EXCHANGE EQUALISATION ACCOUNT ACT 1979

Presented to Parliament 19 July 2006

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 2005–06

ORDERED BY THE HOUSE OF COMMONS TO BE PRINTED 19 July 2006

HM TREASURY

LONDON: The Stationery Office **19 July 2006**

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Contents

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 16).

4. The Bank manages the foreign currency assets and liabilities associated with the official 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 and steady inflation, steady and 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 exchange reserves are held on a precautionary basis - to meet any change in exchange rate policy in the future, if required, or in the event of any unexpected shocks. 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 Special Drawing Rights (SDRs) as required by the UK's membership of the IMF. The way the reserve assets are invested, financed and managed is primarily designed to meet these policy objectives.

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[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 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 £9.1million for 2006 (2004-05: £8.5million).

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 specified:

- benchmarks[3] for investing the reserves, with limits to the Bank's discretion to take currency or interest rate positions relative to these benchmarks;
- the framework for controlling credit, market, 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 investment performance, returns made and risk exposures, including those relating to active management, at a monthly 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 Second Permanent Secretary of the Treasury) 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.

Investment Policy

11. EEA investments need to be highly liquid in order that they can be made available quickly for intervention purposes, or other permitted uses, 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.

12. 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;
- foreign currency spot, forward and swap transactions;
- interest rate and currency swaps;
- bond, interest rate and swap futures;

[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.

- sale and repurchase agreements;
- forward rate agreements;
- gold deposits, location swaps and quality swaps;
- SDRs;
- deposits with, and certificates of deposits and certain covered bonds issued by, highly rated banks; and
- corporate commercial paper.

Management Commentary

Net and borrowed reserves

13. The UK official reserves can be divided into two components: reserves that are hedged for currency risk of £11.8bn, (the ‘borrowed reserves’); and the remaining reserves where the currency exposure is unhedged (the ‘net reserves’).

14. The net reserves comprise dollar and euro denominated bonds, gold, the RTP (which is part of the NLF) and yen exposure obtained largely through forward yen purchases. The net reserves are in the main financed out of sterling through accumulated retained earnings and historic sales of sterling for foreign currencies. A small element of the net reserves is financed by the EEA’s net SDR position.

15. The borrowed reserves comprise portfolios of eligible dollar, euro and yen denominated bonds. Assets in the borrowed 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. In practice the borrowed reserves are also hedged against interest rate risk, through the use of swaps (see paragraph 54-55).

16. The borrowed 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 borrowed 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 can be determined by comparing, on a swapped basis, the cost of issuing bonds in foreign currency of a given maturity and nominal amount, with the cost of issuing in sterling.

17. Financing of the borrowed reserves in 2005-06 included sterling swapped into foreign currencies of £10.1bn (2004-05:£10.0bn) and outstanding foreign currency securities of £1.7bn (2004-05: £1.7bn) at the end of the year. No new foreign currency securities were issued during the year (2004-05: nil).

Management of the official reserves

18. 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 exchange reserves.

19. The size of the official reserves assets that are held in the EEA rose over the course of the year to £28.6bn (2004-05: £25.4bn). This rise consisted primarily of :

- an increase in the holdings of debt securities of £1.8bn, largely as a result of the reduction in the RTP (see paragraph 21);
- a rise in the value of gold holdings in sterling terms of £1.1bn;
- an increase in loans and advances to banks of £0.7bn.

20. This rise in the reserve assets in the EEA was financed by retained earnings taken to capital of £2.0bn, made up of the operating profit for the year of £1.1bn and the notional sterling capital charge of £0.9bn (see paragraph 34) that is credited to the Accumulated Income and Expenditure Reserve; and a rise in the specific liability of £1.1bn to the NLF.

21. In the NLF, the value of the RTP fell during the year to SDR1.2bn at 31 March 2006 (2004-05: SDR 3.4bn) equating to £1.0bn (2004-05: £2.8bn). This was the result of sterling repayments from IMF lending programmes more than offsetting new disbursements. Other things being equal, such a fall in the value of the RTP, an asset of the official reserves, would also lead to a fall in the overall holdings of official reserves. However, the Treasury's current policy is to neutralise the impact of changes in the level of the RTP on the level of the official reserves. So to offset the effect of the reduction in the RTP during the year, the EEA purchased foreign currency for sterling and increased the size of the reserves portfolios. This sterling was advanced by the NLF, leading to a rise in the liability to the NLF recognised on the EEA balance sheet.

22. The foreign currency elements of the total UK 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 £11.3bn. 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 foreign currency debt issuance) and excludes all items denominated in domestic currency (i.e. sterling). The most significant of these are the capital of the EEA, the liability of the EEA to the NLF and the valuation of the sterling leg of foreign currency forwards and cross-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 £27.5bn at end-March 2006) differs by £1.1bn from the official reserves assets held in the EEA. A reconciliation between the EEA's balance sheet and the Template is provided on page 13.

