HM Treasury

Exchange Equalisation Account:

Report and Accounts 2013-14

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July 2014

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Report and Accounts 2013-14

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Contents

Directors' Report

Introduction

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

Origin and Purpose

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

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

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

Administration and Control

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

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

7. The Bank also acts as the Treasury's agent for foreign currency liability management, including the issuance of foreign currency debt to finance some of the reserves. This debt is issued by, and is an obligation of, the NLF under the National Loans Act 1968 since it is that Act (rather than the Exchange Equalisation Account Act 1979) which provides the powers for the Government to issue foreign currency securities. The foreign currency raised by issuing foreign currency debt is transferred to the EEA (see Strategic Report, paragraph 23). At 31 March 2014 there was no foreign currency debt outstanding (*2013: nil*).

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

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

9. The Bank's management costs are charged to the EEA. The management charge in 2013-14 was £8m *(2013: £8m)*.

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

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

The terms of the SLA can be reviewed during the year at the Bank's or the Treasury's request. There were no substantive changes made to the SLA for 2013-14.

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

Audit

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

13. The National Audit Office (NAO) bears the cost of all external audit work performed on the EEA.

14. 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.

15. During the financial year, no non-audit work was undertaken by the National Audit Office in relation to the EEA.

David Ramsden — HM Treasury
Accounting Officer — 3 July 2014

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

Strategic Report

Benchmark Allocations

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

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

Hedged reserves

3. 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, which explicitly trades off liquidity and return.

Unhedged reserves

4. The Treasury sets a benchmark for the currency allocation of the EEA's unhedged reserves, excluding gold. This takes into account past patterns of risk and return, as well as other factors such as the currencies likely to be required in any intervention. As in the previous year, in 2013-14 this benchmark was 40% US dollar, 40% euro and 20% yen.

5. 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.

6. Each currency within the unhedged reserves has a benchmark for the assets within it. In 2013-14 the benchmark for assets denominated in US dollars comprised of US Treasury bonds. The benchmark for euro denominated assets comprised euro denominated sovereign securities. For yen, the benchmark was derived from 1-3 month forward yen rates against the euro and the dollar.

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

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

Active management

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

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

Investment Policy

11. EEA investments need to be highly liquid so that they can be made available for use quickly, while minimising the costs of holding the reserves. Inevitably, these investments carry some element of credit risk. In order to reduce this risk and to ensure the necessary liquidity, the EEA predominantly holds securities issued or guaranteed by the national governments of the United States, Euro area countries and Japan. The Treasury previously took the decision to broaden the currency pool of securities held in the reserves beyond these countries for diversification purposes and the first such purchase, of Canadian dollar assets, took place in October 2013.

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

- Conventional bonds, bills, discount notes and floating rate notes of any maturity and commercial paper issued by other national governments, supranational organisations and selected official sector agencies;
- foreign currency spot, forward and swap transactions;
- interest rate and currency swaps;
- overnight indexed swaps;
- bond and interest rate futures, swap notes and swap futures;
- repurchase and reverse repurchase agreements ('repos' and 'reverse repos');
- forward rate agreements;
- SDRs;
- short-term bank deposits; and
- deposits with the Bank.

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

14. Following the decision made in the previous year by both the Treasury and the Bank, amendments were made to the terms of existing ISDA agreements with market counterparties under which the Bank transacts swaps and foreign exchange transactions. Under the revised terms, as well as taking collateral when the net present value of transactions is positive, the EEA now provides collateral to market counterparties when the net present value to the Treasury of transactions becomes negative. These changes were made with the aim of improved value for money via a reduction in swap transaction costs and increased counterparty diversification. The changes also brought the Bank's ISDA documentation in-line with the current market standard for two-way collateralised transactions.

Key Performance Indicators

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

16. The KPIs for 2013-14, consistent with those in place from the latter part of the prior year, specified that:

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

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

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

(iii) In order to aim to at least cover costs, and to ensure the Bank maintains its capability to intervene in the foreign exchange market if required, the Bank will actively manage the EEA portfolio against the benchmark to meet the active management return target set by the Treasury (see paragraph 37 for details), while ensuring compliance with the limits as detailed in the SLA.

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

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

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

All KPIs were met in 2013-14 and there were no significant breaches of the limits in the SLA.

Risk Management and Control

17. In addition to managing the operational risks discussed in the Governance Statement and financial risks discussed in the 'Risk management and control' note to the accounts on page 35, the Bank also conducts regular stress tests for a range of scenarios. A range of historical and theoretical scenarios involving large shifts in interest rates, spreads between securities and changes in yield curve shapes are applied to both the overall EEA holdings and the active management positions/component. These results are reviewed by senior management and the associated risks accepted or actions taken.

Management Commentary

18. 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, £6 billion of sterling financing was invested in the reserves in 2013-14. This sterling financing was sufficient to meet potential calls on the official reserves from the International Monetary Fund.

Hedged and unhedged reserves

19. As described above, the UK's official reserves, of which £61,882m *(2013: £62,414m)* are held in the EEA and £4,623m *(2013: £5,692m)* are held in the NLF, can be divided into two components: the 'hedged reserves' £40,158m (*2013: £36,791m*), and the 'unhedged reserves' of £26,347m (*2013: £31,315m*). The rise in the hedged reserves is due primarily to the investment of additional financing provided by the NLF. The decrease in unhedged reserves is due to a decrease in the value of gold held and the effect of the depreciation of the dollar, euro and yen against the pound.

20. 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.

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

22. 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.

23. Financing of the hedged reserves as at 31 March 2014 included sterling swapped into foreign currencies of £29,702m *(2013: £23,175m*) and the SDR allocation of £9,395m *(2013: £10,000m*). There were no outstanding foreign currency securities at the end of the year *(2013: nil*). No new foreign currency securities were issued during the year *(2013: nil*).

Management of the reserves

24. 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.

