

## Report by the Non-executive Directors

This section contains the Report from Non-executive Directors required by Section 4(2)(a) of the Bank of England Act 1998. It describes the responsibilities under the Act of the Committee of Non-executive Directors — NedCo — and how it has discharged them. The Report relates to the period from 1 March 2008 to 28 February 2009, referring where relevant to other sections of the Annual Report which cover Non-executive Directors' responsibilities as members of Court.

The Bank of England Act confers a number of specific responsibilities on the Non-executive Directors. The requirements are to review the performance of the Bank in relation to its strategy and objectives as determined by Court; to monitor the extent to which its objectives in relation to financial management have been achieved; to review the Bank's internal financial controls; and to review the procedures of the Monetary Policy Committee (MPC). The Non-executive Directors also have delegated responsibilities for the remuneration of the executive members of Court, which are undertaken by the Remuneration Committee.

### The operation of NedCo

The role of the Non-executive Directors in the governance arrangements of the Bank is similar to that of any commercial organisation and they have similar responsibilities to any board. They are not involved with day-to-day decision-making but they do provide an independent and critical challenge for the management of the Bank.

Directors have continued to receive quarterly reports on implementation of the Bank's strategy, finance, project management, risk management and progress against the Bank's high-level outcomes. These reports have proven to be helpful monitoring mechanisms for NedCo and have provided the basis for discussion with management across a wide range of issues.

A performance evaluation and review of the operation of Court and NedCo was undertaken in 2008 (the previous such exercise was in 2006). The efficiency problems that were brought to light by that exercise are mostly being addressed by structural changes to Court arising from the new Banking Act — described below. Indeed, the results of

that and previous reviews helped to shape Non-executive Directors' contributions to Government consultations about the new legislation. Additionally, the chairman of NedCo has held regular meetings with HM Treasury as the Bank's shareholder and has participated in the interview panels for the selection of new Non-executive Directors. NedCo has had the opportunity to comment on senior appointments at the Bank, and they welcome the change whereby HM Treasury appoints members of the MPC through open competition. One of the Deputy Governor members and one external member has already been appointed through this new process.

### Revised governance arrangements

Some concerns about current governance arrangements arising from the 1998 Banking Act had been recognised and voiced by Non-executive Directors for some time. These included the large size of Court — which at times had limited effective debate — and the Act's requirement that the Governor chaired Court. However, arrangements put in place in 2003 have meant that the Bank's business has been processed through NedCo under the chairmanship of the Senior Non-executive Director. The Banking Act 2009, which received Royal Assent earlier this year, was primarily focused on financial stability and bank resolutions (discussed below). However, it also introduced a number of reforms to Court that addressed the key issues of concern highlighted above. The number of Non-executive Directors will be reduced from 16 to no more than nine, and Court will be chaired by the Senior Non-executive Director. There will also be a new sub-Committee of Court created to oversee the Bank's financial stability work. The Act removes the requirement for monthly meetings of Court, specifying a minimum of seven meetings in each calendar year.

The new governance arrangements come into effect on 1 June. Prior to that, existing Non-executive Directors will have resigned and a new team appointed. Existing members were able to apply for reappointment to serve the remainder of their term. At the time of this *Report* no announcements have been made by HM Treasury about the composition of the new Court other than the appointment of Sir David Lees as Chairman. It will be crucial that the transition is managed effectively to ensure continuity, effective support and challenge to the Bank's management. The existing body of Non-executive Directors will work to ensure a smooth transition. However, an important early task for the new Court will be

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to review its delegated powers and to establish the matters that are reserved for its approval. Importantly, terms of reference for the new Financial Stability Committee will also need to be debated and agreed quickly.

### **Banking Act and financial stability oversight**

The Non-executive Directors believe that Parliament has acted promptly in legislating to create powers to resolve failing banks. The Bank now has specific responsibilities within the Special Resolution Regime (SRR) — used for the first time in March in relation to Dunfermline Building Society. The limitations of the previous arrangements were highlighted by the Governor and others in the aftermath of bank support operations in Autumn 2007 and 2008. The Bank's Non-executive Directors worked with the executive management to shape the banking reforms that received the Royal Assent in February 2009. The full implications of the Act for the Bank are discussed elsewhere in the *Annual Report*.

