HM TREASURY

Exchange Equalisation Account:

Report and Accounts 2008-09

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July 2009

EXCHANGE EQUALISATION ACCOUNT ACT 1979

Presented to Parliament 20 July 2009

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

Exchange Equalisation Account: Report and Accounts 2008–09

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Foreword

Introduction

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

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

3. The Bank also acts as the Treasury's Agent for foreign currency liability management, including the issuance of foreign currency debt to finance some of the reserves. This debt is issued by, and is an obligation of, the NLF under the National Loans Act 1968 since it is that Act (rather than the Exchange Equalisation Account Act 1979) which provides the powers for the Government to issue foreign currency securities. The foreign currency raised by issuing foreign currency debt is transferred to the EEA (see paragraph 20). At 31 March 2009 there was no foreign currency debt outstanding.

4. 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 risk exposures therein, to be managed collectively in an efficient way. These are the financial accounts of the EEA only, but where relevant the management commentary covers issues relating to the NLF assets and liabilities that are managed as part of the official reserves.

Origin and Purpose

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

6. The Government's macroeconomic framework is designed to maintain long-term economic stability. This is achieved by maintaining low inflation, sustainable growth and sound public finances. The framework does not entail management of the exchange rate and the UK has not intervened for the purposes of influencing the sterling exchange rate since 1992. 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. The Treasury's 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.

[1] This and other terms are defined in the Glossary at the back of this document.
[2] A summary is included in the Debt and Reserves Management report produced by HM Treasury at the time of the Budget and available via www.hm-treasury.gov.uk.

7. 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

8. The EEA is under the control of the Treasury, which has appointed the Bank to act as its Agent to carry out dealing in foreign currencies and the investment of the reserves. The Bank also provides advice and analysis to the Treasury on issues relating to the reserves. The Bank's management costs are charged to the EEA; these costs were £9m for 2008-09 (*2007-08: £9m*).

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

- benchmarks[3] 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 these benchmarks;
- the framework for controlling credit, market, liquidity and other risks;
- a target return for active management compared to benchmark positions; and
- the programme for financing the reserves, covering the NLF's foreign currency borrowing and currency swaps out of sterling.

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

10. The Bank reports to the Treasury on size, composition and liquidity of the reserves and their continued consistency with policy objectives, investment performance, returns made and risk exposures, including those relating to active management, at a quarterly meeting chaired by the head of the Treasury's Debt and Reserves Management team. Every six months there is a meeting at which the EEA Accounting Officer (currently the Managing Director responsible for Macroeconomic and Fiscal Policy) and the Bank of England's Executive Director for Markets, or delegated senior officials, review investment performance and discuss strategic issues relating to the reserves.

Key performance indicators

11. The Treasury has agreed with the Bank a set of Key Performance Indicators (KPIs). The purpose of these KPIs is to provide a basket of indicators that can be used to assess the future effectiveness of the management of the EEA. The Treasury and the Bank agree that these KPIs were met during the 2008-09 financial year.

12. The KPIs selected reflect the overall objectives for holding the reserves, as explained in detail above. The Treasury's 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

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

exposure to financial risk is limited through the appropriate choice of portfolio and risk management practices.

13. The Treasury's role in this is to ensure that its choice for the strategic composition for the benchmark asset allocation of the reserves, including gold, meets the policy objectives set out above. Subject to meeting those objectives, the Treasury will make that benchmark asset allocation choice to trade off risk, return and liquidity in line with its risk preferences.

14. The KPIs are that:

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

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

(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 if necessary as to how best to 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 39 for details), whilst 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 so far as possible;
- appropriate preparations are made for possible policy deployment of the reserves (e.g. FX intervention).

Investment Policy

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

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

- securities issued by other national governments, supranational organisations and selected government and government-sponsored agencies;
- Pfandbriefe;
- foreign currency spot, forward and swap transactions;
- interest rate and currency swaps;
- bond, interest rate and swap futures;
- sale and repurchase agreements;
- forward rate agreements;
- gold deposits;
- SDRs;
- deposits with the Bank;
- deposits with, and certificates of deposits issued by, highly rated banks; and
- corporate commercial paper and bonds – no such transactions were entered into during the year.

Management Commentary

Hedged and unhedged reserves

17. The UK's official reserves, of which £32,695m *(2007-08: £30,311m)* are held in the EEA and £1,695m *(2007-08: £561m)* are held in the NLF, can be divided into two components: reserves that are hedged for currency and interest rate risk of £14,665m (*2007-08: £17,235m*) (the 'hedged reserves'), and the remaining reserves of £19,725m (*2007-08: £13,637m*) which are unhedged (the 'unhedged reserves'). The fall in the hedged reserves reflected a number of factors, including currency movements, the maturing of the dollar bond issued in 2003 and difficult market liquidity conditions for the reinvestment of maturing assets.

18. The unhedged reserves comprise dollar and euro denominated bonds, gold, the RTP (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.

19. The hedged reserves comprise portfolios of eligible dollar, euro and yen denominated bonds. Assets in the hedged reserves are hedged for currency risk either by being denominated in the same currency as the liabilities which finance them or by using currency swaps. The hedged reserves are also hedged against interest rate risk, through the use of swaps.

20. The hedged reserves are primarily financed either by issuing securities denominated in foreign currency or by sterling advanced from the NLF to the EEA. As explained in paragraph 3, the issuance of foreign currency securities is effected through the NLF and the resulting foreign currency proceeds are treated as being sold for sterling to the EEA, with the NLF advancing the EEA the sterling required as necessary. Where hedged reserves are financed

out of sterling, the EEA uses sterling from the NLF to purchase foreign currency assets with, as noted above, swaps used to hedge the resulting currency and interest rate risks. The main determinant of which currency to finance out of is cost. The least cost method of financing is determined by comparing, on a swapped basis, the estimated cost of issuing bonds in foreign currency of a given maturity and nominal amount, with the cost of issuing in sterling.

21. Financing of the hedged reserves in 2008-09 included sterling swapped into foreign currencies of £8,105m (*2007-08: £10,063m*). There were no outstanding foreign currency securities at the end of the year (*2007-08: £1,533m*). No new foreign currency securities were issued during the year (*2007-08: nil*).

Management of the reserves

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

23. The size of the official reserves assets that are held in the EEA rose over the course of the year by £2,244m to £34,686m. This increase primarily consisted of rises in the sterling value of debt securities (£2,318m), gold (£1,691m), and treasury bills (£1,131m) offset by a decrease in loans and advances to banks (£3,175m).

24. This rise in the reserve assets in the EEA is matched largely by a rise in the liability to the NLF of £1,229m and a rise in the marked to market value of derivative positions of £2,058m, offset by a decrease in deposits by banks of £1,080m.

