HM TREASURY

Exchange Equalisation Account:

Report and Accounts 2011-12

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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 and lending to the IMF under the New Arrangements to Borrow (NAB), these assets comprise the UK's official holdings of international reserves ("the official reserves"). The RTP and NAB loans are held in the National Loans Fund (NLF).

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 23). At 31 March 2012 there was no foreign currency debt outstanding (*2011: nil*).

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. 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 a report produced by HM Treasury entitled 'Management of the Official Reserves' available at www.hm-treasury.gov.uk/d/management_offical _reserves.pdf

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. The management charge in 2011-12 was £8m *(2011: £8m)*.

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 in 2011-12. 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 those 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, every month and at a quarterly meeting chaired by the Deputy Director responsible for the Debt and Reserves Management team. Every six months there is a meeting at which the EEA Accounting Officer (currently HM Treasury's Chief Economic Adviser) 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.

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

[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.

objective is to preserve the liquidity and security of the reserves and to ensure that the Government maintains its capability to intervene in the foreign exchange market if required. Subject to this, the aim is to minimise the overall cost of holding the reserves, while ensuring exposure to financial risk is limited through the appropriate choice of portfolio and risk management practices.

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 for the current financial year were the same as previous years. They specify 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 equivalent to at least AA-, (Aa3) by two or more of the rating agencies (Moody's, Standard and Poor's, and Fitch), or an equivalent internal measure for unrated entities;
- All assets must be rated investment grade by two or more of the rating agencies (Moody's, Standard and Poor's, and Fitch), or an equivalent internal measure for unrated entities.

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

(iii) In order to aim to at least cover costs, and to ensure the Bank maintains its capability to intervene in the foreign exchange market if required, the Bank will actively manage the EEA portfolio against the benchmark to meet the active management return target set by the Treasury (see paragraph 45 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).

15. At the beginning of the 2011-12 financial year there was a holding of £142m *(2011: £142m)*, which did not meet the KPI that all assets should be rated investment grade by two or

more of the rating agencies, or an internal equivalent measure for unrated entities. This asset has subsequently matured and was not held at year end. The KPI was met for the remainder of the financial year. All other KPIs were met.

16. The threshold for the liquidity and security of assets in the reserves is currently captured with reference to credit rating agency assessments. The Treasury would like to reduce its reliance on credit rating agencies and therefore going forward intends to use an alternative reference point. The intention is to restrict eligibility to high quality securities which are liquid in all but the most extreme circumstances. Similar characteristics apply to securities eligible to be accepted as collateral under the Bank's Open Market Operations (although that list is applied for a different purpose and has additional characteristics of an operational nature). Therefore, from next year the Treasury intends to define the liquidity and security of assets using the Bank's collateral eligibility framework. In practice this means the three bullet points under the first KPI above in paragraph 14 will be replaced by the following:

- A minimum of 75% of assets will be held in cash or invested in securities on the Bank of England's narrow OMO (Open Market Operations) collateral list, which comprises securities expected to remain liquid in all but the most extreme circumstances;
- All assets to be securities that normally trade in liquid markets. Assets must be eligible to be accepted as collateral under the Bank of England's wider OMO collateral list and be in the list of assets eligible for the EEA.

Investment Policy

17. 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.

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

- Conventional bonds, bills, discount notes and floating rate notes of any maturity and commercial paper issued by other national governments, supranational organisations and selected official sector agencies;
- Foreign currency spot, forward and swap transactions;
- Interest rate and currency swaps;
- Overnight indexed swaps;
- bond and interest rate futures, swap notes and swap futures;
- sale and repurchase, sell-back, and buy-sell back agreements;
- forward rate agreements;
- SDRs;
- Short-term bank deposits; and
- Deposits with the Bank.

Management Commentary

19. At Budget 2011, the Chancellor announced an additional £6 billion of sterling financing for the Official Reserves in 2011-12. The Government envisaged sterling financing being held at a similar level on average over the three years up to, and including, 2014-15. In accordance with this plan, £6bn of sterling financing was invested in the reserves in 2011-12. This sterling financing will be sufficient to meet potential calls on the official reserves from the International Monetary Fund and ensure the level of foreign currency reserves held is sufficient.

Hedged and unhedged reserves

20. The UK's official reserves, of which £54,945m *(2011: £48,954m)* are held in the EEA and £5,611m *(2011: £4,391m)* are held in the NLF, can be divided into two components: reserves that are hedged for currency and interest rate risk of £31,956m (*2011: £27,680m*) (the 'hedged reserves'), and the remaining reserves of £28,600m (*2011: £25,665m*) which are unhedged (the 'unhedged reserves'). The rise in the hedged reserves is due primarily to additional financing provided by the NLF. The rise in unhedged reserves is due primarily to an increase in the value of gold holdings and additional lending to the IMF.

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

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

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

24. Financing of the hedged reserves as at 31 March 2012 included sterling swapped into foreign currencies of £19,424m *(2011: £14,546m*) and the SDR allocation of £9,822m *(2011: £10,024m*). There were no outstanding foreign currency securities at the end of the year *(2011: nil*). No new foreign currency securities were issued during the year *(2011: nil*).

Management of the reserves

25. 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.

26. The foreign currency elements of the UK's total official reserves are published in the monthly IMF Reserves Template[4]. The Template shows the net foreign currency position in the official reserves, which at end-March was the equivalent of £28,600m. The assets and liabilities in the Template differ from those of the EEA Statement of Financial Position on page 24 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 treatment of unsettled items and short positions in debt securities, mean that gross reserve assets shown in the Template (the equivalent of £60,556m at 31 March 2012) differ by £604m from the assets held in the EEA. A reconciliation between the EEA's Statement of Financial Position and the Template is provided on page 13.

27. The size of the official reserves assets that are held in the EEA rose over the course of the year by £5,991m to £54,945m. This increase consisted primarily of rises in debt securities (£3,223m), value of gold (£1,422m) and reverse repurchase agreements (£1,607m), offset by a increase in unsettled trades (£266m).

28. The reserve liabilities held in the EEA rose over the course of the year by £4,276m to £31,956m. This increase consisted primarily of rises in the net derivative positions (£4,008m), and repurchase agreements (£681m), offset by a decrease in the sterling value of the SDR allocation (£202m) and unsettled trades (£211m).

29. In the EEA Statement of Financial Position shown on page 24, assets increased over the course of the year by £6,824m to £59,952m. This increase consisted primarily of rises in debt securities (£3,439m), value of gold (£1,420m), and reverse repurchase agreements (£1,608m).

30. A matching increase in EEA liabilities consisted primarily of rises in the liability to the NLF (£6,458m) and repurchase agreements (£681m), offset by a fall in derivative liabilities (£632m).