The Non-executive Directors believe that the new Act goes a long way to provide the necessary machinery and powers for future bank resolutions. In addition, the establishment of a statutory definition of the Bank's Financial Stability objective meets a need to which the Non-executives have been pointing for a number of years. It is good to have plugged this gap in the law. Nonetheless, the Non-executives recognise that much of the associated operational detail still needs to be settled among the members of the Tripartite — mainly between the FSA and the Bank. NedCo will monitor that process. Given recent experience, it is essential now to define clearly, for all to see, who among the Tripartite does what and how they interact.

Directors had expected that the legislation would give the Bank statutory powers to obtain information directly from banks rather than through the FSA. This has not been the outcome. The Non-executive Directors believe the absence of this authority weakens the position of the Bank in determining both the timing and the type of intervention necessary when the health of a financial institution falls into question. Similarly, NedCo felt strongly that the Bank should have at least equal rights to trigger the SRR in the case of a failing bank or financial institution to guard against 'regulatory forbearance'. In these circumstances it will be especially important that co-operation between the Bank and the FSA is fully

effective and Non-executive Directors will need to monitor the process carefully.

The new Act requires the Court of Directors to establish a subcommittee called the Financial Stability Committee, consisting of four Non-executive Directors and the three Governors and to be chaired by the Governor. The new Committee's functions will be (i) to make recommendations to Court about how the Bank should implement its Financial Stability objective; (ii) to provide advice on actions in relation to specific institutions where so required by the Bank's Financial Stability objective; (iii) to advise on the Bank's use of its Special Resolution Regime powers and subsequently to monitor the use of those powers; and (iv) to monitor how the Bank oversees payments systems. The new arrangements are a step forward; but there is still much to be done. We expect the new Non-executive Directors will want to give this high priority in 2009.

### **Financial market developments and the Bank's operations**

Over the past year, the widening and deepening financial and economic crisis has affected all aspects of the Bank's work. NedCo has continued to receive regular reports on financial market developments and the Bank's responses. Where the Bank itself has acted — for example, by providing liquidity to the banking system — Non-executive Directors have been informed and have discussed the Bank's approach at length. They have also discussed the Bank's part in wider proposals such as the recapitalisation of the banking system. With respect to material transactions with individual financial institutions, the Transactions Committee has been consulted in each instance.

The introduction of market-wide facilities such as the Special Liquidity Scheme in April 2008 and the Asset Purchase Facility in January 2009, along with financing to support individual institutions such as Bradford and Bingley (by way of temporary funding for the Financial Services Compensation Scheme), has raised important issues for the Bank which have been the subject of review by the Non-executive Directors. The impact of these operations on the Bank's objectives and its risk, financial and wider resource management have all been discussed and assessed.

In particular, the Bank's processes for collateral management have needed to be expanded to accommodate a greatly increased scale and a wider range of assets that go beyond the Bank's normal market operations and experience. Non-executive Directors have monitored continually the development of processes, the management of risks and the effectiveness of controls — including risks to the Bank's balance sheet. The Bank's budget has had to support this work, increasing resources where they were needed. We have been concerned about the pressures on staff, particularly on key individuals in the Markets and Banking areas. We have had regular reporting from senior management and have questioned whether, and sought re-assurance that, actions were being taken to recruit and redeploy staff and to manage the risks associated with the exceptional level of stress in many parts of the organisation. This is still a challenge, affecting discussions and decisions on the Bank's budget and resources for the coming years (see below). Non-executive Directors are satisfied that the present situation is being effectively managed and that the executive management is fully alive to the issues.

### **The Bank's strategy and its implementation**

The Bank's performance is reviewed on pages 14–25 of this *Annual Report*. In NedCo's opinion this evaluation is a fair statement of the Bank's performance against its objectives and strategy for 2008/09.

Debating and agreeing the Bank's strategic priorities and associated programmes of work has again been a key aspect of NedCo's responsibilities. Over the past year, an important emphasis has been the extent to which new policy and operational developments have been managed alongside the implementation of the Bank's strategic priorities and associated planned work.

