held by the EEA first by geographical region and, second, by credit rating.

Concentration of EEA assets by geographical region

2015

£ millions	United Kingdom	Europe	North America	Asia-Pacific	Other	Total
Cash	1,544	64	134	178	–	1,920
Items in course of collection from banks	131	112	213	–	–	456
Money market instruments	–	3,515	79	79	–	3,673
Debt Securities	–	21,995	29,170	2,637	–	53,802
Gold	–	–	–	–	7,974	7,974
Reverse repurchase agreements	2,266	2,952	459	–	–	5,677
Derivative financial assets	1,721	762	752	10	–	3,245
Other financial assets	28	–	–	–	1	29
IMF SDRs	–	–	–	–	8,938	8,938
Total Assets	**5,690**	**29,400**	**30,807**	**2,904**	**16,913**	**85,714**

2014

£ millions	*United Kingdom*	*Europe*	*North America*	*Asia-Pacific*	*Other*	*Total*
Cash	*1,396*	*131*	*42*	*116*	–	*1,685*
Items in course of collection from banks	*905*	*126*	*90*	*10*	–	*1,131*
Money market instruments	–	*1,241*	–	–	–	*1,241*
Debt Securities	–	*19,267*	*18,450*	*1,805*	–	*39,522*
Gold	–	–	–	–	*7,728*	*7,728*
Reverse repurchase agreements	*3,745*	*1,640*	*340*	–	–	*5,725*
Derivative financial assets	*926*	*892*	*383*	*2*	–	*2,203*
Other financial assets	*1*	–	–	–	*3*	*4*
IMF SDRs	–	–	–	–	*8,956*	*8,956*
Total Assets	***6,973***	***23,297***	***19,305***	***1,933***	***16,687***	***68,195***

Concentration of EEA assets by credit rating

2015

£ millions	1	2	3	Other	Total
Cash	442	106	–	1,372	1,920
Items in course of collection from banks	212	244	–	–	456
Money market instruments	2,529	1,144	–	–	3,673
Debt Securities	50,655	3,147	–	–	53,802
Gold	–	–	–	7,974	7,974
Reverse repurchase agreements	2,313	3,364	–	–	5,677
Derivative financial assets	1,601	1,258	–	386	3,245
Other financial assets	27	1	–	1	29
IMF SDRs	–	–	–	8,938	8,938
Total Assets	**57,779**	**9,264**	**–**	**18,671**	**85,714**

2014

£ millions	*1*	*2*	*3*	*Other*	*Total*
Cash	*175*	*114*	*–*	*1,396*	*1,685*
Items in course of collection from banks	*46*	*1,085*	*–*	*–*	*1,131*
Money market instruments	*1,200*	*41*	*–*	*–*	*1,241*
Debt Securities	*37,658*	*1,864*	*–*	*–*	*39,522*
Gold	*–*	*–*	*–*	*7,728*	*7,728*
Reverse repurchase agreements	*1,277*	*4,448*	*–*	*–*	*5,725*
Derivative financial assets	*905*	*999*	*–*	*299*	*2,203*
Other financial assets	*–*	*1*	*–*	*3*	*4*
IMF SDRs	*–*	*–*	*–*	*8,956*	*8,956*
Total Assets	***41,261***	***8,552***	***–***	***18,382***	***68,195***

The Bank has always internally assessed and independently rated EEA counterparties. The Bank has internal ratings scales of between four and six categories (the number depending on the type of entity). For the purposes of aggregated tables each internal rating on each scale has been assigned to category 1, 2 or 3.

Category '1' comprises banks, banking groups, central banks and supranational organisations with a very low risk of default, approximately equivalent to an external rating agency rating of AA and above.

Category '2' comprises banks, banking groups, central banks and supranational organisations with a low risk of default, approximately equivalent to an external rating agency rating of A to AA.

Category '3' comprises exposures to counterparties which, although less able to withstand severe unexpected shocks without risk of insolvency, there are no immediate concerns about their credit worthiness, approximately equivalent to an external rating agency rating of below A.