25. The foreign currency elements of the total UK's 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 £19,725m. The assets and liabilities in the Template differ from those of the EEA balance sheet on page 21 of these accounts. This is for a number of reasons, but principally it is because the Template is designed to reflect the UK's foreign currency position. Therefore it includes foreign currency assets and liabilities of the NLF (notably the RTP) and 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 accounting treatment of collateral and unsettled items, mean that gross reserve assets shown in the Template (the equivalent of £34,390m at 31 March 2009) differ by £296m from the assets held in the EEA. A reconciliation between the EEA's balance sheet and the Template is provided on page 12.

Benchmark allocations

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

27. In order to determine the benchmark asset allocation for the hedged reserves of the EEA, the Bank employs an asset allocation model, the parameters of which are agreed by the

[4] This can be viewed at: http://www.hm-treasury.gov.uk/press2009_index.htm

Treasury, which explicitly trades off liquidity and return. The model determines an asset mix that maximises expected return for given estimated levels of expected liquidation costs.

28. The Treasury also sets a benchmark for the currency allocation of the EEA's unhedged reserves excluding gold. This takes into account past patterns of risk and return, as well as other factors such as the currencies likely to be required in any intervention. As in the previous year, in 2008-09, this benchmark was 40% US dollar, 40% euro and 20% yen.

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

30. 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 ver y small and it does not have an explicit benchmark for this reason.

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

Links between the International Monetary Fund and the official reserves

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

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

Analysis of returns for the period

34. The EEA's accounts for the year ended 31 March 2009 are given on pages 20 to 39 and show an operating surplus for the year of £4,532m (*2007-08: surplus of £2,064m*). The operating surplus was driven by significant gains made on unhedged foreign currency reserves and gold holdings.

35. The price of gold rose from £470 to £640 an ounce, an increase of 36%, giving rise to a revaluation gain of £1,692m.

36. Fair value gains on financial instruments for the year were £2,913m (*2007-08: £1,239m*). These gains arose on the unhedged reserves, primarily as a result of significant sterling depreciation during the year, but also through gains on holdings of debt instruments which benefited from falling interest rates across all the major currencies. On a financial instrument basis, fair value gains on debt securities of £5,275m *(2007-08: £2,874m)* were the largest contributor, although these gains were partially offset by hedging losses on currency swaps of £2,305m *(2007-08: £1,675m).* The nature of the hedging relationship between currency swaps and the debt securities being hedged by them is that gains and losses will move in opposite directions. Other gains arose on Treasury and other bills of £628m *(2007-08: £116m)*. Other losses arose on net repo positions of £310m *(2007-08: gain of £2m)* and the net SDR position of £348m *(2007-08: £97m)* with the latter due to sterling depreciation.

37. The total interest receivable from the EEA's portfolio of assets was £1,473m (*2007-08: £1,517m*). As in previous years, this consisted primarily of interest received on debt securities of £814m (*2007-08: £668m*) and sterling legs of currency swaps of £489m (*2007-08: £644m*).

38. Total interest payable of £1,537m (*2007-08: £2,001m*) led to a net interest expense of £64m (*2007-08: £484m*). The interest payable figure consisted primarily of the notional sterling capital charge for the EEA reserves of £882m (*2007-08: £1,250m*) and interest expense on the foreign currency legs of currency swaps of £404m (*2007-08: £421m*). The notional sterling capital charge is required by the Accounts Direction attached in Annex A. It is applied to reflect an assumed cost to the NLF of providing sterling advances to finance the reserves held in the EEA. The interest rate is set at the five-year gilt swap rate. The average rate for the year was 3.81% *(2007-08: 5.53%).* The charge is taken through the Income and Expenditure Account for the year and subsequently added back to the Accumulated Income and Expenditure Reserve, as shown in note 12 to the accounts. The net interest expense position reflects the fact that during the year sterling interest rates were higher, on average, than dollar, euro and yen interest rates.

39. The Treasury sets a target for active management return as part of the SLA. 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 £28m (*2007-08: £16m*).

40. The EEA continued to hold assets of a high credit quality throughout the year, and therefore has not suffered credit losses as a result of market turbulence.

Intervention

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

Provision of Foreign Currency Services to Government Departments

42. The EEA continued to provide foreign currency services to various government departments and agencies, i.e. sales of foreign currency to departments with foreign currency obligations and purchases of foreign currency from departments with foreign currency receipts, in aggregate totalling £6,081m (*2007-08: £2,759m*). The increase was due to an increase in forward transactions on behalf of the Foreign and Commonwealth Office and the commencement of forward transactions on behalf of HM Treasury in respect of fees received from the Credit Guarantee Scheme in foreign currency. These purchases and sales, both spot and forward, were hedged through offsetting trades with the market.

Risk Management and Control

43. Although the reserves are not held primarily to make a profit, consistent with the KPIs (see paragraphs 11 to 14), the Treasury seeks to minimise the cost of holding the foreign currency reserves whilst avoiding exposing the public purse to unnecessary risk.

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

Control Framework

45. The key features of the control framework during the year were as follows:

- An annual Service Level Agreement (SLA) was agreed between the Treasury and the Bank, in which the Treasury set out the parameters under which the Bank was to manage the reserves. A summary of the SLA was published in the Debt and Reserves Management Report[5].
- The Bank produced a quarterly report for the Treasury on risk controls and any breaches of the control framework.
- There is a system of financial reporting. Each month the Bank reported to the Treasury on the returns made and the market and credit risks incurred.
- The EEA Accounting Officer and the Bank's Executive Director, Markets met together with Treasury officials twice in the year to review the management of the reserves. Quarterly meetings between the Treasury's Debt and Reserves Management Team and the Bank's Foreign Exchange and Risk Management Divisions supplemented this process.
- A risk-based internal audit programme (agreed with the Treasury) that delivered reports to the Bank's Executive Director, Markets, as well as a quarterly report which is forwarded to the Treasury.
- There is an organisational structure in the Bank containing clear reporting lines. The Bank's Risk Management Division is independent of the Foreign Exchange Division where trading activities were conducted. Both the Risk Management Division and the Foreign Exchange Division report to the Bank's Executive Director, Markets. Settlements of transactions were carried out by the Customer Banking and Market Services Divisions, which report to the Executive Director, Banking Services.
- Operational Risk Officers in the Bank's Foreign Exchange and Risk Management Divisions were responsible for co-ordinating and collecting analysis on the operational risk in the Divisions.

The Bank tested its remote contingency facilities where EEA operations can be carried out in an emergency.

The limits to credit and market risk exposures are explained in the following paragraphs.

46. Credit risk: the management of the reserves involves exposure to counterparties and to the issuers of securities. The creditworthiness of these counterparties and issuers is subject to regular scrutiny by the Bank, both through analysis in the Risk Management Division and review by the Bank's Credit Ratings Advisory Committee. Following this process, limits are agreed for the exposure to each counterparty and issuer, with such exposures being monitored in real time against the limits. A report of any limit excesses is sent to the Treasury each month. In addition, there are limits to contain the overall exposure to each relevant country's banking sector.

