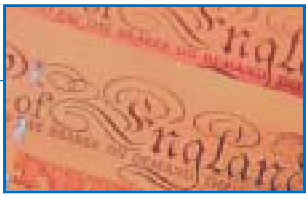
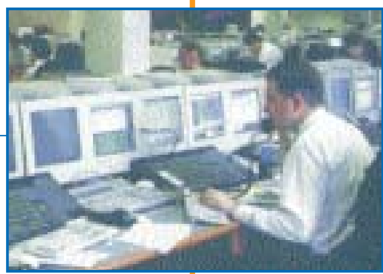




Bank of England

Annual Report 2002

Contents

3 Governor's Foreword
6 The Court of Directors
8 Governance and Accountability
10 The Bank's Core Purposes
12 Organisation Overview
14 The Executive and Senior Management
16 Review of Performance against Objectives and Strategy
32 Monetary Policy Committee Processes
36 Objectives and Strategy for 2002/03
37 Financial Framework for 2002/03
41 Personnel and Community Activities
45 Remuneration of Governors, Directors and MPC Members
49 Report from Members of Court
53 Risk Management
56 Report by the Non-Executive Directors
58 Report of the Independent Auditors
60 The Bank's Financial Statements
60 Banking Department Profit and Loss Account
61 Banking Department Balance Sheet
62 Banking Department Cash Flow Statement
63 Notes to the Banking Department Financial Statements
90 Issue Department Statements of Account
91 Notes to the Issue Department Statements of Account
Addresses and Telephone Numbers

Eddie George, Governor

Governor's Foreword

The UK economy has faced a difficult international environment over the past year. The internationally-exposed sectors were severely affected by the global economic slowdown, aggravated by the events of 11 September, and by the continuing weakness of the euro in foreign exchange markets. Although for much of the time we were able to fend off the worst effects on the economy as a whole by stimulating domestic demand, notably consumer spending, this necessarily meant living with a two-speed economy. Even so growth came to a halt in the fourth quarter of 2001 and the first quarter of 2002. Happily the signs now are that the world economy is beginning to pick up, which holds out the prospect of a return to stronger as well as potentially better balanced growth here at home, with inflation close to target and a continuing relatively high level of employment. If that is how it turns out, then we will have weathered the international storm as well as could reasonably have been expected.

Growth of the UK economy in 2001, at 2.2 per cent, was the highest among the G7 countries and the rate of unemployment is the lowest, on a comparable basis, in the G7. Interest rates are lower than they have been in this country for a generation. Until the flat fourth quarter of last year, GDP had grown for 37 successive quarters, the longest sustained quarter by quarter period of growth since quarterly records began in 1955.

There was nothing we could do directly to counteract the depressing effects of lower activity abroad, and the damaging impact this had on the business of internationally-exposed companies and sectors, because that is something that can only be tackled by the authorities in the countries with which we trade. Neither was there anything we could do deliberately to weaken the exchange rate. Quite apart from the inflationary risks of reducing interest rates too far, it is not at all evident that currencies will respond as people expect to a reduction in relative interest rates, as the behaviour of the dollar and sterling against the euro over the last year have demonstrated. But what we were able to do, given the subdued inflationary pressure, was to compensate for that weakness of demand from abroad by stimulating domestic demand in the UK with lower interest rates, to buoy up consumer spending. The Monetary Policy Committee (MPC) reduced interest rates from 6 per cent in early 2001 to 4 per cent by November, and has since kept them steady. The Government also stepped up its own spending, which was helpful in offsetting the impact of a weak international environment. So we did manage to keep the UK economy as a whole moving forward, despite the painful recession experienced by internationally-exposed manufacturing companies. A two-speed economy is far from ideal, but stimulating domestic demand was our only option, and was very much better than doing nothing at all. Some growth, even though unbalanced, is preferable to contraction for the economy as a whole.

The strategy was not risk free. If external demand does indeed recover as is now expected, the domestic demand growth we have deliberately helped to stimulate will need to moderate in due course if we are to avoid a build up of inflationary pressures. It remains possible that the necessary moderation of consumer demand will come about of its own accord, as a result of the build up of household debt, and the prospect of relatively restrained growth of personal incomes, and if that happens in a measured and not too abrupt way, it will be the best outcome.

The events of 11 September had potentially serious implications for the functioning and stability of the financial system. In the event the system coped remarkably well with the potential dislocation. Much of the credit for that goes to the Federal Reserve and other US agencies, which kept essential payments and settlement services functioning, allowing international markets to continue to operate. The City of London also responded well to the challenge of keeping all its markets going, including those most directly linked to New York. The private sector, along with the Bank, the Financial Services Authority and the Treasury, is now involved in a concerted effort to strengthen the financial system's disaster contingency plans, including the launch recently of a public web site designed to promote the sharing of information.

I have also been impressed by how well the financial system as a whole has coped with the inevitable stresses arising from global economic developments, as well as a succession of corporate strains, including those in the telecoms, IT and energy industries, and the impact of Argentina's default. It suggests that financial institutions have become more discriminating in assessing and diversifying risk than at times in the past.

But there is certainly no room for complacency in this area and the Bank has continued to strengthen its surveillance capability in relation to systemic financial stability. This work is reported in the *Financial Stability Review* published twice a year. On many of the issues that are addressed we cooperate very closely with the Financial Services Authority, and I am pleased that the two organisations continue to work well together.

The Bank has also been working intensively in international fora to encourage greater clarity and predictability in relation to the response of the international community to sovereign debt problems. As things stand neither the debtor countries nor their private sector creditors have any very clear idea as to the extent of official support, or the policy conditions likely to be attached to it, if problems emerge; nor is there any common understanding of what should happen in extreme situations where a country is unable immediately to honour its debts. Greater clarity on normal IMF access policy, and on sovereign debt restructuring principles and processes, would provide stronger incentives to borrowing countries to pursue appropriate policies and, at the same time, helps creditors to make a better-informed assessment of risks. I am encouraged by recent progress on these issues reflected in the recent G7 Action Plan, though a good deal of work remains to be done to put flesh on the bones.

It has been another challenging year for the Bank's financial markets operations area. Their market intelligence and liaison, together with the fact that they were prepared to undertake exceptional sterling liquidity provision, and had arranged an emergency dollar swap facility with the US Federal Reserve, provided necessary reassurance that enabled the money markets to function smoothly in the wake of 11 September. And the financial sanctions team has made a strong contribution to the UK's increased efforts to obstruct the financing of terrorism. More routinely, we concluded the Government's programme of gold sales on behalf of the Treasury. We have also made some minor changes to improve further the running of our euro bills and notes programmes. In our banking and payments activities, we have implemented major changes in our own banking operations; Delivery versus Payment, which eliminates intra-day credit exposures amongst settlement banks, was launched successfully for the CREST securities settlement system; and we have just introduced a new £5 note with enhanced security features, and have agreed arrangements to improve the distribution of this denomination of note to the public.

The Bank carries out a range of other work related to the effectiveness of the UK's financial services as a whole. This includes the considerable effort we have put over the last decade into improving the relationship between small firms and their suppliers of finance, paying particular attention recently to the financing of technology based small firms. Our latest small firms report was published in May. It included an analysis of the financing of university-based programmes to facilitate the exploitation of research, and the results of our second review of financial exclusion. I am sure that both the relationship between small business and the banks and other suppliers of finance, as well as the availability of finance, have much improved over the period.

During the year, the Bank reviewed the financing of the Financial Law Panel which was set up in 1993 and reluctantly decided that we could not continue our open-ended support indefinitely. A new Bank of England Financial Markets Law Committee has been set up, with secretariat provided by the Bank, to seek to identify areas of legal uncertainty affecting wholesale financial markets, and facilitate solutions. (The changes are described in more detail on page 25). Over the years, the Panel made a major contribution to clarifying areas of uncertainty in the operation of financial law, and I would like to thank Lord Donaldson, the chairman, and Colin Bamford, the chief executive, for their achievements in this respect. I welcome Lord Browne-Wilkinson as chairman of the new committee and wish him every success.

Our work on London's position as a financial centre and our preparations for possible membership of the euro area are referred to elsewhere in this Report. But I would like to pay tribute to John Townend, our Director for Europe, who is retiring after making a tremendous contribution both to the UK financial sector's introduction of the euro in wholesale financial markets in January 1999, and to the understanding of what needs to be done in the financial sector if the UK does decide, in a referendum, to join. I welcome Bill Allen as the new Director for Europe, as well as Deputy Director for Financial Stability. Mr Allen's broad experience on European matters will be extremely valuable in taking the work forward. He was a member of the European Union Monetary Committee from mid-1994 to the end of 1998, so he was closely involved in the practicalities of setting up the single currency, right up to its introduction.

I would also like to record my warmest thanks to my long-time colleague Ian Plenderleith, who retires this month from the MPC, of which he was a founding member, and also from his post as Executive Director for Financial Market Operations. He has given exemplary service to the Bank and to monetary policy over 36 years. I wish him a very happy retirement. I welcome his successor, Paul Tucker, as our new Director for markets, and also welcome both him and Marian Bell as new members of the MPC from 1 June. My sincere thanks go to Sushil Wadhwani for the three years he has served as a member of the Committee.

Finally I would like to pay tribute to Sir Neville Simms, who leaves Court at the end of May after more than seven years' service, and in particular for his very valuable contribution as Chairman of the Audit Committee.

I am as always very grateful to my two Deputy Governors, to my fellow members of Court, to our Executive and Deputy Directors, to the members of the MPC and especially to our staff. For them, it has been a somewhat calmer year in a more stable environment that has helped us to consolidate some of the many changes in recent years. But as always in the Bank, there are areas where change has been particularly rapid, and over the past year that has been most evident in our own banking operations, where substantial investment in systems and the creation of new multiskilled teams have required nearly 100 redundancies. I am very grateful for the understanding of staff in helping us facilitate those changes. It remains our priority to continue to improve morale throughout the Bank.

Governor of the Bank of England
May 2002

The Court of Directors

Members of the Court of Directors

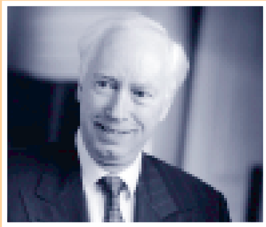
The Rt Hon. Sir Edward George
Governor

David Clementi
Deputy Governor

Mervyn King
Deputy Governor

Sir David Cooksey

Sir Neville Simms



John Neill, CBE

Dame Sheila McKechnie, OBE

Sir Ian Gibson, CBE

Kathleen O'Donovan

Bridget Blow

Sir Brian Moffat, OBE

Sir David Cooksey
Appointed to Court in March 1994. Appointed Chairman of the sub-committee of Directors in June 2001.

Chairman,
Advent Limited.
Chairman,
Bespak plc.
Chairman,
William Baird plc.
Director,
Advent VCT plc.
Director,
Advent 2 VCT plc.
Director,
ITouch plc.
Director,
The Establishment Investment Trust plc.
Chairman,
Small Business Investment Taskforce.

Sir Ian Gibson, CBE
Appointed August 1999.

Chairman,
AIGT.
Director,
Centre for Life Trust.
Director,
ProDrive Limited.
Director,
BPB plc.

Sir Neville Simms
Appointed March 1995.

Chairman,
Carillion plc.
Chairman,
International Power plc.
Member,
CBI Presidents Committee.
Governor,
Ashbridge Management College.
Governor,
Stafford Grammar School.

Kathleen O'Donovan
Appointed August 1999.

Chief Financial Officer,
Invensys plc.
Director,
EMI Group plc.

John Neill, CBE
Appointed March 1996.

Deputy Chairman and Group Chief Executive,
Unipart Group of Companies.
Director,
Business in the Community Limited.
Director,
Charter plc.
Director,
SMMT Industry Forum.
Vice President,
The Institute of the Motor Industry.
Deputy President,
Society of Motor Manufacturers and Traders Limited.

Bridget Blow
Appointed June 2000.

Chief Executive,
ITNET plc.
Member,
CBI Education and Training Affairs Committee.

Dame Sheila McKechnie, OBE
Appointed June 1998.

Director,
Consumers' Association.
Chief Executive,
Which? Limited.

Sir Brian Moffat, OBE
Appointed June 2000.

Chairman,
CORUS Group plc.
Non-Executive Director,
Enterprise Oil plc.
Non-Executive Director and Deputy Chairman,
HSBC Holdings plc.

Bill Morris

Jim Stretton

Sir Howard Davies

Roy Bailie, OBE

Sir John Bond

Mary Francis, LVO

Graham Hall

Dr DeAnne Julius, CBE

Bill Morris
Appointed June 1998.

General Secretary,
Transport and General Workers' Union.
Member,
Executive Board of the International Transport Workers' Federation.
Sitting Member,
The Employment Appeal Tribunal.
Chancellor,
University of Technology, Jamaica.
Member,
Commission for Integrated Transport.

Sir John Bond
Appointed 1 June 2001.

Group Chairman,
HSBC Holdings plc.
Director,
Ford Motor Company.
Director,
HSBC Holdings plc.
Chairman,
Institute of International Finance.

Jim Stretton
Appointed June 1998.

Director,
The Edinburgh Festival Society Limited.
Director,
The Edinburgh Festival Centre Limited.
Director,
The Edinburgh International Festival Limited.
Chairman,
The Wise Group.
Trustee Director,
Bank of England Pension Fund Trustees Ltd.

Mary Francis, LVO
Appointed 1 June 2001.

Director General,
Association of British Insurers.
Member,
Press Complaints Commission.
Member,
CBI Council.
Board Member,
The Pensions Policy Institute.
Director,
International Financial Services, London.

Sir Howard Davies
Appointed to Court as Deputy Governor in September 1995. Resigned in July 1997. Reappointed to Court in March 1998.

Chairman,
The Financial Services Authority.

Graham Hall
Appointed 1 June 2001.

Chairman,
Yorkshire Forward Regional Development Agency for Yorkshire and the Humber.

Roy Bailie, OBE
Appointed June 1998.

Chairman,
W&G Baird Holdings Limited.
Director of Court,
Bank of Ireland.
Non-Executive Chairman,
Northern Ireland Tourist Board.
Non-Executive Director,
UTV (Ulster Television).

Dr DeAnne Julius, CBE
Appointed 1 June 2001.

Director,
Lloyds TSB Group.
Director,
Serco Group plc.
Director,
BP plc.
Director,
Roche Holding SA.
Member,
National Learning and Skills Council.
Vice Chairman,
Institute of Development Studies.

Governance and Accountability

This is the fourth Annual Report prepared under the Bank of England Act 1998, which was summarised in the 1999 Report. This Report reflects the new governance arrangements, the main elements of which are set out below.

The Court of Directors

The 1998 Act provides for Court to consist of the Governor, two Deputy Governors and 16 Directors. The Directors are all non-executive. The Governors are appointed by the Crown for five years and the Directors for three years. Details of the current Court are set out on pages 6-7. During the year the terms of Andrew Buxton, Frances Heaton, Sir Chips Keswick and Baroness Noakes expired and they were replaced by Sir John Bond, Mary Francis, Graham Hall and DeAnne Julius. Sir David Cooksey was appointed for a new three-year term.

Under the Act, the responsibilities of Court are to manage the Bank's affairs, other than the formulation of monetary policy, which is the responsibility of the Monetary Policy Committee (MPC). This includes determining the Bank's objectives and strategy, and aiming to ensure the effective discharge of the Bank's functions and the most efficient use of the Bank's resources. Court must meet at least once a month.

Members of Court have been indemnified by the Bank against personal civil liability arising out of the carrying out or purported carrying out of their functions, provided they have acted honestly and in good faith and have not acted recklessly. These indemnities accord with the practice of the Government in relation to board members of Non-Departmental Public Bodies and their grant was approved by HM Treasury.

The Monetary Policy Committee

The Act establishes the MPC as a Committee of the Bank, subject to the oversight of NedCo, and sets a framework for its operations. The Act provides that the Bank's objectives in relation to monetary policy shall be to maintain price stability and, subject to that, to support the Government's economic policies, including its objectives for growth and employment. At least once a year, the Government specifies the price stability target and its growth and employment objectives in conformity with the Act. Membership of the MPC is given on page 32.

NedCo

The Act provides for a sub-committee of Court consisting of all the (non-executive) Directors, with a Chairman designated by the Chancellor of the Exchequer. It is known as NedCo and Sir David Cooksey was appointed Chairman from 1 June 2001. While Court as a whole is responsible for managing the affairs of the Bank, including setting its objectives and strategy, NedCo is responsible for reviewing the Bank's performance in relation to its objectives and strategy, and monitoring the extent to which the Bank's financial management objectives are met. NedCo is also responsible for reviewing the procedures of the MPC, and in particular whether the Committee has collected the regional, sectoral and other information necessary for formulating monetary policy. Other functions of NedCo include reviewing the Bank's internal controls and determining the Governor's and Deputy Governors' remuneration and pensions. The Act also requires the sub-committee to determine the terms and conditions of service of the four members of the MPC appointed by the Chancellor. NedCo has agreed that the Remuneration Committee should recommend the salaries and pensions of the Governors and the members of the MPC appointed by the Chancellor. NedCo is required to make a report as part of the Bank's Annual Report. This is on page 56.