Category ‘Other’ comprises unrated positions including Gold and SDR holdings and balances with UK Government agencies and the Bank of England.

None of the EEA’s financial assets are past due or impaired.

At 31 March 2015, credit exposures to issuers of money market instruments and debt securities (less debt securities – short positions) stood at £57,224m *(2014: £40,094m).*

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

Netting agreements and collateral

The EEA’s credit exposure in respect of its derivative transactions is mitigated by provisions in the Bank’s ISDA documentation, specifically those relating to collateral and netting arrangements. Additional collateral can be requested from a counterparty in response to changes in the market values of underlying transactions or a deterioration in such counterparty’s credit standing. In the case of a counterparty defaulting on its obligations and the EEA closing-out such transactions, any resulting exposure will be netted across all outstanding transactions under the ISDA documentation with such counterparty, so as to produce a single cash flow.

Similar netting provisions are in place for transaction governed under the EEA’s Foreign Currency Repo Agreements (FCRA).

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

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

Maximum exposure and effects of collateral

Reverse repos	2015 £ millions	*2014* *£ millions*
Reverse repos	5,677	*5,725*
less: securities received as collateral	(5,839)	*(5,852)*
less: margin called under terms of loan agreement	(15)	*(13)*
Reverse repos - collateral (surplus)	**(177)**	***(140)***

Derivatives	2015 £ millions	*2014* *£ millions*
Derivative assets gross exposure	3,245	*2,203*
less: cash collateral held	–	–
less: securities received as collateral	(1,119)	*(1,681)*
Derivative asset - collateral deficit	**2,126**	***522***
Derivative liabilities gross exposure	(2,344)	*(455)*
less: securities pledged as collateral	393	*154*
Derivative liability – collateral (surplus)	**(1,951)**	***(301)***
Derivatives - net collateral deficit	**175**	***221***

Comprised of*:	2015 £ millions	*2014* *£ millions*
Net liability position with a surplus of collateral pledged	38	–
Net liability position with a deficit of collateral pledged	(22)	*(18)*
Net asset position with a surplus of collateral taken	(8)	*(36)*
Net asset position with a deficit of collateral taken	167	*275*
Derivatives - net collateral deficit	**175**	***221***

*Collateral surpluses and shortfalls in the previous table have been calculated at the level of individual counterparties, reflecting the right to offset positions under the ISDA agreements in place.

Collateral pledged

The EEA has pledged the following amounts as collateral for liabilities:

	2015 £ millions	2014 *£ millions*
Repos	5,111	*3,666*
Derivative liabilities	393	*154*
	5,504	***3,820***

Settlement processes

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

c. Liquidity risk

The NLF provides sterling funding to the EEA when required, and therefore the EEA, as an individual entity, is not exposed to sterling liquidity risk.

The EEA maintains a sterling account with the NLF that is used as the mechanism via which funding is transferred to the EEA, and excess cash is repaid to the NLF. This account is monitored daily and is maintained within a range. Forward looking cash flow forecasts are used to predict likely demand for cash in the EEA. Requests for funding from the NLF, and for repayments to be made, are processed when the account is forecasted to fall below, or to exceed, the range.

Undiscounted contractual cash flows of financial assets and liabilities

The tables below present the cash flows to/from the EEA arising from financial assets and liabilities until their contractual maturity date. The amounts disclosed in the tables are the contractual undiscounted cash outflows, whereas amounts are presented in the Statement of Financial Position at their carrying values, as detailed in note 1 – Accounting policies.
The maturity analysis for derivative financial assets and liabilities includes both known cash inflows and outflows predicted by current forward rates for the floating leg of currency and interest rate swaps.