This year, after the Governor's reappointment in June, Non-executive Directors had an opportunity to discuss his second five-year term vision and strategic priorities for the Bank. This enabled Court to debate the implications for resources and the shape of the Bank and its priorities in the years ahead. The regular reporting to NedCo has allowed Non-executive Directors to review competing demands and pressure points in order to challenge the Bank's management on priorities, timescales and resources. Reprioritisation and rescheduling inevitably has been a feature of the past year. Non-executive Directors are satisfied that the decisions taken have been appropriate

and are keeping the overall strategy on track. The monitoring of progress towards milestones will be equally crucial in the years ahead. Key elements of the Bank's strategy are discussed below.

### **Monetary policy**

A year ago we noted that the MPC was facing its stiffest challenge so far. During 2008/09, the MPC has had to address a dramatic and profound change in the economic outlook and, latterly, to adapt its policy response in radically new ways — through the injection of money into the economy. Non-executive Directors are responsible for reviewing the processes and procedures of the MPC, which are discussed on pages 47–48 below.

### **Market operations**

During the financial crisis, the Bank's money market framework has been reformed to meet changing liquidity requirements. Elements of the existing framework were well designed, but the standing facilities did not prove adequate and their use became stigmatised. The new facilities — including a Discount Window Facility — are better designed to provide additional liquidity in both normal and stressed conditions. Non-executive Directors will continue to review the Bank's money market operations to ensure they remain at the forefront of central bank practice. Beyond the present difficult market conditions, it will be important for the Bank to reflect on, and to review, its operations further and to apply any lessons from the past two years.

The strategy in this area inevitably has been overtaken by the major expansion of market operations as new liquidity facilities have been created to deal with the financial crisis. Managing these operations, and the collateral the Bank has acquired, is a major extension of the Bank's work which will need continued investment in people, processes and systems.

### **Financial stability**

A major focus of the past year has been the Bank's contribution to the new Banking Act as discussed earlier. Within the Financial Stability area of the Bank, a substantial team identifies and analyses risks to the financial stability of the economy as a whole. Over several years, Non-executive Directors have pressed management on the efficacy of this work, its impact through communications and other actions the Bank can take to mitigate threats. With responsibility for macroprudential

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risk management but without authority at the institutional level, the Bank has had limited powers to influence events and attitudes.

The new Banking Act and Financial Stability Committee provide a constructive framework for the Bank to exercise its responsibilities. In addition, Non-executive Directors welcome the ongoing debate among policymakers on further measures to enhance systemic financial stability. Whatever the outcomes, a key role for the Bank — as for any central bank — must be to alert markets and authorities to the threats of growing systemic risks.

The Banking Act makes the Bank responsible from 1 June for statutory oversight of payment systems. It will be important to ensure that the Bank has the additional systems and processes needed for this and that effective internal and external accountability is established. The Bank's extended responsibilities need to be clearly understood in and outside the Bank and, as NedCo has indicated in the past, it will be equally important for clarity about where it does not have responsibility.

### Customer banking

Non-executive Directors have continued to monitor the migration of the Government's banking business from the Bank to the commercial sector. Good progress has been made, but NedCo has noted that the project timescale has been extended into 2010. It also recognises that an element of customer banking business may need to remain with the Bank for financial stability reasons. It will need to keep this issue under review.

### Projects

Some major projects have been delayed during the past year because of changing priorities and the strains on resources, particularly senior management time. Non-executive Directors have been kept informed of slippages and related risks and costs, and have been satisfied, on balance, that the right priorities have been set. However, it is recognised that conditions may remain stretched (in terms of resourcing) beyond the short term. We are therefore concerned that some projects that are important to the effective and efficient operation of the Bank, but are not critical to the Bank's handling of the immediate financial crisis, may be deferred for a prolonged period, with related implications for operational risk and resource stretch at the Bank. Accordingly, the

Non-executive Directors have been provided with a comprehensive Bank-wide assessment of what has been deferred, which will be kept under review.

### Human resources

Non-executive Directors have taken a very close interest in staff resourcing issues associated with the developing financial crisis. There has been an ongoing dialogue with management, in both NedCo and the Audit Committee, about the extent to which key staff are being relied upon, and the associated risks involved. We have urged the Executive to provide a range of indicators to properly assess how stretched staff are. Staff redeployment has been regularly reported and Non-executive Directors have been informed how staff resources are to be matched to the Bank's expanded responsibilities under the Banking Act 2009.