31. There has continued to be turbulence in European Sovereign debt markets during the year. This ongoing situation continues to be monitored closely, and its potential impacts on the liquidity and security of the portfolio assessed through stress tests. In this context, credit risk limits to both counterparties and issuers have been closely monitored and adjusted as necessary throughout the year.

Benchmark allocations

32. In accordance with the SLA, the Bank manages the 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.

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

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

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.

34. 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 2011-12, this benchmark was 40% US dollar, 40% euro and 20% yen. Automatic benchmark purchases were resumed during 2011-12.

35. 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 euro denominated sovereign securities. For yen, the benchmark was derived from 1-3 month forward rates against the euro and the dollar.

36. 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 very small and it does not have an explicit benchmark for this reason.

37. There is no benchmark for the RTP and bilateral lending 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

38. The primary means of financing the IMF is through members' quotas. Each member of the IMF is assigned a quota, based broadly on its relative position in the world economy, which is payable in a combination of SDRs and the member's own currency. The difference between a member's quota and the IMF's holdings of its currency is a member's RTP. As explained above, the UK's RTP is an asset of the NLF. The IMF remunerates most of the RTP at slightly below the level of the SDR interest rate, although a portion of the RTP is unremunerated.

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

40. 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

41. The EEA's accounts for the year ended 31 March 2012 are given on pages 23 to 46 and show total comprehensive income for the year of £2,033m (*2011: £1,764m*). This profit was largely driven by gains on gold holdings, and interest rate related gains on the unhedged portfolio of debt securities.

42. The price of gold rose from £898 to £1,040 an ounce, an increase of 16%, giving rise to a revaluation gain of £1,420m.

43. Net trading income for the year was £621m *(2011: £152m).* These gains arose primarily on the unhedged reserves, with gains on the holdings of the debt securities being partially offset by foreign exchange losses as the euro depreciated against sterling during the year.

44. On a financial instrument basis, fair value gains on debt securities (including short positions) (£368m) and currency swaps (£398m) were the largest contributor, although these were offset by losses on interest rate swaps (£280m). A full breakdown of net trading income by instrument is provided in Note 2.

45. The Treasury sets a target for active management return as part of the SLA, above the cost of managing the reserves. This target is set against the benchmarks for the portfolio (as detailed above), and takes account of the limits on active management set as part of the SLA. This target is confidential for policy reasons. The return from the Bank's active management of the reserves against the benchmarks during the year was £18m (*2011: £16m*).

46. The EEA continued to invest in high credit quality assets throughout the year, and has not crystallised any credit losses as a result of market turbulence.

Intervention

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

Provision of Foreign Currency Services to Government Departments

48. The EEA continued to provide foreign currency services to various government departments and agencies. Sales of foreign currency to departments with foreign currency obligations and purchases of foreign currency from departments with foreign currency receipts, in aggregate totalled £11,212m (*2011: £11,642m*). The decrease was due to a fall in forward transactions on behalf of the Ministry of Defence. These purchases and sales, both spot and forward, were hedged through offsetting trades with the market.

Risk Management and Control

49. Although the reserves are not held in order to make a profit, consistent with the KPIs (see paragraphs 11 to 16), the Treasury seeks to minimise the cost of holding the foreign currency reserves whilst avoiding exposing the public purse to unnecessary risk.

50. 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

51. 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].

[5] Available at www.hm-treasury.gov.uk/d/management_offical_reserves.pdf

- 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, credit, and liquidity 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 Treasury officials and Bank officials 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, which analyses financial risk and Markets Strategy and Risk Operations Division, which produces returns and risk information, are independent of the Foreign Exchange Division where trading activities were conducted. The Risk Management Division, Markets Strategy and Risk Operations 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, Risk Management, and Markets Strategy and Risk Operations Division 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 Bank's risk and control framework is detailed further in the Governance Statement.

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

52. 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. Any limit excesses are reported to the Treasury each month. In addition, there are limits to contain the overall exposure to each relevant country's banking sector.

53. The arrangements for custody of EEA assets in 2011-12 were as follows. US Treasury bonds and other US dollar denominated securities were held in custody at the Federal Reserve Bank of New York. Euro denominated securities were held in custody at Clearstream. Japanese bonds were held in custody at the Bank of Japan. The gold bars and gold coin in the reserves were stored physically at the Bank's premises.

54. 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 on active management positions primarily by using a Value at Risk (VaR) model, which estimates, 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. The Bank uses these data to generate two VaR measures: an unweighted VaR where an equal weight is assigned to historic market data, and an exponentially-weighted VaR which gives greater weight to more recent historic market data. The higher of these two numbers is then reported as VaR.

55. 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.

56. 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 2011-12 the VaR limit for active management was $20m. During the year the Bank's use of VaR did not exceed $4.01m. The average use of VaR during the year was $2.65m and the lowest VaR usage at the end of any one day was $1.84m.

57. Quantitative data in respect of the financial risks faced by the EEA is provided in note 19 to the accounts.

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

59. The Treasury's financing of the hedged foreign currency reserves, by engaging in foreign currency swaps out of sterling (see paragraph 22), was done in a way that minimised the exposure to fluctuations in the value of currencies.

60. Currency swaps were used to hedge exchange rate risk, 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. Similarly, interest rate risk was hedged through interest rate swaps. Typically, the EEA paid fixed rate interest on the currency it acquired 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.

61. The above arrangements produced a portfolio of assets that closely hedged the obligations to repay the NLF's foreign currency liabilities.

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

Audit

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

64. 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 10 July 2012

Reconciliation of EEA Statement of Financial Position to IMF Reserves Template

As at 31 March 2012	Unaudited **£ millions**	Unaudited **$ millions**
Total assets per EEA statement of financial position	**59,952**	
Adjustments to reflect IMF Reserves Template presentation:		
Eliminate sterling cash balance	(1,215)	
Reclassification between assets and liabilities	(3,799)	
Other adjustments[6]	7	
Reserve assets held in the EEA	54,945	
Reserve assets held in NLF	5,611	
Sterling total assets using Template presentation	**60,556**	
Dollar equivalent per Template		**96,787**
Total liabilities per EEA statement of financial position	**59,952**	
Eliminate EEA's Liability to the NLF (see note 15)	(43,615)	
Adjustments to reflect IMF Reserves Template presentation:		
Eliminate sterling leg of derivative trades	19,427	
Reclassification between assets and liabilities	(3,799)	
Other adjustments	(9)	
Sterling total liabilities using Template presentation	**31,956**	
Dollar equivalent per Template		**51,075**
Net assets per Template	**28,600**	**45,712**

Conversion rate into US dollars is 1.5983 as at close 31 March 2012

For a currency breakdown of the EEA's unhedged reserves please see Note 19.