25. The foreign currency elements of the UK's total official reserves are published in the monthly IMF Reserves Template[3]. The Template shows the net foreign currency position in the official reserves, which at end-March was the equivalent of £26,347m. The assets and

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

liabilities in the Template differ from those of the EEA Statement of Financial Position on page 21 of these accounts. This is for a number of reasons, but principally it is because the Template is designed to reflect the UK's foreign currency position. Therefore it includes foreign currency assets and liabilities of the NLF (notably the RTP) and excludes all items denominated in domestic currency (i.e. sterling). The most significant of these are the liability of the EEA to the NLF and the valuation of the sterling leg of foreign currency forwards and currency swaps. These factors, coupled with the effects of differing treatment of unsettled items and short positions in debt securities, mean that gross reserve assets shown in the Template (the equivalent of £66,505m at 31 March 2014) differ by £1,690m from the assets held in the EEA. A reconciliation between the EEA's Statement of Financial Position and the Template is provided on page 10.

26. The size of the official reserves assets that are held in the EEA fell over the course of the year by £532m to £61,882m. This fall was the result of decreases in gold holdings (£2,773m), money market instruments (£1,071m), items in course of settlement (£742m) and SDR assets (£538m) largely offset by increases in debt securities (£2,494m) and reverse repos (£2,029m).

27. The reserve liabilities held in the EEA rose over the course of the year by £3,367m to £40,158m. This increase consisted primarily of a rise in the net derivative positions (£4,875m), offset by decreases in the value of the SDR allocation (£605m), repurchase agreements (£474m) and unsettled trades (£429m).

28. In the EEA Statement of Financial Position shown on page 21, assets increased over the course of the year by £2,205m to £68,195m. This increase consisted primarily of rises in debt securities (£2,494m), reverse repurchase agreements (£2,029m) and derivative financial assets (£1,240m) offset by a fall in the value of the gold held (£2,773m) and in money market instruments (£1,071m).

29. A matching increase in EEA liabilities consisted primarily of a rise in the liability to the NLF (£2,855m).

Links between the International Monetary Fund and the official reserves

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

31. 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 a standing multilateral borrowing arrangement - the New Arrangements to Borrow (NAB) - a number of member countries and institutions, including the UK, stand ready to lend additional funds to the IMF. Any lending against this facility is an asset of the NLF.

32. 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.

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

Analysis of returns for the period

34. The EEA's accounts for the year ended 31 March 2014 are given on pages 20 to 48 and show a total comprehensive loss for the year of £3,845m (*2013: £735m gain*).

35. The price of gold fell from £1,053 to £775 an ounce, a decrease of 26%, giving rise to a revaluation loss of £2,773m.

36. The net trading loss for the year was £1,066m *(2013: £616m gain).* On a financial instrument basis, net trading losses on debt securities (including short positions) (£2,439m) were the largest contributor to the overall net trading loss. This was partly offset by gains on currency swaps (£1,670m). A full breakdown of net trading income by instrument is provided in Note 2.

37. 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 £23m (*2013: £18m*).

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

Intervention

39. 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

40. 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 £12,128m (*2013: £12,438m*). These purchases and sales, both spot and forward, were hedged through offsetting trades with the market.

David Ramsden — HM Treasury
Accounting Officer — 3 July 2014

Reconciliation of EEA Statement of Financial Position to IMF Reserves Template

As at 31 March 2014	Unaudited **£ millions**	Unaudited **$ millions**
Total assets per EEA statement of financial position	**68,195**	
Adjustments to reflect IMF Reserves Template presentation:		
Eliminate sterling cash balance	(1,396)	
Reclassification between assets and liabilities	(4,921)	
Other adjustments[4]	4	
Reserve assets held in the EEA	61,882	
Reserve assets held in NLF	4,623	
Sterling total assets using Template presentation	**66,505**	
Dollar equivalent per Template		**110,884**
Total liabilities per EEA statement of financial position	**68,195**	
Eliminate EEA's Liability to the NLF (see note 14)	(52,805)	
Adjustments to reflect IMF Reserves Template presentation:		
Eliminate sterling leg of derivative trades	29,702	
Reclassification between assets and liabilities	(4,921)	
Other adjustments	(13)	
Sterling total liabilities using Template presentation	**40,158**	
Dollar equivalent per Template		**66,955**
Net assets per Template	**26,347**	**43,929**

Conversion rate into US dollars is 1.6673 as at close 31 March 2014

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

Statement of the Accounting Officer's Responsibilities

Under the Exchange Equalisation Account Act 1979 (as amended by the Finance Act 2000), the Treasury is required to prepare for each financial year a statement of accounts in the form and on the basis considered appropriate by the Treasury. The accounts are prepared on an accruals basis and must give a true and fair view of the state of affairs of its Comprehensive Income and cash flows for the financial year.

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

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

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

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

David Ramsden
Accounting Officer

HM Treasury
3 July 2014

Governance Statement

1. Scope of responsibility

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 2013-14. This includes the Treasury Board's assessment of its compliance with the 'Corporate Governance Code'. The Chancellor of the Exchequer, as Minister in charge of the Treasury, is responsible and answerable to Parliament on all the policies, decisions and actions of the Treasury and ultimately of the EEA.

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

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

2. The purpose of the system of internal control

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

2.2 The system of internal control is designed to manage risk to an acceptable level, balancing the impact of potential risks with the resources to manage them, rather than to eliminate all risk. It can therefore only provide reasonable and not absolute assurance of effectiveness. The system of internal control is based on an ongoing process designed to identify and prioritise the risks to the achievement of the EEA's policies, aims, and objectives; to evaluate the likelihood of those risks being realised and the impact should they be realised; and to manage them efficiently, effectively and economically. The system of internal control has been in place throughout the year ended 31 March 2014 and up to the date of approval of the annual report and accounts, and accords with Treasury guidance.