In addition to current staffing and organisational issues, NedCo has explored with the Bank's executive management how to nurture the level of expertise required to conduct future special resolution operations when lengthy periods of more benign economic conditions may dissipate experience in the practical issues. The Non-executive Directors have also discussed how to manage talent effectively. NedCo continues to believe, especially in light of the recent financial crisis, that the Bank needs to continue to increase the depth of senior management expertise in execution and project management. While NedCo recognises the value of a Bank-wide policy, they judge that it is especially important to set up individual development programmes for members of the Executive Team.

### Business resilience

The financial crisis has delayed some business continuity projects. While recognising the reasons, Non-executive Directors have considered revised timetables and their implications. Even so, good progress was made on co-operation with other central banks. NedCo had previously asked how the Bank's arrangements ranked against external benchmarks. In response, management had demonstrated that the Bank's preparations measured positively against recognised best practice. While scenario planning has progressed well, the Non-executive Directors have urged management to plan for a business continuity incident during a financial crisis.

### Financial management

The Non-executive Directors have continued to take a particularly close interest in the financial management of the Bank's operations during the year. NedCo has focused on the budgetary and expenditure implications of the Bank's enhanced responsibilities as well as on the effect on the Bank's balance sheet of the exceptional market operations undertaken this year.

The Bank's budgetary and financial reporting processes provide the link between its financial management and its business operations and strategic priorities. Court agrees the strategy and key objectives for the year ahead and provides the oversight of the budgetary position to ensure that those objectives are achieved within the Bank's financial framework. We are pleased with the improvement in the Bank's financial processes and systems. Reporting to Court on these matters is now high quality and supports well-directed debate on the main issues.

The budget for 2009/10 to 2011/12 is discussed on page 32. The Bank has been successful in containing costs over the past five years but Non-executive Directors recognise that there will be challenges in the future given the enhanced responsibilities under the new Banking Act and any future changes in the Bank's remit. Non-executive Directors approved the planned additional costs that arise from the delivery of the Bank's new responsibilities, as well as the need for some expenditure on the Bank's expanded collateral management operations. However, as current spending on policy functions will exceed projected CRD income, the Bank will need to discuss its financing with HM Treasury in due course. This will be an important matter for Non-executive Directors to consider in 2009/10 and beyond. NedCo endorses the proposals to constrain nominal spending growth and welcomes the permanent commitment to value for money.

Non-executive Directors have been kept apprised of the effect that the greatly expanded market operations have had (and will have) on the Bank's balance sheet, and the related indemnity arrangements with HM Treasury. In addition, Directors have discussed the Bank's capital position while recognising that there is no indisputable standard for a central bank's level of capital. Non-executive Directors expect discussions with HM Treasury to start on the appropriate capital position of the Bank once more normal conditions have returned.

### Audit and Remuneration Committees

Certain of the functions of Court are delegated to the Audit and Remuneration Committees. The terms of reference of each of the committees have been reviewed again during the year — a more substantive review and verification will be undertaken when the new Court and its subcommittees are formed after 1 June. Non-executive Directors consider that the Audit and Remuneration Committees have operated effectively during the year.

Awareness of risk within the organisation and risk reporting have improved further, helped by a new incident reporting framework which has evolved into a valuable tool. Directors welcome the work that is being undertaken to ensure that themes and issues detected in incident reports transfer into the management of risk and the Bank's internal control system.

The Audit Committee assists Court in meeting its responsibilities for ensuring that the Bank has an effective system of financial reporting, internal control, risk and value for money management. Over the past year it also has focused on the demands on the Bank's balance sheet and resources arising from its increased market operations, and the need for new or strengthened controls. The Committee has reviewed the effectiveness of the system of internal financial controls which operated during 2008/09 and this is reported in the internal controls section of the *Annual Report* (pages 39–41) which, so far as appropriate, forms part of NedCo's report.

The Remuneration Committee assesses the remuneration of the executive members of Court and the Bank's Executive Directors. It also recommends to Court the terms and conditions of service of the members of the Monetary Policy Committee appointed by the Chancellor of the Exchequer. The report on remuneration for 2008/09 is set out on pages 33–36 and, so far as appropriate, forms part of this report.