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

[5] Produced by HM Treasury at the time of the Budget, available via www.hm-treasury.gov.uk.

48. The arrangements for custody of EEA assets in 2008-09 were as follows. US Treasury bonds and other US dollar-denominated securities were held in custody at either the Federal Reserve Bank of New York or at JP Morgan Chase Bank. Euro denominated securities was held in custody at State Street Bank and Trust Company. Japanese government bonds were held in custody at the Bank of Japan. Other yen denominated bonds were held at JP Morgan Chase. The gold bars and gold coin in the reserves were stored physically at the Bank's premises.

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

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

51. The Bank also conducts regular stress tests for a range of scenarios.

Operational Guidelines

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

53. The Treasury's financing of the hedged foreign currency reserves, whether through borrowing directly in foreign currency or by engaging in foreign currency swaps out of sterling (see paragraph 20), was done in a way that minimised the exposure to fluctuations in the value of currencies.

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

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

56. Similarly, interest rate risk was controlled in two main ways, according to the method chosen for raising foreign currency to finance the reserves. Where financing was through the issue of NLF foreign currency securities, the interest rate risk was controlled by entering into interest rate swaps on both the EEA assets and the NLF foreign currency securities. Where currency swaps out of sterling were used, interest rate risk was hedged through interest rate swaps. Typically, the EEA paid floating rate interest on the currency it acquired through the initial swap out of sterling and generated fixed interest income in the same currency through

purchasing an asset such as a bond. By swapping the fixed interest receipts for floating interest receipts through an interest rate swap, the EEA acquired an income stream that matched its interest payment liability and thus minimised its interest rate exposure.

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

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

59. Under the SLA, the Bank actively managed the hedged and unhedged reserves, in order to improve the return. The Treasury sets the Bank a VaR limit for active management relative to benchmarks, with the VaR being calculated at close of business each day. In 2008-09 the VaR limit for active management was $20m. During the year the Bank’s use of VaR did not exceed $6.1m. The average use of VaR during the year was $4.3m and the lowest VaR usage at the end of any one day was $2.4m.

60. During the year the Treasury agreed with the Bank to keep in place a number of actions undertaken in 2007-08 to ensure that the risks to which the EEA is exposed as a result of market turbulence continue to be aligned with the Treasury’s risk preferences. Perceived risks as a result of further market turbulence in 2008-09 were assessed and were mitigated where considered to be excessive.

Accounting Policies

61. The accounts of the EEA for the year are drawn up in accordance with the Accounts Direction, reproduced at Annex A (on page 40) to this report, which reflects UK GAAP and the Companies Act as far as appropriate. Detailed accounting policies are provided in the notes to the accounts.

Audit

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

63. 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 14 July 2009

Reconciliation of EEA Balance Sheet to IMF Reserves Template

As at 31 March 2009	Unaudited **£ millions**	Unaudited **$ millions**
Total assets per EEA balance sheet	**34,686**	
Add Reserve Tranche Position in NLF	1,695	
Adjustments to reflect IMF Reserves Template presentation:		
Deduct cash collateral and derivatives	(1,286)	
Reclassification between assets and liabilities	(651)	
Other adjustments	(54)	
Sterling total assets using Template presentation	**34,390**	
Dollar equivalent per Template		**49,284**
Total liabilities per EEA balance sheet	**34,686**	
Eliminate EEA's Liability to NLF (see note 12)	(26,086)	
Add NLF issued debt	–	
Adjustments to reflect IMF Reserves Template presentation:		
Add foreign currency liability on FX trades and swaps	10,900	
Deduct cash collateral and derivatives	(4,182)	
Reclassification between assets and liabilities	(651)	
Other adjustments	(2)	
Sterling total liabilities using Template presentation	**14,665**	
Dollar equivalent per Template		**21,016**
Net assets per Template	**19,725**	**28,268**

Conversion rate into US dollars is 1.4331 as at close 31 March 2009

Statement of the Accounting Officer's Responsibilities

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

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

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

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

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

The responsibilities of an Accounting Officer, including responsibility for the propriety and regularity of the public finances for which an Accounting Officer is answerable, for keeping proper records and for safeguarding the Department's assets, are set out in Chapter 3 of "Managing Public Money". The Accounting Officer's Statement on Internal Control can be found on page 14.

Statement on Internal Control

1. Scope of responsibility

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

1.2 The management of the EEA is divided between the Treasury and the Bank of England (the Bank). The EEA is under the control of the Treasury. The Bank is the Treasury's Agent and is responsible for the day-to-day management of the EEA, within the framework set by the Treasury. 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. 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 The system of internal control is designed to manage risk to an acceptable level, balancing the impact of potential risk 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 2009 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. 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, 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, specific DRM and EFA staff 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, financial risk analysis and measurement is undertaken by the Risk Management Division, which is independent from the Foreign Exchange Division where transactions are executed. Both the Risk Management and Foreign Exchange Divisions are independent from the Banking Services Directorate where the transactions are settled.

4.2 The Bank has an overarching Risk Management Framework in order to provide consistency and transparency in risk management processes across the organisation. This framework is supported by a central Risk Oversight Unit in the Finance Directorate and ultimately overseen by the Business Risk Committee (BRC). 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 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 Operational Risk Standards: Business Practice Risk, Information Technology Risk, Security Risk, Business Continuity Risk, Project Risk and Human Resources Risk. The BRC ensures that these Risk Standards are “fit for purpose”, and reviews the Standards on an annual basis. The Risk Standards are reported against quarterly to the BRC. Mitigating actions in response to incidents and exceptions relating to these Standards, as for all significant operational risks in the Bank, are also reported to the BRC.

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 Statement on Internal Control. 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 financial reporting detailing, on a management accounting basis, the returns made with respect to the management of the EEA and the market and credit risks incurred.
- The Bank’s Executive Director for Markets provides the Accounting Officer with a quarterly assurance that the processes and framework in place are sufficient to identify current and future sources of material risk and meet the Turnbull requirements. It also states that it is evidence which can be relied upon in making this Statement on Internal Control. In addition, the Treasury are provided with quarterly management reports on risk issues and the Bank’s compliance with the guidance issued by the Turnbull Report. These reports highlight the Bank’s role in identifying, assessing, managing and monitoring the risks relating to its management of the EEA. This process is supported by an Operational Risk Officer in both the Foreign Exchange Division and, with specific responsibility for the co-ordination of the quarterly reporting framework, the Risk Management Division.
- EFA considers and discusses the information provided with the Bank and Exchequer Funds Internal Audit and provides the Accounting Officer with quarterly reports that highlight the key risks.
- The Bank’s Internal Audit Division conducts an agreed internal audit programme as part of the SLA. The Bank’s Executive Director for Markets forwards the Internal Audit quarterly reports on this activity to the Accounting Officer.