3. Capacity to handle risk

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

3.2 At the Bank, senior management are responsible for ensuring 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.

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

4. The risk and control framework

4.1 Within the Bank, the Risk Management Division is responsible for financial risk analysis and risk methodologies, whilst the Markets Strategy and Risk Operations Division is responsible for: running, developing and streamlining 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.

4.2 The Bank has an overarching Risk Management Framework in order to provide consistency and transparency in operational risk management processes across the organisation. This framework is supported by a central Risk Oversight Unit in the Finance Directorate and 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 following operational risk standards: Business Continuity Risk, Business Practice Risk, Human Resources Risk, Information Technology Risk, Legal Risk, Project Risk and Security 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. Risks identified by each Bank Directorate and Risk Standard owner are consolidated into the Bank-wide risk profile reported to BRC, the Audit & Risk Committee and Court. Mitigating actions in response to incidents and exceptions relating to the Bank’s risk profile, are also reported to the BRC.

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

- Monthly reports to the Treasury on the size, composition and liquidity of the reserves, their consistency with policy objectives, investment performance, returns made and risk exposures. The management accounts are reconciled to 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 making this Governance Statement. In addition, EFA are provided with quarterly management reports on risk issues and the Bank's compliance with the guidance issued by the Turnbull Report. These reports highlight the Bank's role in identifying, assessing, managing and monitoring the risks relating to its management of the EEA and any breaches of the control framework. Any significant breaches are reported as they occur. This process is supported by Operational Risk Officers in the Foreign Exchange Division, the Risk Management Division, Banking Services 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.
- The Bank's Internal Audit Division conducts an agreed internal audit programme. The Bank's Executive Director for Markets forwards the Internal Audit quarterly reports on this activity to the Accounting Officer and the results of all relevant internal audits are provided to EFA.
- Exchequer Funds Internal Audit provides an independent and objective opinion to the Accounting Officer on risk management, control and governance of the EEA. Assurance is provided following reviews of relevant Bank Internal Audit reports and EFA's oversight of the Bank's work, as agreed by the Accounting Officer and the Treasury Group Audit Committee. Exchequer Funds Internal Audit's reviews aim to measure and evaluate the effectiveness of the Treasury in achieving its agreed objectives in respect of the EEA. Exchequer Funds Internal Audit also reviews EFA's quarterly report to the Accounting Officer (mentioned above).
- Bank and Treasury officials meet quarterly to review performance against the parameters set out in the SLA and to consider wider operational and policy issues. Additionally the Accounting Officer and the Bank's Executive Director for Markets hold half-yearly meetings to discuss overall strategy and governance issues.
- Bank accountancy professionals produce the financial accounts on behalf of the Treasury using Bank IT systems. EFA liaises with the Bank and DRM to produce the annual accounts. The Treasury Accountant in EFA reviewed and approved the 2013-14 financial accounts, Directors' Report and Strategic Report in draft before I formally approved them.
- The Bank regularly tests its remote contingency facilities where EEA operations can be carried out.

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

4.5 Members of the Committee are appointed by the Permanent Secretary for periods up to three years, extendable by no more than two additional three-year periods. The Chair of the Committee (Michael O'Higgins) reports directly to the Permanent Secretary and is a Non-

Executive Member of the Treasury Board. The membership of the Audit Committee at the close of 2013-14 was:

- Michael O'Higgins – Chairman, Pensions Regulator (until 31 March 2014); Chairman, NHS Confederation; Non-Executive Board Member, Network Rail; Chairman, Investec Structured Products Calculus VCT plc.
- Mike Ashley – Non-Executive Director, and Audit Committee Chairman, Barclays Plc. Previously Head of Quality and Risk Management and Board Member, KPMG Europe LLP.
- Mary Hardy – Audit Committee Member, Institute of Chartered Accountants in England and Wales; Audit and Risk Committee Member, Glasgow 2014; Non-Executive Member, Defence Audit Committee; Non-Executive Member of the Board of the Royal Navy, and Chair of its Audit Committee.
- Abhai Rajguru – Non-Executive Director, Leeds Building Society; Chairman, Alexander Rosse; Managing Partner, Pravara Capital LLP; Non-Executive Director, Tollers LLP; Governor, Northampton College.
- Janet Baker (until 31 July 2013) - 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.

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

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

4.8 The Treasury Audit Committee met five times during 2013-14.

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

5. Risk profile

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

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

- **Errors in trade execution leading to financial loss:** Back office controls to check all trade confirmations with counterparties; end of day reconciliations; dealer training; senior dealers validating trades input by junior dealers; assessment of incidents when they arise.

- **Errors in complying with regulatory or tax requirements associated with EEA operations:** 3rd party expertise employed to advise and support on fulfilling requirements; Internal cross-directorate tax board to deal with tax issues; Legal Directorate review of custody SLAs prior to execution.

- **Incorrect static data set up, or manipulation leads to financial/reputational loss:** Agreed principles governing management of static data across Financial Operations; segregation of static duties between teams; minimum of 4 eye checks for manual inputs and changes; management review and sign off of static data changes;

- **Insufficient resources to manage EEA objectives in a crisis:** Specific agreed contingency planning to cope with unexpected credit events (e.g. default); Cross training to cover several roles in an emergency; Re-prioritisation of tasks and rapid redeployment of resources if needed.

5.2 The Bank announced on the 12 March 2014 that its Oversight Committee had appointed Lord Grabiner QC to lead its investigation into the role of Bank officials in relation to conduct issues in the foreign exchange market. The investigation, supported by Travers Smith LLP, will focus on matters relevant to the Financial Conduct Authority's current investigation into trading on the foreign exchange market, and specifically whether any Bank official, during the period July 2005 to December 2013:

- was either (i) involved in attempted or actual manipulation of the foreign exchange market (including the WMR FX benchmark), or (ii) aware of attempted or actual manipulation of the foreign exchange market , or (iii) aware of the potential for such manipulation or (iv) colluded with market participants in relation to any such manipulation or aware of any such collusion between participants;

- was either (i) involved in the sharing of confidential client information or (ii) aware of the sharing of such information between participants for the purposes of transacting business in the foreign exchange market; or

- was involved in, or aware of, any other unlawful or improper behaviour or practices in the foreign exchange market.