Benchmark asset allocation

23. 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.

[4] This can be viewed at: http://www.hm-treasury.gov.uk/media/658/79/reservespn_050406.pdf

24. In order to determine the benchmark asset allocation for the borrowed reserves of the EEA, the Bank employs an asset allocation model, the parameters of which are agreed by the Treasury, which explicitly trades off liquidity and return; the model determines an asset mix that maximises expected return for given levels of expected liquidation costs.

25. The Treasury also sets a benchmark for the currency allocation of the EEA's net 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 2005-06, this benchmark was 40% US dollars; 40% euro and 20% yen.

26. Each currency bloc within the net reserves has a benchmark for the assets within that bloc. The benchmark for assets denominated in US dollars comprised a combination of US Treasury and other US dollar denominated bonds. The benchmark for euro-denominated assets comprised a combination of euro-denominated sovereign and other eligible securities. For yen, the benchmark was derived from 1-month forward rates against the euro and the dollar. For gold lending, the benchmark portfolio comprised a weighted average of one, three and six month gold deposits.

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

28. 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

29. 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.

30. 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

31. The EEA's accounts for the year ended 31 March 2006 are given on pages 20 to 35 and show an operating profit for the year of £1.1bn (2004-05: deficit of £0.5bn). The operating profit was the result of a number of influences, notably the rise in the sterling value of gold of £1.1bn (2004-05: £45mn loss) over the year.

32. The net gain from foreign exchange rate movements was £0.6bn (2004-05: £0.1bn), primarily resulting from the appreciation of the US Dollar, and to a lesser extent, the euro, against sterling.

33. The total interest receivable from the EEA's portfolio of assets was £1.3bn (2004-05: £1.2bn). As in the previous year, this consisted primarily of interest received on debt securities (£0.6bn) and currency swaps (£0.5bn).

34. Interest payable of £1.5bn (2004-05: £1.4bn) exceeded the interest receivable in the year. The interest payable figure consisted primarily of the notional sterling capital charge for the EEA reserves of £0.9bn (2004-05: £0.8bn) and interest expense on currency swaps of £0.4bn (2004-05: £0.4bn), largely offsetting the interest income on these instruments. The notional sterling capital charge is applied to reflect an assumed cost of financing for the reserves held in the EEA. The interest rate is set at the five-year gilt swap rate. 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.

35. The deficit on net interest income of £0.2bn (2004-05: £0.2bn) reflects the fact that during the year sterling interest rates continued to be higher, on average, than dollar, euro and yen interest rates.

36. There was a dealing loss for the year of £0.3bn (2004-05: £0.4bn loss). The dealing loss represents the mark-to-market change in value of the assets and liabilities held arising from movements in market variables and the majority of this balance consists of returns on the benchmark positions in the net reserves. Dealing losses exclude interest receivable and payable, and so do not represent the entire return on positions. The main components of dealing losses were the returns on the foreign currency debt securities held and, where appropriate, the related hedging transactions. During the year, increases in US and Euro bond yields resulted in a loss of £0.4bn (2004-05: £0.4bn loss). Cross-currency and interest rate swap positions, which hedged the bonds held in the borrowed reserves, recorded a dealing profit of £0.2bn (2004-05: £0.1bn).

37. Taken together, bonds and related hedges incurred a loss of £0.2bn (2004-05: £0.3bn loss), reflecting the fact the bonds held in the net reserves are not hedged for interest rate or currency risk. The remaining elements of the dealing loss arose from spot and forward foreign exchange transactions.

38. The Treasury set a target for active management return as part of the annual SLA. This target is confidential as the limits and controls on the managers' ability to take risk within the portfolio are confidential for policy reasons. The return from the Bank's active management of the reserves against the benchmarks during the year was £20.1million.

39. The returns on assets held in the EEA represent the vast majority of returns on the overall official reserves. The main additional item for the official reserves is the impact of exchange rate movements between the SDRs, in which the RTP is denominated, and sterling. For the current year, this generated a small unrealised exchange rate gain.

Intervention

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

Provision of Foreign Currency Services to Government Departments

41. 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 £5.4bn (2004-05: £4.9bn). These purchases and sales, both spot and forward, were hedged through offsetting trades with the market.

Risk Management and Control

42. 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.

43. 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

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

- An annual Service Level Agreement (SLA) 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 Bank's performance in managing the reserves. Monthly meetings between the Treasury's Debt and Reserves Management Team and the Bank's Foreign Exchange and Risk Management Divisions supplemented this process.
- 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.
- 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, Market Services and Notes 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.

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

45. 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.

46. 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.

47. The arrangements for custody of EEA assets in 2005-06 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 NA. Euro denominated securities were 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 in the reserves were stored physically at the Bank's premises. The gold coin in the reserves was held partly at the Bank and partly at the premises of the Royal Mint.

48. 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.

49. 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.