Remuneration Committee

The members of the Remuneration Committee during 2001/02 were John Neill (Chairman), Bill Morris, Jim Stretton and Graham Hall, the latter having joined in June 2001. Sir David Cooksey, Frances Heaton and Baroness Noakes stood down in May 2001. The Committee's approach to remuneration is set out in the Remuneration Report on page 45.

Audit Committee

The members of the Audit Committee during 2001/02 were Sir Neville Simms (Chairman), Kathleen O'Donovan, Bridget Blow, Sir Brian Moffat and Mary Francis, the latter having joined in June 2001 to replace Andrew Buxton. The Deputy Governor (Financial Stability), the Finance Director and the Auditor normally attend the meetings of the Committee.

The functions of the Audit Committee are to:-

a/ Keep under review the internal financial controls in the Bank.

b/ Receive reports from, and review the work of, the internal and external auditors. The Committee also considers and makes recommendations on the appointment of the external auditors, and their fees.

c/ Review the annual financial statements prior to their submission to Court, including consideration of the appropriateness of the accounting policies and procedures adopted. The Committee reports its conclusions to Court.

Management structure

Under the Court of Directors, the Bank's senior policy-making body is Governor's Committee, comprising the Governors and Executive Directors. The internal management of the Bank is the responsibility of Management Committee, comprising the Deputy Governor (Financial Stability), the Deputy Directors, the Finance Director and the Director of Personnel.

The Bank's management structure and Heads of Function are shown on pages 14-15. The responsibilities of each area are described in more detail on pages 12-13. This structure, based on three main operational areas – Monetary Analysis and Statistics, Financial Market Operations and Financial Stability, supported by Central Services – was introduced in June 1998 to reflect the Bank's new responsibilities following the commencement of the Bank of England Act.

The Bank's Core Purposes

The Bank's Core Purposes form a part of the objectives and strategy of the Bank determined by the Court of Directors under Section 2 of the Bank of England Act 1998. They are reviewed each year and supplemented by an annual statement of Bank Objectives. The Bank Objectives for 2002/03 are set out on page 36 of this Report. The Bank Objectives for 2001/02 were set out in last year's Annual Report and the Bank's performance in relation to them and the Core Purposes is reviewed on pages 16-31 of this Report.

The three Core Purposes

As the central bank of the United Kingdom, the Bank is committed to promoting the public good by maintaining a stable and efficient monetary and financial framework as its contribution to a healthy economy. In pursuing this goal it has three Core Purposes; achieving them depends on the work of the Bank as a whole.

Because the Bank is a national institution, its three Core Purposes relate primarily to the United Kingdom. But achieving them requires it not only to understand the international developments that may have a bearing on them, but also to co-operate actively with other monetary authorities and international organisations.

1/ Maintaining the integrity and value of the currency

Above all, this involves maintaining price stability, as defined by the inflation target set by the Government, as a precondition for achieving the wider economic goals of sustainable growth and employment. The Bank pursues this core purpose through its decisions on interest rates taken at the monthly meeting of the Monetary Policy Committee; by participating in international discussions to promote the health of the world economy; by implementing monetary policy through its market operations and its dealings with the financial system; and by maintaining confidence in the note issue.

2/ Maintaining the stability of the financial system, both domestic and international

This the Bank seeks to achieve through monitoring developments in the financial system both at home and abroad, including the links between individual institutions and between financial markets; through analysing the health of the domestic and international economy; through close co-operation with financial supervisors both domestically and internationally; and through promoting sound financial infrastructure including efficient payment and settlement arrangements. In exceptional circumstances, in consultation with the Financial Services Authority and HM Treasury as appropriate, the Bank may also provide, or assist in arranging, last-resort financial support where this is needed to avoid systemic damage.

3/ Seeking to ensure the effectiveness of the UK's financial services

The Bank wants a financial system that offers opportunities for firms of all sizes to have access to capital on terms that give adequate protection to investors, and which enhances the international competitive position of the City of London and other UK financial centres. It aims to achieve these goals through its expertise in the market place; by acting as a catalyst to collective action where market forces alone are deficient; by supporting the development of a financial infrastructure that furthers these goals; by advising government; and by encouraging British interests through its contacts with financial authorities overseas.

Organisation Overview

Monetary Analysis and Statistics

International Economic Analysis
Structural Economic Analysis
Monetary Instruments and Markets
Monetary Assessment and Strategy
Conjunctural Assessment and Projections
Inflation Report and Bulletin
Regional Agencies
Monetary and Financial Statistics

The Monetary Analysis divisions are responsible for providing the Bank with the economic analysis it needs to discharge its monetary policy responsibilities. Its economists conduct research and analysis of current and prospective developments in the UK and international economies. The MA divisions produce the *Quarterly Bulletin* and the quarterly *Inflation Report*, which sets out the Monetary Policy Committee's assessment of the current monetary and economic situation in the UK and of the outlook for inflation and growth. The work of the divisions, including reports from the 12 regional Agencies, provides the analytical information for the interest rate decisions taken each month by the Bank's Monetary Policy Committee to achieve the Government's inflation target. The Monetary and Financial Statistics Division compiles, publishes and briefs on financial statistics; in particular the monetary aggregates and banking statistics. Special studies directed at international harmonisation and improvements to the statistics are also a feature of the work.

Financial Market Operations

Gilt-Edged and Money Markets
Foreign Exchange
Customer Banking and Notes
Market Services
Risk Analysis and Monitoring
Registrar's Department

The Gilt-Edged and Money Markets and Foreign Exchange divisions conduct the Bank's operations in the core financial markets, to establish short-term interest rates at the level required by monetary policy. They also manage the Bank's foreign currency operations and, as agent, HM Treasury's foreign exchange and gold reserves. They contribute market analysis and intelligence to the Monetary Policy Committee and the Financial Stability Committee from their operational presence in the markets, and seek to promote efficient structures in those markets. The Risk Analysis and Monitoring Division is responsible for analysing and monitoring the risks involved in the Bank's financial operations and for producing management and accounting information. Customer Banking and Notes and Market Services provide banking services to the Government and other customers, principally banks and other central banks. They manage the note issue. They also operate the RTGS system through which the major UK payments systems are settled and, from this operational role, contribute analysis to the Bank's continuing work in developing safe and efficient payment and settlement systems. The Registrar's Department provides the principal stock registration service for the Government and an execution-only postal brokerage service for retail gilt investors.

Financial Stability

Domestic Finance
Financial Industry and Regulation
Financial Stability Assessment
G10 Financial Surveillance
International Finance
Market Infrastructure

The Financial Stability divisions have the main responsibility for discharging the Bank's remit to maintain the stability of the financial system as a whole. The Financial Stability Committee acts as a focus for the Bank's work in this area. The Committee is chaired by the Governor. Its other members are David Clementi, Mervyn King, Charlie Bean, Alastair Clark, Ian Plenderleith, Charles Goodhart and Paul Tucker. The work of the Financial Stability divisions covers both UK and overseas financial markets. The divisions identify, analyse and carry out research into issues concerning the structure and functioning of these markets and the operation of the international financial system, and make policy proposals and encourage changes designed to increase its overall safety and effectiveness.
The divisions also contribute to the monetary policy process, for example through the Bank's Deputy Governor for Financial Stability as a member of the Monetary Policy Committee. The divisions aim to promote public understanding of issues relating to financial stability through, for instance, the regular *Financial Stability Review.*

Co-ordination Unit for Europe

The Co-ordination Unit for Europe is responsible for co-ordinating the Bank's work on Europe, specifically in relation to the euro. It monitors the evolution of the euro financial markets and supporting infrastructure; and provides information on this (and other euro-related matters) in the biannual *Practical Issues* report. It leads the Bank's involvement in HMT's National Changeover Plan work, focusing on the financial sector preparations. It co-ordinates the Bank's involvement in the main official and private sector euro fora; and provides a body of expertise on the European Central Bank. Working with the Agents, it also monitors the use of the euro in the UK.

Audit

The Internal Audit Division provides independent risk assurance to senior management under arrangements authorised by the Audit Committee on behalf of the Court of Directors, and gives advice where appropriate to ensure that the Bank follows good practice in risk control. It reviews the adequacy of the Bank's internal control system and tests compliance with agreed procedures for managing risks.

Central Services

Personnel
Secretary's Department
Legal Unit
Finance and Resource Planning
Investment Unit
Management Services
Property Services and Security

The Central Services divisions encompass a range of support functions that underpin the Bank's activities and help to ensure that the Bank's reputation is maintained. These include finance, IT, personnel, the Governors' private offices, press and public relations, and legal and information services.

CCBS

The Bank of England's Centre for Central Banking Studies offers technical assistance, courses, workshops, seminars and comparative research on and for central banks throughout the world. Its primary aims are to foster monetary and financial stability worldwide, to promote the Bank's core purposes, and to provide opportunities for Bank of England staff to obtain broader perspectives on their own areas of expertise. Its goal is to be recognised internationally as a leading centre of intellectual excellence for the study of practical central banking.

Printing Works

The Bank of England Printing Works is located on a purpose-built high-security site in Debden in Essex. It employs about 400 people and is responsible for the printing of about 1 billion notes annually, together with the manufacture of its own inks, printing plates and threads. In addition the Printing Works provides technical and specialist security advice to a number of central banks worldwide.

The notes are produced in a highly developed printing process which combines high technology and quality craftmanship, making the Bank one of the most cost-effective note producers worldwide.

The Printing Works' expertise has led to commercial sales in overseas markets through Debden Security Printing Limited, the Bank's wholly owned commercial subsidiary.

The Executive and Senior Management

Governor's Committee

Eddie George, Governor

David Clementi,
Deputy Governor,
Financial Stability

Mervyn King,
Deputy Governor,
Monetary Stability

Ian Plenderleith,
Executive Director,
Financial Market Operations

Alastair Clark,
Executive Director,
Financial Stability

Charlie Bean,
Executive Director,
Monetary Analysis and
Statistics

Management Committee

David Clementi,
Deputy Governor,
Financial Stability

Bill Allen,
Deputy Director,
Market Operations

John Footman,
Director of Personnel

Nigel Jenkinson,
Deputy Director,
Monetary Analysis and
Statistics

Merlyn Lowther,
Deputy Director,
Banking and Market Services
and Chief Cashier

Clifford Smout,
Finance Director

Paul Tucker,
Deputy Director,
Financial Stability

With effect from 1 June 2002 Paul Tucker will replace Ian Plenderleith as Executive Director, Market Operations, and Bill Allen will replace Paul Tucker as Deputy Director, Financial Stability. Bill Allen will also take over as Director for Europe on John Townend's retirement on 11 June.

Management Structure

Eddie George
Governor

Kevin Butler
Auditor

Peter Rodgers
Secretary of the Bank and Public Relations

Mervyn King
Deputy Governor
Monetary Stability

David Clementi
Deputy Governor
Financial Stability

Mike Thompson
General Manager
Printing Works

Monetary Analysis and Statistics

Charlie Bean
Executive Director

Nigel Jenkinson
Deputy Director

Peter Andrews
Monetary Assessment and Strategy

Andrew Bailey
International Economic Analysis

Ian Bond
Structural Economic Analysis

Roger Clews
Monetary Instruments and Markets

Mark Cornelius
Inflation Report and Bulletin

Spencer Dale
Conjunctural Assessment and Projections

Agencies – see page 35

Joanna Place
Monetary and Financial Statistics

Peter Sinclair
Centre for Central Banking Studies

** reports to Charlie Bean and Bill Allen*

Financial Market Operations

Ian Plenderleith
Executive Director

Bill Allen
Deputy Director

Merlyn Lowther
Deputy Director and Chief Cashier

Paul Fisher
Foreign Exchange

David Ingram
Risk Analysis and Monitoring

David Rule
Gilt-Edged and Money Markets

Christopher Mann
Market Services

Colin Mann
Customer Banking and Notes

Geoff Sparkes
Registrar's Department

Europe

John Townend
Director for Europe

Co-ordination Unit for Europe

Financial Stability

Alastair Clark
Executive Director

Paul Tucker
Deputy Director

Alex Bowen
Financial Stability Assessment

Peter Brierley
Domestic Finance

Stephen Collins
G10 Financial Surveillance

Andy Haldane
International Finance

Patricia Jackson
Financial Industry and Regulation

John Trundle
Market Infrastructure

Central Services

Clifford Smout
Finance Director
Finance and Resources

John Footman
Director of Personnel

Andy Brookes
Management Services

Michael Craig
Investment Unit

Peter Higgs
Property Services and Security

John Matheson
Personnel

Secretary's

Advisers to the Governors

Malcolm Glover
Legal

Professor Charles Goodhart
Financial Stability

Sir Peter Petrie
European and Parliamentary Affairs

Review of Performance against Objectives and Strategy

This section of the Report provides an account of the Bank's performance during 2001/02 against the Bank's Core Purposes and the ten Strategic Objectives set for the year by Court. These were published in last year's Annual Report, and have provided a framework for the Bank's business planning and budgets over the past year.

The Bank of England Act 1998 requires Court to determine the Bank's objectives (including objectives for its financial management) and strategy. It also requires NedCo to keep under review the Bank's performance in relation to its objectives and strategy and to monitor the extent to which the objectives set by Court for the Bank's financial management have been met. NedCo's own report is published on pages 56-57. The objectives set for the year 2002/03 are shown on page 36.

THE CORE PURPOSES

The Bank's first Core Purpose is to maintain the integrity and value of the currency. Relevant functions include the interest rate decisions taken by the Monetary Policy Committee in pursuit of the inflation target set by the Government, the implementation of monetary policy decisions through market operations and other dealings with the financial system, participating in international discussions to promote the health of the world economy, and maintaining confidence in the physical note issue itself.

The Bank's second Core Purpose is to promote the stability of the financial system, both domestic and international. In the framework of the Bank of England Act 1998, and the 1997 Memorandum of Understanding (MoU) between the Treasury, the Bank and the Financial Services Authority, the Bank is responsible for "the overall stability of the financial system as a whole". In practice, this translates into work under three main headings:

1/ analysing, and promoting initiatives to strengthen, the financial system's capacity to withstand shocks;

2/ surveillance, that is monitoring developments in the financial system to try to identify potential threats to financial stability at an early stage; and

3/ reinforcing arrangements for handling financial crises should they occur.

The Bank's third Core Purpose is to promote the effectiveness of the UK's financial system. The objective is also reflected in the terms of the MoU. The Bank's work on financial market infrastructure, on the reform of domestic markets, and on the competitiveness of the City all contribute to this objective, as do specific initiatives such as those directed at the financing of small firms.

The three Core Purposes underpin all of the Bank's work, and are reflected in the ten objectives set by Court. The remainder of this Chapter discusses the Bank's activities against the background of those objectives, and of the price stability objective set by the Government.

MEETING THE INFLATION TARGET

The monetary policy objective is set by the Bank of England Act 1998. It is **"to maintain price stability and, subject to that, to support the economic policy of HM Government including its objectives for growth and employment"**. Under the Act the Government is required to set a price stability objective each year. Throughout the year just past, the Government has defined this in terms of a target for inflation of 2.5% on the RPIX (excluding mortgage interest) measure. Should inflation move more than 1% either side of the target the Governor would be required to write an open letter to the Chancellor explaining the deviation and stating how the MPC intended to remedy the situation.

The MPC's decisions themselves, and the background to them, are recorded in the published minutes of its monthly meetings alongside the Bank's *Inflation Report*, and are not repeated here. For most of the year under review the rate of inflation was a little below the target, averaging 2.2%, and at the end of the year the twelve-month growth rate was also 2.2%. The MPC's latest central projection sees inflation moving up towards the target level over the next two years, although that central projection is surrounded by considerable uncertainties.

SUPPORT FOR THE MONETARY POLICY COMMITTEE

The MPC's own processes are described on pages 32-35. For the Bank itself, the strategic objective set by Court was **"to maintain the range and quality of information and economic briefing provided to the Monetary Policy Committee"**.

Full support to the MPC in terms of briefing and analysis has been maintained by the Bank's Monetary Analysis, Market Operations and Monetary and Financial Statistics Divisions, with assistance from the Financial Stability area. And the Agencies (page 35) continue to make an important direct input into the policy process. The adequacy and mode of delivery of this support is kept under constant review. As reported last year, a number of changes were made to the process during 2000/01, in part in response to the Kohn Report on MPC processes. These included: streamlining the pre-MPC presentations; simplifying the forecast round; introducing a meeting each quarter to set short-term analytical priorities; and allocating two economists to each external member of the MPC to support their personal research. This year has seen the fine-tuning of these arrangements, rather than any major changes. An article describing the main MPC processes appeared in the Winter 2001 *Quarterly Bulletin*.