5.3 The conclusions of the investigation will be contained in a report that will be made publicly available. The publication of this report is likely to be deferred until the conclusion of the Financial Conduct Authority's investigation.

On the basis of the assurance provided to me by the Bank I believe that the Bank's ongoing investigation has had no impact on the EEA accounts.

Exposures to credit and market risk are detailed in Note 18.

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 2013-14 and the executive managers within DRM, EFA and in the Bank, who have responsibility for the development and maintenance of the internal control framework, as well as comments made by external auditors in their management letter and other reports. I have been supported by the Treasury Group Audit Committee and risk owners in addressing weaknesses and ensuring continuous improvement of the system is in place. The Treasury Group Audit Committee considered the 2013-14 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 2013-14, and no significant new risks have been identified in the year. No ministerial directions have been given in 2013-14.

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 — 3 July 2014

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 2014 under the Exchange Equalisation Account Act 1979 (as amended by the Finance Act 2000). The financial statements comprise: the Statement of Comprehensive Income, the Statement of Financial Position, the Statement of Cash Flows and the related notes. These financial statements have been prepared under the accounting policies set out within them.

Respective responsibilities of HM Treasury, the Accounting Officer and auditor

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

Scope of the audit of the financial statements

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

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

Opinion on regularity

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

Opinion on financial statements

In my opinion:

- the financial statements give a true and fair view of the state of the Exchange Equalisation Account's affairs as at 31 March 2014 and of its total comprehensive loss 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 Directors' Report and Strategic Report for the financial year for which the financial statements are prepared are consistent with the financial statements.

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

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

Report
I have no observations to make on these financial statements.

Sir Amyas C E Morse
Comptroller and Auditor General
7 July 2014

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

Statement of Comprehensive Income

For the year ended 31 March 2014:

	Note	2014 £ millions	*2013* *£ millions*
Net trading income	2	(1,066)	*616*
Fair value changes in gold		(2,773)	*127*
Fees and commissions		2	–
Management charge	3	(8)	*(8)*
Total comprehensive (loss)/income for the year	14	**(3,845)**	***735***

Statement of Financial Position

	Note	31 March 2014 £ millions	*31 March 2013 £ millions*
Assets			
Cash	16	1,685	*1,386**
Items in the course of collection from banks		1,131	*608*
Money market instruments	4	1,241	*2,312*
Debt securities	5	39,522	*37,028*
Gold	6	7,728	*10,501*
Reverse repurchase agreements	7	5,725	*3,696*
Derivative financial assets	8	2,203	*963*
Other financial assets	9	4	*2**
Holdings of IMF Special Drawing Rights	13	8,956	*9,494*
Total assets		**68,195**	***65,990***
Liabilities			
Items in the course of transmission to banks		1,142	*307*
Debt securities - short positions	10	669	*669*
Repurchase agreements	11	3,727	*4,202*
Derivative financial liabilities	12	455	*861*
Other financial liabilities		2	*1*
SDR allocation	13	9,395	*10,000*
Liability to the National Loans Fund	14	52,805	*49,950*
Total liabilities		**68,195**	***65,990***

* Comparative figures have been re-presented as outlined in note 1.vi.

The notes on pages 23 to 48 form an integral part of these accounts.

David Ramsden
Accounting Officer

HM Treasury
3 July 2014

Statement of Cash Flows

For the year ended 31 March 2014:

	Note	2014 £ millions	*2013* *£ millions*
Net cash outflow from operating activities	15	**(8,338)**	***(3,659)***
Net cash flows from financing activities:			
Cash inflow from National Loans Fund	14	9,250	*7,600*
Cash outflow to National Loans Fund	14	(2,550)	*(2,000)*
Net cash inflow from financing activities		**6,700**	***5,600***
Net decrease in cash and cash equivalents during the year	16	**(1,638)**	***1,941***
Cash and cash equivalents at the beginning of the year	16	3,840	*1,899*
Cash and cash equivalents at the end of the year	16	**2,202**	***3,840***

Notes to the Accounts

1 Accounting policies

Basis of preparation

The EEA produces accounts under the Exchange Equalisation Account Act 1979, as amended by the Finance Act 2000. These accounts have been prepared in accordance with the Accounts Direction, reproduced in the Annex to this report. The financial statements have been prepared in accordance with the 2013-14 Government Financial Reporting Manual (FReM) issued by the HM Treasury. The accounting policies contained in the FReM apply International Financial Reporting Standards as adapted or interpreted for the public sector context. Where the FReM permits a choice of accounting policy, the accounting policy which is judged to be most appropriate to the particular circumstances of the EEA for the purpose of giving a true and fair view has been selected. The particular policies adopted are described below. They have been applied consistently in dealing with items that are considered material to the accounts.

These accounts are prepared 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).

The Statement of Financial Position has been re-ordered in the current year to reflect decreasing liquidity. This is a presentational change with no effect on figures reported.

IFRS 13 ‘Fair Value Measurement’ became effective for annual periods beginning on or after 1 January 2013. This standard sets out a single IFRS framework for all fair value measurements required or permitted by IFRS. The introduction of this standard has had no effect on the financial reporting of the EEA.

At 31 March 2014, 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.