- Exchequer Funds Internal Audit provides an independent and objective opinion to the Accounting Officer on risk management, control and governance of the EEA. Assurance is provided following reviews of relevant Bank Internal Audit reports and EFA's oversight of the Bank's work, as agreed by the Accounting Officer and the Exchequer Funds Audit Committee. Exchequer Funds Internal Audit's reviews aim to measure and evaluate the effectiveness of the Treasury in achieving their agreed objectives in respect of the EEA. Exchequer Funds Internal Audit also reviews EFA's quarterly report to the Accounting Officer (mentioned above).

- Bank and Treasury officials met quarterly to review performance against the parameters set out in the SLA and to consider wider operational and policy issues. Additionally the Accounting Officer and the Bank's Executive Director for Markets held 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 liaise with the Bank and DRM to produce the annual accounts. The Treasury Accountant reviewed and approved the 2008-09 financial accounts and the Foreword to the accounts.
- The Treasury agreed with the Bank to keep in place a number of actions undertaken in 2007-08 to ensure that the risks to which the EEA is exposed as a result of market turbulence continue to be aligned with the Treasury's risk preferences. Perceived risks as a result of further market turbulence in 2008-09 were assessed and were mitigated where considered to be excessive.
- DRM undertook co-ordinated contingency site tests with the Bank in 2008-09.

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

- Colin Price, Chair, non-executive Director of the Debt Management Office's Managing Board and formerly Global Pension Fund Adviser/Finance Director at Shell Pensions Management Services Limited;

- Brian Larkman, non-executive Director of the Debt Management Office's Managing Board and formerly Global Head of Money Markets at the Royal Bank of Scotland PLC; and

- Mark Clarke, formerly Director General (Finance & Strategy) at the Department for Business, Enterprise and Regulatory Reform.

The Exchequer Funds Audit Committee meets quarterly.

5. Review of effectiveness

5.1 As Accounting Officer, I have responsibility for reviewing the effectiveness of the system of internal control. My review is informed by the work of Exchequer Funds Internal Audit and Bank Internal Audit, who both provided positive assurance as to the management and control of the EEA in 2008-09 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 Exchequer Funds Audit Committee and risk owners in addressing weaknesses and ensuring continuous improvement of the system is in place. The Exchequer Funds Audit Committee considered the 2008-09 accounts in draft and provided me with its views before I formally signed the accounts.

5.2 In my opinion, the system of internal control was effective with no significant control events identified in 2008-09.

David Ramsden	HM Treasury
Accounting Officer	14 July 2009

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 2009 under the Exchange Equalisation Account Act 1979. These comprise the Income and Expenditure Account, the Balance Sheet, the Cash Flow Statement and the related notes. These financial statements have been prepared under the accounting policies set out within them.

Respective responsibilities of the Accounting Officer and auditor

The Accounting Officer is responsible for preparing the Foreword, the Statement on Internal Control and the financial statements in accordance with the Exchange Equalisation Account Act 1979 and HM Treasury directions made thereunder. The Accounting Officer is also responsible for ensuring the regularity of financial transactions. These responsibilities are set out in the Statement of Accounting Officer's Responsibilities.

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

I report to you my opinion as to whether the financial statements give a true and fair view and whether they have been properly prepared in accordance with HM Treasury directions issued under the Exchange Equalisation Account Act 1979. I report to you whether, in my opinion, the information included in the Foreword, excluding the Reconciliation of EEA Balance Sheet to IMF Reserves Template, is consistent with the financial statements. I also report whether, in all material respects, the expenditure and income have been applied to the purposes intended by Parliament and the financial transactions conform to the authorities which govern them.

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

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

I read the Foreword, excluding the Reconciliation of EEA Balance Sheet to IMF Reserves Template, and consider the implications for my report if I become aware of any apparent misstatements within it.

Basis of audit opinions

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

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

Opinions

In my opinion:

- the financial statements give a true and fair view, in accordance with the Exchange Equalisation Account Act 1979 and directions made thereunder by HM Treasury, of the state of the Exchange Equalisation Account's affairs as at 31 March 2009 and of its surplus, recognised gains and losses and cash flows for the year then ended;
- the financial statements have been properly prepared in accordance with HM Treasury directions issued under the Exchange Equalisation Account Act 1979; and
- information included in the Foreword, excluding the Reconciliation of EEA Balance Sheet to IMF Reserves Template, is consistent with the financial statements.

Opinion on Regularity

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

Report

I have no observations to make on these financial statements.

Amyas CE Morse
Comptroller and Auditor General
15 July 2009

National Audit Office
151 Buckingham Palace Road
Victoria
London
SWIW 9SS

Income and Expenditure Account

For the year ended 31 March:

	Notes	2009 £ millions	*2008* *Restated* *£ millions*
Interest receivable and similar income arising from debt securities	2	814	*668*
Other interest receivable and similar income	2	659	*849*
Notional sterling capital charge	12	(882)	*(1,250)*
Interest payable	3	(655)	*(751)*
Net interest expense		**(64)**	***(484)***
Fees and commissions		–	*(1)*
Gains on revaluation of gold		1,692	*1,319*
Fair value changes in financial instruments	4	2,913	*1,239*
Management charge	5	(9)	*(9)*
Surplus on ordinary activities		**4,532**	***2,064***
Surplus for the financial year	12	**4,532**	***2,064***

All income and expenditure arose from continuing operations.
There are no recognised gains and losses other than those included above.
The notes on pages 23 to 39 form an integral part of these accounts.

Balance Sheet

As at 31 March:

	Notes	2009 £ millions	*2008 £ millions*
Assets			
Cash and balances at central banks and the Government Banking Service	18	435	*778*
Holdings of IMF SDRs		301	*176*
Settlement balances		231	*284*
Treasury bills	6	1,606	*475*
Loans and advances to banks	7	302	*3,477*
Debt securities	8	23,803	*21,485*
Gold and gold receivables	9	6,377	*4,686*
Other financial assets	10	1,287	*775*
Prepayments and accrued income		344	*306*
Total assets		**34,686**	***32,442***
Liabilities			
Settlement balances		253	*403*
Deposits by banks	11	1,944	*3,024*
SDR allocation	13	1,996	*1,583*
Other financial liabilities	14	4,400	*2,560*
Accruals		7	*15*
Liability to the National Loans Fund	12	26,086	*24,857*
Total liabilities		**34,686**	***32,442***

The notes on pages 23 to 39 form an integral part of these accounts.

David Ramsden
Accounting Officer

HM Treasury
14 July 2009

Cash Flow Statement

For the year ended 31 March:

	Notes	2009 £ millions	*2008* *£ millions*
Net cash inflow from operating activities	17	3,842	*1,081*
Financing:			
Net outflow from National Loans Fund	12	(570)	*(475)*
Capital repayments	12	(3,615)	–
(Decrease)/increase in cash in the year	18	**(343)**	***606***

The notes on pages 23 to 39 form an integral part of these accounts.