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

Operational Guidelines

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

52. The Treasury's financing of the borrowed foreign currency reserves, whether through borrowing directly in foreign currency or by engaging in foreign currency swaps out of sterling (see paragraph 16), was done in a way that minimised the exposure to fluctuations in the value of currencies.

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

54. 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.

55. 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 matching the risk characteristics, for example the maturity, of the EEA's assets to those of 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.

56. The above arrangements produced a portfolio of assets that closely hedged the obligations to repay the NLF's foreign currency liabilities. The currency and interest rate risk in the net reserves was controlled through the selection of benchmarks. The Bank may incur currency risk by deviating from the benchmark in its operations, within the VaR limit mentioned below. 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.

57. 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.

58. Under the SLA, the Bank actively managed the borrowed and net 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 2005-06 the limit was US$40 million, and during the year the Bank's use of it did not exceed US$8.05 million. The average use of VaR during the year was US$5.75 million and the lowest VaR usage at the end of any one day was US$3.76 million.

Accounting Policies

59. The accounts of the EEA for the year are drawn up in accordance with the Accounts Direction, reproduced at Annex A (on page 36) to this report, which reflects UK GAAP and the Companies Act as far as appropriate. The EEA's accounts have been prepared under the early adoption rules for FRS26 and FRS29 which are part of the convergence programme between UK GAAP and IFRS. FRS26 and FRS29 represent the UK equivalent of International Accounting Standard 39 and International Financial Reporting Standard 7, respectively. The quantitative impact of adopting these new accounting standards for the EEA has not been significant, given that the EEA has previously recognised most of its assets at fair value in accordance with the Companies Act over-ride permitted by the British Banking Association Statement of Recommended Practice for banks' trading books. Under FRS26, the EEA's assets and liabilities are classified as "held for trading" and are therefore also measured at their fair values. More details are provided in the accounting policies note to the accounts.

Jon Cunliffe	HM Treasury
Accounting Officer	10 July 2006

Reconciliation of EEA Balance Sheet to IMF Reserves Template

As at 31 March 2006	Unaudited **£ millions**	Unaudited **$ millions**
Total assets per EEA balance sheet	**28,604**	
Add Reserve Tranche Position in NLF	1,021	
Adjustments to reflect IMF Reserves Template presentation:		
Deduct cash collateral and derivatives	(971)	
Reclassification between assets and liabilities	(1,053)	
Other adjustments	(66)	
Sterling total assets using Template presentation	**27,535**	
Dollar equivalent per Template		**47,759**
Total liabilities per EEA balance sheet	**28,604**	
Eliminate EEA's Liability to NLF (see note 12)	(22,198)	
Add NLF issued debt	1,715	
Adjustments to reflect IMF Reserves Template presentation:		
Add foreign currency liability on FX trades and swaps	9,825	
Deduct cash collateral and derivatives	(668)	
Reclassification between assets and liabilities	(1,053)	
Other adjustments	(11)	
Sterling total liabilities using Template presentation	**16,214**	
Dollar equivalent per Template		**28,123**
Net assets per Template	**11,321**	**19,636**

Conversion rate into US dollars is 1.7345 as at close 31 March 2006

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 Second Permanent Secretary of the Treasury as the Accounting Officer for the Account, with responsibility for preparing the accounts and for transmitting them to the Comptroller and Auditor General.

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

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

The responsibilities of an Accounting Officer, including responsibility for the propriety and regularity of the public finances for which an Accounting Officer is answerable, for keeping proper records and for safeguarding the Department's assets, are set out in the Accounting Officers' Memorandum issued by HM Treasury and published in "Government Accounting". The Accounting Officer's Statement on Internal Control can be found on page 15.

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 Government Accounting.

1.2 The management of the EEA is divided between the Reserves branch of the Debt and Reserves Management (DRM) team at 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. DRM has oversight of the Bank's EEA operations and reports directly to me on risk issues. An Annual Service Level Agreement (SLA) between the Treasury and the Bank 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.

2. The purpose of the system of internal control

2.1 The system of internal control is designed to manage risk to a reasonable level rather than to eliminate all risk of failure to achieve policies, aims and objectives; it can therefore only provide reasonable and not absolute assurance of effectiveness. The system of internal control is based on an ongoing process designed to identify and prioritise the risks to the achievement of the EEA's policies, aims, and objectives; to evaluate the likelihood of those risks being realised and the impact should they be realised; and to manage them efficiently, effectively and economically. The system of internal control in DRM together with the Bank has been in place throughout the year ended 31 March 2006 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 There is a risk management strategy, set via the SLA, and 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 report from the Bank to DRM described below.

3.3 At the Treasury, Internal Audit provides an independent and objective opinion to the Accounting Officer on risk management, control and governance of the EEA. Assurance is provided by a targeted programme of work, agreed by the Accounting Officer and the Treasury Audit Committee, to measure and evaluate the effectiveness of the Treasury in achieving their agreed objectives in respect of the EEA. Internal Audit also review DRM's quarterly report to the Accounting Officer (mentioned below) and facilitate risk management workshops to maintain and develop DRM staff's risk awareness. Specific DRM staff are trained in risk appraisal and management.