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

Statement of the Accounting Officer's Responsibilities

Under the Exchange Equalisation Account Act 1979 (as amended by the Finance Act 2000), the Treasury is required to prepare for each financial year, 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 and cash flows for the financial year.

The Treasury has appointed its Chief Economic Adviser 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”.

Governance Statement

1. Governance Framework

1.1 The Exchange Equalisation Account (EEA) is managed within the Treasury's governance framework as set out in the Treasury's Annual Report and Accounts 2011-12. This includes the Treasury Board's assessment of its compliance with the 'Corporate Governance Code'.

1.2 The Chancellor of the Exchequer, as Minister in charge of the Treasury, is responsible and answerable to Parliament on all the policies, decisions and actions of the Treasury, and ultimately of the EEA.

1.3 As Accounting Officer for the EEA, I am personally responsible and accountable to Parliament for the organisation and quality of management of the EEA, including its use of public money and the stewardship of its assets, in line with those responsibilities assigned to me in 'Managing Public Money'.

(a) Management of the EEA

1.4 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.

(b) Internal Audit

1.5 As the Treasury's Agent, the Bank is responsible for internal audit of the EEA. 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.

1.6 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 the quarterly report, and EFA's oversight of the Bank's work, as agreed by the Accounting Officer and the Treasury Group Audit Committee. Exchequer Funds Internal Audit's reviews aim to measure and evaluate the effectiveness of the Treasury in achieving its agreed objectives in respect of the EEA.

(c) Audit Committee

1.7 The Treasury Audit Committee is a committee of the Treasury Board sub-committee, and is tasked with supporting the Principal Accounting Officer, and the Treasury's Additional and other Accounting Officers in their responsibilities for managing risk, internal control and governance related to the:

- Treasury Group's Annual Report and Accounts;
- Consolidated Fund;
- Contingencies Fund;
- National Loans Fund; and,
- Exchange Equalisation Account.

1.8 Members of the Committee are appointed by the Permanent Secretary for periods up to three years, extendable by no more than two additional three-year periods. The Chair of the Committee reports directly to the Permanent Secretary and is invited to report concerns or issues to the Treasury Board (sub-committee). The membership of the Audit Committee at the close of 2011-12 was:

- Michael O'Higgins (Chair) - Chairman of the Audit Commission; Chairman of the Pensions Regulator; Chairman, Investec Structured Products Calculus VCT plc;
- Mike Ashley[7] - Head of Quality and Risk Management, KPMG Europe LLP; Board Member, KPMG Europe LLP;
- Janet Baker – Crown Commercial Lead, Better Business Models, Cabinet Office; Board Member and Audit Committee Member, Audit Commission; Non Executive Director, Remuneration Committee Chair and Audit Committee Member, Defence Support Group, MoD; Non Board Member and Audit Committee Member, Rural Payments Agency; and
- Bradley Fried[8] - Managing Partner, Grovepoint Capital LLP, Non Executive Director of the Group Board, Investec plc; Non Executive Director and Audit Committee Chair, Investec Wealth and Investment Limited.

1.9 During 2011-12, two members, Zenna Atkins and Avinash Persaud, stepped down from the Audit Committee.

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

1.11 In addition to the independent members, the appropriate Accounting Officers, HM Treasury's Group Director of Finance, the Chief Executives of Debt Management Office and the Asset Protection Agency, and the Treasury Accountant also attend Committee meeting as required. Members have the opportunity for a pre-committee discussion with the National Audit Office, Group Head of Internal Audit for HM Treasury and Head of Internal Audit for the Exchequer Funds.

1.12 The Treasury Audit Committee met four times during 2011-12.

1.13 The external auditor is the Comptroller and Auditor General and the National Audit Office (NAO) attend all Audit Committee meetings on his behalf.

[7] During the year, Mike Ashley ceased to be the KPMG audit partner responsible for the Bank of England's audit. Up until this time, he did not receive Committee papers on the EEA and was required to withdraw from Committee meetings before EEA agenda items were discussed.

[8] After the year end Bradley Fried was appointed non-Executive Director of the Bank of England. He did not receive Committee papers on the EEA for the June 2012 Audit Committee meeting, and is now required to withdraw from Committee meetings before EEA agenda items are discussed.

1.14 The Treasury Audit Committee receives all the NAO audit reports relating to the EEA.

(d) Reporting to the Treasury's Boards

1.15 EFA feeds into the Treasury's quarterly internal Performance Reporting which is produced for the Ministerial Board and its sub-committee.

1.16 As mentioned previously, the Chair of the Audit Committee is invited to report concerns or issues to the Treasury's Board and its sub-committee.

2 Risk Management

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

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

2.3 At the Treasury, management ensures that specific DRM and EFA staff are trained in risk appraisal and management. Individuals' objectives reflect the need to manage risk. Job instructions are maintained for time and business-critical tasks.

2.4 During the year, there were no significant changes to the control environment.

3 The Risk and Control Framework

3.1 Within the Bank, the Risk Management Division is responsible for financial risk analysis and risk methodologies, whilst Markets Strategy and Risk Operations Division is responsible for: running, developing and stream-lining the operations and processes in Markets which underpin risk management; reconciling and producing the EEA financial and management accounts; and all Markets-wide crisis and contingency planning. Both divisions are independent from the Foreign Exchange Division where transactions are executed. The Risk Management, Markets Strategy and Risk Operations, and Foreign Exchange Divisions are independent from the Banking Services Directorate where the transactions are settled.

3.2 The Bank has an overarching Risk Management Framework in order to provide consistency and transparency in operational risk management processes across the organisation. This framework is supported by a central Risk Oversight Unit in the Finance Directorate and 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 the Strategic and Policy Risk Statement, the Operational Risk Policy and in a number of Risk Standards. The Standards are a high-level articulation of how key categories of risk are identified, assessed, controlled and monitored within the Bank. Those relevant to the management of the EEA include the 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 Policy and Risk Standards are “fit for purpose”, and reviews them on an annual basis prior to approval by the Governors. Each Bank Directorate reports its risk profile quarterly to BRC, as do Risk Standard Owners in respect of each Risk Standard. Mitigating actions in response to incidents and exceptions relating to the Bank’s risk profile, are also reported to the BRC.

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

- Monthly 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. Management accounts are reconciled to financial accounts.
- 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 producing this Governance Statement 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 the Foreign Exchange Division, the Risk Management division and, with specific responsibility for the co-ordination of the quarterly reporting framework, the Markets Strategy and Risk Operations 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.
- 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 liaises with the Bank and DRM to produce the annual accounts. The Treasury Accountant in EFA reviewed and approved the 2011-12 financial accounts and the Foreword to the accounts in draft before I formally approved them.