Notes to the Accounts

1 Accounting policies

Basis of accounting

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

These accounts apply FRS 29 (Financial Instruments: Disclosures), excluding the disclosures pertaining to Appendix E (capital disclosures) which are not considered relevant to this entity and are specifically excluded from the Accounts Direction.

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

Change in accounting policy

A presentational change has been made to the Income and Expenditure Account. The categories of dealing profit/(losses) and exchange gains/(losses) on foreign currencies have been combined on the face of the Income and Expenditure Account into a new category called fair value changes in financial instruments. The new presentation reflects more clearly the overall effect on the EEA of changes in fair value, and is accompanied by an analysis of the change in fair value according to the instruments that generated the gains and losses.

The above presentational change constitutes a change in accounting policy. There has been no change in the methods of calculating fair value gains and losses, therefore the net surplus for the financial years 2007-08 and 2008-09 is not affected.

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 whilst 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 FRS 26, and therefore all financial assets and liabilities are held at fair value with gains and losses being taken through the Income and Expenditure Account. There have been no reclassifications of financial instruments during the year. Financial assets 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 are given below of the methodologies used to revalue different instrument classes.

Interest receivable and payable

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

Notional sterling capital charge

A notional sterling capital charge is included within the Income and Expenditure Account. There is no cash movement in respect of this charge, which is intended to reflect an assumed cost of sterling capital used by the EEA. The charge is calculated on the outstanding reserves of the EEA (including the Income and Expenditure Account) and the EEA's outstanding liability to the NLF, less cash balances with the Government Banking Service, at the 5-year gilt swap rate, calculated on a daily basis. This charge is subsequently added back to the Accumulated Income and Expenditure Reserve (see note 12). The charge is a requirement of the Accounts Direction set out in Annex A of this report.

Special Drawing Rights (SDR) remuneration

The EEA is remunerated (in SDRs) on its holdings of SDRs. This income is included within interest receivable. Remuneration of the UK's Reserve Tranche Position (RTP) at the IMF (an NLF asset) is also received, by the EEA, in the form of SDRs and is recognised in these accounts as interest receivable. Interest is paid on the EEA's SDR Allocation. All SDR remuneration is accounted for on an accruals basis.

Fair value changes in financial instruments

Fair value changes in financial instruments comprises all changes in the fair value of the EEA financial assets and liabilities, excluding interest payable and receivable, which is disclosed separately. Realised gains and losses on disposal or maturity are also included.

Foreign currency translation

The accounts of the EEA have been presented in sterling. 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 balance sheet date are recognised in the Income and Expenditure Account within fair value changes in financial instruments.

Fees and commissions

Fees and commissions are not material and are recognised in the Income and Expenditure Account as incurred.

Debt securities

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

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

Treasury bills

Treasury bills are reported at fair value. Treasury bills are initially recognised at cost, as the best estimate of fair value and are subsequently revalued to their market price daily. Changes in the fair value of treasury bills are recognised in the Income and Expenditure Account, within fair value changes in financial instruments, when they arise.

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

Loans and advances

Loans and advances are initially recorded at the cost of funds advanced and are then revalued using a discounted cash flow valuation technique. All inputs into the pricing model are externally sourced and assumptions used are supported by observable market prices. Loans and advances are marked to bid prices. Changes in the fair value of loans and advances are recognised in the Income and Expenditure Account, within fair value changes in financial instruments, when they arise.

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

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

Repurchase and reverse repurchase agreements are initially recognised at cost as the best estimate of fair value and subsequently revalued daily. These are valued using a discounted cash flow valuation technique. All inputs into the pricing model are externally sourced and assumptions used are supported by observable market prices. Changes in the fair value of repos and reverse repos are recognised in the Income and Expenditure Account, within fair value changes in financial instruments when they arise.

Gold

Gold holdings and gold assets on deposit are valued at the sterling equivalent of the London Bullion Market Association (LBMA) dollar denominated spot price on the balance sheet date. Revaluation gains and losses on gold assets are recognised within gains on revaluation of gold in the Income and Expenditure Account.

International Monetary Fund Special Drawing Rights (SDRs)

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

Derivative transactions

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

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

Interest receipts and payments relating to derivative transactions are recognised in the Income and Expenditure Account within interest income or interest payable (as appropriate) as they accrue.

Collateral and Netting

The EEA enters into master agreements with counterparties and, when appropriate, obtains collateral. Master agreements provide that if an event of default occurs, all outstanding transactions with the counterparty will fall due and all amounts outstanding will be settled on a net basis.

The EEA receives collateral in respect of counterparty liabilities where this is considered appropriate. Collateral is received in the form of cash or securities. Collateral received in the form of securities is not recorded on the balance sheet. Collateral received in the form of cash is recorded on the balance sheet with a corresponding liability, assigned to deposits by banks. Any interest arising on collateral received is recorded as interest expense.

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 balance sheet.

Securities Lending

Securities lent to third parties under lending programmes remain on the balance sheet. Collateral held by custodians against these transactions is legally separated from EEA assets and, in the absence of default, the EEA is not permitted to sell or repledge the collateral. As such, the collateral is not recorded on the balance sheet.

2 Interest receivable and similar income

	2009 £ millions	*2008* *£ millions*
Interest receivable and similar income arising from debt securities:	**814**	***668***
Other interest receivable and similar income:		
Nostro Accounts	9	*9*
Currency swaps	489	*644*
Interest rate swaps	123	*112*
Money market deposits	2	*23*
Reverse repos	24	*47*
Reserve Tranche Position	4	*1*
Special Drawing Rights	5	*7*
Securities lending	3	*6*
Sub-total	**659**	***849***
Total	**1,473**	***1,517***

3 Interest payable

	2009 £ millions	*2008* *£ millions*
Currency swaps	404	*421*
Interest rate swaps	117	*154*
Repos	85	*95*
SDR allocation	35	*56*
Interest on short positions in bonds	13	*16*
Interest on cash collateral taken	1	*9*
Total	**655**	***751***

4 Fair value changes in financial instruments

	2009 £ millions	*2008* *Restated* *£ millions*
Currency swaps	(2,305)	*(1,675)*
Debt securities	5,275	*2,874*
Foreign exchange transactions	7	*3*
Futures	(2)	*3*
Interest rate swaps	(32)	*36*
Loans and deposits	(10)	*(23)*
Other instruments	10	*–*
Repos and reverse repos	(310)	*2*
SDRs	(348)	*(97)*
Treasury bills	628	*116*
Total	**2,913**	***1,239***

5 Management charge

The management charge of £9m represents the cost of the Bank of England's management of the EEA during the year (*2007-08: £9m*).