4. The risk and control framework

4.1 Within the Bank, 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 At the Treasury, DRM are responsible for monitoring the risk environment and performance of the Bank in managing the reserves and for providing the Accounting Officer with the assurance to sign off the Statement on Internal Control. To support this process, the Bank provides the following management information:

- Monthly financial reporting detailing, 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 and that this is evidence which can be relied upon in this Statement on Internal Control. In addition, DRM 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.
- DRM considers and discusses the information provided with the Bank and Treasury 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 to the Accounting Officer the Internal Audit quarterly reports on this activity.
- Bank and Treasury officials meet at monthly reserves meetings to review performance against the parameters set out in the SLA and to consider wider operational and policy issues. The Accounting Officer and the Bank's Executive Director for Markets met in May 2005 and November 2005 to discuss overall strategy and governance issues.

Some of the actions initiated during the year

4.3 The Bank and DRM aim continuously to identify possible areas for operational risk reduction and control improvements. Some of the actions initiated during the year were:

- A new EEA general ledger system was installed and has been receiving live data since December 2005. This new system will enable improved analysis of FX revaluation gains and losses; performance of 'closeout' (the split between realised and unrealised P&L on bond trades); and enhanced controls around the financial accounts including through increased automation.
- The Bank conducted a series of successful live tests of its operations at its contingency site.
- DRM enhanced their quarterly monitoring of the risk framework. DRM met with the Bank to ensure that there was a shared view on the necessary action needed following instances of control failure during the year.
- Bank accountancy professionals produced the financial accounts on behalf of the Treasury using Bank IT systems. DRM brought in additional accountancy resource to provide the Treasury with additional assurance around the reconciliation of management information and the financial accounts and to undertake a high level review of the financial accounts.

Planned action for 2006-07

4.4 The Bank and DRM will continue to review and develop the control environment. This will include implementing recommendations made by both Bank Internal Audit and Treasury Internal Audit. No major changes are envisaged. Work on the new EEA general ledger will continue, to allow reconciliation between monthly management information provided in dollars and the financial accounts provided in sterling. The Treasury will secure additional accountancy expertise to advise on preparation of the 2006-07 financial accounts.

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 Treasury Internal Audit and Bank Internal Audit, who both provided positive assurance as to the management and control of the EEA in 2005-06 and the executive managers within DRM 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 advised on the implications of the result of my review of the effectiveness of the system of internal control by DRM and Bank officials and a plan to address weaknesses and ensure continuous improvement of the system is in place.

5.2 The Treasury Audit Committee has considered the governance, internal control and risk management of the Exchange Equalisation Account since June 2004. The Treasury Audit Committee (with two non-executives including the Chairman) considered the 2005-06 accounts in draft and provided me with their views before I formally signed the accounts.

Jon Cunliffe	HM Treasury
Accounting Officer	10 July 2006

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 2006 under the Exchange Equalisation Account Act 1979 (as amended by the Finance Act 2000). 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 and the financial statements in accordance with the Exchange Equalisation Account Act 1979 (as amended by the Finance Act 2000) and HM Treasury directions made thereunder and for ensuring the regularity of financial transactions. These responsibilities are set out in the Statement of the 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 have been properly prepared in accordance with the Exchange Equalisation Account Act 1979 (as amended by the Finance Act 2000) and HM Treasury directions made thereunder. 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. I also report to you if, in my opinion, the Foreword is not consistent with the financial statements, 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 relevant authorities is not disclosed.

I review whether the statement on pages 15-17 reflects compliance with HM Treasury's guidance on the Statement on Internal Control, and I report if it does not. I am not required to consider whether the Accounting Officer's Statement on Internal Control covers all risks and controls, or form an opinion on the effectiveness of the Exchange Equalisation Account's corporate governance procedures or its risk and control procedures.

I read the other information contained in the Foreword and consider whether it is consistent with the audited financial statements. I consider the implications for my report if I become aware of any apparent misstatements or material inconsistencies with the financial statements. My responsibilities do not extend to any other information.

Basis of audit opinion

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 (as amended by the Finance Act 2000) and directions made thereunder by HM Treasury, of the state of the Exchange Equalisation Account's affairs as at 31 March 2006 and of its surplus for the year then ended; and

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

I have no observations to make on these financial statements.