3.4 The risk and control framework is also described in paragraph 51 of the Foreword.

4 The system of internal control

4.1 As Accounting Officer, I am responsible 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’.

4.2 The system of internal control is designed to manage risk to an acceptable level, balancing the impact of potential risks with the resources to manage them, rather than to eliminate all risk. It can therefore only provide reasonable and not absolute assurance of effectiveness. The system of internal control is based on an ongoing process designed to identify and prioritise the risks to the achievement of the EEA's policies, aims, and objectives; to evaluate the likelihood of those risks being realised and the impact should they be realised; and to manage them efficiently, effectively and economically.

4.3 The system of internal control has been in place throughout the year ended 31 March 2012 and up to the date of approval of the annual report and accounts, and accords with Treasury guidance.

5 Risk profile

5.1 The key risks in managing the EEA and their associated controls are listed below. The EEA's exposures to credit risk and market risk are detailed in paragraphs 52 and 54 of the Foreword).

- **The reserves are not fit for purpose and do not meet current policy objectives or any potential future changes in policy:** An annual Service Level Agreement is agreed between the Treasury and the Bank, which sets out the parameters under which the reserves are managed. This sets out the guidelines for investing the reserves, including risk limits and the required management information to ensure that the reserves are available to use as required to meet policy objectives. Bank and HMT senior management meet quarterly to discuss, amongst other things, the appropriateness of the reserves for current policy objectives and future changes in policy.
- **Inadequate system functionality impedes delivery of EEA operations:** An IT Executive Committee reviews IT strategy and monitors the delivery and value of Bank-wide IT services. A quarterly IT Services Board - for senior management from Information Systems & Technology Division (ISTD) and business areas - meet to discuss services and performance measures. In addition, Service Level Agreements exist between ISTD and business areas - included in those are guidance on likely recovery times in the event of a system being unavailable. Those recovery times are currently under review. There is a process in place to investigate, report and review EEA incidents with appropriate action(s) taken where necessary to prevent similar incidents. Control improvements and responses to control failures are summarised in the quarterly Turnbull (Risk) report from the Bank to EFA described above.
- **Failure in processes to deliver the EEA SLA:** Detailed monitoring and reporting processes are in place with appropriate controls, including management sign-offs in certain instances. Established policy, procedure and control documentation around EEA operations is also in use and are reviewed on a regular basis. Where staff are dealing with specific risk matters, such as market risk or credit risk, appropriate training is made available. This helps minimise unintended risk exposures and/or potential financial loss.

6 Review of effectiveness

6.1 In line with HM Government guidance, set out within the Corporate Governance Code of Good Practice for central government departments, I have reviewed the effectiveness of the system of internal control. My review is informed by the work of Exchequer Funds Internal Audit and Bank Internal Audit, who both provided positive assurance as to the management and control of the EEA in 2011-12 and the executive managers within DRM, EFA and in the Bank, who have responsibility for the development and maintenance of the internal control framework, as well as comments made by external auditors in their management letter and other reports. I have been supported by the Treasury Audit Committee and risk owners in addressing weaknesses and ensuring continuous improvement of the system is in place. The Treasury Audit Committee considered the 2011-12 accounts in draft and provided me with its views before I formally signed the accounts.

6.2 No significant control issues, including data related incidents, have been identified in 2011-12, and no significant new risks have been identified in the year. No ministerial directions have been given in 2011-12.

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

David Ramsden HM Treasury
Accounting Officer 10 July 2012

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 2012 under the Exchange Equalisation Account Act 1979 (as amended by the Finance Act 2000). The financial statements comprise: the Statement of Comprehensive Income, the Statement of Financial Position, the Statement of Cash Flows and the related notes. These financial statements have been prepared under the accounting policies set out within them.

Respective responsibilities of HM Treasury, Accounting Officer and auditor

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

Scope of the audit of the financial statements

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

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

Opinion on regularity

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

Opinion on financial statements

In my opinion:

- the financial statements give a true and fair view of the state of the Exchange Equalisation Account's affairs as at 31 March 2012 and of the total comprehensive income for the year then ended; and

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

Opinion on other matters

In my opinion the information given in the Foreword for the financial year for which the financial statements are prepared is consistent with the financial statements.

Matters on which I report by exception

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

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

Report

I have no observations to make on these financial statements.

Amyas C E Morse
Comptroller and Auditor General

12 July 2012

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

Statement of Comprehensive Income

For the year ended 31 March 2012:

	Note	2012 £ millions	*2011* *£ millions* *Restated*
Net trading income	2	621	*152*
Fair value changes in gold		1,420	*1,620*
Management charge	3	(8)	*(8)*
Total comprehensive income for the year	15	**2,033**	***1,764***

Statement of Financial Position

	Note	31 March 2012 £ millions	*31 March 2011 £ millions*
Assets			
Cash at central banks	17	1,496	*1,512*
Items in the course of collection from banks		884	*672*
Treasury bills	4	593	*488*
Debt securities	5	32,601	*29,162*
Derivative financial assets	6	923	*782*
Reverse repurchase agreements	7	3,710	*2,102*
Holdings of IMF Special Drawing Rights	14	9,266	*9,202*
Gold	8	10,374	*8,954*
Other financial assets	9	105	*254*
Total assets		**59,952**	***53,128***
Liabilities			
Deposits by banks	10	–	*57*
Items in the course of transmission to banks		864	*597*
Debt securities - short positions	11	1,212	*889*
Derivative financial liabilities	12	533	*1,165*
Repurchase agreements	13	3,904	*3,223*
Other financial liabilities		2	*16*
SDR allocation	14	9,822	*10,024*
Liability to the National Loans Fund	15	43,615	*37,157*
Total liabilities		**59,952**	***53,128***

The notes on pages 26 to 46 form an integral part of these accounts.

David Ramsden
Accounting Officer

HM Treasury
10 July 2012

Statement of Cash Flows

For the year ended 31 March 2012:

	Note	2012 £ millions	*2011* *£ millions*
Net cash outflow from operating activities	16	**(4,783)**	***(3,502)***
Net cash flows from financing activities:			
Cash inflow from National Loans Fund	15	5,375	*6,550*
Cash outflow to National Loans Fund	15	(950)	*(1,350)*
Net cash inflow from financing activities		**4,425**	***5,200***
Net increase / (decrease) in cash and cash equivalents during the year	17	**(358)**	***1,698***
Cash and cash equivalents at the beginning of the year	17	2,257	*559*
Cash and cash equivalents at the end of the year	17	**1,899**	***2,257***

Notes to the Accounts

1 Accounting policies

Basis of preparation

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

These accounts are prepared under the historical cost convention on a trade date basis and all assets and liabilities are recognised on their trade dates. The Exchange Equalisation Account is stated in millions of pounds sterling (£m).