6 Treasury and other eligible bills

	2009	*2008*
	£ millions	*£ millions*
Maturing in not more than 3 months	918	*261*
Maturing in 1 year or less but over 3 months	688	*214*
Total	**1,606**	***475***

7 Loans and advances to Banks

	2009	*2008*
	£ millions	*£ millions*
Repayable on demand	1	*1*
Repayable in not more than 3 months	301	*3,432*
Repayable in 1 year or less but over 3 months	–	*44*
Total	**302**	***3,477***
Of which, reverse repo transactions are:	301	*3,476*

The fall in reverse repo transactions is due to recommencement of forward yen purchases for the unhedged reserves and the repayment of outstanding foreign currency securities, in the context of difficult market conditions.

Collateral with a carrying value of £309m (*2007-08: £3,500m)* is held in respect of reverse repo transactions. Cash collateral held is recognised within Deposits by Banks (see note 11). Other collateral held is not recognised by the EEA. The EEA is permitted under the terms of its reverse repo transactions to sell debt securities held as collateral. The carrying amount of short positions in debt securities arising as a result of selling collateral held is given in note 14.

8 Debt securities

All amounts in £ millions	2009			*2008*		
	Listed overseas	Unlisted	Total	*Listed overseas*	*Unlisted*	*Total*
Issued by Public Bodies:						
Government Securities	19,438	–	19,438	*16,890*	*–*	*16,890*
Other Public Sector	3,945	420	4,365	*3,387*	*177*	*3,564*
	23,383	420	23,803	*20,277*	*177*	*20,454*
Other Issuers:						
Bank and building society certificates of deposit	–	–	–	*1,031*	*–*	*1,031*
	–	–	–	*1,031*	*–*	*1,031*
Total	23,383	420	**23,803**	*21,308*	*177*	***21,485***
Amounts maturing:						
Within less than one year			4,498			*3,839*
In more than one year			19,305			*17,646*
Total			**23,803**			***21,485***

9 Gold and gold receivables

	2009 £ millions	*2008* *£ millions*
Gold stock	6,377	*4,596*
Gold deposits maturing in:		
Not more than 3 months	–	*60*
1 year or less but over 3 months	–	*30*
Total	**6,377**	***4,686***

There were no gold deposit trades undertaken during the year *(2007-08: 3)*. No gold swaps were entered into *(2007-08: nil)*. There were no changes in the quantity of gold owned by the EEA in 2008-09 or in 2007-08. The increase in balance sheet value in 2008-09 is attributable to the increase in the sterling market value of the stock of gold since the start of the year.

10 Other financial assets

	2009 £ millions	*2008* *£ millions*
Margin accounts	1	*1*
Balances arising from other financial instruments:		
- Currency swaps	7	*32*
- Interest rate swaps	40	*33*
- Foreign exchange transactions	1,239	*709*
Total	**1,287**	*775*

A maturity analysis of derivatives classified within 'Other financial assets' is provided in note 15.

11 Deposits by Banks

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

All amounts in £ millions

	2009			*2008*		
Maturing in:	3 months or less	Over 3 months but less than 1 year	Total	*3 months or less*	*Over 3 months but less than 1 year*	*Total*
Repo transactions	1,867	37	1,904	*2,894*	*38*	*2,932*
Cash collateral received	40	–	40	*92*	*–*	*92*
Total	1,907	37	**1,944**	*2,986*	*38*	***3,024***

There were no deposits by banks repayable on demand as at 31 March 2009 (*2008: nil).*

The EEA pledges collateral to counterparties in repo transactions. Collateral pledged remains on the balance sheet of the EEA within Debt Securities. The total carrying amount of collateral pledged as at 31 March 2009 was £1,901m (*2007-08: £2,800m*).

The total carrying amount of securities on loan under the securities lending programmes at the balance sheet date was £148m (*2007-08: £5,364m*).

12 Liability to the National Loans Fund

There are two elements of the Liability to the NLF: a specific liability, recognised in accordance with the National Loans Act (1968) of £760m (*2008: £1,330m*) 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, the NLF has issued foreign currency securities in order to raise foreign currency finance that is subsequently transferred to the EEA. As a result, the EEA's net assets, having been derived from initial NLF financing, are ultimately due to the NLF, and are recognised as such on the balance sheet. If a policy decision is taken to reduce the assets of the EEA, the sterling excess raised via sale of foreign currency assets would be paid to the NLF, at the direction of the Treasury.

Specific liability to the NLF

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

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

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

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

Capital Contribution Reserve

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

Accumulated Income & Expenditure Reserve

All gains and losses of the EEA, since UK GAAP compliant accounts were first prepared in 2001, have been taken to the Accumulated Income and Expenditure Reserve, except the notional sterling capital charge. As described in the accounting policy in note 1, the notional sterling capital charge is charged to the Income & Expenditure Account and subsequently credited to the Accumulated Income & Expenditure 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 I&E Reserve	Capital Contribution Reserve	Specific liability to the NLF	2009 Overall liability to the NLF
Balance at 1 April 2008	10,620	12,907	1,330	24,857
Transfers from the NLF	–	–	960	960
Repayments to the NLF	–	–	(1,530)	(1,530)
Capital repayments	–	(3,615)	–	(3,615)
Surplus for the year	4,532	–	–	4,532
Notional sterling capital charge	882	–	–	882
Balance at 31 March 2009	**16,034**	**9,292**	**760**	**26,086**

All amounts in £ millions	*Accumulated I&E Reserve*	*Capital Contribution Reserve*	*Specific liability to the NLF*	*2008 Overall liability to the NLF*
Balance at 1 April 2007	*7,306*	*12,907*	*1,805*	*22,018*
Transfers from the NLF	*–*	*–*	*1,125*	*1,125*
Repayments to the NLF	*–*	*–*	*(1,600)*	*(1,600)*
Surplus for the year	*2,064*	*–*	*–*	*2,064*
Notional sterling capital charge	*1,250*	*–*	*–*	*1,250*
Balance at 31 March 2008	***10,620***	***12,907***	***1,330***	***24,857***

13 SDR allocation

The EEA has a liability to the IMF for those SDRs that have been allocated since the UK became a participant in the Special Drawing Rights Agreement. If the UK withdraws from participation or the Agreement is wound up, payment to the IMF would be required at current exchange rates. The SDR liability as at 31 March 2009 was £1,996m *(2008: £1,583m)*.

14 Other financial liabilities

	2009 £ millions	*2008 £ millions*
Short positions in securities	257	*475*
Balances arising from other financial instruments:		
- Currency swaps	2,676	*1,340*
- Interest rate swaps	70	*13*
- Foreign exchange transactions	1,397	*732*
Total	**4,400**	***2,560***

Short positions in securities relate to the sale of bonds acquired as collateral through reverse repo transactions (see note 7). All bonds are government or other public sector securities listed overseas *(the same applied to 2007-08)*. The maturity analysis of short positions in securities is given below:

	2009 £ millions	*2008 £ millions*
Amounts maturing:		
In more than one year	257	*475*
Total	**257**	***475***

15 Risk management and control

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

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

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

Market risk

Market risk is the 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 risks arising from each of these factors, and how those risks are managed, are detailed below. Further details are also provided in the Foreword.