Peer review – of which the Kohn Report is a prime example – constitutes a key mechanism for ensuring that the monetary policy process is of high quality and continually improving. The February 2001 report by the House of Lords Select Committee on Monetary Policy recommended that "a review of the method of forecasting inflation used by the MPC should take place, with a view to discerning whether it is state of the art." In response the Court of the Bank has commissioned a review of the forecasting and analytical work carried out by Bank staff for the MPC. This review is being undertaken by Professor Adrian Pagan of the Australian National University and Nuffield College, Oxford, and himself a former member of the Board of the Reserve Bank of Australia (their equivalent of the MPC). Professor Pagan's remit is:

"to report on the statistical and economic modelling and forecasting work carried out by the staff of the Bank for the MPC and evaluate whether that work is "state of the art". The review should in particular:

- Focus on the technical aspects of the modelling and forecasting process, rather than the procedural and presentational issues addressed by the Kohn Report, and judged against the purposes set out for the monetary policy regime;
- Cover the full range of modelling and forecasting approaches presently employed by the Bank and note where those methods lag behind best practice or are capable of improvement;
- Identify any additional techniques or approaches that could usefully be employed;
- Evaluate the procedures for ex post forecast evaluation."

Professor Pagan's review will complement the Kohn Report, which focused on the Committee's procedures and processes.

In preparing the quarterly economic forecasts that appear in the *Inflation Report*, the Bank staff use a "suite" of empirical models of the economy, amongst which is the Medium-Term Macroeconomic Model (MTMM). Following a recommendation in the Kohn Report that more resources should be devoted to model development, a major project is in train to make the MTMM a more flexible tool for analysis and forecasting.

Particular attention this year has been directed at developing the infrastructure that supports MPC processes through more effective use of information technology and through improvements in business processes. An example is the introduction of a new system for the capture, construction and analysis of monetary and financial statistics (MIDAS). This, together with other initiatives within Monetary Analysis, will allow information and analysis to be disseminated more easily and widely within the relevant parts of the Bank, and facilitate the rapid provision of data and analysis to the Committee.

Links between the Bank and the Office for National Statistics (ONS) have become closer over the past year. The ONS has run a number of courses for Bank staff which explain how various statistics are constructed and Bank staff have given a number of seminars on how statistics are used. The Bank has also organised two workshops, on data revision and uncertainty and on the measurement of the capital stock, to bring ONS and Bank staff together to discuss topics of mutual interest. The MPC continues to specify its priorities for data provision and improvement under the Service Level Agreement with the ONS. In September 2001 ONS officials made a presentation to the Court.

Recruitment and retention of high-calibre staff remains a major priority. During 2001, a total of 33 economists were recruited to Monetary Analysis, while 22 economists left the area (usually to other parts of the Bank). Further efforts are being made to widen the recruitment net and raise average experience levels.

RESEARCH PROGRAMME

As well as research and analysis directed to immediate conjunctural questions, the Bank also undertakes a programme of longer-term research to underpin the Bank's and the MPC's analytical capabilities. The objective here is **"to enhance the Bank's programme of economic analysis of key aspects of monetary policy."**

Bank staff have produced research on a wide range of policy-relevant themes. The list of topics researched in the past year includes: analysis of forecast errors and data revisions; measuring the capital stock, particularly in the context of information and communication technology; financial factors and investment; the role of credit market imperfections in the transmission mechanism of monetary policy; factors affecting exchange rate movements; and monetary policy strategy.

Much of this work is being, or has already been, subject to peer review outside the Bank and will appear in the Bank's *Working Paper* series in 2002. Some of it will also be presented to academic and professional audiences at external seminars and conferences.

Research priorities are set by the MPC collectively. The programme for 2001/2 was set by the Committee at a meeting in January 2001 and reviewed in July 2001. The Committee met in January 2002 to set priorities for the coming budget year. Broad research themes were suggested by staff and supplemented by the ideas of MPC members. The Committee then prioritised the themes, leaving Bank staff to develop a research programme that addressed them.

The results of the research are reviewed informally by members of the Committee at a series of "Research Awaydays" at which the main findings and conclusions of three or four papers are examined in a two-hour meeting. Four Awaydays, covering 15 papers in total, took place over 2001/02. The findings are often drawn on in the monthly and quarterly rounds.

BUILDING SUPPORT FOR PRICE STABILITY

Monetary policy achieves its results more effectively if its processes are transparent and its objectives have wide public understanding and support. The strategic objective set by Court was **"through speeches, the Inflation Report and other publications and other initiatives such as the launch of the Schools Competition, to build public support for price stability, and public understanding of the MPC's approach to its remit"**.

Inflation Report

The Bank has an extensive public information programme, built around the MPC's two key publications, the quarterly *Inflation Report* and the minutes of the monthly MPC meetings. The *Inflation Report* explains the MPC's approach to its remit in the context of forecasts for inflation and economic growth. It complements the minutes, which are published within two weeks of each meeting, giving a detailed account of the proceedings, including the vote of each member.

Parliamentary committees

The Governor and other MPC members appeared twice before the House of Commons Treasury Committee to answer questions about the *Inflation Report*. (There was no May *Inflation Report* hearing owing to the General Election.) There was one other Treasury Committee hearing for a newly-appointed MPC member, Kate Barker. The Governor appeared before the House of Lords Select Committee on Economic Affairs in May 2001. Mr King gave evidence on globalisation to the Committee in private session in October 2001 and again (in a public session with the Governor) in February 2002.

Speeches and media appearances

All members of the MPC undertook programmes of speeches, meetings, visits and media interviews, throughout the UK, to explain policy and exchange views with a wide variety of audiences. During the year, 49 formal visits, organised by the Bank's Agents, were made to the regions by MPC members, typically of one or two days. Visits involve a combination of speeches, lectures, meetings with local business groups and other bodies, and visits to companies, schools and universities. In October the Court of the Bank held the fourth of a regular series of meetings outside London, on this occasion in Cardiff.

While there were about 30 major published speeches on monetary policy by the Governor and other MPC members, executive and external, during the year, they also gave more than 80 other private and public speeches, lectures and informal talks on the economy. The Bank's regional Agents undertook extensive speaking programmes of their own, and also organised, for regional business audiences, a series of presentations on the *Inflation Report* given by MPC members. About two-thirds of all the media interviews given to UK media by MPC members over the year were with regional newspapers, TV and radio.

Web site

The Bank has continued to develop its web site as a medium for promoting understanding of monetary policy. Total visits to the Bank's site have recently been averaging 211,000 a week, compared with 200,000 a year ago. A substantial proportion of the visits are directed at the wide range of monetary policy and statistics content published on the site, including the *Inflation Report*, the MPC minutes, speeches and educational material. Following the launch of a redesigned and restructured site last spring, a rolling programme was commenced to upgrade the content.

The Bank began a live webcast of the quarterly *Inflation Report* press conference, which is also stored on a server so that the public can access a recording during the following three months. The live webcast and the recording are accessed by a link from the home page of the Bank's web site. The live television broadcast continues alongside the webcast.

Education programme

The Bank also continues to foster links with schools and universities. The main development during the year was the launch of the second year of the annual schools competition, *Target 2Point5*, in which 16-18 year-old students of economics and business make presentations on monetary policy in regional heats in November and February, with the final in March. The second year attracted a significantly larger entry of 219 schools in the first round, compared with 167 first-round entries a year earlier. The second national final was held in London in March. The winning team was from Blackpool Sixth Form College. The feedback from participating schools was again enthusiastic and supportive. The Bank believes that the competition itself, including the extensive briefing material the Bank produced, will encourage an interest in the study of economics and help improve understanding of monetary policy and of the Bank's role. The publicity for the competition has also helped the MPC to explain its role to a wide audience.

Among other activities, there is a long-standing programme in which about 15,000 visitors a year, half of them students, are given talks in the Bank. Regular seminars are arranged for teachers of economics and business studies, and senior staff and members of the MPC give presentations at universities, in part to help the Bank's recruitment effort.

Opinion polls

It is difficult to quantify the wider success and benefits of the Bank's efforts to build general public support for price stability. However, the Bank has trialled, and from last June published, a national opinion poll, designed to explore the evolution over time of public opinion and understanding of a range of monetary policy matters.

The Bank carries out quarterly surveys, with one longer survey each year in February containing a larger sample and some additional questions (whose answers are not likely to vary much quarter to quarter). The results of the full annual survey are reported in the Bank's summer *Quarterly Bulletin*, with the full data available on the web site. Quarterly surveys are published in a press release and on the web site.

The five annual questions cover perceptions of the relationship between interest rates and inflation and knowledge of who sets interest rates. The nine quarterly questions cover expectations of price and interest rate changes, perceptions of the impact of inflation and interest rate changes on both the economy and on the individual, and satisfaction/dissatisfaction with the way the Bank of England is doing its job of setting interest rates in order to control inflation.

The proportion satisfied with the way the Bank "is doing its job to set interest rates in order to control inflation" has climbed to 61 per cent in February 2002 from 55 per cent a year earlier and 41 per cent in February 2000. The peak was 62 per cent in November 2001. The Bank believes that approval ratings for its actions are likely to be affected quite strongly in the short term by the direction of movements in interest rates, so this part of the survey will be most valuable when studied over a number of cycles.

The credibility of monetary policy as measured by inflation expectations has been consolidated over the year: survey measures and market indicators are largely consistent with inflation expectations being firmly anchored around the 2.5% inflation target in the medium term.

THE CENTRE FOR CENTRAL BANKING STUDIES (CCBS)

During the year, the CCBS described on page 13 ran 20 courses in London on a range of central banking subjects, lasting from three days to two weeks. 387 central bankers attended these courses. The speakers on the courses were drawn from Bank of England staff, foreign central bankers, academics, participants in financial markets and other institutions relevant to central banking and the course participants themselves. Other CCBS activities included:

- Two Research Workshops, on inflation and exchange rates, attended by 151 people. These involved a week of lectures and presentations by leading experts, such as Rudi Dornbusch, David Hendry, Mervyn King, Michael Mussa, Michael Woodford, and Lars Svensson.

Each workshop was followed by a three-month project, in which a small group of central bankers pursued research related to the subject matter of the workshop. Each project concluded with a one-day seminar at which the research results were presented to an audience of central bankers, academics and others.

- The Central Bank Governors' Seminar, in June, which provided an opportunity for the governors or their representatives from 37 central banks to meet in London and exchange views on a range of subjects, with particular emphasis on the transmission mechanism of monetary policy.

- 16 courses abroad, in Eastern Europe, Africa, the Far East, and Latin America, among others. 448 participants attended these courses. The subjects covered included economic modelling and forecasting, monetary policy and operations, exchange rate policy and corporate governance. Many of these were regional courses, attended by central banks from several countries in the area. For example the CCBS ran a regional course on exchange rate policy in Tehran for 28 central bankers from 5 countries (Iran, India, Pakistan, Bangladesh and Nepal). A team also visited Ghana, to discuss issues arising from the planned second monetary zone in West Africa.

- Technical assistance involving 27 visits to central banks abroad. This ranged from advising on the economic research programme in the Czech Republic, Monetary Policy Committee procedures in Malta, and advising senior central bank officials in Estonia and Botswana on implementing strategy change.

- Programmes for 160 central bank visitors to the Bank of England.

ASSESSING RISKS TO FINANCIAL STABILITY

The objective set by Court was: **"drawing on an increased research effort, to enhance the Bank's assessment of the nature and scale of (domestic and international) risks to financial stability, and to step up the Bank's oversight of payment systems"**.

The Financial Stability Committee and the Standing Committee

Each month, the Bank's Financial Stability Committee (FSC)[1] meets to review Bank staff's latest assessment of actual or potential risks to stability as well as major current policy issues. These discussions help in identifying areas where action by the Bank itself may be indicated, but also provide the basis for Bank input to policy debate within the UK and in international groups. Issues considered by the FSC are frequently taken to the tripartite Treasury/Bank/FSA Standing Committee. This Committee was established as part of the MoU arrangements described on page 16, and provides a regular means of exchanging information and identifying broad policy concerns related to financial stability.

Financial Market Infrastructure

Many factors contribute to the environment in which financial business is conducted. These include the legal, regulatory, accounting, disclosure, corporate governance and tax regimes, as well as market and IT systems. A broad objective for the Bank is to identify features of the environment which give rise to significant risks, and to seek ways of ameliorating those risks.

Developments in payment and settlement systems

The Bank has continued its heavy involvement in efforts to enhance the structure of payment and settlement systems. It has, for example, participated in the discussions between G10 central banks (the Committee on Payment and Settlement Systems, CPSS) and IOSCO (the International Organisation of Securities Commissions) to establish a set of core principles for the design of securities settlement systems. In many ways, this exercise has paralleled the earlier work to establish such principles for the design of systemically important payment systems. The Bank has also participated in a G30 study to review the agenda for further development of, especially, cross-border settlement arrangements. For

1: The membership of the FSC is set out on page 12.

CPSS/IOSCO the primary target was the identification and amelioration of risk; for the G30, as well as risk issues, questions about cost and efficiency have also been addressed.

Again under the heading of enhancing the robustness of payment systems, the Bank has contributed to updating the technical infrastructure on which the domestic high-value payments system (CHAPS) operates, and to developing and implementing arrangements for Delivery versus Payment (DvP) in central bank money within CREST. Although a form of DvP was already in place within CREST, providing payment assurance to market participants, there remained substantial intra-day unsecured exposures among certain banks. The new arrangements eliminate these exposures, thereby contributing to the overall robustness of the system. Both initiatives involved the Bank's Banking and Market Services area, working alongside private sector system operators and market participants. Both projects were completed on time and within budget.

Partly associated with these developments, but also for separate reasons related to competition and transparency, the Bank has reviewed its own criteria for granting settlement account facilities to payment systems and their members. A consultation paper was published in mid-January this year and a paper setting out the conclusions is planned. The intention is to ensure that, in providing settlement accounts, the Bank acts in a transparent way which facilitates competition while recognising other public policy objectives, in particular the maintenance of financial stability, and the need to control its own risks.

Basel Capital Accord

Work on the proposed new Accord, which aims to provide a more refined treatment of credit risk, has continued throughout the past year. The original intention was to finalise a proposal in the first half of 2002 with a view to implementation in 2005. In fact, the need for further analysis of various aspects of the proposals, and to test their effect in practice on a representative sample of banks, has meant that the timetable has had to be extended. The Bank and the FSA have been jointly involved in the exercise on behalf of the UK, with the Bank concentrating especially on appropriate capital charges for certain kinds of business and on co-ordination of the Basel Committee's assessment of the proposals' practical impact. Although a revised timetable has not been set for completion of the work, the hope is that a final version of the new Accord could be delivered early in 2003.

Standards and Codes

In the area of international financial arrangements, the Bank has participated actively in the work, especially through the Financial Stability Forum (FSF), to promote implementation of international standards and codes. One output has been a review, presented to the Forum in September 2001, and subsequently published on the Forum's web site, of possible incentives to encourage sovereign borrowers to achieve compliance with international standards and to encourage private market participants to pay greater attention to such compliance in their lending and investment decisions.

Assessing threats to financial stability

Developing a surveillance capacity remains a central part of the Bank's financial stability remit. Given the overseas activities of major UK financial institutions and the extent of foreign involvement in UK financial markets there is a substantial international element in this work. Over the past year, it has meant keeping developments in individual countries such as Argentina, Turkey and Venezuela under review; analysing the financial position of both the corporate and household sectors, notably in the US; seeking to identify more precisely vulnerabilities in the Japanese financial system and the potential impact on financial markets more widely; and reviewing developments in financial markets within the euro zone. The Bank has also reinforced its capacity to analyse developments in the domestic UK financial system, not just within the banking sector but also among non-bank financial intermediaries. The Bank's surveillance work draws on desk-based analysis of financial systems, markets and economies together with intelligence gathered from a range of domestic and overseas contacts. It is published in the *Financial Stability Review*, and discussed with international colleagues in the FSF, the BIS Committee on the Global Financial System, the ECB's Banking Supervision Committee and elsewhere.

Payment system oversight

An important part of the Bank's surveillance, and central to its responsibility for overall financial stability, is the enhanced regime of payment system oversight introduced in autumn 2000. This is distinct from, but of course interacts closely with, the Bank's involvement in, on the one hand the design and on the other the operation, of payment systems. The new arrangements involve regular and systematic reviews of the functioning of the main UK payment systems and associated infrastructure, conducted partly through "desk analysis" of material published by the systems themselves and partly on periodic discussions at senior executive level with the system managers and system members. This work has identified a number of areas in which improvements on present design or practice could be achieved. Although the regime is non-statutory, the Bank has generally found system operators receptive to the issues raised by the oversight process, and has been able to monitor the progress of actions taken in response. The Bank does, however, have a statutory role as designating authority for UK payment systems under the EU Settlement Finality Directive.

Statistical Development

The Bank's Monetary and Financial Statistics Division (MFSD) has been developing its analysis to support the financial stability function. This analytical work draws on data from the standard suite of statistical returns submitted by all banks operating in the UK, and the resulting outputs are designed specifically to assist the monitoring of developments in the financial system. A central tenet of this work is the analysis of groups of banks selected because they have similar characteristics or a common business focus; the results of some of this peer group analysis have been reported in the *Financial Stability Review*.

Analysis of credit risk transfer

One of the major themes in the recent evolution of financial markets has been the accelerating pace of risk transfer between sectors that have traditionally been regarded as distinct.