At 31 March 2012, a number of standards and interpretations and amendments thereto, had been issued by the IASB which are not yet effective for the EEA's financial statements. Those which are expected to have an effect on the EEA are discussed below.

IFRS 9 'Financial Instruments', which was issued in November 2009, introduced new requirements for the classification and measurement of financial assets. In October 2010, the IASB issued additions to IFRS 9 relating to financial liabilities. Together, these changes represent the first phase in the IASB's planned replacement of IAS 39 'Financial Instruments: Recognition and Measurement'. The standard is effective for annual periods beginning on or after 1 January 2015 with early adoption permitted. IFRS 9 is subject to EU endorsement, the timing of which is uncertain. Accordingly, the EEA is unable to provide a date by which it intends to apply IFRS 9.

IFRS 9 is still subject to change and, as a result, the impact of the standard upon the financial statements of the EEA cannot be quantified.

IFRS 13 'Fair Value Measurement' was issued in May 2011, and sets out a single IFRS framework for all fair value measurements required or permitted by IFRS. It is effective for annual periods beginning on or after 1 January 2013. The effect of IFRS 13 on the EEA's financial reporting is under review.

Change in accounting policy

The Statement of Comprehensive Income has been restated to combine interest receivable and similar income, interest payable and fair value changes in financial instruments into one line called 'net trading income'. It is considered that this presentation is more in line with the reporting requirements of IFRS 7 'Financial Instruments: Disclosures'. This is a presentational change only and there is no impact on the overall results of the EEA.

Recognition of financial assets and financial liabilities

The EEA is managed on a homogeneous basis and, although the reserves are not held primarily to make a profit, the Treasury seeks to minimise the cost of holding the foreign currency reserves 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 IAS 39, and therefore all financial assets and liabilities are held at fair value with gains and losses being taken through the Statement of Comprehensive Income. There have been no reclassifications of financial instruments during the year. Financial assets are derecognised when the rights to receive cash flows from them have expired or where the EEA has transferred substantially all the risks and rewards of ownership. Financial liabilities are derecognised when they are extinguished, that is, when the obligation is discharged, cancelled or expires.

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

Net trading income

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

Special Drawing Rights (SDR) remuneration

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

Foreign currency translation

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

Fees and commissions

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

Cash and cash equivalents

For the purpose of the Statement of Cash Flows, cash comprises balances at central banks. Cash equivalents comprise highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of change in value. Such investments normally have maturities of less than three months from the date of acquisition and include settlement balances, treasury bills, and loans and advances to banks. Repos and reverse repos are excluded from cash and cash equivalents.

Items in course of collection from or transmission to other banks

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

Debt securities (including short positions)

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

The majority of bonds are valued directly by reference to published price quotations at 31 March 2012. 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 Statement of Comprehensive Income, within net trading income, when they arise.

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

Loans and advances to banks

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

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

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

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

Gold

Gold is treated as being similar to a financial asset and, as such, is reported at fair value. Gold holdings on deposit are valued at the sterling equivalent of the London Bullion Market Association (LBMA) dollar denominated spot bid price as at 31 March 2012. Revaluation gains and losses on gold assets are recognised within fair value changes of gold in the Statement of Comprehensive Income.

International Monetary Fund Special Drawing Rights (SDRs)

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

Derivative transactions

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

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

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

Collateral and Netting

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

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

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

Critical accounting judgements and key sources of estimation uncertainty

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

Management believes that the EEA's critical accounting policies where judgement is necessarily applied are those relating to the valuation of financial instruments where there is no readily available market price, and the valuation of gold. Further information about how financial instruments are valued in such circumstances is provided in the 'Debt securities' and 'Derivative transactions' accounting policies above. At 31 March 2012 there were no valuations which are not supported by observable market prices or rates (*2011: £nil*). Gold and gold assets are treated as being similar to a financial asset and are reported at fair value as described in the 'Gold' accounting policy. The valuation of gold at 31 March 2012 was £10,374m (*2011: £8,954m*).

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

2 Net trading income

	2012 £ millions	*2011* *£ millions* *Restated*
Treasury bills	(6)	*(39)*
Debt securities	412	*(230)*
Debt securities – short positions	(44)	*(12)*
Currency swaps	398	*60*
Interest rate swaps	(280)	*41*
Foreign exchange transactions	152	*223*
Futures	(1)	*(8)*
Loans and deposits	(1)	*7*
Reverse repurchase agreements	(132)	*80*
Repurchase agreements	101	*12*
Reserve Tranche Position	13	*8*
Special Drawing Rights	9	*10*
Total	**621**	***152***

3 Management charge

The management charge of £8m represents the cost of the Bank of England's management of the EEA during the year (*2011: £8m*).

4 Treasury bills

	2012 £ millions	*2011* *£ millions*
Maturing in not more than 3 months	281	*435*
Maturing in 1 year or less but over 3 months	312	*53*
Total	**593**	***488***

5 Debt securities

	2012	*2011*
	£ millions	*£ millions*
Issued by Public Bodies		
Government Securities	31,272	*27,514*
Other Public Sector – Listed	1,329	*1,648*
Total	**32,601**	***29,162***

	2012	*2011*
Amounts Maturing:	£ millions	*£ millions*
Current	4,181	*4,617*
Non-current	28,420	*24,545*
Total	**32,601**	***29,162***

6 Derivative financial assets

	2012	*2011*
	£ millions	*£ millions*
Currency swaps	604	*263*
Interest rate swaps	52	*83*
Foreign exchange transactions	267	*436*
Total	**923**	***782***

An analysis of derivative financial assets together with their collateral backing is provided in note 19.

7 Reverse repurchase agreements

	2012	*2011*
	£ millions	*£ millions*
Amounts maturing:		
Current	3,710	*2,102*
Total	**3,710**	***2,102***

An analysis of reverse repos together with their collateral backing is provided in note 19.

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 11.

8 Gold

	2012 £ millions	*2011* *£ millions*
Gold Stock	10,374	*8,954*
Total	**10,374**	***8,954***

There were no gold loan/deposit or swap trades undertaken during the year *(2011: nil)*.

9 Other financial assets

	2012 £ millions	*2011* *£ millions*
Loans and advances to banks	102	*235*
Prepayments and accrued income	3	*19*
Total	**105**	***254***

10 Deposits by banks

	2012 £ millions	*2011* *£ million*
Amounts maturing:		
Current	–	*57*
Total	**–**	***57***

There were no deposits by banks repayable on demand as at 31 March 2012 (*2011: nil).*

11 Debt securities - short positions

	2012 £ millions	*2011* *£ millions*
Debt securities – short positions	1,212	*889*
Total	**1,212**	***889***

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

12 Derivative financial liabilities

	2012 £ millions	*2011* *£ millions*
Currency swaps	55	*636*
Interest rate swaps	142	*22*
Foreign exchange transactions	336	*507*
Total	**533**	***1,165***

An analysis of derivative financial liabilities together with the collateral pledged is provided in note 19.