All benchmarks for the reserves are determined by the Treasury given the EEA's policy objectives. Market risk is structured and is taken into account when determining the benchmark (see Benchmark allocations section in the Foreword).

VaR is the primary market risk management tool employed in relation to the active management of the EEA against the benchmarks. A summary of the method of calculation of VaR is given in the Foreword in paragraphs 49 and 50. Active management usage of VaR during the year, (calculated at the close of business each day in US dollars), was as follows:

	$ millions 2009	*$ millions 2008*
VaR usage as at 31 March	2.92	*2.11*
Maximum VaR usage during the year	6.08	*4.35*
Minimum VaR usage during the year	2.37	*2.09*
VaR limit during the year	20.00	*20.00*

Interest Rate Risk

Methods employed for hedging interest rate risk in the benchmarks are described in detail in the Foreword. The majority of the assets and liabilities of the EEA, after taking account of the effect of derivatives that alter the interest rate risk profile of instruments, are floating rate.

Foreign Exchange Risk

As explained in the Foreword, the official reserves (i.e. reserves of the EEA plus those foreign currency assets and liabilities of the NLF that are managed together with the EEA) can be divided into two categories; the reserves that are hedged for foreign exchange and interest rate risk (the 'hedged' reserves), and those reserves that are not hedged for foreign exchange and interest rate risk (the 'unhedged' reserves).

Assets and liabilities in the hedged reserves are funded by either sterling swapped into foreign currency, via asset swap packages, or through foreign currency issuances on the NLF. In either of these cases, the future cash flows from the assets invested in are swapped back into the currency and interest rate profile of the originating liability. Any residual foreign exchange risk is immaterial.

Assets and liabilities in the unhedged reserves are held in a benchmark foreign currency allocation of 40% US dollar; 40% Euro and 20% Yen. This is a structural benchmark position and reflects Treasury investment policy. Further detail on the policy processes for determining benchmark asset allocations is given in the Foreword.

Credit risk

The reserves are exposed to credit risk through exposures to counterparties and to the issuers of securities. Details of the risk management processes undertaken to limit this exposure to credit risk, and to ensure the creditworthiness of counterparties and issuers, is provided in the Foreword.

The EEA continued to hold assets of a high credit quality throughout the year. The changes in value of any instruments held by the EEA resulting from changes in credit quality were immaterial in 2007-08 and 2008-09.

Credit Risk Limits and Measurement

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

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

Other risk mitigation policies

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

a) Netting Agreements

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

b) Collateral

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

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

At 31 March 2009, credit exposure to issuers stood at £25,475m *(2008: £20,879m)*. Net credit exposure to counterparties stood at £212m *(2008: £1,465m)*. £2,399m *(2008: £6,400m)* of collateral was held. The EEA is fully collateralised within its margin arrangements.

c) Settlement processes

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

Settlement limits are used to control FX settlement risk.

Liquidity risk

The funding structure of the EEA and the EEA's relationship with the NLF is described in detail in the Foreword. As described there, 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 non-derivative financial liabilities

The table below presents the cash flows payable by the EEA arising from non-derivative financial liabilities until their contractual maturity date. The amounts disclosed in the table are the contractual undiscounted cash outflows, whereas amounts are presented in the balance sheet at their carrying values, as detailed in note 1 – Accounting Policies. Undiscounted contractual cash outflows for derivatives are described in the subsequent section of this note on derivatives.

As at 31 March 2009: All amounts in £ millions	**Up to 1 month**	**1 to 3 months**	**3 to 12 months**	**Undated**	**Total**	**Carrying value**
Settlement balances	(253)	–	–	–	(253)	(253)
Deposits by banks	(1,872)	(321)	(37)	–	(2,230)	(1,944)
SDR Allocation	–	–	–	(1,996)	(1,996)	(1,996)
Short positions in securities	(290)	–	–	–	(290)	(257)
Liability to the NLF	–	–	–	(26,086)	(26,086)	(26,086)
Total	**(2,415)**	**(321)**	**(37)**	**(28,082)**	**(30,855)**	**(30,536)**

As at 31 March 2008: All amounts in £ millions	***Up to 1 month***	***1 to 3 months***	***3 to 12 months***	***Undated***	***Total***	***Carrying value***
Settlement balances	*(403)*	–	–	–	*(403)*	*(403)*
Deposits by banks	*(2,307)*	*(682)*	*(38)*	–	*(3,027)*	*(3,024)*
SDR Allocation	–	–	–	*(1,583)*	*(1,583)*	*(1,583)*
Short positions in securities	*(453)*	–	–	-	*(453)*	*(475)*
Liability to the NLF	–	–	–	*(24,857)*	*(24,857)*	*(24,857)*
Total	***(3,163)***	***(682)***	***(38)***	***(26,440)***	***(30,323)***	***(30,342)***

Derivatives

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

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

All amounts in £ millions

	2009			*2008*		
	Notional Principal Amounts	Fair values Assets	Fair values Liabilities	*Notional Principal Amounts*	*Fair values Assets*	*Fair values Liabilities*
Exchange rate contracts:						
Spot and forwards	17,621	1,239	(1,397)	*674*	*709*	*(732)*
Currency swaps	8,118	7	(2,676)	*10,653*	*34*	*(1,340)*
	25,739	1,246	(4,073)	*11,327*	*743*	*(2,072)*
Interest rate contracts:						
Interest rate swaps	1,813	40	(70)	*834*	*33*	*(13)*
Interest rate futures	3,295	–	–	*2,479*	–	–
	5,108	40	(70)	*3,313*	*33*	*(13)*
Total	**30,847**	**1,286**	**(4,143)**	***14,640***	***776***	***(2,085)***

The maturity of the notional principal amounts and replacement cost of derivative contracts entered into with third parties is shown below. The replacement cost is the fair value of derivatives after netting positive and negative fair values where there is legal right of offset.

				2009
	£ millions Under 1 Year	£ millions 1 to 5 Years	£ millions Over 5 Years	£ millions Total
Exchange rate contracts:				
- Notional principal amount	15,400	10,339	–	25,739
- Net replacement cost	(1,408)	(1,419)	–	(2,827)
Interest rate contracts:				
- Notional principal amount	2,952	2,026	130	5,108
- Net replacement cost	(8)	(22)	–	(30)

				2008
	£ millions Under 1 Year	*£ millions 1 to 5 Years*	*£ millions Over 5 Years*	*£ millions Total*
Exchange rate contracts:				
- Notional principal amount	*3,632*	*7,695*	–	*11,327*
- Net replacement cost	*(532)*	*(797)*	–	*(1,329)*
Interest rate contracts:				
- Notional principal amount	*2,580*	*454*	*279*	*3,313*
- Net replacement cost	*22*	–	*(2)*	*20*

At 31 March 2009 the exposure to financial institutions on derivative positions, after taking account of netting, where ISDA netting Master Agreements permit was £85m (*2007-08: £147m*). Net of collateral held, the exposure was £45m (*2007-08: £56m*).