In this vein, the Bank has been reviewing new techniques for transferring risk amongst financial institutions, and from financial to non-financial firms. Such transfers have long been a feature of financial markets but the range of instruments employed has grown over recent years. In principle, the capacity to disperse risk should be helpful from a financial stability point of view. But the process of risk transfer gives rise to a number of issues – for example, the legal robustness of the transfer, the capacity to monitor the underlying credits and the possibility of inadvertent concentrations of risk – which could potentially give rise to stability concerns. The Bank's objective to date has been to identify the issues involved and to publish its analysis, often in its *Financial Stability Review*. The Bank has also been chairing a G10 central bank group, under the auspices of the Committee for the Global Financial System, looking at the policy issues raised by credit risk transfer.

Indicators of potential financial instability

There is no single quantitative measure of financial stability, and no single reliable indicator of potential threats to stability. Despite this – indeed partly because of it – the Bank has continued to try to develop a range of quantitative techniques for assessing degrees of exposure and risk, so as to provide some benchmark against which to assess the significance of potential threats. A particular focus has been the interaction between macroeconomic developments and the financial position of companies and households. Although modelling the response to financial pressures is an area in which much remains to be done, worthwhile insights can nevertheless be gained by looking at the immediate financial implications of economic prospects. Analysis of this kind has again been published in the Bank's *Financial Stability Review*.

Crisis management

The Bank has continued to be heavily involved in a range of initiatives concerned with crisis management. Some of those aim to develop better ways of handling country debt crises, for the benefit of the countries concerned, their private creditors and the international financial institutions (IFIs). Central to the Bank's approach has been the need to establish a clearer framework, so that all parties have realistic expectations about the behaviour of the others, and know what the process will be if debt service difficulties occur. One element of this is the determination of a "presumptive limit" on the financial support available from IFIs, to be exceeded only in exceptional circumstances and subject to special approval procedures. Some proposals in this area, produced jointly by the Bank and the Bank of Canada, were set out in a paper published in November 2001. Discussion on the issue continues in the G7, through the IMF and in other fora.

The analysis of the issues which would arise in handling problems in a so-called large and complex financial institution (LCFI) has also remained the focus of considerable effort, to which the Bank has made a significant contribution. One of the issues has been to identify clearly the range of information which those handling such a crisis would need. This analysis is being pursued internationally and is designed inter alia to improve cross-border co-ordination should a crisis occur. Work in this area is underway in the Financial Stability Forum and within the EU, where the Bank participates, alongside the FSA, via the ECB's Banking Supervision Committee.

Research and publications

As mandated by Court, the Bank has built up the research effort supporting its financial stability remit. Each of the divisions in the Financial Stability Area now has a research capability, producing papers underpinning much of the work reported above. Outlets are provided by the Bank's *Working Paper* series, the *Quarterly Bulletin*, and the twice-yearly *Financial Stability Review*. A number of central banks and international organisations now produce similar reviews.

Financial Sector Assessment Programme

At the 2000 IMF Annual Meetings in Prague, the Chancellor of the Exchequer committed the UK to undertaking a financial sector assessment exercise with the IMF. (The Financial Sector Assessment Programme is intended to review thoroughly the structural aspects of a country's financial system against a set of internationally agreed standards, and also to identify any shorter-term vulnerabilities in the face of possible economic or financial disturbances.) A first mission under the UK FSAP took place in February 2002, focusing especially on issues of concern to the Bank, namely payment and settlement systems, monetary policy transparency and systemic liquidity and indicators and measures of financial strain. Working with the Treasury and FSA, staff from Monetary Analysis, MFSD, Financial Stability and Financial Market Operations were involved in preparing substantial amounts of material for the mission, and in discussions during the mission with IMF officials. Two further missions are planned for later in 2002. This is the first time that the IMF has conducted an FSAP for a major international financial centre and as such has provided a valuable perspective not only on the UK but also on the special issues that arise because of the extent of the international business conducted in the City.

EFFICIENCY AND EFFECTIVENESS OF UK FINANCIAL SERVICES

For 2001/02, the specific target set by Court was **"to enhance the Bank's contribution to international and domestic initiatives which could significantly affect the efficiency and effectiveness of UK financial markets"**.

Many of the items mentioned above under the heading of financial stability also have an efficiency dimension. This is true, for example, in relation to improvements in payment systems. In addition, however, the Bank has been involved in other initiatives focused more directly on the effectiveness of financial services, including in particular its work on preparing the UK financial markets for the euro (page 28).

Finance for Small Firms

Over the past decade, the Bank has devoted considerable efforts to improving the relationship between small firms and their major suppliers of finance, especially the major domestic banks. Since 1993, an annual report on the topic has been issued, following a seminar involving interested parties. Recently, particular attention has been given to the issues which arise in the financing of technology-based small firms. A first report devoted to this issue was published in 1996 and a follow-up study was produced in 2001. The Bank is now preparing an analysis of the financing of university-based programmes to facilitate the exploitation of research. This was the subject of a chapter in the Bank's latest annual small firms report, published in May 2002.

Financial Exclusion

Again building on the Bank's work on small firm finance, the Government in 1999 requested the Bank to produce periodic reviews of the issues facing existing or potential small firms in areas of social deprivation. A first report was published in the autumn of 2000 which provided a general survey of the issues. A second review, again published in the annual report on finance for small firms in May, focused on the characteristics of businesses in deprived areas and what might be done to enhance their bankability. It also considered the relationship between conventional providers of finance, especially the banks, and Community Development Finance Institutions.

Financial Law Panel

In 1993, in the light of the Hammersmith and Fulham case, in which ambiguity about the legal status of certain swap transactions led to substantial losses for a number of banks, the Bank set up the Financial Law Panel (FLP) as a forum to identify and review areas of legal uncertainty. The Panel has contributed many worthwhile pieces of analysis over the past eight years. During that time, however, several aspects of the environment have changed, including the internal capacity of firms to assess the legal risks involved in their business. Partly as a result, but partly also because of the continuing consolidation within the financial sector, the Panel's funding base came under pressure.

The Bank, with the Panel's agreement, instituted and carried through a review of the Panel's financing and concluded that it could not continue indefinitely and in an open-ended fashion to underwrite the Panel's liabilities. Without the financial support of the Bank, the FLP concluded that it would have to close at its financial year-end of March 2002.

Following consultations, it was decided that a new Committee, supported by a Secretary based in the Bank's Legal Unit, should continue the task of identifying areas of legal uncertainty with potentially material effects on wholesale financial markets, and seek to facilitate solutions. The Committee will be chaired by Lord Browne-Wilkinson. While operating independently in terms of its analysis, the Committee will nevertheless work closely with relevant areas within the Bank.

Contingency Planning and Disaster Recovery

An important aspect of the reliability and robustness of the financial services sector, both at the level of individual firms and of the system as a whole, is the capacity to withstand physical shocks, such as major IT failures, natural disasters or terrorist attacks. Addressing such threats has been an important issue for the financial authorities and firms for some time but the intensity of this work has increased in the aftermath of the 11 September terrorist attacks in the US. The Bank, working closely through the Standing Committee with HM Treasury and the FSA, has played a major role in this intensified activity. A number of broad areas for action have been identified, including the need to strengthen arrangements for communication, to ensure that firms' own contingency plans are adequate both individually and taken in aggregate, and to review arrangements for allowing markets to continue to function under abnormal conditions. The Bank has hosted, jointly with HM Treasury and the FSA, two meetings with infrastructure providers, financial firms, trade associations and others to help ensure co-ordination of the various initiatives underway. The Bank has also established, again on behalf of the financial authorities, a web site (http:\\www.financialsectorcontinuity.gov.uk) as a way of disseminating information about the activities of the main parties involved. In a number of ways this work covers similar ground to that involved in dealing with the Y2K threat, although the nature, scale and timing of the threats are clearly different.

Survey of Foreign Exchange Market Activity

The Bank (through MFSD) again co-ordinated the UK's contribution to the triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity, the final version of which was published in March 2002. An analysis of the preliminary results was published in the Winter 2001 *Quarterly Bulletin*.

FINANCIAL MARKET OPERATIONS

The objective for the Bank's operational divisions was **"to conduct the Bank's financial market and banking operations with a high degree of professional competence, in order to execute the Bank's policy decisions and meet customer requirements cost-effectively, and to make full use in the Bank's monetary and financial stability roles of the intelligence gained through these operations".**

Open Market Operations

The Bank's sterling open market operations operated smoothly during 2001/02 and achieved their purpose of implementing the interest rate decisions of the Monetary Policy Committee while providing sufficient sterling funds each night. In June 2001, the Bank successfully added an overnight deposit facility to the normal round of open market operations, to allow excess liquidity to be placed with the Bank towards the end of the trading day. This facility has helped to moderate volatility in very short-dated interest rates.

Sterling liquidity was provided smoothly during the period of market stress that followed the events of 11 September, and no special operations were necessary. The Bank agreed a dollar swap facility with the US Federal Reserve in order to stand ready to provide dollar liquidity in London if necessary. However, no drawings under this facility were needed.

Foreign Currency Operations

The Bank's foreign currency operations include the provision of foreign exchange transactions and deposit facilities to foreign central bank customers, the management of the Government's foreign exchange reserves and currency requirements, and the management of the Bank's euro-denominated debt programmes.

As part of this task, the Bank, as agent for HM Treasury, manages HM Government's foreign exchange assets and liabilities, including its gold reserves, in line with the objectives set by HM Treasury in its annual Remit, and has met those objectives in 2001/02. The Government's programme of gold sales, announced in May 1999, to reduce the UK's gold reserves from 715 tonnes to about 300 tonnes, was successfully concluded in March 2002. The proceeds of the sales were reinvested in dollar, euro and yen denominated reserve assets.

In January 2002, the Bank changed its monthly auctions of euro-denominated bills to take advantage of more attractive funding levels for longer-dated bills. The Bank ceased to issue 1-month bills, and hence issues correspondingly more 3-month paper. The Bank's euro-denominated note auction programme, taken over from HM Treasury in January 2001, was also adjusted to improve liquidity by bringing this year's issue up to its maximum size of €2 billion more quickly.

Market Intelligence

The Market Operations divisions' aim of further enhancing their role in gathering and interpreting market information, in order to help fulfil the Bank's monetary policy and financial stability functions, has been successfully pursued. The importance of this information was highlighted in the aftermath of the events of 11 September, when continuous market liaison in London and with other centres contributed materially to management of the crisis.

Domestic Payment and Settlement systems

The initiatives to enhance the effectiveness of UK payments and settlement systems started in 2000 (page 23) were all completed successfully last year. The initiatives included updating the technical infrastructure on which the domestic high-value payment system (CHAPS) operates and reforming the CREST securities settlement system through the introduction of Delivery versus Payment (DvP) in order to eliminate intra-day credit exposures amongst settlement banks.

The Note Issue

In December 2001 the Bank announced the planned introduction of a new £5 note, featuring Elizabeth Fry on the reverse, scheduled to take place around the middle of 2002. The new £5 will replace the old note, which features George Stephenson, and will include the same enhanced security features as the new £20 and £10 notes.

Work continued throughout the year with the institutions involved in wholesale note distribution on the phased transition to new arrangements designed to improve the efficiency of note issue and distribution. The new arrangements are planned to be fully operational by the middle of 2003.

In recent years the Bank has become concerned that the quality and quantity of £5 notes in circulation was below acceptable levels and began work this year investigating ways to address the issue. It has been pursuing initiatives with the institutions involved in wholesale note distribution and retailers (through the British Retail Consortium) and, with their co-operation, has been able to increase significantly the distribution of new £5 notes.

Bank Note Printing Operations

During the year the Bank reviewed the future of note printing operations at its plant at Debden in Essex, and in February 2002 set out for the staff at Debden the options that it was considering. These were, first, a continuation of the present arrangements under which the Bank prints its own notes but little else; and second, the transfer of the printing operations to a private company that would remain on the Debden site but be able to take on other business and have the necessary commercial and marketing skills to do so. The first option would probably involve a continuation of the cuts in capacity and employment that have been a feature of the past ten years; under the second, there could be a better chance of increasing throughput and thus safeguarding employment. Either way, the Bank's own requirements would continue to be met from the Debden site, which will remain under Bank ownership and control. The Bank is continuing to explore those and other options in consultation with the Trades Unions.

Banking services change programme

This programme to modernise the Bank's banking services continued to proceed satisfactorily. Many of the necessary staff changes have been made and the remaining ones are planned for 2002. The implementation of the selected IT packages is proceeding with the largest single implementation planned for 2002.

Stock registration

The Bank, through its Registrar's Department in Gloucester, continued to operate the gilt-edged stock register for HM Government within the agreed unit cost target. As the number of accounts on the register continued to fall, the Bank is reviewing with HMT and the UK Debt Management Office options for the future of gilts registration. The Registrar's Department continues to operate its retail postal brokerage service.

PREPARING FOR EMU

This year the Bank's objective was: **"without compromising its existing responsibilities, to ensure that the Bank is prepared to operate as a member of the European System of Central Banks should the UK join Economic and Monetary Union, to contribute to preparations in the UK financial sector, and to enhance the Bank's economic analysis of EMU".**

Preparing the Bank

The Bank has continued to plan for possible UK entry into EMU, so that it can be in a position to implement the necessary changes should a decision to enter be made. The Bank has used its frequent contacts with the ECB and euro-area national central banks (collectively the Eurosystem) to ensure that it keeps up to date with its operating framework as this evolves. As a result, the Bank believes it currently has a more or less complete understanding of what would be necessary to become a full member of the Eurosystem, and believes that it could be prepared for entry within twelve months. In the meantime, completion of other projects to enhance the Bank's systems (like NewCHAPS and DvP, described above) will facilitate the Bank's preparedness for EMU in the event that the UK should decide to enter.

Preparing the UK financial sector

On 1 January 2002, euro notes and coin were launched, marking the completion of the euro as a currency and the culmination of eight years of practical work by the euro-area authorities. It proved to be a highly successful event, and has been widely applauded. 2001 was thus a key year in the final technical preparations, and the Bank took the opportunity to follow them closely, both because of their intrinsic interest and because of any lessons for the UK if it were to join EMU. The Bank studied carefully all the relevant information on the changeover which was made publicly available within the euro area, and supplemented this through bilateral discussions with the central banks and many commercial banks and others involved. The resulting information and analysis on the changeover has been published in the Bank's six-monthly *Practical Issues* publications.

The potential changeover in the wholesale financial markets is already pretty fully articulated, having taken on board lessons from the euro's introduction in the financial markets at the beginning of 1999. The City Euro Group, chaired by the Bank and with representation from all relevant markets associations and the clearing banks, has taken the planning for a market changeover more or less as far as it can at present; identified the decisions that remain to be taken, and by whom; established the conditions necessary for a 'phased approach' to a UK changeover (under which the financial markets would change from sterling to euro at entry but mass retail financial service in euro would only become available later); and translated these into guidance for companies and their registrars.

Impact of the euro on London's financial markets

The Bank continues to monitor closely the effects on the UK financial markets of the introduction of the euro, and of subsequent developments in the pan-European financial markets. This market surveillance has put the Bank in a good position to provide working level assistance to the Treasury in its preliminary technical work, preparatory to making its assessment of the potential impact of EMU entry on the competitive position of the UK financial services industry (one of the Government's five economic tests).

All the evidence available to date indicates that the UK financial sector has continued to perform strongly and has, if anything, gained market share: for international firms, London remains the most effective and efficient base for pan-European financial operations. This picture is supported by data on bond issuance and trading, international bank lending, stock exchange turnover and related financial infrastructure business, the 2001 BIS triennial survey (which shows London to have maintained its one-third share of the global foreign exchange and derivatives markets), and the location and staffing levels of international financial firms.

Economic analysis of EMU

The Bank has an ongoing programme of analytical work on EMU. This includes the operation and implementation of monetary policy within the euro zone, and how the introduction of the euro has affected the transmission mechanism of monetary policy. This work both informs the Bank's quarterly conjunctural analysis of international economic prospects, and also allows the Bank to play an active role in discussions with the ECB and other EU institutions.

Representing the Bank in Europe

The Governor is a member of the ECB General Council and the Bank is represented on the ESCB committees. The Bank is also a member of the Economic and Financial Committee in Brussels which advises European finance ministers. Over the year, the Bank has continued to seek to deepen its relationship with the Eurosystem as well as with other European central banks.

MANAGING THE BANK'S HUMAN RESOURCES

The Bank's objective for the year was **"through appropriate policies for recruitment, rewards, training and career development, to ensure that the Bank recruits, retains and develops staff with relevant skills and experience; and to build strong staff motivation and morale"**.

Last year 211 staff joined the Bank and 225 left. Most of the departures arose under the Bank's redundancy and severance arrangements, connected with changes in the banking, note printing and central services areas. The resignation rate in the policy and analytical areas was 6%, slightly lower than in the previous year. In the key market for new graduates the Bank recruited 46, 16 with Masters degrees in economics or finance. The Bank has continued to sponsor new graduates in their Masters year, either before entering the Bank or shortly afterwards. This autumn, 14 existing staff will be starting Masters degree courses, mostly in economics. 34 mid-career staff joined the Bank, most to work in the monetary analysis and financial stability areas, but some to provide specific skills in the banking and market operations areas and in central services.