13 Repurchase transactions

	2012 £ millions	*2011* *£ millions*
Amounts maturing:		
Current	3,904	*3,223*
Total	**3,904**	***3,223***

An analysis of repos together with the collateral pledged is provided in note 19.

14 SDR allocation and SDR Holdings

The EEA has a liability to the IMF for those SDRs that have been allocated since the UK became a participant in the Special Drawing Rights Agreement. If the UK withdraws from participation or the Agreement is wound up, payment to the IMF would be required at current exchange rates. The SDR liability as at 31 March 2012 was £9,822m *(2011: £10,024m)*.

The SDR holdings of the EEA as at 31 March 2012 was £9,266m (*2011: £9,202m*). These holdings result from SDR allocations made by the IMF, any subsequent purchases and sales of SDRs from or to other IMF members and fair value changes. During 2011-12, the EEA bought £238m worth of SDRs (*2010-11: £149m*).

Further detail on the SDRs is provided in the Foreword.

15 Liability to the National Loans Fund

The net assets of the EEA represent a liability to the NLF. There are two elements of the Liability to the NLF: a specific liability, recognised in accordance with the National Loans Act 1968 of £13,585m (*2011: £9,160m*) 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, if the NLF were to issue foreign currency securities in order to raise foreign currency finance that would subsequently be transferred to the EEA. As a result, the EEA's net assets, having been derived from initial NLF financing, are ultimately due to the NLF, and are recognised as such on the Statement of Financial Position. If a policy decision is taken to reduce the assets of the EEA, the sterling excess raised via sale of foreign currency assets would be paid to the NLF, at the direction of the Treasury.

Specific liability to the NLF

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

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

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

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

Capital contribution reserve

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

Accumulated comprehensive income reserve

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

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

All amounts in £ millions	Accumulated comprehensive income reserve	Capital contribution reserve	Specific liability to the NLF	2012 Overall liability to the NLF
Balance at 1 April 2011	18,760	9,237	9,160	37,157
Transfers from the NLF	–	–	5,375	5,375
Repayments to the NLF	–	–	(950)	(950)
Total comprehensive income	2,033	–	–	2,033
Balance at 31 March 2012	**20,793**	**9,237**	**13,585**	**43,615**

All amounts in £ millions	*Accumulated comprehensive income reserve*	*Capital contribution reserve*	*Specific liability to the NLF*	*2011 Overall liability to the NLF*
Balance at 1 April 2010	*16,996*	*9,237*	*3,960*	*30,193*
Transfers from the NLF	–	–	*6,550*	*6,550*
Repayments to the NLF	–	–	*(1,350)*	*(1,350)*
Total comprehensive income	*1,764*	–	–	*1,764*
Balance at 31 March 2011	***18,760***	***9,237***	***9,160***	***37,157***

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

	2012 £ millions	*2011 £ millions*
Total comprehensive income for the year	2,033	*1,764*
Net (increase) in treasury bills	(259)	*(53)*
Net (increase) in debt securities	(3,439)	*(5,277)*
Net (increase)/decrease in derivative financial assets	(141)	*81*
Net (increase) in holding of SDRs	(64)	*(44)*
Net (increase) in gold and gold receivables	(1,420)	*(1,620)*
Net (increase)/decrease in reverse repurchase agreements	(1,608)	*1,899*
Net decrease/(increase) in other assets	16	*(13)*
Net (decrease) in SDR allocation	(202)	*(120)*
Net increase in debt securities - short positions	323	*257*
Net (decrease)/increase on deposits by banks	(57)	*21*
Net (decrease) in derivative financial liabilities	(632)	*(725)*
Net increase in repurchase agreements	681	*316*
Net (decrease)/increase in other financial liabilities	(14)	*12*
Net cash (outflow) from operating activities	**(4,783)**	***(3,502)***

17 Cash and cash equivalents

	1 April 2011 £ millions	Cash flow £ millions	31 March 2012 £ millions
Balances at Central Banks	1,512	(16)	1,496
Amounts with original maturity less than 3 months:			
Items in the course of collection from banks	672	212	884
Treasury bills	435	(154)	281
Other financial assets	235	(133)	102
Items in the course of transmission to banks	(597)	(267)	(864)
	745	(342)	403
Total	**2,257**	**(358)**	**1,899**

	1 April 2010 £ millions	*Cash flow £ millions*	*31 March 2011 £ millions*
Balance at the Government Banking Service	*250*	*(250)*	*–*
Balances at Central Banks	*303*	*1,209*	*1,512*
	553	*959*	*1,512*
Amounts with original maturity less than 3 months:			
Items in the course of collection from banks	*783*	*(111)*	*672*
Treasury bills	*132*	*303*	*435*
Other financial assets	*99*	*136*	*235*
Items in the course of transmission to banks	*(1,008)*	*411*	*(597)*
	6	*739*	*745*
Total	***559***	***1,698***	***2,257***

18 Related Party Transactions

The Royal Bank of Scotland Group plc is regarded as a related party of the EEA. On 1 December 2008, the UK Government, through HM Treasury[7], became the ultimate controlling party of The Royal Bank of Scotland Group plc. 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 2012 the net exposures with The Royal Bank of Scotland Group plc were:

	2012 £ millions	*2011* *£ millions*
Derivative assets	–	*2*
Derivative liabilities	–	*(58)*
Reverse Repos	172	*60*
Repos	(48)	*(91)*

The UK Government, through HM Treasury[9], owns 41% of the ordinary share capital of the Lloyds Banking Group. As a result, the Lloyds Banking Group is 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 2012 *(31 March 2011: nil).*

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

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

19 Risk management and control

A detailed review of the financial risks to which the EEA is exposed, how these risks arise and how they are managed is given in the Foreword (paragraphs 52 to 56). The Foreword also details management's objectives and policies for managing risks (paragraphs 11 to 16).

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 Master Legal Agreements with counterparties. Swaps and foreign exchange transactions are governed by the ISDA Master Agreement. Repo and reverse repo transactions are governed by bespoke documentation.

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 (paragraphs 54 to 56).

All benchmarks for the reserves are determined by the Treasury, and are in line with the EEA's policy objectives. Market risk is taken into account when determining the benchmark (see Benchmark allocations section in the Foreword (paragraphs 32 to 37)).

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 54 and 55. Active management usage of VaR during the year, (calculated at the close of business each day in US dollars), was as follows:

[9] Details of HM Treasury's holdings can be found on its website at www.hm-treasury.gov.uk.