Recognition of financial assets and financial liabilities

The EEA is managed on a homogeneous basis and, although the reserves are not held primarily to make a profit, the Treasury seeks to minimise the cost of holding the foreign currency reserves while avoiding exposing the public purse to unnecessary risk. The Bank actively manages the EEA portfolio against the benchmark to meet the active management return set by the Treasury. As a result, the financial assets and liabilities of the EEA are all 'held for trading', in accordance with the definition of IAS 39, and therefore all financial assets and liabilities are held at fair value 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.

i. Net trading income

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

ii. Special Drawing Rights (SDR) remuneration

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

iii. Fees and commissions

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

iv. Foreign currency translation

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

v. Cash and cash equivalents

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

vi. 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. Changes in the fair value of loans and advances are recognised in the Statement of Comprehensive Income, within net trading income, when they arise.

In prior years, on the Statement of Financial Position, loans and advances to banks were reported within other financial assets. In the current year, these balances have been included within cash to better reflect their substance. Prior year's balances have also been reclassified in line with this change.

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

Money market instruments, debt securities, loans and advances to banks, reverse repos, deposits by banks, debt 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.

viii. Money market instruments

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

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

ix. Debt securities (including short positions)

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

All bonds are valued directly by reference to published price quotations at 31 March 2014. Certificates of deposit are valued using a discounted cash flow valuation technique. All inputs into this pricing model are externally sourced and assumptions used are supported by observable market prices. Bonds and certificates of deposit are priced at bid prices.

x. Gold

Gold is treated as being similar to a financial asset and, as such, is reported at fair value. Gold holdings on deposit are valued at the sterling equivalent of the London Bullion Market Association (LBMA) dollar denominated spot bid price as at 31 March 2014. Revaluation gains and losses on gold assets are recognised within fair value changes of gold in the Statement of Comprehensive Income.

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

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

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

xii. Derivative transactions

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

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

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

xiii. International Monetary Fund Special Drawing Rights (SDRs)

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

xiv. Collateral and netting

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

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

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

Critical accounting judgements and key sources of estimation uncertainty

The preparation of financial statements in conformity with 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.

Judgement would be necessary in the valuation of financial instruments and gold should there be no readily available market prices. Further information about how financial instruments are valued in such circumstances is provided in the 'Debt securities' and 'Derivative transactions' accounting policies above. At 31 March 2014 there were no valuations which are not supported by observable market prices or rates (*2013: £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 2014 was £7,728m (*2013: £10,501m*).

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

	2014 £ millions	*2013* *£ millions*
Money market instruments	(143)	*(99)*
Debt securities	(2,541)	*1,399*
Debt securities – short positions	102	*(40)*
Reverse repurchase agreements	(263)	*57*
Repurchase agreements	216	*(177)*
Futures	1	*(1)*
Foreign exchange transactions	(195)	*(135)*
Currency swaps	1,670	*(216)*
Interest rate swaps	(25)	*(194)*
Nostros	–	*(2)*
Loans and deposits	1	*(2)*
Reserve Tranche Position	4	*4*
Special Drawing Rights	107	*22*
Total	**(1,066)**	***616***

3 Management charge

The management charge of £8m represents the cost of the Bank of England’s management of the EEA during the year (*2013: £8m*).

4 Money market instruments

	2014 £ millions	*2013* *£ millions*
Treasury bills	92	*775*
Commercial paper	1,149	*1,537*
Total	**1,241**	***2,312***

	2014 £ millions	*2013* *£ millions*
Amounts maturing:		
In not more than 3 months	528	*2,153*
In 1 year or less but over 3 months	713	*159*
Total	**1,241**	***2,312***

In prior years, all money market instruments (issued by national governments, supranational organisations and selected official sector agencies) were reported under the title of ‘Treasury bills’. An analysis by instrument type has now been included for transparency.

5 Debt securities

	2014	*2013*
	£ millions	*£ millions*
Issued by:		
Government	37,992	*35,490*
Other Public Sector	1,530	*1,538*
Total	**39,522**	*37,028*

	2014	*2013*
	£ millions	*£ millions*
Amounts maturing:		
Current	3,726	*3,646*
Non-current	35,796	*33,382*
Total	**39,522**	*37,028*

6 Gold

	2014	*2013*
	£ millions	*£ millions*
Gold Stock	7,728	*10,501*
Total	**7,728**	***10,501***

There were no gold loan/deposit or swap trades undertaken during the year *(2013: nil)*.

7 Reverse repurchase agreements

	2014	*2013*
	£ millions	*£ millions*
Amounts maturing:		
Current	5,725	*3,696*
Total	**5,725**	***3,696***

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

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

8 Derivative financial assets

	2014 £ millions	*2013* *£ millions*
Foreign exchange transactions	359	*358*
Currency swaps	1,569	*506*
Interest rate swaps	275	*99*
Total	**2,203**	***963***

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

9 Other financial assets

	2014 £ millions	*2013* *£ millions*
Margin accounts	1	–
Prepayments and accrued income	3	*2*
Total	**4**	***2***

Comparative figures have been re-presented as outlined in note 1.vi.

10 Debt securities - short positions

	2014 £ millions	*2013* *£ millions*
Debt securities – short positions	669	*669*
Total	**669**	***669***

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

11 Repurchase transactions

	2014 £ millions	*2013* *£ millions*
Amounts maturing:		
Current	3,727	*4,202*
Total	**3,727**	***4,202***

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

12 Derivative financial liabilities

	2014 £ millions	*2013* *£ millions*
Foreign exchange transactions	336	*312*
Currency swaps	19	*388*
Interest rate swaps	100	*161*
Total	**455**	***861***

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

13 SDR Allocation and SDR Holdings

The EEA has a liability to the IMF for those SDRs that have been allocated since the UK became a participant in the Special Drawing Rights Agreement. If the UK withdraws from participation or the Agreement is wound up, payment to the IMF would be required at current exchange rates. The SDR liability as at 31 March 2014 was £9,395m *(2013: £10,000m)*.