John Bourn
Comptroller and Auditor General
National Audit Office
157-197 Buckingham Palace Road
Victoria
London
SWIW 9SP

12 July 2006

Income and Expenditure account

For the year ended 31 March:

	Notes	2006 £ millions	*2005* *£ millions*
Interest receivable and similar income arising from debt securities	2a	634	*647*
Other interest receivable and similar income	2b	645	*569*
Interest payable	3	(1,504)	*(1,414)*
Net interest expense		(225)	*(198)*
Fees and commissions		(1)	*1*
Dealing losses	4	(312)	*(374)*
Exchange gains/(losses) on revaluation of gold		1,092	*(45)*
Exchange gains on foreign currencies		605	*148*
Management charge	5	(9)	*(9)*
Profit /(deficit) on ordinary activities		**1,150**	***(477)***
Retained profit/(deficit) for the financial year	12	**1,150**	***(477)***

All income and expenditure arose from continuing operations.
No separate statement of recognised gains and losses has been prepared, as there are no recognised gains and losses other than those included above.
The notes on pages 23 to 35 form an integral part of these accounts.

Balance Sheet

As at 31 March:

	Notes	2006 £ millions	*2005* *£ millions*
Assets			
Cash and balances at central banks and Paymaster General	18	180	*306*
Holdings of IMF Special Drawing Rights		182	*177*
Settlement balances		239	*525*
Treasury bills	6	291	*-*
Loans and advances to banks	7	3,073	*2,395*
Debt securities	8	20,398	*18,613*
Gold and gold receivables	9	3,347	*2,279*
Other assets	10	624	*894*
Prepayments and accrued income		270	*236*
Total assets		**28,604**	***25,425***
Liabilities			
Settlement balances		286	*474*
Deposits by banks	11	3,641	*3,354*
SDR allocation	13	1,589	*1,535*
Other liabilities	14	863	*964*
Accruals and deferred income		27	*18*
Liability to the National Loan Fund	12	22,198	*19,080*
Total liabilities		**28,604**	***25,425***

The notes on pages 23 to 35 form an integral part of these accounts.

Jon Cunliffe — HM Treasury
Accounting Officer — 10 July 2006

Cash Flow Statement

For the year ended 31 March:

	Notes	2006 £ millions	*2005* *£ millions*
Net cash outflow from operating activities	17	(1,220)	*(100)*
Financing			
Net inflow from the National Loans Fund	12	1,095	*240*
Capital repayments	12	-	*(100)*
(Decrease)/increase in cash in the year	18	**(125)**	***40***

The notes on pages 23 to 35 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 appendix 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 have applied FRS26 (Financial Instruments: Measurement) and FRS29 (Financial Instruments: Disclosures) for the first time for the year ended 31 March 2006 under the early adoption rules for these standards. Comparative figures have not been restated, as permitted under the exemption for early adoption. The disclosures pertaining to Appendix E (capital disclosures) of FRS29, have not been adopted at this stage, as allowed for by the standard. The impact of applying FRS26 is not considered to have had a material impact on the position or performance of the account over the reporting period.

Recognition of financial assets and financial liabilities

The Exchange Equalisation Account is managed on a homogeneous basis, and although the reserves are not held primarily to make a profit, the Treasury seek to minimise the cost of holding the foreign currency reserves whilst avoiding exposing the public purse to unnecessary risk. 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 and liabilities are recognised at fair value. 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 separately on a straight line basis.

A notional sterling capital charge is included within interest payable. 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 Paymaster General, 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).

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 in the form of SDRs and is recognised in these accounts as interest receivable. Interest paid on SDRs is accounted for on an accruals basis.

Dealing profits

Dealing profits includes unrealised gains and losses resulting from changes in the fair value of the portfolio and realised gains and losses on disposal or maturity. Included within dealing profits are the gains and losses on foreign exchange trading, when denominated in the currencies of the transaction involved. Subsequent gains or losses on translation into sterling for reporting purposes are included within exchange gains and losses on foreign currencies.

Fees and commissions

Fees and commissions are recognised in the income and expenditure account as incurred.

Gains on revaluation of gold

Gold is recognised on the balance sheet at fair value. Changes in the fair value of gold are recognised in the income and expenditure account.

Exchange gains on foreign currencies

The accounts of the EEA have been compiled in sterling. Transactions denominated in foreign currencies are recorded in sterling at the rates of exchange ruling on the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are subsequently retranslated into sterling at the rates of exchange prevailing on the balance sheet date. Resulting exchange differences are recognised in the Income and Expenditure account within exchange gains on foreign currencies.

Debt securities

All debt securities are held for trading purposes and are reported at fair value. Changes in the fair value of debt securities are recognised in the Income and Expenditure account, within dealing profits, when they arise.

The majority of bonds are valued directly by reference to published price quotations from trade 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 to mid-market prices.

Treasury bills

Treasury bills are recognised at fair value. Treasury bills are valued directly by reference to quoted mid-market prices. Changes in the fair values of Treasury bills are recognised in the income and expenditure account within dealing profits, as they arise.

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 mid-market prices.

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 mid-market prices.

Repurchase and reverse repurchase agreements are initially recognised at cost and subsequently revalued to their fair values. 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.