By the end of the year the Bank was close to its budgeted strength, a considerable improvement on earlier years. This achievement partly reflects the effort going into recruitment, which involves management and staff from all parts of the Bank. Trends in the employment market, particularly among City firms, have also helped the Bank in its efforts to retain key staff; but this cannot be expected to persist indefinitely, and the Bank continues to use the flexibility in its pay and job banding systems to address retention issues and also to build cadres of experienced staff in the key business areas.

Major changes in the Bank's banking operations were implemented during the year and as part of this 97 staff were made redundant. As described in earlier reports, the changes in banking were part of a major business re-engineering, with substantial new investment in systems and the creation of new multiskilled teams.

The contracts of six staff who chose not to accept the Bank's new benefit arrangements were terminated in 2000/01, and a further member of staff's contract was terminated for the same reason in 2001/02. The Bank very much regretted that the staff involved felt unable to accept the new terms. All of those dismissed have entered claims in Employment Tribunals, which the Bank is contesting vigorously. In general the new benefits system has settled down well and is now in its third year of operation.

The rapid pace of change over the past few years has clearly been unsettling for some groups of staff, and the Bank has attempted to address this during the year. Improvements have been made in staff communications, most notably through the internal intranet site. Additional resources have been directed to training and career development. A further survey of staff attitudes is being undertaken and the results of this will be available to management and shared with staff during the coming year.

MANAGING THE BANK'S FINANCES

The Bank's financial framework is discussed in more detail on pages 37 to 40 of this Report. The objective for the year was: **"to maintain the Bank's overall spending within the agreed budget of £209.4 million for 2001/02 set by Court in the context of the medium-term framework for its finances which called for £20 million reduction in overhead costs over the five-year period to 2002/03"**.

Budgets

For 2001/02 Court set an expenditure budget of £209.4 million. The Bank's total spending for the year was £207.7 million, below budget in spite of the additional legal fees following on from the House of Lords judgement in relation to the BCCI case (discussed on page 89). The main factors contributing to this outturn are discussed on page 37.

The medium-term spending plan within which the Bank has operated for the past two years includes a £20 million reduction in the annual costs of centrally borne overheads. The £20 million relates to the overhead costs that remained with the Bank when supervision was transferred to the FSA in 1998. At the beginning of the current year, the Bank was three-quarters of the way to achieving the £20 million reduction in overheads.

The remaining £5 million saving in centrally borne overheads will be achieved through the continuing rationalisation of the Bank's occupancy of its remaining properties, in particular on the completion of the refurbishment of the Ground Floor at the Threadneedle Street building which will then permit the Bank to vacate Bank Buildings.

Property

The Bank's strategy in relation to central London properties is to consolidate all activities in the main Threadneedle Street building. A new dealing room was completed in October, on time and within budget. This was the first stage of refurbishment of the Ground Floor of the Threadneedle Street building, which is continuing and due for completion in the first quarter of 2003.

Outside central London, the office space in Leeds and Gloucester is being released through the sale of the buildings and leaseback of the parts required by the Bank. A priority for the coming year will be rationalisation of the Debden site.

Business continuity and contingency planning

The Bank has well-established procedures for recovering from both localised and general emergencies, and these are regularly tested and kept up to date. During the year they were retested in the light of the events of 11 September. The adequacy of the Bank's business continuity arrangements, in particular, were reassessed as part of the risk monitoring process described on pages 53-55, and are being amended to take account of the intensified City-wide planning described on page 25.

IT STRATEGY AND MANAGEMENT INFORMATION

Following the review last year of IT strategy, the Bank has made a number of changes in the way it plans IT and has intensified the use of IT in a range of business and support processes. A key finding of the review was that the Bank's success in delivering major IT-based infrastructure projects in the financial sector was not always matched in its internal systems, and the objective set by Court was **"to improve the Bank's use of IT in pursuit of its objectives and to provide timely and cost-effective management information".**

Three cross-Bank coalitions have been formed, covering the analytical areas, the process areas and business support; these enable management of individual business areas to pool IT development and in some cases the delivery of IT, ensure that where possible common platforms are used, and make more efficient use of limited IT resources.

In the business support areas common databases have been introduced for HR and finance, enabling data to be input directly and allowing workflow monitoring; this has supported the significant downsizing of those areas and has also improved the quality and timeliness of management information flows. A project to examine ways in which the Bank's accounting mechanisms can be better integrated with its back office systems has been approved and is underway.

The Bank has also started a project to introduce Electronic Document Management across all areas, with the aim of ensuring the capture, sharing, safekeeping and retrieval of information throughout the Bank, and the interlinking of the Bank's main networks so that analysts and managers can easily find and draw on material originating in all parts of the Bank. In the long term this project is likely to lead to more initiatives in the area of knowledge management, and it is already affecting thinking about the future development of the Bank's intranet and internal networks.

Development of the Bank's IT systems will remain a priority in the year ahead, with the primary objective remaining the continued improvement of the Bank's business processes. Added to this is the need to maintain adequate contingency arrangements to support the Bank's key processes and to support the financial sector in the event of any emergency (see page 25).

Monetary Policy Committee

Processes

Members of the Monetary Policy Committee

Eddie George

Mervyn King

David Clementi

Christopher Allsopp

Kate Barker

Charlie Bean

Professor Stephen Nickell

Ian Plenderleith*

Dr Sushil Wadhwani**

The principal external activities of the MPC members appointed from outside the Bank by the Chancellor of the Exchequer are:

Mr Christopher Allsopp: Fellow in Economics, New College, Oxford. Reader in Economic Policy, Oxford University. Editor and Director, Oxford Review of Economic Policy. Trustee, Index on Censorship.

Kate Barker: Member of Board of Governors, Anglia Polytechnic University. Member of Council, Society of Business Economists. Commissioner, Independent Football Commission.

Professor Stephen Nickell: School Professor of Economics, LSE (part-time). President of the European Association of Labour Economists. President of the Royal Economic Society. Fellow of the British Academy and of the Econometric Society. Member of the International Board of Advisers of the Tinbergen Institute (Amsterdam). Member of the Council of the European Economic Association.

Dr Sushil Wadhwani: Member of the Council of Management of the National Institute of Economic and Social Research. Fellow of the Royal Society of Arts. Visiting Professor at the City University Business School and the London School of Economics.

*Paul Tucker has been appointed to the MPC with effect from 1 June 2002. He will succeed Ian Plenderleith.

**Marian Bell has been appointed to the MPC with effect from 1 June 2002. She will succeed Dr Sushil Wadhwani.

In respect of monetary policy, the Bank's objective is to maintain price stability and, subject to that, to support the economic policy of the Government, including its objectives for growth and employment.

Throughout the period covered by this Report, the Government defined the price stability objective in terms of a symmetric inflation target of 2.5% (measured by RPIX). That was most recently confirmed by the Chancellor in his budget statement on 17 April. The Bank pursues this objective through the interest rate decisions taken by the Monetary Policy Committee (MPC). The MPC is a committee of the Bank constituted by the Bank of England Act 1998, with responsibility for formulating monetary policy. This section of the Report deals with those aspects of the MPC which are relevant to the Directors of the Bank in fulfilling their responsibility under Section 16(1) of the Act: that is, to review the procedures followed by the MPC and in particular whether the MPC has collected the necessary regional, sectoral and other information.

In terms of MPC processes, the past year has been one of continued monitoring and consolidation in light of the recommendations from the external peer review by Don Kohn of the Federal Reserve Board, which was discussed in the 2001 *Annual Report*.

AN UPDATE ON THE KOHN REPORT

At the suggestion of the Bank's non-executive Directors, the Bank decided to commission an informed expert to undertake an external review of the procedures of the MPC, and its analytical support in the Bank of England. The Bank invited Don Kohn, Director of the Division of Monetary Affairs at the Federal Reserve Board in Washington, to undertake this task. The Report, and the MPC's response to the issues it raised, were published in December 2000. The main recommendation from Kohn was that the MPC should keep everything under active review. Some of the specific points that were raised had already been acted upon when the MPC's response was agreed; for example the reduction in the length of the regular monthly staff briefings (known as "pre-MPC"). Further specific issues have since been acted upon; for example there are now more staff devoted to the development of models used by the MPC. Other issues, such as how best to present the views of the Committee where members are both individually and collectively accountable for their actions, remain under review.

ARRANGEMENTS FOR EXTERNAL MPC MEMBERS

Each external MPC member has the use of two economists to provide personal research support and this arrangement appears to be working well.

THE PAGAN REVIEW

Following the recommendation of the House of Lords Committee on the MPC in the report of February 2001, the Court of the Bank of England has commissioned a study of the statistical and economic modelling and forecasting work carried out by the staff of the Bank for the MPC. The report should provide an evaluation of whether this work is "state of the art". This review is being undertaken by Adrian Pagan of the Australian National University and Nuffield College, Oxford, in the light of his expertise in the field and his experience of serving on the Board of the Reserve Bank of Australia. The terms of reference are set out on page 17.

THE MAIN MPC PROCESSES

A short summary of the main MPC procedures is provided in this section. Although there have been some changes during the year, the broad structure remains the same as in last year's Annual Report. The processes of the Committee can be grouped into three categories:

- The monthly policy round;
- The quarterly forecast and *Inflation Report* round;
- Other tasks

A detailed account of these processes can be found in "The formulation of monetary policy at the Bank of

England", *Bank of England Quarterly Bulletin*, Winter 2001, by Charles Bean and Nigel Jenkinson.

The monthly policy round

The Bank of England Act 1998 stipulated that the Committee must meet (at least) monthly to review and if necessary change interest rates to achieve the target set by the Government. The MPC satisfies this mandate by holding a regular monthly meeting – typically on the Wednesday afternoon and the Thursday morning of the first full week of each month – announcing the policy decision at noon on the Thursday. On September 18 a special meeting of the MPC was convened by the Governor in the light of the tragic events of 11 September in the US and the ensuing response of central banks around the world. The minutes of this meeting were published in October along with the minutes of the regular October meeting.

The pre-MPC briefing meeting is subject to continuous peer review by senior officials from other central banks and institutions that are regularly invited to observe the meeting. As in previous years, the comments have generally been very positive.

The Quarterly Forecast and Inflation Report

The *Inflation Report* fulfils the obligations under the Act for the Bank to provide a quarterly report approved by the MPC, which reviews monetary policy decisions, assesses developments in UK inflation and provides an indication of the expected approach to meeting the objectives set by the Government. The core sections of the Report itself have changed little over the past year, but a new Division (The Inflation Report and Bulletin Division) was set up in the summer to improve the focus and quality of the Bank's publications on monetary policy.

The quarterly forecast round remains under constant review, as suggested in the Kohn Report. The structure has been fairly stable over the past twelve months. One change is that, as of August 2001, in order to promote constructive top-down discussion among the Committee the final two meetings in the forecast round now take place in the presence of only four staff rather than the larger number hitherto.

Other tasks

The Committee also meets outside the regular policy rounds to review a range of issues, which include: research priorities; statistical priorities of the MPC; responses to requests from the Treasury Select Committee and the House of Lords Committee on the MPC; media coverage and messages; and a range of ad hoc economics topics. Committee members undertake a programme of regional visits and speaking arrangements to explain the role of the MPC and the analysis underlying the policy decision. These activities form part of the Bank's effort in building a constituency for low inflation, as well as gathering first-hand information about the economy. Members also make regular appearances before Parliamentary Committees.

REGIONAL AND SECTORAL INFORMATION

Regional information

The MPC's statutory objective is the pursuit of national price stability and monetary policy decisions are necessarily directed to that end, rather than aiming at regional or sectoral objectives. Regional analysis can, however, aid the understanding of national economic developments and the transmission of monetary policy. And through its network of 12 regional Agents, the MPC can pool information from across the regions to provide a very timely or specially targeted view of developments in the economy.

The Bank's 12 Agents play a key role in providing regional information to the Committee. Regular contact is maintained with 7,000 businesses across the UK. The Agents produce monthly written reports and presentations at the pre-MPC meeting on economic conditions as seen from the perspective of businesses in their area. Taken together, these reports can provide the Committee with an up-to-date view of developments in the economy. This intelligence can be particularly useful in times of turbulence, such as the aftermath of the 11 September terrorist attacks. The Agents also give a

Regional Agents

Chris Bailey,
South East and East Anglia

John Bartlett,
West Midlands

John Beverly,
South West

Chris Brown,
East Midlands

David Buffham,
North East

Janet Bulloch,
Scotland

Sue Camper,
Wales

Phil Eckersley,
Northern Ireland

Wendy Hyde,
Greater London

Stuart Iles,
Central Southern England

Mark Pratt,
Yorkshire and the Humber

Tony Strachan,
North West

presentation at pre-MPC focusing on a particular key issue of the month of interest to the MPC.

In recognition of the importance of regional information for the monetary policy process, the Bank has extended its analysis of regional developments beyond the immediate economic conjuncture. A new regional economist, appointed in September 2001, now undertakes more in-depth regional research with a view to informing the understanding of national developments.

Sectoral Information

The MPC continues to benefit from, on the broadest definition, detailed analysis of sectoral information. This information takes the form of official ONS data, but also numerous sectoral surveys made available to the Committee by trade associations and others. Members of the MPC also have meetings with national and local trade associations which represent sectoral interests.

Some of the sectoral analysis carried out for the MPC has been published in the *Inflation Report* and the *Quarterly Bulletin*. For example, recent *Inflation Report* issues have had individual boxes on the advertising industry, trends in ICT manufacturing in the United Kingdom, and the financial position of households and companies.

Objectives and Strategy
for 2002/03

Under the Bank of England Act 1998 the Court of Directors is required to determine the Bank's objectives, including its objectives for financial management, and strategy.

The Court has decided that the Core Purposes of the Bank, which are reviewed but usually not changed each year, taken together with the annual statement of Bank Objectives, should constitute the objectives and strategy of the Bank for the purposes of the Act. The Core Purposes are set out on pages 10-11. The Bank Objectives for 2002/03 are set out below. These Objectives provide the basis for objective setting in the local management areas of the Bank and a basis for the allocation of budgetary resources.

BANK OBJECTIVES FOR 2002/03

1/ To maintain the range and quality of information and economic briefing provided to the Monetary Policy Committee.

2/ To enhance the Bank's programme of economic analysis of key aspects of monetary policy.

3/ To build public support for price stability, and public understanding of the MPC's approach to its remit, through speeches, the *Inflation Report* and other publications, and through other initiatives such as the Schools Competition.

4/ To enhance the Bank's assessment of (domestic and international) risks to financial stability, to support and/or undertake measures designed to increase the resilience of financial markets (eg through oversight of payment systems), and to contribute to the debate on arrangements for handling financial crises.

5/ To enhance the Bank's contribution to initiatives aimed at reinforcing the efficiency and effectiveness of UK financial markets, including the capacity to respond to major business disruption.

6/ To conduct the Bank's financial market and banking operations with a high degree of professional competence, in order to execute the Bank's policy decisions and meet customer requirements cost-effectively, and to make full use in the Bank's monetary and financial stability roles of the intelligence gained through these operations.

7/ To ensure that the Bank would be ready, should a decision be made to join EMU; and to contribute to preparations in the UK financial sector.

8/ To ensure, through appropriate policies for recruitment, reward, training and career development, that the Bank recruits, retains and develops staff with relevant skills and experience; and to build strong staff motivation and morale.

9/ To maintain the Bank's overall spending within the agreed budget of £220.5 million for 2002/03 set by Court in the context of the medium-term framework for its finances, which called for a £20 million reduction in overhead costs over the five-year period to 2002/03.

10/ To improve the efficiency and robustness of the Bank's business processes, in particular through improved use of, and continued investment in, IT; and through the maintenance of appropriate back-up arrangements in the event of major business disruption.

Financial Framework

for 2002/03

Budget for 2002/03

Reflecting the objectives set out opposite, Court has agreed an expenditure budget of £220.5 million for 2002/03, an increase of £11.1 million on last year's budget. Most of the increase represents additional legal expenses in relation to the BCCI case. Excluding this, the increase over last year's budget is £1.8 million, more than accounted for by higher investment.

Within total current spending, operating expenses (excluding legal fees) are budgeted at £186.9 million, £2.4 million less than budgeted for last year, and revenue expenditure on investment projects is budgeted at £23 million, up £4.2 million on last year. The reductions in operating expenses are broadly spread, the largest being at the Printing Works (through more efficient methods of working), in Registrars' (in response to lower volumes) and in Property Services. Increases are in Banking and Market Services (on account of higher business volumes) and in Financial Stability.