The SDR holdings of the EEA as at 31 March 2014 was £8,956m (*2013: £9,494m*). These holdings result from SDR allocations made by the IMF, any subsequent purchases and sales of SDRs from or to other IMF members and fair value changes. SDR holdings may include SDR denominated promissory notes received by the IMF in return for the advance of SDRs via the Poverty Reduction and Growth Facility. At 31 March 2014 £11m worth of such notes were held by the EEA (*2013: £12m*). During 2013-14, the EEA sold £42m worth of SDRs (*2013: bought £24m*).

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

14 Liability to the National Loans Fund

The net assets of the EEA represent a liability to the NLF. There are two elements of the Liability to the NLF: a specific liability, recognised in accordance with the National Loans Act 1968 of £25,885m (*2013: £19,185m*) 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	2014 Overall liability to the NLF
Balance at 1 April 2013	21,528	9,237	19,185	49,950
Transfers from the NLF	–	–	9,250	9,250
Repayments to the NLF	–	–	(2,550)	(2,550)
Total comprehensive income	(3,845)	–	–	(3,845)
Balance at 31 March 2014	**17,683**	**9,237**	**25,885**	**52,805**

All amounts in £ millions	*Accumulated comprehensive income reserve*	*Capital contribution reserve*	*Specific liability to the NLF*	*2013 Overall liability to the NLF*
Balance at 1 April 2012	*20,793*	*9,237*	*13,585*	*43,615*
Transfers from the NLF	–	–	*7,600*	*7,600*
Repayments to the NLF	–	–	*(2,000)*	*(2,000)*
Total comprehensive income	*735*	–	–	*735*
Balance at 31 March 2013	***21,528***	***9,237***	***19,185***	***49,950***

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

	2014 £ millions	*2013 £ millions*
Total comprehensive (loss)/income for the year	(3,845)	*735*
Net (increase)/decrease in money market instruments	(554)	*153*
Net (increase) in debt securities	(2,494)	*(4,427)*
Net decrease/(increase) in gold	2,773	*(127)*
Net (increase)/decrease in reverse repurchase agreements	(2,029)	*14*
Net (increase) in derivative financial assets	(1,240)	*(40)*
Net (increase)/decrease in other assets	(2)	*1*
Net decrease/(increase) in holding of SDRs	538	*(228)*
Net (decrease) in debt securities - short positions	–	*(543)*
Net (decrease)/increase in repurchase agreements	(475)	*298*
Net (decrease)/increase in derivative financial liabilities	(406)	*328*
Net increase/(decrease) in other financial liabilities	1	*(1)*
Net (decrease)/increase in SDR allocation	(605)	*178*
Net cash (outflow) from operating activities	**(8,338)**	***(3,659)***

16 Cash and cash equivalents

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

	1 April 2012 £ millions	*Cash flow £ millions*	*31 March 2013 £ millions*
Balances at Central Banks	*1,496*	*(116)*	*1,380*
Loans and advances to banks	*102*	*(96)*	*6*
	1,598	*(212)*	*1,386*
Amounts with original maturity less than 3 months:			
Items in the course of collection from banks	*884*	*(276)*	*608*
Money market instruments	*281*	*1,872*	*2,153*
Items in the course of transmission to banks	*(864)*	*557*	*(307)*
	301	*2,153*	*2,454*
Total	***1,899***	***1,941***	***3,840***

17 Related Party Transactions

The Royal Bank of Scotland Group plc is regarded as a related party of the EEA. On 1 December 2008, the UK Government, through HM Treasury[5], became the ultimate controlling party of The Royal Bank of Scotland Group plc. At 31 March 2014, the

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

Government's holding is 81%. 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. There was no outstanding exposure at 31 March 2014 *(2013: nil)*.

The UK Government, through HM Treasury[6], owns 25% 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 transactions with the Lloyds Banking Group, which were all conducted on an arm's length basis and were part of the EEA's normal activity. There was no outstanding exposure at 31 March 2014, *(2013: less than £1 million).*

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

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

18 Risk management and control

A summary of the key features of the control framework for the EEA during the year and management's objectives and policies for managing risks is provided in the Governance Statement (page 12).

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

Market risk

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

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

The composition of both elements of the reserves is determined by the benchmark allocations set out by the Treasury and market risk is taken into account when determining those benchmarks. Further detail on the policy processes for determining benchmark asset allocations is given in the Strategic Report (paragraphs 1 to 8).

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

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

Hedged reserves

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

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

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

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

Unhedged reserves

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

Value at Risk

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

Benchmark Reserves

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

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

Hedged Reserves

	$ millions 2014	*$ millions 2013*
VaR as at 31 March	56	*55*
VaR as at 30 September	54	*64*

Unhedged Reserves

	$ millions 2014	*$ millions 2013*
VaR as at 31 March	1,293	*1,789*
VaR as at 30 September	1,475	*2,041*

Active Management

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

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

The Bank measures the VaR on active management positions on a daily basis and undertakes regular back-testing of the VaR models. Assuming that both models are correct, and that the volatility and correlation inputs are an accurate reflection of current market conditions, losses greater than the VaR figure are expected to occur with a probability of 1%.

Over the financial year, there were a total of nineteen exceptions noted, ten P&L exceptions to the unweighted VaR and nine to the exponentially weighted VaR.

However, five exceptions to unweighted and four exceptions to exponentially weighted VaR occurred in June 2013 and are attributable to an increase in market volatility at that time. These P&L exceptions can therefore be categorised as the result of heightened market volatility, and not as an error in the VaR model. Removing those observations leaves us with five exceptions to the unweighted VaR and five to the exponentially weighted VaR. Both models are therefore within the Basel yellow zone (models in this category are questioned but are not considered inaccurate). We have reviewed the models and do not deem them erroneous.