### MPC procedures

Non-executive Directors are responsible for keeping the procedures followed by the MPC under review and to ensure that it has adequate resources to do its work. This includes reviewing the regional, sectoral and other information used by the MPC for the purposes of formulating monetary policy.

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As required under Schedule 3 of the Bank of England Act, Non-executive Directors receive a monthly report from the MPC. Every three months, following publication of the Bank's *Inflation Report*, MPC members are invited to attend NedCo to discuss both the *Inflation Report* and MPC procedures. As well as receiving the minutes of the monthly MPC meetings, the Bank's quarterly Inflation Report and summaries of other meetings, Non-executive Directors also periodically attend pre-MPC meetings and visit the Bank's Agencies. They also see examples of the regional, sectoral and other information collected by the MPC during the year.

The intelligence gathered by the Bank's Agencies remains an important part of the information used by the MPC. This has been especially true at a time of increased uncertainty and divergent economic trends.

Non-executive Directors note that MPC members value the help of the Agencies in arranging their own visits around the United Kingdom to hear first-hand about business and economic conditions and to explain their own views about the economy and interest rate decisions.

Aside from receiving periodic presentations to Court on MPC processes, NedCo formally reviews procedures for setting monetary policy by way of a questionnaire completed each year by MPC members. These provide the basis for a private discussion between the Senior Non-executive Director and individual members of the MPC on a one-to-one basis.

In 2008/09 Non-executive Directors were pleased to note that work on streamlining the pre-MPC processes was completed early. However, there were some delays to model development work and further process automation as a result of resources having to be diverted to other priorities — for example, the implementation of unconventional monetary policy measures (quantitative easing). Non-executive Directors had valuable discussions with MPC members on a range of process-related issues, including the way in which the scale of Bank Rate changes was assessed in a severe downturn and how money could be injected directly into the economy when interest rates were close to zero. Additionally, they discussed how the Bank and the MPC communicate with the financial community and how key messages could be better transmitted.

Non-executive Directors have welcomed improvements in the planning for MPC appointments and succession. In that regard, they supported the Treasury Committee's proposal for a confidential pool of experts to be maintained to help fill vacancies in a timely fashion. The recent appointment of David Miles showed that effective procedures are now in place.

In NedCo's opinion, based on its review and notwithstanding adverse economic conditions, the MPC's procedures, including those relating to the collection of regional, sectoral and other information, operated well during the year and provided valuable input to MPC debate and decisions. The Bank continues to improve and adapt processes to address specific issues raised by MPC members and NedCo.

The table overleaf sets out attendance by the Bank's 16 Non-executive Directors at meetings of Court, NedCo, the Audit and Remuneration Committees.

The figures in brackets refer to the total number of meetings during the financial year. Attendance by other members of Court is also listed.



<b>Attendance</b>	<b>Court (12)</b>	<b>NedCo (10)</b>	<b>Audit (3)</b>	<b>RemCo (6)</b>
Sir John Parker — Attendance as an observer at Audit Committee and RemCo	10	10	1	5
Mr Barber	8	9		
The Hon Peter Jay	10	10		6
Dr Potter	9	9		6
Sir Callum McCarthy — Resigned from Court 19 September 2008	5 of 7	5 of 6		
Ms Fawcett	7	7	3	
Sir Andrew Likierman — Resigned from Court 12 December 2008	8 of 10	8 of 9	1 of 2	
Mr Wilkinson	10	10		5
Mr Myners — Resigned from Court 3 October 2008	5 of 7	5 of 6	2 of 2	
Mr Sarin	9	9		2
Professor Rhind	10	10		6
Mr Wigley	8	8	3	
Mr Strachan	10	10	3	
Mr Carr	10	10		6
Ms Rice	10	10	3	
Lord Turner — Appointed to Court 20 September 2008	4 of 5	4 of 4		
Mr King	11	9*		
Ms Lomax — Retired from Court 31 May 2008	3 of 4	3 of 4*		
Sir John Gieve	9	10*		
Mr Bean	6 of 8	6 of 6*		

\* Attendance by invitation.