Undiscounted contractual cash flows of financial assets

As at 31 March 2015:

All amounts in £ millions	**Up to 1 month**	**1 to 3 months**	**3 to 12 months**	**1 to 5 years**	**More than 5 years**	**Undated**	**Total**
Cash balances	1,842	78	–	–	–	–	1,920
Items in course of collection from banks	456	–	–	–	–	–	456
Money market instruments	285	1,874	1,516	–	–	–	3,675
Debt securities	491	262	2,827	43,819	7,636	–	55,035
Gold	–	–	–	–	–	7,974	7,974
Reverse repurchase agreements	3,963	1,714	–	–	–	–	5,677
Derivative financial instruments - inflow	3,192	2,191	6,818	19,388	1,595	–	33,184
Derivative financial instruments - outflow	(2,997)	(2,075)	(6,065)	(16,928)	(1,402)	–	(29,467)
Other financial assets	2	–	28	–	–	–	30
SDR Holdings	–	–	–	–	–	8,938	8,938
Total	**7,234**	**4,044**	**5,124**	**46,279**	**7,829**	**16,912**	**87,422**

Undiscounted contractual cash flows of financial liabilities

As at 31 March 2015:

All amounts in £ millions	**Up to 1 month**	**1 to 3 months**	**3 to 12 months**	**1 to 5 years**	**More than 5 years**	**Undated**	**Total**
Items in the course of transmission to banks	(728)	–	–	–	–	–	(728)
Debt securities – short positions	(251)	–	–	–	–	–	(251)
Repurchase agreements	(4,290)	*(442)*	*(467)*	–	–	–	(5,199)
Derivative financial liabilities – inflows	1,931	4,851	4,526	19,876	5,603	–	36,787
Derivative financial liabilities – outflows	(2,016)	(4,966)	(5,122)	(21,364)	(5,887)	–	(39,355)
Other financial liabilities	(1)	–	–	–	–	–	(1)
SDR Allocation	–	–	–	–	–	(9,416)	(9,416)
Liability to the NLF	–	–	–	–	–	(67,774)	(67,774)
Total	**(5,355)**	**(557)**	**(1,063)**	**(1,488)**	**(284)**	**(77,190)**	**(85,937)**

Undiscounted contractual cash flows of financial assets

As at 31 March 2014:

All amounts in £ millions	***Up to 1 month***	***1 to 3 months***	***3 to 12 months***	***1 to 5 years***	***More than 5 years***	***Undated***	***Total***
Cash balances	*1,685*	–	–	–	–	–	*1,685*
Items in course of collection from banks	*1,131*	–	–	–	–	–	*1,131*
Money market instruments	*529*	–	*713*	–	–	–	*1,242*
Debt securities	*207*	*33*	*4,047*	*32,061*	*4,284*	–	*40,632*
Gold	–	–	–	–	–	*7,728*	*7,728*
Reverse repurchase agreements	*5,296*	*431*	–	–	–	–	*5,727*
Derivative financial instruments - inflow	*4,615*	*1,375*	*9,062*	*22,687*	*3,719*	–	*41,458*
Derivative financial instruments - outflow	*(4,540)*	*(1,350)*	*(8,425)*	*(21,007)*	*(3,560)*	–	*(38,882)*
Other financial assets	*4*	–	–	–	–	–	*4*
SDR Holdings	–	–	–	–	–	*8,956*	*8,956*
Total	***8,927***	***489***	***5,397***	***33,741***	***4,443***	***16,684***	***69,681***

Undiscounted contractual cash flows of financial liabilities

As at 31 March 2014:

All amounts in £ millions	***Up to 1 month***	***1 to 3 months***	***3 to 12 months***	***1 to 5 years***	***More than 5 years***	***Undated***	***Total***
Items in the course of transmission to banks	*(1,142)*	–	–	–	–	–	*(1,142)*
Debt securities – short positions	*(669)*	–	–	–	–	–	*(669)*
Repurchase agreements	*(2,959)*	*(769)*	–	–	–	–	*(3,728)*
Derivative financial liabilities – inflows	*1,684*	*3,116*	*3,472*	*6,115*	*264*	–	*14,651*
Derivative financial liabilities – outflows	*(1,721)*	*(3,167)*	*(3,701)*	*(6,278)*	*(232)*	–	*(15,099)*
Other financial liabilities	*(2)*	–	–	–	–	–	*(2)*
SDR Allocation	–	–	–	–	–	*(9,395)*	*(9,395)*
Liability to the NLF	–	–	–	–	–	*(52,805)*	*(52,805)*
Total	***(4,809)***	***(820)***	***(229)***	***(163)***	***32***	***(62,200)***	***(68,189)***

d. Derivatives

The EEA uses derivatives to manage its exposure to interest rate and exchange rate risks. All derivative instruments are held at their fair values. Fair values are determined by reference to market rates prevailing on the date of valuation or by discounting future cash flows. The notional principal amounts of these instruments indicate the volume of transactions outstanding as at 31 March 2015 and are not a representation of the amount of risk.