The increase of £4.2 million in the contribution of investment spending to the total expenditure budget reflects the profile of spending on the refurbishment of

Bank Expenditure Budget

	2001/02 Budget	2001/02 Outturn	2002/03 Budget £m
Business units			
Monetary Analysis and Statistics	20.7	19.5	20.8
Financial Market Operations	49.8	49.1	51.1
Financial Stability	9.7	9.5	10.8
Co-ordination Unit for Europe	1.4	1.3	1.3
Centre for Central Banking Studies	1.5	1.3	1.5
Printing Works	29.8	27.9	29.2
Registrar's Department	3.5	3.1	3.5
	116.6	**111.7**	**118.3**
Centrally borne costs			
Personnel, Audit and Secretary's Department	25.0	22.0	25.4
Property Services and Security	30.6	31.6	31.5
Finance and central IT	7.8	7.0	7.0
Depreciation, VAT	28.0	29.3	27.7
	91.5	**89.9**	**91.6**
Total of above	**208.1**	**201.5**	**209.9**
BCCI legal fees	1.3	6.2	10.6
Total expenditure	**209.4**	**207.7**	**220.5**

Due to roundings, the individual figures may not sum to the rounded totals.
During the year responsibility for Note Issue at the Debden Cash Centre moved from the Printing Works to Financial Market Operations and the figures for 2001/02 have been restated on this basis.

the Ground Floor of the Threadneedle Street building, due to finish in early 2003. IT investment continues at a slightly higher rate than in the previous year's budget. A summary of the Bank's budget for the current year is given in the table on page 37.

Actual spending in 2001/02

Despite higher than budgeted legal fees, actual spending in 2001/02 was below budget. The main areas of underspend were at the Printing Works, reflecting a reduced note order, in Monetary Analysis (where increases in staff numbers took longer to achieve than planned) and in Personnel Division.

Costs of functions

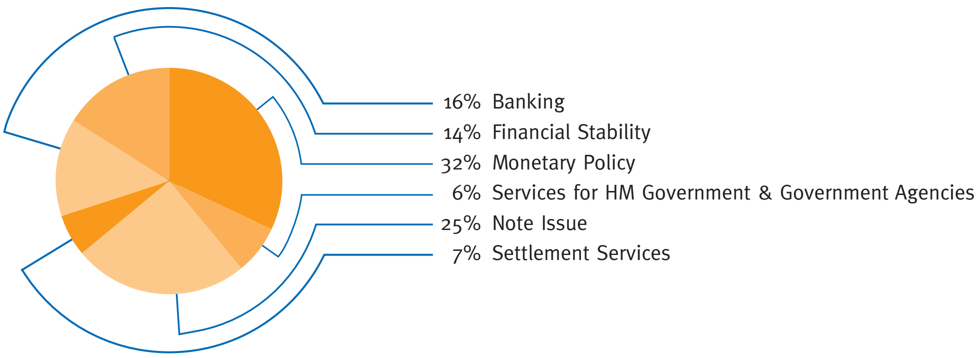
The breakdown of expenditure shown in the table is based on the organisational structure of the Bank, which is the basis on which Court agrees the Bank's spending. These figures do not show the cost of each of the Bank's functions, as many areas of the Bank contribute to more than one of these. For example, note issue costs, which amount to some £49 million in 2002/03, arise partly at the Printing Works (note production) and partly in Financial Market Operations (distribution and overall policy). Similarly, the Bank's expenditures directly stemming from monetary policy analysis and its implementation include contributions from Financial Market Operations and from the Press Office and Information Services in Secretary's Department, as well as those recorded against Monetary Analysis and Statistics. The chart below shows the distribution of the Bank's budgeted costs for 2002/03 on a broad functional basis, with overheads fully allocated to functions.

Medium-term spending plans

The medium-term expenditure plans continue to reflect improvements in the efficiency of processing and manufacturing activities and further progress in reducing overheads and other centrally-borne costs, while next year providing more resources for policy work. Over the next three years, though, this underlying reduction in overall spending may be masked by the costs of defending the BCCI case.

One of the consequences of the change in the Bank's responsibilities under the Bank of England Act 1998 was an expectation that the Bank would reduce its overhead costs by £20 million, consistent with the transfer of banking supervision to the FSA. The Bank is now more

Budgeted Costs of Functions 2002/03



than three-quarters of the way to achieving the £20 million reduction in overheads. Headcount in overhead functions has fallen by 287 since 1997/98, an annual staff cost saving of £9 million. Building occupancy has fallen and this has reduced costs by a further £4.8 million annually. Other related savings amount to a further £2 million a year. The Bank has now sold two of the five buildings it occupied in London. The Bank expects the reductions in centrally-borne costs to be fully realised in 2003, when refurbishment of the Threadneedle Street building is complete and the remaining buildings in London can then be vacated. The chart below shows the trend in the Bank's expenditure over the past eight years and the expected path four years ahead.

The financial framework

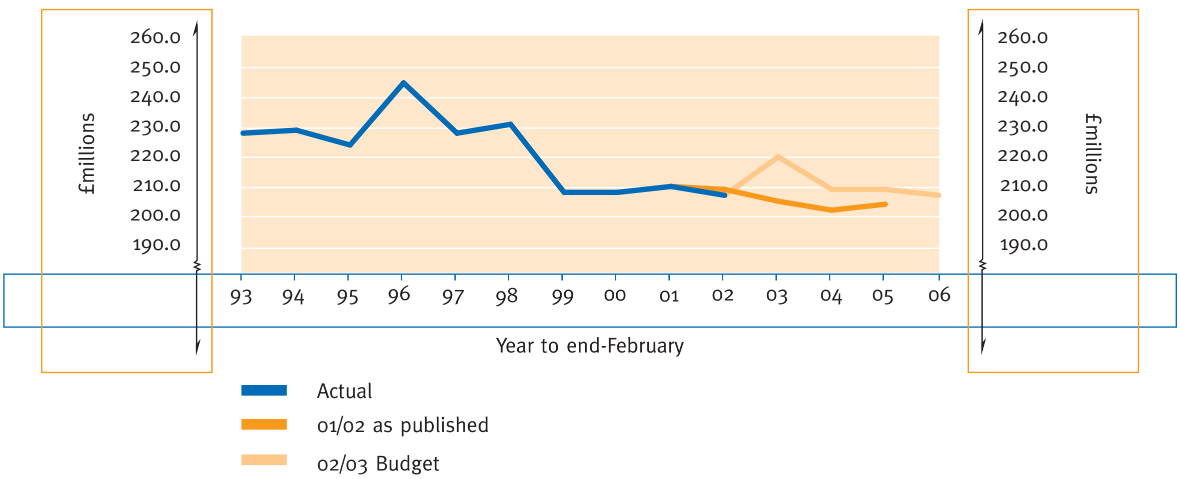
In planning its finances in the medium term, the Bank takes into account the return on its capital and reserves and the implications for Cash Ratio Deposits.

The Bank's objective in relation to its capital and reserves, agreed with Government, is to ensure a reasonable return, on an opportunity cost basis, on the Government's investment in the Bank. This is taken to be related to the return on Government bonds. When this was originally set in 1998/99, the Bank agreed with the Government that it would plan its finances on the basis of a benchmark return of 7%, the return on gilts in mid-1997. Market yields have continued to be significantly lower than 7%, but in the near term, this has only a limited impact on the Bank's income. Court is therefore content, as last year, to retain the benchmark of 7% for the year ahead.

Cash Ratio Deposits

Cash Ratio Deposits (CRDs) are the interest-free balances that deposit-taking institutions place with the Bank to finance its unrecovered costs associated with its monetary policy and financial stability activities. The Bank of England Act provided the Government with powers to set the level of CRDs, after consultation with the Bank and others, and having regard to the financial needs of the Bank. In 1998, the Government subsequently set CRDs at a level intended to deliver income to the Bank of £79 million in a full year. This reflected the Bank's estimate of its prospective average unrecovered costs associated with its monetary policy and financial stability activities, but excluding any share of the £20 million overhead initially retained by the Bank.

Bank Expenditure 1993-2006



In establishing the initial level of CRDs, an interest rate of 7% was assumed to translate the required level of income (£79 million) into an initial deposit ratio of 0.15%, intended to give a starting level of CRDs of £1,130 million. During 2001/02, interest rates averaged $4^3/_4$%, and balances £1,500 million, implying an annual income of £71 million if invested at the Bank's repo rate. In fact, actual investment income was higher overall because of the Bank's remaining holdings of high-coupon gilts but this buffer is unwinding as the gilts mature.

The CRD scheme itself is to be reviewed in 2003, at the end of the initial five-year period, but the Government has said that the level of CRDs will be kept under review in the meantime, in the light of changing circumstances and in consultation with the Bank. Although there continue to be upward pressures on the Bank's expenditure, changes in the Bank's total expenditure from that used in setting the initial level of CRDs remain modest, and Court sees no need this year to seek a change in the CRD ratio. However Court will continue to keep the adequacy of CRD income under review.

Personnel and Community Activities

STAFFING

The table on page 42 shows the average number of people employed during the year by the Bank and its subsidiaries, including the Governors and Executive Directors, and their aggregate remuneration.

Staff numbers

At the end of February 2002 the Bank employed 2,024 full-time staff and 183 part-time staff. Chart 1 on page 42 shows how the composition of the Bank's staff changed between 2001 and 2002. As in the previous year, staff numbers fell in the Registrar's Department at Gloucester, at the Printing Works at Debden, in the Banking & Market Services area and within some of the Bank's central support functions. There were small increases in the numbers of staff working in the policy divisions of the Bank.

The fall in staff numbers last year continued the well-established trend illustrated in Chart 2 on page 42. The decline in staff numbers – as a result of reducing routine processing jobs, by changing processes and by using IT more intensively – is expected to continue.

Recruitment

In total (and across all categories), the Bank recruited 211 staff. This included 27 staff to work in IT. In line with a number of other employers, the Bank has launched a dedicated recruitment web site. This facilitates the initial screening of candidates and allows the electronic submission of application forms. In fact, all the candidates for graduate entrant positions in the 2002 round submitted applications through the internet. Although more than 60% of clerical applicants applied on-line, paper applications continue to be accepted at this level of entry.

The Bank recruited 59 clerical staff, mainly to the operational areas of the Bank. Of these, 36 joined at the clerical entrant level (21 GCSE, 15 A-level), 4 as secretaries and 19 as experienced hires. This was slightly fewer than in the previous year *(2000/01: 66 clerical recruits, of which 44 were at entrant level)*.

In terms of graduate recruitment, the Bank's demand for high-quality candidates increased further, and at least until the middle of the year the market remained very competitive. 46 new graduates joined during the year; 42 joined the banking staff *(2000/01: 37)* and 4 joined the IT ranks. Major efforts have been made to raise the Bank's profile in the market and to attract the best candidates. A highlight of the year was winning the Best Graduate Recruitment Web site award from the Association of Graduate Recruiters.

The demand for experienced specialist staff remained high. In response to a number of external recruitment campaigns, 34 mid-career staff were recruited *(2000/01: 33)*. The majority were economists for the Financial Stability and Monetary Analysis areas of the Bank. Other areas (including Audit, Banking & Market Services, Management Services Division and Secretary's Department) recruited professionally qualified and/or experienced specialists to fill specific vacancies.

Training and development

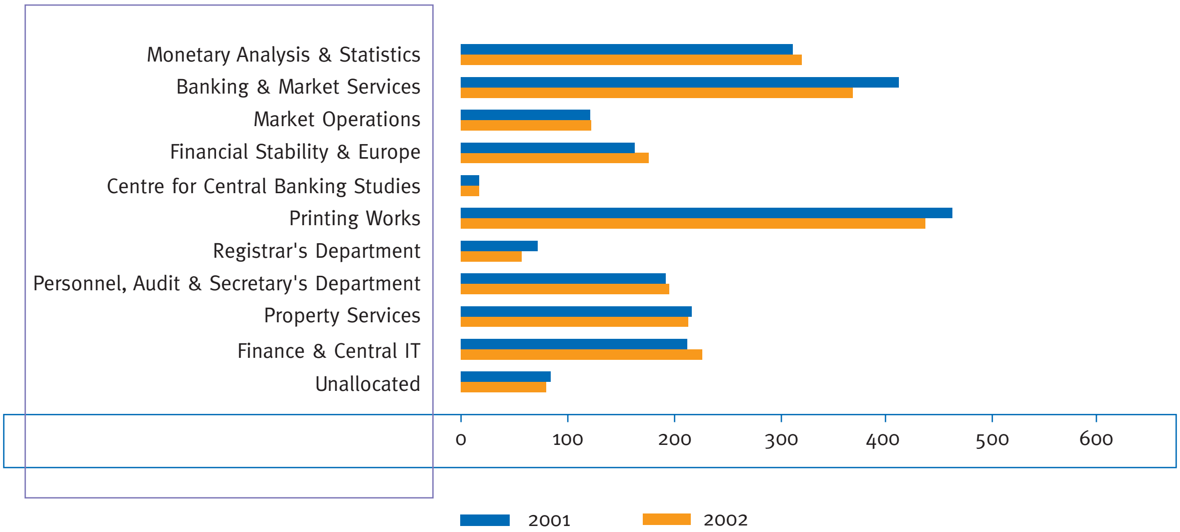
Following last year's review of the Bank's competency framework, an on-line appraisal system based on the new competencies has been introduced. The appraisal system enables managers to access information about their team as well as information about the development solutions available to support staff in improving their performance. The system encourages managers to think about performance in a more defined manner, and encourages the delivery of clearer messages about performance and development. The system also provides useful information about assessment completion rates, as well as about individual and organisational strengths and development needs.

The Bank introduced a Learning Resources web site, accessible by all staff, which can be searched using either key words or competencies. The search results will point the user to a range of learning resources that have been selected to match the needs of those who might want to use them. The resources include books, videos, tapes, courses and CDs, and will also allow the user to undertake e-learning packages at their desk.

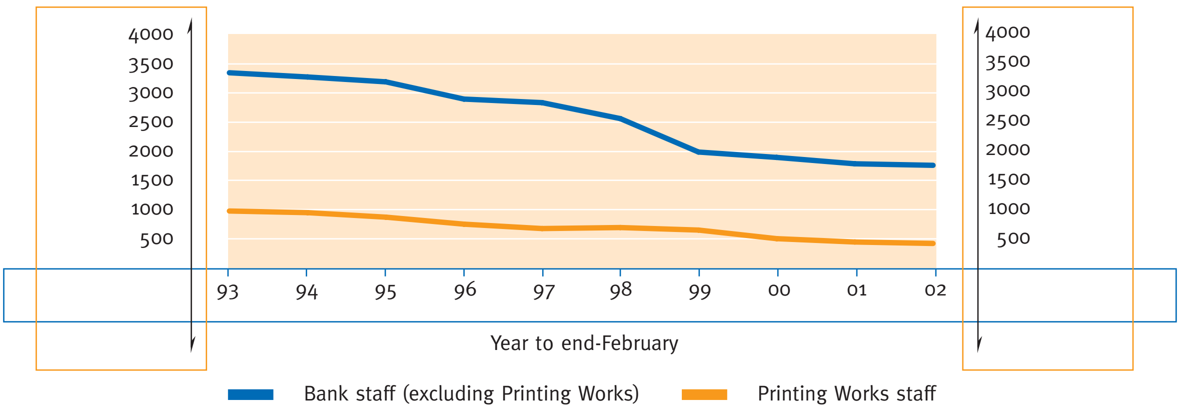
Aggregate Remuneration and Average Number of Staff

	2001/02		*2000/01*
Aggregate remuneration (£m)	**Average number of staff**	*Aggregate remuneration (£m)*	*Average number of staff*
80	**2,242**	*79*	*2,345*

Numbers of Staff by Area 2001 and 2002 (Chart 1)



Bank Staff Numbers 1993-2002 (Chart 2)



The initiative to improve IT literacy continues in the Bank, using the internationally recognised computing qualification, the European Computer Driving Licence. So far 268 people have passed all 7 modules and received their "licence". In total more than 3,000 tests have been successfully taken as some 400 people continue to work towards the qualification.

Other new ventures in training and development over the year include offering employees the opportunity to study internally for the Maths and Statistics 'A' Level, increased use of the LSE's economics summer schools and a trial of 360 degree feedback. In addition there has been a series of 'masterclasses' aimed at managers, covering a wide range of management skills from motivation to giving feedback. 14 staff are undertaking Masters courses in economics or finance, sponsored by the Bank.

Strengthening the career development function for the Bank's analytical and managerial staff was a key objective, and it will continue to be so this year. To that end, a career development adviser was appointed in 2001, giving staff the opportunity to discuss, plan and test their future career ambitions and aspirations, and allowing management to improve the operation of the internal jobs market. It is intended that the service will help to equip individuals better for the analytical and managerial challenges of the future, and to help the Bank plan for the succession of key jobs.

Employment policies

The Bank remains fully committed to diversity in the workplace and endeavours to avoid any form of discrimination. Relevant information and training is provided to staff, and they are encouraged to raise any instances of discrimination through the Bank's internal procedures: any complaints are investigated thoroughly. The Bank continues to support a number of targeted initiatives, including Opportunity Now, Race for Opportunity, The Employer's Forum on Disability, and a similar Forum on Age.

The Bank continues to operate a range of policies to help people balance work and family responsibilities, including paid time off for family emergencies and flexible and part-time working. Over the past year the Bank has introduced a series of seminars for staff designed to support the work/life balance: these have covered a variety of subjects from managing stress to helping children with their homework.