Gold

Gold holdings and gold assets on deposits, although not falling within the FRS 26 definition of financial instruments, are held at fair value and changes in the market value of gold assets are recognised in the income and expenditure account when they arise. Changes in the fair values of gold lending transactions are recognised within dealing profits and changes to the balance sheet valuation of gold holdings are recognised in a separate line 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 dealing profits 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 mid-market prices.

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

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

	2006 £ millions	*2005 £ millions*
Bonds	593	*627*
Certificates of deposit	41	*20*
Total	**634**	***647***

2b. Other interest receivable and similar income

	2006 £ millions	*2005 £ millions*
Currency swaps	485	*474*
Money market deposits	49	*18*
Reverse repos	36	*25*
Reserve Tranche Position	34	*46*
Interest rate swaps	32	-
Special Drawing Rights	5	*3*
Securities lending	3	*3*
Gold deposits	1	-
Total	**645**	***569***

3 Interest payable

	2006 £ millions	*2005 £ millions*
Notional sterling capital charge	873	*829*
Currency swaps	420	*444*
Repos	85	*30*
Interest rate swaps	48	*56*
SDR allocation	44	*31*
Interest on short positions in bonds	22	*17*
Interest on cash collateral taken	12	*7*
Total	**1,504**	***1,414***

4 Dealing losses

	2006 £ millions	*2005* *£ millions*
Debt securities	(360)	*(395)*
Foreign exchange transactions	(101)	*(51)*
Futures	(2)	*(6)*
Other instruments	(2)	*6*
Interest rate swaps	6	*36*
Currency swaps	147	*36*
Total	**(312)**	***(374)***

All dealing losses relate to financial instruments that are held for trading purposes, in accordance with the FRS 26 definition.

5 Management charge

The management charge of £9.1 million represents the cost of the Bank of England's management of the EEA during the year (*2004-05: £8.5 million*).

6 Treasury and other eligible bills

	2006 £ millions	*2005* *£ millions*
Treasury bills and similar securities	291	-

7 Loans and advances to Banks

	2006 £ millions	*2005* *£ millions*
Repayable on demand	6	*5*
Repayable in not more than 3 months	3,067	*2,390*
Total	**3,073**	***2,395***
Of which, reverse repo transactions are:	1,989	*1,717*

Collateral is held in respect of reverse repo transactions. Cash collateral held is recognised within Other Liabilities (see note 14). 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

	2006			*2005*		
	Listed overseas	Unlisted	Total	*Listed overseas*	*Unlisted*	*Total*
Issued by Public Bodies:						
Government Securities	15,532	-	15,532	*13,778*	*-*	*13,778*
Other Public Sector	1,772	47	1,819	*2,212*	*125*	*2,337*
	17,304	47	17,351	*15,990*	*125*	*16,115*
Other Issuers:						
Bank and building society certificates of deposit	2,946	-	2,946	*2,420*	*-*	*2,420*
Other debt securities	101	-	101	*78*	*-*	*78*
	3,047	-	3,047	*2,498*	*-*	*2,498*
Total	20,351	47	**20,398**	*18,488*	*125*	***18,613***

	2006	*2005*
Amounts maturing:		
Within less than one year	4,898	*4,514*
In one year and over	15,500	*14,099*
Total	**20,398**	***18,613***

9 Gold and gold receivables

	2006	*2005*
	£ millions	*£ millions*
Gold stock	3,047	*1,925*
Gold deposits	300	*354*
Total	**3,347**	***2,279***

10 Other assets

	2006 £ millions	*2005* *£ millions*
Margin accounts	5	*1*
Balances arising from other financial instruments:		
- Currency swaps	408	*705*
- Interest rate swaps	89	*81*
- Foreign exchange transactions	122	*107*
Total	**624**	***894***

11 Deposits by Banks

All amounts in £ millions

Maturing in:	2006			*2005*		
	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	3,158	137	3,295	*2,638*	*355*	*2,993*
Cash collateral received	346	-	346	*361*	*-*	*361*
	3,504	137	**3,641**	*2,999*	*355*	***3,354***

There were no deposits by banks repayable on demand as at 31 March 2006 (*2004-05: 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 2006 was £3.2bn.

12 Liability to National Loans Fund

The balance sheet presentation of the Liability to the NLF has changed since the previous year. The liability to the NLF now represents two distinct elements that were previously shown separately.

The two elements are: a specific liability to the NLF, recognised in accordance with the National Loans Act (1968) of £2bn 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 financial liabilities. In previous years, the specific liability element was recognised under the heading "liability to the NLF" and the remaining element was referred to as "retained reserves".

The new presentation has been adopted in order to make the financing structure of the EEA clearer. 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 considered to be an amount ultimately due to the NLF, and are recognised as such on the balance sheet. If a policy decision 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 Paymaster General 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 I&E Reserve, except the notional sterling charge, which is charged to the Income & Expenditure Account and subsequently credited to the Accumulated Income & Expenditure Reserve, as shown in the table below.