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

All amounts in £ millions

	2015			*2014*		
	Notional Principal Amounts	Fair values Assets	Fair values Liabilities	*Notional Principal Amounts*	*Fair values Assets*	*Fair values Liabilities*
Exchange rate contracts:						
Spot and forwards	24,463	797	(771)	*26,384*	*359*	*(336)*
Currency swaps	40,312	2,111	(1,260)	*25,405*	*1,569*	*(19)*
	64,775	2,908	(2,031)	*51,789*	*1,928*	*(355)*
Interest rate swaps	45,080	337	(313)	*27,918*	*275*	*(100)*
Futures	1,695	–	–	*914*	*–*	*–*
	46,775	337	(313)	*28,832*	*275*	*(100)*
Total	**111,550**	**3,245**	**(2,344)**	***80,621***	***2,203***	***(455)***

19 Fair Value Valuation Basis

The table below provides an analysis of the various bases described in the notes which have been deployed for valuing the financial instruments measured at fair value in the financial statements.

The valuations of financial instruments have been classified into three levels according to the quality and reliability of information used to determine the fair values.

Level 1 – quoted market price: financial instruments with quoted prices for identical instruments in active markets.

Level 2 – valuation technique using observable inputs: financial instruments with quoted prices for similar instruments or quoted prices for identical or similar instruments in inactive markets and financial instruments valued using models where all significant inputs are observable. All inputs into pricing models are externally sourced and assumptions used are supported by observable market prices. No valuations used model pricing this year (*2014: nil*).

Level 3 – valuation technique with significant unobservable inputs: financial instruments valued using techniques where one or more significant inputs are unobservable.

During the financial year no financial instruments were measured at fair value with significant unobservable inputs (*2014: nil*). There were no significant transfers between Level 1 and Level 2 of the fair value hierarchy.

As at 31 March 2015

Assets	Level 1 £ millions	Level 2 £ millions	Level 3 £ millions	Total £ millions
Money market instruments	2,236	1,437	–	3,673
Debt securities	53,802	–	–	53,802
Reverse repurchase agreements	–	5,677	–	5,677
Derivative financial assets	–	3,245	–	3,245
Other financial assets	29	–	–	29
Holding of IMF Special Drawing Rights	8,938	–	–	8,938
Total assets	**65,005**	**10,359**	**–**	**75,364**
Liabilities				
Debt securities – short positions	251	–	–	251
Repurchase agreements	–	5,200	–	5,200
Derivative financial liabilities	–	2,344	–	2,344
Other financial liabilities	1	–	–	1
SDR allocation	9,416	–	–	9,416
Total liabilities	**9,668**	**7,544**	**–**	**17,212**

As at 31 March 2014

Assets	*Level 1 £ millions*	*Level 2 £ millions*	*Level 3 £ millions*	*Total £ millions*
Money market instruments	*92*	*1,149*	*–*	*1,241*
Debt securities	*39,522*	*–*	*–*	*39,522*
Reverse repurchase agreements	*–*	*5,725*	*–*	*5,725*
Derivative financial assets	*–*	*2,203*	*–*	*2,203*
Other financial assets	*4*	*–*	*–*	*4*
Holdings of IMF Special Drawing Rights	*8,956*	*–*	*–*	*8,956*
Total assets	***48,574***	***9,077***	*–*	***57,651***
Liabilities				
Debt securities – short positions	*669*	*–*	*–*	*669*
Repurchase agreements	*–*	*3,727*	*–*	*3,727*
Derivative financial liabilities	*–*	*455*	*–*	*455*
Other financial liabilities	*2*	*–*	*–*	*2*
SDR allocation	*9,395*	*–*	*–*	*9,395*
Total liabilities	***10,066***	***4,182***	***–***	***14,248***

20 Events after the Reporting Period

There are no events after the reporting period to report.