Over the past year the proportion of women managers in the Bank grew slightly to 21.3%. The national gender profile of economists in university courses means that the goal of recruiting equal numbers of male and female economists is unlikely to be achieved; but the proportion of women in the graduate entrant rank has increased from 22% to 24% and in the main analytical grade from 34% to 36%. The proportion of staff declaring themselves to be from an ethnic minority background remained broadly unchanged at 6%.

The Bank uses the Department of Employment's "Positive about Disabled" symbol, which guarantees an interview to disabled candidates meeting the minimum job criteria. Where necessary the Bank provides specialist training and equipment to staff with disabilities.

Employee involvement

The Bank has well-established arrangements for consulting staff on matters that are likely to affect their interests. Formal and informal discussions are held on a regular basis with representatives of the recognised trades unions on matters relating to employment conditions. In addition to the formal consultation process, briefings, notices, e-mails and the Bank-wide intranet are used to update staff on developments in this area.

The Bank-wide intranet site has continued to expand and now covers a wide range of internal information and external links. A new Human Resources computer system allows staff to access and update personal records.

Opinion survey questionnaires were circulated to all staff at the end of 2001 seeking views on a range of topics. It is intended to repeat this at regular intervals. Management will be using the results of this survey, and future ones, to inform decisions relating to staff matters.

COMMUNITY INVOLVEMENT

Last year the Bank contributed £646,000 in support of its community programme. This covers donations to charities and to academic research, and the cost of other contributions to community-related activities. Donations in cash totalled £474,000, while the cost of other community contributions, including time spent by staff on community involvement activities, was £172,000.

The Bank's charitable giving policy primarily focuses on two areas: helping disadvantaged people to access worthwhile employment through training; and supporting the staff's personal involvement in the community. £36,000 was donated to charities and schools in recognition of funds raised or time given by staff. The Bank also matched, on a pound for pound basis, £93,600 donated by staff and pensioners to registered charities under the Give-As-You-Earn Scheme and £8,000 of staff fundraising for Action Research. The Bank provides office space for three charities and hosted receptions for various community organisations. In addition, the Bank donates surplus goods and furniture as gifts in kind, while more than 200 surplus computers were donated to Tools for Schools.

The Bank participates in a number of Education Business Partnership (EBP) activities in Greenwich, Hackney, Islington, Newham and Tower Hamlets. Staff volunteers act as group facilitators at job-finding skills workshops, interviewers at practice interview sessions, business reading and number partners and as mentors to pupils. A number of managers are matched with headteachers on the Partner in Leadership programme and some members of staff have become school business governors. The Bank also regularly offers work experience placements to partner schools in these boroughs. During the year the Bank has been working with Greenwich EBP to develop a mentoring scheme in which mentor and mentee will communicate by e-mail.

The Bank recognises the positive impact that its community programme can have, not only on the projects that benefit, but also on the development of its own staff. For example the Bank is taking part in a Business in the Community scheme to match managers from business with a senior manager or leader of a black and ethnic minority community organisation, offering the opportunity to work together on matters related to leadership and management. The programme aims to develop the management and leadership skills of both the community partner and the business partner.

The Bank continued to play a leading role in the Heart of the City (HOTC) initiative, of which the Governor is a joint President together with the Chairman of the Financial Services Authority (FSA) and the Lord Mayor of London. HOTC aims to raise awareness among City, Docklands and City Fringe businesses of the range of ways they can help the wider community. Bank staff undertook a survey of community and charitable involvement by firms based in this area. This report, along with the FSA's good practice guide for community involvement, was launched on 27 June at the HOTC Carnival organised by the Corporation of London. These reports can be found on the HOTC web site[1].

1: www.theheartofthecity.com

Remuneration
of Governors, Directors and MPC Members

Court determines the remuneration of the Bank's most senior executives, including the Governors, the Executive Directors (who are not members of Court), the Advisers to the Governors and the members of the Monetary Policy Committee (MPC) appointed by the Chancellor of the Exchequer. Court is advised by the Remuneration Committee, the composition of which is shown on pages 8-9.

REMUNERATION POLICY

The Remuneration Committee's approach is to review salaries annually, aiming to set remuneration and conditions of service to reflect adequately qualifications, experience, responsibilities and performance. In addition to recommending salary levels, the Committee may recommend the payment of bonuses as a means of rewarding special services or individual performance. In proposing salary and bonuses, the Committee takes into account both internal and external salary comparators. Where appropriate, it commissions external professional advice on the levels of pay and benefits in comparable public institutions and in the private sector. However, in advising Court on remuneration at senior levels within the Bank, the Committee also bears in mind the Bank's position within the public sector. Although no executive member of Court sits on the Committee, the Governor may be invited to attend meetings that do not consider his own remuneration.

REMUNERATION STRUCTURE FOR THE GOVERNORS

The remuneration arrangements for the Governor and Deputy Governors consist of the following components:

Base salaries

The Governor is currently serving a second five-year term, which began on 1 July 1998. On 1 July 2001 the Governor's salary was increased from £244,454 to £250,567, in line with the Government's annual inflation target. The Remuneration Committee's intention is to continue to propose increases in line with the inflation target each year during the Governor's current term.

The Deputy Governors' salaries have been set in line with the policy described above.

Benefits

The Remuneration Committee also keeps under review other benefits available to Governors. The Governor and Deputy Governors do not receive the full additional benefit allowance available to staff, but medical insurances are provided and these, together with pension, were the principal benefits received during the year to 28 February 2002.

The table of emoluments on page 46 includes payments of tax in respect of notional benefits of travel on Bank business. These arise because of the Inland Revenue's practice of treating travel by spouses accompanying a Governor or Deputy Governor on official business as a taxable benefit. The presence of the spouse on certain official business is regarded by the Bank as necessary and accordingly the Bank meets any tax liability that may arise in respect of such occasions.

Post retirement benefits

Post-retirement benefits are generally provided through the Court Pension Scheme. This is separate from the scheme for staff, and is described on pages 46-47.

Service contracts

The Governor and Deputy Governors do not have service contracts with the Bank. Under the Bank of England Act, Governors are required to provide services only to the Bank. With Court's approval other directorships relevant to the Bank's work may be accepted, but any fees must be paid to the Bank.

REMUNERATION OF DIRECTORS

The Bank of England Act 1998 provides for the remuneration of the non-executive Directors to be determined by the Bank with the approval of the Chancellor of the Exchequer. The remuneration of the non-executive Directors is £5,000 per annum and the remuneration of the Chairman of NedCo is £7,500 per annum. Non-executive Directors do not receive any post-retirement benefits from the Bank.

PENSIONS OF THE GOVERNOR AND DEPUTY GOVERNORS

The Court Pension Scheme, in which the Governors participate, is non-contributory and is governed by an independent trust. Executive Directors are also members of the scheme. The normal retirement age is 60, which allows members to achieve a maximum pension of two-thirds of their pensionable salary at normal retirement age after 20 years' service. The scheme also provides for early retirement in certain circumstances (including ill-health), payment of a lump sum in the event of death in service, and allowances for spouses and dependants.

In the event of death in service, the scheme provides for the payment of a lump sum, surviving spouse's pension of 60% of the member's base pension, and discretionary allowances for dependants. Pensions and deferred pensions are reviewed annually and are normally increased in line with the rise in the Retail Prices Index.

For Governors subject to the pensions earnings cap introduced in the Finance Act 1989, the Bank offers additional unfunded pensions so that their total

Remuneration of Members of Court

	Salary £	Benefits £	Total 2002 £	*Total 2001 £*
Governors				
Governor				
Sir Edward George	248,530	1,379	249,909	*244,983*
Deputy Governors				
Mr D C Clementi	207,085	966	208,051	*202,949*
Mr M A King	207,085	315	207,400	*202,350*
Non-Executive Directors				
(Note i)	77,500	391	77,891	*77,500*
Total	**740,200**	**3,051**	**743,251**	***727,782***

Notes

i/ Sir Howard Davies is a member of Court in his capacity as Chairman of the FSA. Mr Clementi as Deputy Governor, Financial Stability, also sits on the Board of the FSA. Each has agreed to waive the remuneration due from the other body. Accordingly, Sir Howard Davies waived remuneration of £5,000 due from the Bank and Mr Clementi waived remuneration of £14,000 due from the FSA.

pensions broadly match what would have been provided by the Court scheme in the absence of the cap. During the year ended 28 February 2002, there were two capped members – Mr Clementi and Mr King. Provision for these unfunded benefits is made in the Bank's financial statements.

REMUNERATION OF MONETARY POLICY COMMITTEE MEMBERS

The Bank of England Act 1998 requires NedCo to determine the terms and conditions of service of the four members of the MPC appointed by the Chancellor of the Exchequer. NedCo has agreed that the Remuneration Committee should recommend the salaries and pensions of these members of the MPC.

The four members of the MPC appointed by the Chancellor are paid £137,979 *(2001 £134,613)* per annum, pro rated for the number of days worked per week. They are appointed for terms of three years. Dr DeAnne Julius's term expired on 31 May 2001 and she was succeeded by Ms Kate Barker. Dr Sushil Wadhwani's term expires on 31 May 2002. Dr Wadhwani works full-time in the Bank. Ms Barker and Professor Nickell work in the Bank on a four day a week basis, and Mr Allsopp works in the Bank for three days a week. They are paid respectively four-fifths and three-fifths of the basic MPC rate. In addition Mr Allsopp pursues in Oxford a programme of research on MPC-related issues and his remuneration for that is equivalent to a further one-fifth of the basic MPC rate. The members of the MPC appointed by the Chancellor do not receive the normal

Pension Entitlements (Including Unfunded Entitlements)

	Age at 28 February 2002	Years of service to 28 February 2002	Accrued pension as at 28 February 2002 £	Increase in accrued pension in 2002* £
Mr D C Clementi	53	4	31,700	7,200
Mr M A King	53	11	77,500	7,600

* The increase in accrued pension during the year excludes any increase for inflation.

Notes

i/ The Governor, Sir Edward George, is not shown in the above table having reached the age of 60 on 11 September 1998, the normal retirement age under the Court Pension Scheme, after 38 years' service. At normal retirement age, the Governor's pension entitlement was £167,000 per annum. Under the Court Pension Scheme, the Governor's remuneration became non-pensionable on his 60th birthday and, accordingly, no further pension entitlement under this scheme will accrue, although the pension will increase each year until drawn, to reflect deferment. The death-in-service provisions described above remain in force for the duration of his service.

Court has granted the Governor an additional ex-gratia unfunded pension to reflect his service since his normal retirement date which will comprise the difference between the £167,000 referred to above and two-thirds of his final salary on retirement. This further entitlement will accrue over his second term of office and provision for its cost will be made over this period. At 28 February 2002 an additional entitlement of £1,600 had arisen.

ii/ Unfunded pensions are included in the above table.

staff benefits. They are however entitled to death-in-service benefits on the same terms as Bank staff and are eligible to join the Bank's group medical insurance scheme. They receive a sum equal to 15% of salary towards their own pension provision. On leaving the Bank MPC members are bound for three months not to take up employment that may represent a conflict with their former MPC responsibilities, and the Bank will in those circumstances agree to continue their MPC salary for this period.

The salaries of Executive Directors would not be disclosable under the Companies Act requirements, as they are not members of Court. However, the salaries of the two Executive Directors who are members of the MPC are given here for consistency with other members. Mr Ian Plenderleith's current annual salary is £177,816; and Mr Charles Bean's is £147,000. Both are eligible for the Bank's normal range of benefits, including non-contributory pensions.

Report from Members of Court

for the year ended 28 February 2002

PRINCIPAL ACTIVITIES AND REVIEW OF OPERATIONS

The Bank's Core Purposes are set out on pages 10-11. The Governor's Foreword, the Review of Performance against Objectives and Strategy and the Financial Review give a detailed account of the Bank's activities and operations during the year.

PRESENTATION OF THE FINANCIAL STATEMENTS

The Bank Charter Act 1844 requires that the Bank's note issue function be separated from its other activities. Accordingly, for accounting purposes, the Bank is divided into "Issue" and "Banking". The Issue Department is solely concerned with the note issue, the assets backing the issue, the income generated by those assets and the costs incurred by the Bank in printing, issuing, sorting and destroying notes. The entire profit of the note issue is paid over to HM Treasury.

The Banking Department comprises all the other activities of the Bank. Neither the Issue Department nor the Banking Department is an organisational unit of the Bank.

Banking Department

Under the Bank of England Act 1998, the Bank, in preparing the financial statements of the Banking Department, is subject to requirements corresponding to the Companies Act requirements relating to a banking company. The Bank may, however, disregard a requirement to the extent that it considers it appropriate to do so, having regard to its functions. Accordingly the financial statements of the Banking Department follow, insofar as is appropriate having regard to its functions, in particular with the limitation described below, the accounting requirements for banks as laid down in the legislation or in applicable Accounting Standards and Statements of Recommended Accounting Practice.

In exceptional circumstances, as part of its central banking functions, the Bank may act as "lender of last resort" to financial institutions in difficulty, in order to prevent a loss of confidence spreading through the financial system as a whole. In some cases, confidence can best be sustained if the Bank's support is disclosed only when the conditions giving rise to potentially systemic disturbance have improved. Accordingly, although the financial effects of such operations will be included in the Department's financial statements in the year in which they occur, these financial statements may not explicitly identify the existence of such support. However, the existence of such support will be disclosed in the Annual Report when the need for secrecy or confidentiality has ceased.

As a result, the Banking Department's financial statements disclose less detail of the constituent elements of the profit and loss account than would be required under the Companies Acts and applicable Accounting Standards. In particular, there is less disclosure in respect of interest income and expense and any provisions for bad and doubtful debts, together with consequential restrictions in detailed disclosures in the balance sheet, cash flow statement and the notes to the financial statements.

In preparing this year's financial statements the Bank has adopted two new accounting standards, Financial Reporting Standards 18, on accounting policies, and 19 on deferred taxation, but these have no material impact on the financial statements. It has also adopted the transitional arrangements of FRS 17 on pensions and other post-retirement costs.

Issue Department

The statements of account of the Issue Department are prepared in accordance with the requirements of the Currency and Bank Notes Act 1928 and the National Loans Act 1968.

FINANCIAL RESULTS

The Banking Department's financial statements for the year ended 28 February 2002 are given on pages 60-89, and show a profit after provisions and before tax of £103 million (2000/2001 £156 million). The 2001 result included a profit of £22 million on the sale of one of the

Bank's properties, New Change. This disposal is part of the retrenchment programme, announced three years ago, under which the Bank will move all its City-based staff into one building. Excluding this item, profits were lower than last year, mainly due to decreased interest income. After payment in lieu of dividend of £42 million (2000/2001 £68 million) and a tax charge of £19 million (2000/2001 £20 million), the profit transferred to reserves amounts to £42 million (2000/2001 £68 million).

The statements of account for the Issue Department (which are given on pages 90-92) show that the profits of the note issue were £1,410 million (2000/2001 £1,584 million). The decrease was the net effect of more notes in circulation and lower interest rates. These profits are all payable to HM Treasury. In accordance with the Currency and Bank Notes Act 1928, the assets of the Issue Department comprise securities sufficient to cover the fiduciary note issue.

Balance sheets

The size of Banking Department's balance sheet is affected by the allocation of open market operations between Banking and Issue Departments. When market operations are conducted on Banking Department's balance sheet, they may be funded by an increase in the Issue Department's Deposit with Banking Department. At 28 February 2002 the level of market assistance provided by Banking Department was around £1.6 billion, approximately £600 million lower than at the previous year-end.

The Bank issued further three-year euro-denominated securities, Euro Notes, during the year. The remaining three tranches, amounting to some €1,500 million, of the first issue of €2,000 million maturing in 2004 were sold in three quarterly auctions. On 28 January 2002, the Bank issued €2,000 million of Notes maturing on 28 January 2005. As with the first issue of Notes, these securities will be sold by auction: the first tranche of €1,000 million was sold on 28 January and further tranches of €500 million were sold by auction on 19 March and 16 April. The proceeds of the issue have been invested in foreign currency assets so as to minimise market risk exposures, particularly interest rate and currency exposures.

The structure of the Issue Department balance sheet remains as in previous years, but the footings have increased due to a rise in the note circulation. The matching assets remain similar to previous years and include reverse repo transactions used in the Bank's market operations and the Ways and Means advance to HM Treasury, which has been fixed at £13.4 billion since April 2000.

SUPPORT OPERATIONS

A dividend of £2.35 million (2000/2001 £5 million) was received from Minories Finance Limited (formerly Johnson Matthey Bankers Limited). The company had reached the position where the likely realisation pattern of its remaining assets no longer justified the maintenance of an operating company with its own personnel. Consequently the company went into members' voluntary liquidation on 22 February 2002. The liquidation is expected to last several years and the Bank expects to recover its remaining investment of £12.5 million.

EMPLOYEES

Details of the Bank's employees, their involvement in the Bank's affairs and the Bank's approach to equal opportunities are given on pages 41 to 44.