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	Overall liability to the NLF
Balance at 1 April 2005	5,263	12,907	910	19,080
Transfers from the NLF			3,245	3,245
Repayments to the NLF[6]			(2,150)	(2,150)
Retained profit for the year	1,150			1,150
Notional sterling charge	873			873
Balance at 31 March 2006	**7,286**	**12,907**	**2,005**	**22,198**

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 2006 was £1.6bn *(2004-05 £1.5bn)*.

14 Other liabilities

	2006 £ millions	*2005 £ millions*
Short positions in securities	541	*484*
Balances arising from other financial instruments:		
- Currency swaps	81	*282*
- Interest rate swaps	100	*88*
- Foreign exchange transactions	138	*110*
- Futures	3	*0*
Total	**863**	***964***

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 2004-05).* The maturity analysis of short positions in securities is given below:

	2006 £ millions	*2005* *£ millions*
Amounts maturing:		
Within less than one year	57	-
In one year and over	484	*484*
Total	541	*484*

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 to the accounts (paragraphs 42 to 58). The Foreword also details management's objectives and policies for managing risks.

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

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 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

The benchmark asset allocation for the reserves is determined by the Treasury given the EEA's policy objectives. VaR is the primary market risk management tool employed in relation to the active management of the EEA against these benchmarks. A summary of the method of calculation of VaR is given in the Foreword in paragraph 48. Active management usage of VaR during the year, (calculated at the close of business each day in US Dollar as the primary risk currency), was as follows:

	$ millions 2006	*$ millions* *2005*
VaR usage as at 31 March	3.76	*6.13*
Maximum VaR usage during the year	8.05	*8.06*
Minimum VaR usage during the year	3.76	*2.47*
VaR limit during the year	40.0	*40.0*

Interest Rate Risk

Methods employed for hedging interest rate risk in the EEA are described in detail in the Foreword to the accounts (paragraph 55). 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. Indices used to set floating rates are typically current 3-month LIBOR rates.

Derivatives

The EEA uses derivatives to manage its exposure to interest rate and exchange risks. A description of the use of derivatives is given in the Management Commentary on pages 5 to 8. 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

	2006			*2005*		
	Notional Principal Amounts	Fair values Assets	Fair values Liabilities	*Notional Principal Amounts*	*Fair values Assets*	*Fair values Liabilities*
Exchange rate contracts:						
Spot and forwards	5,590	122	(138)	*15,587*	*107*	*(110)*
Currency Swaps	10,725	408	(81)	*10,960*	*705*	*(282)*
	16,315	530	(219)	*26,547*	*812*	*(392)*
Interest rate contracts:						
Interest rate swaps	1,761	89	(100)	*5,281*	*81*	*(87)*
Interest rate futures	4,120	1	(4)	*1,343*	*1*	*(1)*
	5,881	90	(104)	*6,624*	*82*	*(88)*
Total	**22,196**	**620**	**(323)**	***33,171***	***894***	***(480)***

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

				2006
	£ millions	£ millions	£ millions	£ millions
	Under 1 Year	1 to 5 Years	Over 5 Years	Total
Exchange rate contracts:				
- Notional Principal Amount	6,979	9,336	-	16,315
- Net replacement cost	144	167	-	311
Interest rate contracts:				
- Notional Principal Amount	3,306	2,355	220	5,881
- Net replacement cost	15	(34)	5	(14)

				2005
	£ millions	*£ millions*	*£ millions*	*£ millions*
	Under 1 Year	*1 to 5 Years*	*Over 5 Years*	*Total*
Exchange rate contracts:				
- Notional Principal Amount	*14,181*	*12,366*	-	*26,547*
- Net replacement cost	*213*	*208*	-	*421*
Interest rate contracts:				
- Notional Principal Amount	*2,053*	*4,131*	*440*	*6,624*
- Net replacement cost	*19*	*(27)*	*1*	*(7)*

During the financial year, the approach to collateralisation of derivatives was changed, such that where forward foreign exchange transactions were executed with a counterparty with whom cross currency and interest rate swaps were also executed, FX and swap positions were netted under the same ISDA Master Agreement and collateral called to mitigate the total net exposure. Previously only swap positions had been collateralised. At 31 March 2006 the exposure to financial institutions on such derivative positions documented under ISDA, after taking account of netting, was £358mn. Net of collateral held, the exposure was £104mn.

Credit risk

There are no significant concentrations of credit risk in the accounts; the vast majority of the EEA is invested in high quality sovereign bonds. The same applied to the prior year.

16 Related Party Transactions

There were no related party transactions, within the definition of FRS 8, during the year.