Under the SLA, the Treasury sets the Bank a VaR limit for active management relative to benchmarks, with the VaR being calculated at close of business each day. In 2013-14 the VaR limit for active management was $20m. During the year the Bank's use of VaR did not exceed $6.88m. The average VaR during the year was $4.47m and the lowest VaR at the end of any one day was $2.15m.

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

	$ millions 2014	*$ millions 2013*
VaR as at 31 March	3.54	*2.14*
Average during the year	4.47	*3.19*
Maximum VaR during the year	6.88	*5.37*
Minimum VaR during the year	2.15	*1.83*
VaR limit during the year	20.00	*20.00*

The minimum VaR is the higher of unweighted and exponentially weighted, which for 2013-14 was unweighted (*2013: unweighted*).

A change to the VaR model was made in September 2013. Previously, a single set of euro volatility data was used to calculate VaR on all euro sovereigns. This was revised so that each sovereign issuer is now mapped to a volatility curve that more accurately reflects their volatility. This change resulted in a small increase in the overall VaR on the Active Management and Benchmark portfolios.

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

Credit risk

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

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

The arrangements for custody of EEA assets in 2013-14 were as follows: US Treasury bonds and other US dollar denominated securities were held in custody at the Federal Reserve Bank of New York, Canadian dollar denominated securities were held in custody at Bank of Canada and 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.

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

Concentration of Exposure

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

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

Concentration of EEA assets by geographical region

2014

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

2013

£ millions	*United Kingdom*	*Europe*	*North America*	*Asia-Pacific*	*Other*	*Total*
Cash	*1,164*	*5*	*99*	*118*	*–*	*1,386**
Items in course of collection from banks	*354*	*254*	*–*	*–*	*–*	*608***
Money market instruments	*–*	*1,537*	*–*	*775*	*–*	*2,312*
Debt Securities	*–*	*17,430*	*17,195*	*2,403*	*–*	*37,028*
Gold	*–*	*–*	*–*	*–*	*10,501*	*10,501*
Reverse repurchase agreements	*2,050*	*1,574*	*72*	*–*	*–*	*3,696*
Derivative financial assets	*301*	*397*	*255*	*10*	*–*	*963*
Other financial assets	*–*	*–*	*–*	*–*	*2*	*2**
IMF SDRs	*–*	*–*	*–*	*–*	*9,494*	*9,494*
Total Assets	***3,869***	***21,197***	***17,621***	***3,306***	***19,997***	***65,990***

[*]Comparative figures have been restated as outlined in note 1.vi.

[**] Prior disclosure erroneously allocated exposure based on instrument issuer. This has been restated to reflect the exposure to the buying counterparty.

Concentration of EEA assets by credit rating

2014

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

2013

£ millions	*1*	*2*	*3*	*Other*	*Total*
Cash	*108*	*114*	*–*	*1,164*	*1,386*
Items in course of collection from banks	*129*	*479*	*–*	*–*	*608*
Money market instruments	*1,537*	*775*	*–*	*–*	*2,312*
Debt Securities	*34,265*	*2,623*	*140*	*–*	*37,028*
Gold	*–*	*–*	*–*	*10,501*	*10,501*
Reverse repurchase agreements	*1,442*	*2,254*	*–*	*–*	*3,696*
Derivative financial assets	*531*	*378*	*–*	*54*	*963*
Other financial assets	*–*	*–*	*–*	*2*	*2*
IMF SDRs	*–*	*–*	*–*	*9,494*	*9,494*
Total Assets	***38,012***	***6,623***	***140***	***21,215***	***65,990***

The Bank has always internally assessed and independently rated EEA counterparties. In prior years, however, the concentration of EEA assets by credit quality has been illustrated by reference to the ratings allocated by external rating agencies. In order to better reflect the risk information used by those that manage the EEA, these tables now summarise EEA exposures reflecting the substance of the Bank's internal ratings. The Bank has internal ratings scales of between four and six categories (the number depending on the type of entity). For the purposes of aggregated tables each internal rating on each scale has been assigned to category 1, 2 or 3.

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

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

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

Category 'Other' comprises unrated positions including Gold and SDR holdings and balances with UK government agencies and the Bank of England.

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

At 31 March 2014, credit exposures to issuers of money market instruments and debt securities (less debt securities – short positions) stood at £40,094m *(2013: £38,671m)*.

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

Netting agreements and collateral

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

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

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

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

Maximum exposure and effects of collateral

Reverse repos	2014 £ millions	*2013* *£ millions*
Reverse repos	5,725	*3,696*
less: securities received as collateral	(5,852)	*(3,788)*
less: margin called under terms of loan agreement	(13)	*(5)*
Reverse repos - collateral surplus	**(140)**	***(97)***

Derivatives	2014 £ millions	*2013* *£ millions*
Derivative assets gross exposure	2,203	*963*
less: cash collateral held	–	–
less: securities received as collateral	(1,681)	*(269)*
Derivative asset - collateral deficit	**522**	***694***
Derivative liabilities gross exposure	(455)	*(861)*
less: securities pledged as collateral	154	–
Derivative liability – collateral surplus	**(301)**	***(861)***
Derivatives - net collateral deficit/(surplus)	**221**	***(167)***

Comprised of*:	2014 £ millions	*2013* *£ millions*
Net liability position with a deficit of collateral pledged	(18)	*(129)*
Net asset position with a surplus of collateral taken	(36)	*(42)*
Net asset position with a deficit of collateral taken	275	*4*
Derivatives - net collateral deficit/(surplus)	**221**	***(167)***

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

Collateral pledged

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

	2014 £ millions	*2013* *£ millions*
Repos	3,666	*4,122*
Derivative liabilities	154	–
	3,820	***4,122***

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 assets and liabilities

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

Undiscounted contractual cash flows of financial assets

As at 31 March 2014:

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

Undiscounted contractual cash flows of financial liabilities

As at 31 March 2014:

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

Undiscounted contractual cash flows of financial assets

As at 31 March 2013: All amounts in £ millions	***Up to 1 month***	***1 to 3 months***	***3 to 12 months***	***1 to 5 years***	***More than 5 years***	***Undated***	***Total***
Cash balances	*1,386*	–	–	–	–	–	*1,386*[*]
Items in course of collection from banks	*608*	–	–	–	–	–	*608*
Money market instruments	*1,595*	*568*	*159*	–	–	–	*2,322*
Debt securities	*214*	*174*	*3,860*	*31,029*	*2,152*	–	*37,429*
Gold	–	–	–	–	–	*10,501*	*10,501*
Reverse repurchase agreements	*3,551*	*145*	–	–	–	–	*3,696*
Derivative financial instruments - inflow	*3,325*	*2,821*	*6,118*	*11,323*	*370*	–	*23,957*
Derivative financial instruments - outflow	*(3,233)*	*(2,752)*	*(5,926)*	*(10,696)*	*(328)*	–	*(22,935)*
Other financial assets	*2*	–	–	–	–	–	*2*[*]
SDR Holdings	–	–	–	–	–	*9,494*	*9,494*
Total	***7,448***	***956***	***4,211***	***31,656***	***2,194***	***19,995***	***66,460***

Undiscounted contractual cash flows of financial liabilities

As at 31 March 2013: 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	*(307)*	–	–	–	–	–	*(307)*
Debt securities – short positions	*(669)*	–	–	–	–	–	*(669)*
Repurchase agreements	*(3,328)*	*(845)*	*(30)*	–	–	–	*(4,203)*
Derivative financial liabilities – inflows	*2,965*	*1,917*	*4,330*	*12,207*	*1,793*	–	*23,212*
Derivative financial liabilities – outflows	*(3,091)*	*(1,957)*	*(4,600)*	*(12,608)*	*(1,836)*	–	*(24,092)*
Other financial liabilities	*(1)*	–	–	–	–	–	*(1)*
SDR Allocation	–	–	–	–	–	*(10,000)*	*(10,000)*
Liability to the NLF	–	–	–	–	–	*(49,950)*	*(49,950)*
Total	***(4,431)***	***(885)***	***(300)***	***(401)***	***(43)***	***(59,950)***	***(66,010)***

[*]Comparative figures have been restated as outlined in note 1.vi.

Derivatives

The EEA uses derivatives to manage its exposure to interest rate and exchange rate risks. All derivative instruments are held at their fair values. Fair values are determined by reference to market rates prevailing on the date of valuation or by discounting future cash flows. The notional principal amounts of these instruments indicate the volume of transactions outstanding as at 31 March 2014 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

	2014			*2013*		
	Notional Principal Amounts	Fair values Assets	Liabilities	*Notional Principal Amounts*	*Fair values Assets*	*Liabilities*
Exchange rate contracts:						
Spot and forwards	26,384	359	(336)	*24,904*	*358*	*(312)*
Currency swaps	25,405	1,569	(19)	*20,568*	*506*	*(388)*
	51,789	1,928	(355)	*45,472*	*864*	*(700)*
Interest rate swaps	27,918	275	(100)	*29,402*	*99*	*(161)*
Futures	914	–	–	*4,541*	*–*	*–*
	28,832	275	(100)	*33,943*	*99*	*(161)*
Total	**80,621**	**2,203**	**(455)**	***79,415***	***963***	***(861)***

19 Fair Value Valuation Basis

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

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

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

Level 2 – valuation technique using observable inputs: financial instruments with quoted prices for similar instruments or quoted prices for identical or similar instruments in inactive markets and financial instruments valued using models where all significant inputs are observable. All inputs into pricing models are externally sourced and assumptions used are supported by observable market prices. No valuations used model pricing this year (*2013: nil*).

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

During the financial year no financial instruments were measured at fair value with significant unobservable inputs (*2013: nil*). There were no significant transfers between Level 1 and Level 2 of the fair value hierarchy.

As at 31 March 2014

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

As at 31 March 2013

Assets	*Level 1* *£ millions*	*Level 2* *£ millions*	*Level 3* *£ millions*	*Total* *£ millions*
Money market instruments	*775*	*1,537*	*–*	*2,312**
Debt securities	*37,028*	*–*	*–*	*37,028*
Reverse repurchase agreements	*–*	*3,696*	*–*	*3,696*
Derivative financial assets	*–*	*963*	*–*	*963*
Other financial assets	*2*	*–*	*–*	*2***
Holdings of IMF Special Drawing Rights	*9,494*	*–*	*–*	*9,494*
Total assets	***47,299***	***6,196***	***–***	***53,495***
Liabilities				
Debt securities – short positions	*669*	*–*	*–*	*669*
Repurchase agreements	*–*	*4,202*	*–*	*4,202*
Derivative financial liabilities	*–*	*861*	*–*	*861*
Other financial liabilities	*1*	*–*	*–*	*1*
SDR allocation	*10,000*	*–*	*–*	*10,000*
Total liabilities	***10,670***	***5,063***	***–***	***15,733***

* The prior year fair value valuation disclosure erroneously showed all money market instruments (previously termed 'Treasury bills', see note 4) as having been valued using a technique based on observable inputs (Level 2). This has been restated to reflect the true valuation bases, with the commercial paper being Level 2 and Treasury bills being valued from a quoted market price (Level 1).

** Comparative figures have been restated as outlined in note 1.vi.

20 Events after the Reporting Period

There are no events after the reporting period to report.

21 Date of Authorisation for Issue of Account

The Accounting Officer authorised these financial statements for issue on 7 July 2014.

ANNEX A

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

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

[7] As amended by the Finance Act 2000

Glossary

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

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

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

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

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

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

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

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

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

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

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

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

Euro area is the area of 18 nations which have adopted the euro as a single currency.

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

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

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

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

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

Government Financial Reporting Manual (FReM) – 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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This document can be downloaded from
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