21 Date of Authorisation for Issue of Account

The Accounting Officer authorised these financial statements for issue on 14 July 2015.

ANNEX A

ACCOUNTS DIRECTION GIVEN BY HM TREASURY UNDER THE EXCHANGE EQUALISATION ACCOUNT ACT 1979[9]

1. This direction applies to the Exchange Equalisation Account.
2. The Treasury shall prepare accounts for the Exchange Equalisation Account ("the Account") for the year ending 31 March 2012 and each subsequent financial year, which give a true and fair view of the state of affairs of the Account at the reporting date, and of its income and expenditure and cash flows for the year then ended.
3. The accounts shall be prepared in accordance with the requirements of the relevant version of the Government Financial Reporting Manual (FReM).
4. The accounts shall present a Statement of Comprehensive Income, a Statement of Financial Position and a Statement of Cash Flows. The Statement of Financial Position shall present assets and liabilities in order of liquidity.
5. The notes to the accounts shall include disclosure of assets and liabilities, and of income and expenditure, relating to other Central Government funds, including the National Loans Fund, and shall also include disclosure of management costs.
6. The report shall include:
   - (i) a brief history of the Account, and its statutory background;
   - (ii) an outline of the scope of the Account, its relationship to HM Treasury and other central funds, and its management operations;
   - (iii) a management commentary including appropriate information on financial performance and position reflecting the relationship between the Account and other central funds;
   - (iv) a governance statement.
7. Compliance with the requirements of the FReM will, in all but exceptional circumstances, be necessary for the accounts to give a true and fair view. If, in these exceptional circumstances, compliance with the requirements of the FReM is inconsistent with the requirement to give a true and fair view, the requirements of the FReM should be departed from only to the extent necessary to give a true and fair view. In such cases, informed and unbiased judgement should be used to devise an appropriate alternative treatment which should be consistent with both the economic characteristics of the circumstances concerned and the spirit of the FReM. Any material departure from the FReM should be discussed in the first instance with the Treasury.
8. This Accounts Direction shall be reproduced as an appendix to the accounts.
9. This Accounts Direction supersedes that issued on 17 March 2010.

Chris Wobschall

Chris Wobschall
Deputy Director, Assurance and Financial Reporting Policy, HM Treasury
6 January 2012

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[7] As amended by the Finance Act 2000

Glossary

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

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

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

Certificate of deposit is a savings certificate entitling the holder to receive interest.

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

Counterparty is the other party that participates in a financial transaction.

Credit risk is the risk of financial loss arising from 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.

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

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. For the EEA, the main derivatives are futures, forwards and swaps.

Discount note is a short–term debt instrument issued at a discount to its face value.

Euro area is the area of 19 nations which have adopted the euro as a single currency.

Floating rate note is a debt instrument that pays a variable interest rate.

Foreign currency reserves consists of bonds and notes, money market instruments, foreign currency and deposits, less unsettled trades and excluding the market valuation of foreign currency FX forwards and swaps.

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.

Government Financial Reporting Manual (FReM) – the technical accounting guide that complements guidance on the handling of public funds published separately by the relevant authorities.

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

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

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

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

Issuer is a legal entity, i.e. a government, supranational or corporation, that develops, registers and sells securities to investors in order to finance its own operations.

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.

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

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.

New Arrangements to Borrow (NAB) – a set of credit arrangements between the IMF and 38 member countries and institutions, including the UK. The NAB was extended in March 2011 as a key part of efforts to overcome the global financial crisis. The expanded NAB has tripled the resources available to the IMF from pre-crisis levels.

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

Reserves – refers to the UK holdings of international reserves, reported on a gross basis. Gross reserves consist of foreign currency reserves, IMF position (the RTP and the net SDR position) and gold holdings.

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

Supranational refers to an international government or quasi-government organisation.

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

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

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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This document can be downloaded from www.gov.uk

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