	$ millions 2012	*$ millions 2011*
VaR usage as at 31 March	3.16	*1.75*
Average usage during the year	2.65	*2.50*
Maximum VaR usage during the year	4.01	*5.17*
Minimum VaR usage during the year	1.84	*1.16*
VaR limit during the year	20.00	*20.00*

The minimum VaR usage is the higher of unweighted and exponentially weighted, which for 2011-12 was unweighted (*2010-11: unweighted*).

Interest rate risk

Methods employed for hedging interest rate risk in the benchmarks are described in detail in the Foreword (paragraph 60). 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 (paragraph 20), 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 (paragraphs 32 to 37).

An analysis of EEA unhedged reserves by currency is provided in the tables below:

	2012 £ millions	*2011 £ millions*
US Dollar	5,274	*5,346*
Euro	5,262	*5,338*
Yen	2,629	*2,454*
Other Currencies	4	*4*
	13,169	*13,142*
SDR net position	(556)	*(822)*
Gold	10,376	*8,954*
EEA Unhedged Reserves	**22,989**	***21,274***

Credit risk

The reserves are exposed to credit risk through exposures to trading 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, are provided in the Foreword (paragraphs 52 and 53).

The EEA continued to invest in high credit quality assets throughout the year. Foreign currency assets held in the EEA inevitably carry some element of credit risk. In order to keep this risk at a low level, the funds of the EEA are predominantly invested in securities issued, or guaranteed by the national governments of the United States, euro-zone countries and Japan. The majority of the EEA funds are invested in high quality sovereign or supranational bonds.

Regular credit assessments are performed on all market counterparties and issuers to which the EEA may be exposed. These are performed both regularly, following a timetable that reflects the risk of the actual or potential exposure, and dynamically, in response to market or specific entity conditions.

The EEA’s Credit Ratings Advisory Committee (CRAC), chaired by the Head of the Bank of England’s Risk Management Division, reviews regularly the creditworthiness of issuers, counterparties and customers to whom the EEA may have credit exposures. CRAC makes recommendations to the Executive Director for Markets, who is responsible for decisions on internal credit ratings. CRAC is supported by a credit risk analysis team.

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 repo and foreign exchange transactions with counterparties. Any limit excesses are reported to the Treasury each month.

The amount that best represents the EEA’s maximum exposure to credit risk at the end of the reporting period without taking account of any collateral held or other credit enhancements is the carrying value of the EEA’s assets.

Concentration of Exposure

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

Concentration of EEA assets by geographical region

	2012	*2011*
	£ millions	*£ millions*
United Kingdom	4,229	*2,197*
North America	14,981	*13,520*
Europe	18,370	*16,141*
Asia-Pacific	2,732	*3,114*
	40,312	*34,972*
IMF SDRs	9,266	*9,202*
Gold	10,374	*8,954*
Total Assets	**59,952**	***53,128***

Concentration of EEA assets by credit rating

	2012	*2011*
	£ millions	*£ millions*
AAA	31,368	*26,642*
AA	4,489	*7,436*
A	4,455	*752*
BB	–	*142*
	40,312	*34,972*
IMF SDRs	9,266	*9,202*
Gold	10,374	*8,954*
Total Assets	**59,952**	***53,128***

The above table reflects an average rating from the three rating agencies, set out in paragraph 14 of the Foreword. None of the EEA's financial assets are past due or impaired.

At 31 March 2012, credit exposures to issuers of Treasury bills and debt securities (less debt securities – short positions) stood at £31,982m *(2011: £28,762m).*

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 netting arrangements under master agreements with counterparties that allow the EEA to net transactions under the master agreement in the event of a counterparty default. These agreements incorporate terms for provision of collateral, 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 foreign exchange transactions transacted under ISDA Master Agreements, collateral can take the form of US dollar denominated cash or high quality securities.

An analysis of repos and reverse repos, together with their collateral backing is set out in the table below.

		2012		*2011*
	Market Value £ millions	Fair value of securities collateral £ millions	*Market Value £ millions*	*Fair value of securities collateral £ millions*
Reverse Repos	3,710	3,798	*2,102*	*2,159*
Repos	(3,904)	(3,830)	*(3,223)*	*(3,192)*
	(194)	32	*(1,121)*	*1,033*
Additional collateral held		35		*15*
Collateral Surplus		197		*103*
Collateral Deficit		–		*–*

An analysis of derivatives, together with their collateral backing is set out in the table below.

		2012		*2011*
	Market Value £ millions	Fair value of securities collateral £ millions	*Market Value £ millions*	*Fair value of securities collateral £ millions*
Assets	923	369	*782*	*72*
Liabilities	(533)	–	*(1,165)*	*–*
	390	369	*(383)*	*72*
Collateral Surplus		224		*75*
Collateral Deficit		203		*530*

Collateral surpluses and shortfalls in the above tables have been calculated at the level of individual counterparties.

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

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

Undiscounted contractual cash flows of financial liabilities

The table below presents the cash flows payable by the EEA arising from 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 Statement of Financial Position at their carrying values, as detailed in note 1 – Accounting policies.
The maturity analysis for derivative financial liabilities includes both known cash inflows and cash outflows predicted by current forward rates for the floating leg of currency and interest rate swaps.

As at 31 March 2012: All amounts in £ millions	**Up to 1 month**	**1 to 3 months**	**3 to 12 months**	**1 to 5 years**	**More than 5 years**	**Undated**	**Total**
Items in the course of transmission to banks	(864)	–	–	–	–	–	(864)
Debt securities – short positions	(1,212)	–	–	–	–	–	(1,212)
Derivative financial liabilities – inflows	1,749	3,405	3,747	7,358	506	–	16,765
Derivative financial liabilities – outflows	(1,846)	(3,489)	(3,963)	(7,489)	(455)	–	(17,242)
Repurchase agreements	(3,475)	(429)	–	–	–	–	(3,904)
Other financial liabilities	(2)	–	–	–	–	–	(2)
SDR Allocation	–	–	–	–	–	(9,822)	(9,822)
Liability to the NLF	–	–	–	–	–	(43,615)	(43,615)
Total	**(5,650)**	**(513)**	**(216)**	**(131)**	**51**	**(53,437)**	**(59,896)**