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

	2006 £ millions	*2005* *£ millions*
Operating surplus/(deficit)	1,150	*(477)*
Notional sterling capital charge	873	*829*
Net (increase)/decrease in prepayments and accrued income	(34)	*11*
Net increase in accruals and deferred income	9	*7*
Net (increase)/decrease in SDRs	(5)	*7*
Net decrease/(increase) in settlement balances	99	*(74)*
Net increase in treasury and other eligible bills	(291)	*-*
Net (increase)/decrease in loans and advances to banks	(678)	*1,275*
Net increase in debt securities	(1,785)	*(2,561)*
Net (increase)/decrease in gold and gold receivables	(1,068)	*55*
Net decrease in other assets	270	*143*
Net increase in deposits by banks	287	*812*
Net increase in SDR allocation	54	*6*
Net decrease in other liabilities	(101)	*(133)*
Net cash outflow from operating activities	**(1,220)**	***(100)***

18 Cash and similar balances

	1 April 2005 £ millions	Cash flow £ millions	31 March 2006 £ millions
Balance with Paymaster General	199	(136)	63
Balances at Central Banks	107	10	117
	306	(126)	180
Loans and advances to banks (Note 7) repayable on demand	5	1	6
Total	**311**	**(125)**	**186**

ANNEX A

ACCOUNTS DIRECTION GIVEN BY HM TREASURY UNDER THE EXCHANGE EQUALISATION ACCOUNT ACT 1979[7]

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. 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.

2. 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. Schedule 1 (Statement of Parliamentary Supply) and Schedule 5 (Statement of Operating Costs by Departmental Aim and Objectives), are also not relevant;

   b. The accounts shall follow the requirements of FRS 23 (IAS 21) *The Effects of Changes in Foreign Exchange Rates* (instead of SSAP 13, *Foreign Currency Translation*), FRS 25 (IAS 32) *Financial Instruments: Presentation*), FRS 26 (IAS 39) *Financial Instruments: Measurement*, and FRS 29 (IFRS 7) *Financial Instruments: Disclosures* (instead of FRS 13 *Derivatives and other 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.

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

4. This Accounts Direction supersedes that issued on 19 December 2001.

Ian Carruthers
Director, Government Reporting
HM Treasury

26 May 2006

[7] 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 Financial Reporting Manual, the following extra information shall be disclosed, including 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;
c) A Management Commentary:
    i) Taking into consideration the recommendations outlined in the Accounting Standards Board's Reporting Statement 1, *Operating and Financial Review*; and
    ii) Including appropriate information on financial performance and position reflecting the relationship between the Account and other relevant central funds reflected in the UK's official holdings of international reserves, and information on targets for the EEA set by HM Treasury and their achievement.

Notes to the accounts

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

a) Analyses of assets, between fixed and current assets;
b) Analyses of debtors and creditors, between those falling due within and after one year;
c) Where not separately disclosed on the face of the income and expenditure accounts, analyses of income and expenditure giving totals for the following:
    i) Interest receivable and similar income
    ii) Interest payable and similar charges, separately identifying any notional cost of capital charge
    iii) Other operating income, including income derived from the provision of services
    iv) 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 100^{th} of a percentage point, e.g. 0.5% is equal to 50bp.

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

Borrowed 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.

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

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

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

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

Delta measures the change in the value of a portfolio for each one basis point shift in the relevant yield curve.

Derivatives are a collective name for contracts whose value is derived from the prices of another (underlying) investment. The main derivatives are futures, options, and swaps.

Euro area is the area of 12 nations which have adopted the euro as a single currency.

Forward rate agreement - a contract obligating two parties to exchange the difference between two interest rates at some future date; one rate being fixed now and the other being a rate to be fixed in the future.

Forward transaction - an agreement to pay a specific amount at a specific time in the future for a currency or financial instrument.

Futures - a contract to buy or sell a specified asset at a fixed price at some future point in time.

Gold location swap - exchange of gold stored in one location for gold stored in another location with a commitment to reverse the exchange at some specified future date.

Gold quality swap - exchange of gold of one delivery standard (purity) for gold of another delivery standard with a commitment to reverse the exchange at some specified future date.

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

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

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

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

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

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.

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

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

Operational risk is the risk of financial loss arising from failures in the transaction, settlement and resource management processes associated with reserves and liability management. This broad definition includes risks such as fraud risk, settlement risk, IT risks, legal risk, accounting risk, personnel risk and reputational risk.

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

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

Special Drawing Rights (SDRs) – an international reserve asset created by the IMF in 1969 as a supplement to the then existing reserve assets. It is currently valued in terms of a weighted basket of four currencies (US dollar, sterling, yen and euro).

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

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

US dollar bloc - US and Canadian dollar holdings.

Value at Risk (VaR) measures the aggregate market risk on a portfolio. VaR is an estimate of the maximum potential loss in the value of a portfolio. For example, "99% of the time losses will not exceed $10 million over a two week period".

Yield curve plots the relationship between bonds' maturity and their yield.

Printed in the UK by The Stationery Office Limited
on behalf of the Controller of Her Majesty's Stationery Office

ID 5378894 07/06

Published by TSO (The Stationery Office) and available from:

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www.tso.co.uk/bookshop

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ISBN 0-10-293842-3

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