The table below presents the cash flows payable by the EEA under derivative contracts that are settled gross by remaining contractual periods at the balance sheet date. The amounts disclosed in the table are the contractual undiscounted cash flows, or the undiscounted cash flows predicted by current forward rates for the floating legs of currency swaps. Note that net settled derivatives are not presented as the cash outflows on these instruments are not material.

As at 31 March 2009: **All amounts in £ millions**	**Up to 1 month**	**1 to 3 months**	**3 to 12 months**	**1 to 5 years**	**Total**
Currency swaps	(398)	(766)	(4,062)	(5,920)	(11,146)
Foreign exchange transactions	(6,654)	(8,083)	(5,832)	(6,677)	(27,246)
Total	**(7,052)**	**(8,849)**	**(9,894)**	**(12,597)**	**(38,392)**

As at 31 March 2008: ***All amounts in £ millions***	***Up to 1 month***	***1 to 3 months***	***3 to 12 months***	***1 to 5 years***	***Total***
Currency swaps	*(585)*	*(746)*	*(3,685)*	*(7,676)*	*(12,692)*
Foreign exchange transactions	-	*(536)*	*(4,485)*	*(7,738)*	*(12,759)*
Total	***(585)***	***(1,282)***	***(8,170)***	***(15,414)***	***(25,451)***

16 Related Party Transactions

On 1 December 2008, the UK Government, through HM Treasury, became the ultimate controlling party of The Royal Bank of Scotland Group plc. As a result, the Royal Bank of Scotland Group plc is now regarded as a related party of the EEA. 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. At 31 March 2009 balances with The Royal Bank of Scotland Group plc were:

	2009	*2008*
	£ millions	*£ millions*
Derivative assets	256	*135*
Derivative liabilities	(448)	*(306)*

On 19 January 2009, the UK Government, through HM Treasury, acquired 43.4% of the ordinary share capital of the Lloyds Banking Group. As a result, the Lloyds Banking Group became a related party of the EEA. During the year the EEA entered into various 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 were no balances outstanding at 31 March 2009 *(31 March 2008: £nil)*.

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

17 Reconciliation of operating surplus to net cash outflow from operating activities

	2009	*2008*
	£ millions	*£ millions*
Operating surplus	4,532	*2,064*
Notional sterling capital charge	882	*1,250*
Net increase in accrued income	(38)	*(60)*
Net decrease in accruals	(8)	*(11)*
Net (increase)/decrease in SDRs	(125)	*16*
Net (increase)/decrease in settlement balances	(97)	*183*
Net increase in treasury and other eligible bills	(1,131)	*(364)*
Net decrease/(increase) in loans and advances to banks	3,175	*(967)*
Net increase in debt securities	(2,318)	*(1,399)*
Net increase in gold and gold receivables	(1,691)	*(1,321)*
Net (increase)/decrease in other assets	(512)	*255*
Net decrease in deposits by banks	(1,080)	*(345)*
Net increase in SDR allocation	413	*110*
Net increase in other liabilities	1,840	*1,670*
Net cash inflow from operating activities	**3,842**	***1,081***

18 Cash and similar balances

	1 April 2008 £ millions	Cash flow £ millions	31 March 2009 £ millions
Balance at the Government Banking Service	192	(161)	31
Balances at Central Banks	586	(182)	404
	778	(343)	435
Loans and advances to banks repayable on demand (Note 7)	1	–	1
Total	**779**	**(343)**	**436**

19 Date of Authorisation for Issue of Account

The Account was authorised for issue by the Accounting Officer on 15 July 2009.

ANNEX A

ACCOUNTS DIRECTION GIVEN BY HM TREASURY UNDER THE EXCHANGE EQUALISATION ACCOUNT ACT 1979[6]

1. The Treasury shall prepare accounts for the Exchange Equalisation Account ("the Account") for the year ending 31 March 2006 and each subsequent financial year that give a true and fair view of the state of affairs of the Account at the balance sheet date and of its income and expenditure, total recognised gains and losses and cash flows for the year then ended.

2. The accounts shall be prepared under the historical cost convention modified to include certain investments at valuation and in accordance with applicable accounting standards and where appropriate, although not subject to the Companies Act and technically not being the accounts of a bank, the special provisions of Schedule 9 of the Companies Act 1985 relating to banking companies (to be replaced by the Companies Act 2006 (Regulations 2008/410) applying to financial years beginning on or after 6 April 2008).

3. The accounts shall also be consistent with relevant requirements of the Government Financial Reporting Manual, except to the extent set out in sub-paragraphs a., b. and c. below, and shall meet the extra information requirements set out in Appendix A:

a. An income and expenditure account shall be prepared instead of Schedule 2, the operating cost statement, and both it and the balance sheet shall be prepared in the same format as those required by Schedule 9 of the Companies Act 1985 (to be replaced by the Companies Act 2006 (Regulations 2008/410) applying to financial years beginning on or after 6 April 2008). The Statement of Parliamentary Supply and Statement of Net Operating Costs by Departmental Strategic Objectives are also not relevant;

b. The accounts shall follow the requirements of FRS 29 *Financial Instruments: Disclosures* other than Appendix E, *Capital Disclosures*;

c. A notional cost of capital charge shall apply at a rate to be determined by the Treasury. The cost shall be included in the Income and Expenditure Account and credited direct to the reserve at the year-end.

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

5. This Accounts Direction supersedes that issued on 26 May 2006.

Chris Wobschall
Head, Assurance and Financial Reporting Policy
HM Treasury
5 March 2009

[6] As amended by the Finance Act 2000

EXTRA INFORMATION REQUIRED TO BE DISCLOSED

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

Annual Report

2. The Annual Report shall include:

a) A brief history of the Account, and its statutory background;
b) An outline of the scope of the Account, its status in relation to HM Treasury and other central funds, and its management arrangements;
    i) A Management Commentary in line with the FReM as far as possible.

Notes to the accounts

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

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

Glossary

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

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

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

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

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

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

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. The main derivatives are futures, options, and swaps.

Euro area is the area of 16 nations which have adopted the euro as a single currency.

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.

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

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

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

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

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

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.

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

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

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

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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If you require this information in another language, format or have general enquiries about HM Treasury and its work, contact:

Correspondence and Enquiry Unit
HM Treasury
1 Horse Guards Road
London

SW1A 2HQ

Tel: 020 7270 4558
Fax: 020 7270 4861

E-mail: public.enquiries@hm-treasury.gov.uk

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