As at 31 March 2011: All amounts in £ millions	Up to 1 month	1 to 3 months	3 to 12 months	1 to 5 years	More than 5 years	Undated	Total
Deposits by banks	*(57)*	–	–	–	–	–	*(57)*
Items in the course of transmission to banks	*(597)*	–	–	–	–	–	*(597)*
Debt securities – short positions	*(889)*	–	–	–	–	–	*(889)*
Derivative financial liabilities – inflows	*2,333*	*3,527*	*5,777*	*9,514*	*2*	–	*21,153*
Derivative financial liabilities – outflows	*(2,406)*	*(3,691)*	*(6,438)*	*(10,000)*	*(2)*	–	*(22,537)*
Repurchase agreements	*(2,615)*	*(584)*	*(24)*	–	–	–	*(3,223)*
Other financial liabilities	*(16)*	–	–	–	–	–	*(16)*
SDR Allocation	–	–	–	–	–	*(10,024)*	*(10,024)*
Liability to the NLF	–	–	–	–	–	*(37,157)*	*(37,157)*
Total	***(4,247)***	***(748)***	***(685)***	***(486)***	**–**	***(47,181)***	***(53,347)***

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 (paragraph 60). All derivative instruments are held at their fair values. Fair values are determined by reference to market rates prevailing on the date of valuation or by discounting future cash flows. The notional principal amounts of these instruments indicate the volume of transactions outstanding as at 31 March 2012 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

	2012			*2011*		
	Notional Principal Amounts	Fair values Assets	Fair values Liabilities	*Notional Principal Amounts*	*Fair values Assets*	*Fair values Liabilities*
Exchange rate contracts:						
Spot and forwards	22,708	267	(336)	*23,374*	*436*	*(507)*
Currency swaps	18,601	604	(55)	*14,783*	*263*	*(636)*
	41,309	871	(391)	*38,157*	*699*	*(1,143)*
Interest rate contracts:						
Interest rate swaps	14,200	52	(142)	*5,757*	*83*	*(22)*
Interest rate futures	1,892	–	–	*2,552*	–	–
	16,092	52	(142)	*8,309*	*83*	*(22)*
Total	**57,401**	**923**	**(533)**	***46,466***	***782***	***(1,165)***

20 Fair Value Valuation Basis

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

During the financial year no financial instruments were measured at fair value with significant unobservable inputs (*2011: nil*). There were no significant transfers between Level 1 and Level 2 of the fair value hierarchy.

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

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

Level 2 – valuation technique using observable inputs: financial instruments with quoted prices for similar instruments or quoted prices for identical or similar instruments in inactive markets and financial instruments valued using models where all significant inputs are observable. All inputs into pricing models are externally sourced and assumptions used are supported by observable market prices. No pricing used model pricing this year (*2011: Nil*).

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

As at 31 March 2012	Quoted market price	Using observable inputs	With significant unobservable inputs	Total
	Level 1	Level 2	Level 3	
Assets	£ millions	£ millions	£ millions	£ millions
Treasury bills	–	593	–	593
Debt securities	32,601	–	–	32,601
Derivative financial assets	–	923	–	923
Reverse repurchase agreements	–	3,710	–	3,710
Holdings of IMF Special Drawing Rights	9,266	–	–	9,266
Other financial assets	–	102	–	102
Total assets	**41,867**	**5,328**	**–**	**47,195**
Liabilities				
Debt securities – short positions	1,212	–	–	1,212
Derivative financial liabilities	–	533	–	533
Repurchase agreements	–	3,904	–	3,904
SDR allocation	9,822	–	–	9,822
Total liabilities	**11,034**	**4,437**	**–**	**15,471**

As at 31 March 2011	*Quoted market price*	*Using observable inputs*	*With significant unobservable inputs*	*Total*
	Level 1	*Level 2*	*Level 3*	
Assets	*£ millions*	*£ millions*	*£ millions*	*£ millions*
Treasury bills	*–*	*488*	*–*	*488*
Debt securities	*29,162*	*-*	*–*	*29,162*
Derivative financial assets	*–*	*782*	*–*	*782*
Reverse repurchase agreements	*–*	*2,102*	*–*	*2,102*
Holdings of IMF Special Drawing Rights	*9,202*	*–*	*–*	*9,202*
Other financial assets	*–*	*235*	*–*	*235*
Total assets	***38,364***	***3,607***	***–***	***41,971***
Liabilities				
Debt securities – short positions	*889*	*–*	*–*	*889*
Derivative financial liabilities	*–*	*1,165*	*–*	*1,165*
Repurchase agreements	*–*	*3,223*	*–*	*3,223*
SDR allocation	*10,024*	*–*	*–*	*10,024*
Total liabilities	***10,913***	***4,388***	***–***	***15,301***

21 Events after the Reporting Period

There are no events after the reporting period to report.

22 Date of Authorisation for Issue of Account

The Account was authorised for issue on 12 July 2012.

ANNEX A

ACCOUNTS DIRECTION GIVEN BY HM TREASURY UNDER THE EXCHANGE EQUALISATION ACCOUNT ACT 1979[10]

1. This direction applies to the Exchange Equalisation Account.

2. The Treasury shall prepare accounts for the Exchange Equalisation Account ("the Account") for the year ending 31 March 2012 and each subsequent financial year, which give a true and fair view of the state of affairs of the Account at the reporting date, and of its income and expenditure and cash flows for the year then ended.

3. The accounts shall be prepared in accordance with the requirements of the relevant version of the Government Financial Reporting Manual (FReM).

4. The accounts shall present a Statement of Comprehensive Income, a Statement of Financial Position and a Statement of Cash Flows. The Statement of Financial Position shall present assets and liabilities in order of liquidity.

5. The notes to the accounts shall include disclosure of assets and liabilities, and of income and expenditure, relating to other central government funds, including the National Loans Fund, and shall also include disclosure of management costs.

6. The report shall include:

   (i) a brief history of the Account, and its statutory background;
   (ii) an outline of the scope of the Account, its relationship to HM Treasury and other central funds, and its management operations;
   (iii) a management commentary including appropriate information on financial performance and position reflecting the relationship between the Account and other central funds;
   (iv) a governance statement.

7. Compliance with the requirements of the FReM will, in all but exceptional circumstances, be necessary for the accounts to give a true and fair view. If, in these exceptional circumstances, compliance with the requirements of the FReM is inconsistent with the requirement to give a true and fair view, the requirements of the FReM should be departed from only to the extent necessary to give a true and fair view. In such cases, informed and unbiased judgement should be used to devise an appropriate alternative treatment which should be consistent with both the economic characteristics of the circumstances concerned and the spirit of the FReM. Any material departure from the FReM should be discussed in the first instance with the Treasury.

8. This Accounts Direction shall be reproduced as an appendix to the accounts.

9. This Accounts Direction supersedes that issued on 17 March 2010.

Chris Wobschall

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

[10] As amended by the Finance Act 2000

Glossary

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

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

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

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

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

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

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

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

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

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

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

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

Euro area is the area of 17 nations which have adopted the euro as a single currency.

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

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

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

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

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

General Arrangements to Borrow (GAB) – allows the IMF to borrow specific amounts of currencies from industrialised countries, including the UK, at market related rates of interest.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Swap 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 Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 5000
Fax: 020 7270 4861

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

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