PAYMENT IN LIEU OF DIVIDEND TO HM TREASURY

The Bank of England Act 1946, as amended by the Bank of England Act 1998, requires the Bank to pay to HM Treasury, in lieu of dividend on the Bank's capital, on both 5 April and 5 October, a sum equal to 25% of the Bank's post-tax profit for the previous financial year or such other sum as the Bank and HM Treasury may agree. The overall effect is that the Bank and HM Treasury will normally share post-tax profits equally. Accordingly the Bank paid £33 million in April 2001 and

£35 million in October 2001 in respect of the year to 28 February 2001. In April 2002 the Bank paid the first payment of £21 million in respect of the financial year ended 28 February 2002 which was based on provisional figures. The balance of £21 million is payable on 5 October 2002.

GOVERNANCE OF THE BANK

The role of the Court of Directors and its Committees, and the names of the members of the Court of Directors, together with the principal outside appointments of the non-executive Directors are given on pages 6-7.

Internal Controls

The Court of Directors is responsible for the system of internal control in the Bank and its subsidiaries. The responsibility for day-to-day operations is delegated to the executive management. The system of internal control is based on what Court consider to be appropriate to the Bank's activities, to the materiality of the financial and other risks inherent in those activities and to the relative costs and benefits of implementing specific controls. It is designed to manage rather than eliminate the risk of failure to achieve business objectives and, as such, provides reasonable, but not absolute, assurance against material mis-statement and loss.

In accordance with the Internal Control Guidance for Directors on the Combined Code issued by the Institute of Chartered Accountants in England and Wales, Court has reviewed the effectiveness of the system of internal control and confirms that an ongoing process of identifying, evaluating and managing the Bank's significant risks has operated throughout the year covered in this Annual Report, and up to the date of its approval.

The key features of the control system are set out as below:

i/ An organisational structure, as shown on page 15, that is closely aligned to the Bank's Core Purposes in order to provide a framework for the control of its various activities.

ii/ A planning framework covering a five-year period, with objectives and financial targets set at each level so that they are specific to the various operational areas in the Bank.

iii/ The appointment of experienced and suitably-qualified staff. Annual objective-setting and appraisal procedures for all staff enable standards of performance to be monitored by management. A Bank-wide programme of training and development enables continuing improvement in relevant skills and knowledge.

iv/ A system of financial reporting via the Executive to Court, including forecasts and budgets which allow the monitoring of the key activities and progress towards strategic, including financial, objectives.

v/ Defined procedures governing approval of capital and other project expenditure. These include annual budgets, detailed project approval procedures, monitoring reports and post-implementation reviews.

vi/ Oversight of the management of the Bank's balance sheet as a whole and monitoring of the financial performance and risk profile of its main business activities by the Assets and Liabilities Committee (ALCO), which is chaired by the Deputy Governor, Financial Stability, and meets quarterly. A Risk Analysis and Monitoring Division (RAMD) is responsible for monitoring risk controls in the Bank's banking and market operations. It provides a regular report for ALCO on balance sheet changes and developments. The financial risks and associated controls are separately reported on pages 53-55, as required under FRS 13.

vii/ A procedure, supported by the maintenance of a Bank-wide risk and controls matrix, under which the Executive report to Court once a year on risk management in each of their areas of responsibility. In particular, such reports cover the nature and scale of the risks, how they are managed and monitored and, taking into account the control framework, the likelihood of risks materialising. In addition, the reports include any weaknesses or failures in controls during the year, which have not been previously reported to Court or to the Audit Committee on behalf of Court. The system of internal control is subject to scrutiny by the Executive and by internal audit, the head of which reports to the Governor. A risk-based internal audit programme is prepared annually and is approved by the Management Committee and endorsed by the Audit Committee. Monitoring the effectiveness of internal control is undertaken by Court and by the Audit Committee, which receives regular reports from management, from internal audit and, where appropriate, from the external auditors. The Audit Committee reviews the activities of the internal and external auditors to ensure comprehensive audit coverage.

STATEMENT OF THE RESPONSIBILITIES OF THE COURT OF DIRECTORS IN RELATION TO THE FINANCIAL STATEMENTS

The Court of Directors is responsible for ensuring that the financial statements, as prepared on the basis set out therein, present fairly the state of affairs of the Banking Department as at 28 February 2002 and of the profit for the year to that date. The statements of account of the Issue Department are prepared in accordance with provisions agreed between the Bank and HM Treasury to implement the requirements of the Currency and Bank Notes Act 1928 and the National Loans Act 1968. The Court of Directors is responsible for ensuring that the statements of account are prepared in accordance with these requirements.

The Court of Directors is responsible for ensuring proper accounting records are kept, which disclose at any time the financial position of the Bank and enable Court to ensure that the financial statements comply with the requirements set out in note 1 thereto. The Court of Directors is also responsible for safeguarding the assets of the Bank and its subsidiaries, and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The Court of Directors confirms that suitable accounting policies, consistently applied and supported by reasonable and prudent judgement and estimates, have been used in the preparation of the financial statements of the Banking Department. Accounting standards applicable in the United Kingdom have been followed in preparing the financial statements of the Banking Department insofar as they are appropriate to the basis of accounting set out in the notes to the financial statements.

HEALTH AND SAFETY

Effective health, safety and risk management is recognised throughout the Bank. Appropriate policies and procedures are in place to protect employees and members of the public from workplace hazards.

POLITICAL AND CHARITABLE DONATIONS

No donation was made for any political purpose. Details of charitable donations are set out on page 44.

POLICY ON PAYMENT OF SUPPLIERS

The Bank's policy is to pay all suppliers within 30 days of receipt of a valid invoice or within specifically agreed terms of payment if these are shorter. Sampling during the year shows that the Bank paid 98% (2000/2001 95%) of its bills within these timescales.

The Bank estimates that the average trade creditor payment days for 2001/02 were 23 (2000/2001: 21). This is an arithmetical calculation and does not necessarily reflect our practice, described above, nor the experience of any individual creditor.

The Bank supports the aims and principles of the Better Payments Practice Group but is not a member.

Risk Management

This section describes the management of risks arising from the Bank of England's financial operations, including its use of derivatives. As indicated in previous Annual Reports, the Bank runs various types of financial risk, whether in managing its own capital; in its banking business; through its involvement in payment and settlement systems; in implementing monetary policy; or in acting as agent for HM Treasury in managing the UK's official reserves. These risks are monitored and managed in the context of the Bank's internal control framework, described on pages 51-52.

New Developments in 2001/02

Over the past year, there have been two significant changes to the profile of the Bank's balance sheet. First, as described in last year's Annual Report, the Bank took over the Government's 3-year Euro Note programme in January 2001. During the 2001 calendar year €2,000 million of notes were issued to the market; in January 2002 a new series of auctions under the programme was announced, and a further tranche of €1,000 million was issued. The €2,000 million programme was completed in April. The proceeds of these issues have been invested in accordance with credit and market risk limits agreed by the Assets and Liabilities Committee (ALCO). The second development concerns the Bank's own funds (comprising the Bank's capital and reserves plus the proceeds of Cash Ratio Deposits), which have previously been invested in gilt-edged securities and money market assets. Following discussions in ALCO and agreement by Court, the Bank began to diversify this portfolio, to include high-quality public debt securities other than gilts (predominantly issued by foreign governments and supranational institutions). Before implementation, new product procedures were conducted to ensure that financial risks and performance could be measured and monitored, and that operational issues had been satisfactorily addressed.

Three significant risk reduction measures were implemented in 2001/02. The first of these was the phased introduction, from April 2001, of the Note Circulation Scheme, which has almost entirely eliminated the Bank's intra-day credit exposure to the institutions responsible for wholesale banknote distribution. Second, the introduction of Delivery versus Payment (DvP) in CREST in November 2001 substantially reduced the risks involved in the settlement of securities business in London financial markets, which included eliminating the intra-day exposures incurred by the Bank vis-à-vis other CREST settlement banks. Finally, the Bank has been able to reduce credit exposures in its foreign currency operations through the implementation of repo remargining and swap collateralisation.

The following notes describe the approaches the Bank takes to different types of risk.

Reputational Risk

To operate effectively, the Bank needs to maintain a high level of public confidence across the full range of its activities. Risks to the Bank's reputation may arise, for example, from shortcomings in its market operations, which might impair the effective implementation of policy decisions, or the services provided to customers, or lead to financial loss. Potential risks are identified and evaluated by line management (using, for example, the risk and controls matrix referred to on pages 51-52, which facilitates a systematic assessment of the various risks to which the Bank is exposed, of their potential impact, and of the controls in place to mitigate them). This enables line management to keep the control environment under review and to take whatever steps are needed to strengthen it. Risks are contained by procedures for the selection, training and development of staff, by defining their key responsibilities and objectives, by performance measurement for staff at all levels, and by a structured process for the management and oversight of the work of the Bank.

Financial Risk

The main financial risks associated with the Bank's banking and market activities are credit, market and operational risks. They are largely incurred in the Financial Market Operations area in pursuit of the Bank's responsibilities for monetary and financial stability.

The Bank, as agent, also manages HM Government's foreign currency assets and gold reserves, and its foreign currency liabilities, within a risk framework agreed annually with HM Treasury. In its asset and liability management operations, both for HM Treasury and on its own account, the Bank has continued to develop the functionality and coverage of its management information systems.

Credit Risk is incurred by the Bank in the monetary operations through which it implements interest rate decisions taken by the Monetary Policy Committee; in other core central banking activities, notably through its participation in the major sterling and the euro wholesale systems (including CHAPS, CREST, TARGET, etc); in its banking operations for its public sector, central bank and other customers; and, as agent, in the management of the official reserves on behalf of HM Treasury. Credit and settlement limits are set for individual counterparties on the basis of continuous review conducted by a Credit Risk Advisory Committee, which is chaired by the Head of the Risk Analysis and Monitoring Division (RAMD) and reports to the Executive Director for Financial Market Operations, who is responsible for decisions on limits. This Committee is supported by a credit risk analysis team, which also draws on the output of ratings agencies, and on relevant knowledge and experience across the Bank as a whole. Credit exposures in gold and foreign currency operations are monitored against credit limits on a real-time basis. In 2001/02, this facility was extended to the investment of the Bank's own funds.

Where the Bank, as a central bank, is obliged to accept large exposures to individual counterparties because the scale of its operations is determined by the liquidity needs of the financial system as a whole, credit risk is contained by structuring the Bank's operations so that it deals with counterparties that meet appropriate creditworthiness and functional criteria, and the exposures that arise are fully collateralised by high-quality, marketable securities. These exposures are monitored on a regular basis, and additional margin is called as required.

Market Risk is also incurred by the Bank, principally in the form of exposure to changes in the relative interest rates received on its assets and paid on its liabilities; limited exposure may also be incurred to changes in exchange rates and to shifts in general market conditions such as liquidity. The Bank has adopted policies to manage its exposure to these risks, consistent with the underlying purposes for which its operations are conducted. Details of the Bank's interest rate and foreign currency exposures are given in note 7 of the financial statements on pages 71-77.

In relation to interest rate exposure, Cash Ratio Deposits are interest-free, while the Banking Department's income on the corresponding assets is exposed to interest rate movements. The Bank reduces the variability in its interest income by investing a significant proportion of these funds in medium to long-term securities. Historically, the Bank has held predominantly gilts and money market instruments, but as noted above, it now also holds debt securities issued by other highly-rated public bodies. The Note Issue is also interest-free, and the corresponding assets acquired by the Bank in providing liquidity to the banking system through open market operations typically have a maturity of two weeks or less, so that the interest rate exposure arising from these operations is of short maturity. Longer-maturity instruments have been employed on occasion (eg over the millennium period), but these have been at floating rates, again limiting the Bank's interest rate exposure. Short-term sterling deposits taken by the Bank may be employed in its monetary operations, resulting in a slight maturity mismatch; such sterling deposits may also be on-placed in the market, via foreign exchange swaps, in the form of foreign currency deposits of matching maturity. Finally, customer deposits taken in foreign currency and gold are on-placed with the market, in either deposits or reverse repos of matching maturity.

In relation to *exchange rate* risk, the foreign currency and gold deposits taken from customers are employed on a fully matched basis. The Bank may also use foreign exchange swaps as a technique in its sterling open market operations, but no foreign exchange exposure is incurred. The Bank uses cross-currency, foreign exchange and interest rate swaps in order to hedge its market exposures in connection with the portfolio of fixed-interest euro securities and other assets acquired for the purpose of providing the UK's intra-day liquidity for the TARGET system and in relation to the portfolio of securities funded by the euro-denominated medium-term note programme. On occasion, futures have also been used for hedging purposes. Other than this, the Bank has not used derivatives on its own balance sheet. The TARGET portfolio is largely funded by euro bills. As these bills have matured they have been replaced by new issuance.

Under the monetary arrangements introduced in May 1997, the Bank may undertake foreign currency intervention in support of its monetary policy objectives. Such operations would give rise to interest rate and foreign exchange rate exposures on the Bank's balance sheet, but no such operations have so far been conducted. In its reserves management operations on behalf of HM Treasury the Bank does take exchange rate and interest rate risk; it also employs the swap and futures products described in the previous paragraph, as well as forward rate agreements. In line with good market practice, the Bank monitors Value at Risk on a daily basis for its reserves management operations, and where necessary on its own balance sheet, in order to monitor the effectiveness of its hedging operations. Value at Risk measures the aggregate market risk of a portfolio by gauging the effect on the value of assets and liabilities of potential changes in the profile of interest rates and exchange rates. The Bank recognises that VaR methodology cannot be guaranteed to predict the maximum potential loss in any trading period, and stress testing is used to simulate the effect of extreme market movements on outstanding positions.

Operational or other related risks may arise directly or indirectly through inadequate internal processes, human error, systems or business continuity failures, fraud, or inadequate legal and other documentation. These are the types of risk faced by any institution active in banking and financial markets. Shortcomings in any of these areas could have reputational or financial consequences. In the context of its preparations for the Turnbull sign-off for 2001/02, a sub-committee of Management Committee conducted a review of controls over operational risks that are common to all areas of the Bank. This exercise covered six particular aspects of operational risk: disaster recovery and business continuity; health and safety; management controls; risks of error in information and transaction processing; personnel risks; and information systems security risks.

In the Financial Market Operations area of the Bank, such risks are subject to a comprehensive framework of internal controls, including contingency arrangements for both business processes and IT systems. Each business area has responsibility for detailed management of its operational risk and the monitoring of associated controls. As with other kinds of risks, these are included in the Bank's risk matrix referred to above. As already noted, any new product (defined as any instrument, transaction type or service that requires changes to the systems and procedures needed to transact, monitor, settle or account for it) is subject to detailed new product procedures before senior management can authorise its introduction.

In the event of a serious technical failure or unavailability of systems, the Bank maintains remote contingency facilities to support its own operations and the market-wide systems run by the Bank. In the wake of the 11 September disaster, Bank senior management participated in high-level discussions on maintaining systems vital for the financial markets infrastructure. At the same time, measures were taken to raise further the level of preparedness of the Bank's disaster plans, including the conduct of a successful live test of front, middle and back office operations at remote sites in January and April.

Report by the Non-Executive Directors of the Bank of England

This section of the Bank's Annual Report contains the Report of the 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 sub-committee of non-executive Directors and how it has discharged them. In order to minimise repetition, the report refers where relevant to other sections of the Annual Report, for which the non-executive Directors, as members of Court, are also responsible.

Under the Bank of England Act 1998 certain functions of Court are delegated to a sub-committee comprising the non-executive Directors of the Bank. This sub-committee is known as NedCo.

The delegated functions are:

a/ keeping under review the Bank's performance in relation to its objectives and strategy for the time being determined by Court;

b/ monitoring the extent to which the objectives set in relation to the Bank's financial management have been met;

c/ keeping under review the internal financial controls of the Bank with a view to securing the proper conduct of its financial affairs;

d/ determining how the remuneration and pensions of the executive members of Court should be fixed;

e/ keeping under review the procedures followed by the Monetary Policy Committee, including determining whether the MPC has collected the regional, sectoral and other information necessary for the purposes of formulating monetary policy;

f/ determining the terms and conditions of employment of the members of the MPC who are appointed by the Chancellor of the Exchequer.

NedCo is required by Section 4(2)(a) of the Act to make a report in respect of the matters for which it is responsible for inclusion in the Bank's Annual Report. This report relates to the period from 1 March 2001 to 28 February 2002. The Core Purposes and Strategic Objectives of the Bank for 2001/02 are set out in the 2001 Annual Report.

In discharging its functions, NedCo decided that it would, as far as practicable, rely on processes established for and work done for or in Court. Certain of the work required to fulfil NedCo's delegated functions is carried out by the Audit and Remuneration Committees of Court. The membership of these committees comprises only non-executive Directors, and the work of these committees is considered in Court. In addition, various reports on particular issues were prepared by the Bank at the request of NedCo. NedCo met eight times during the year to satisfy itself that the delegated functions were being satisfactorily discharged.

The Bank's performance in relation to its strategy and objectives (including the extent to which the objectives in relation to financial management have been met) was reviewed by Court and is evaluated by the Bank on pages 16-31 of this Annual Report. In NedCo's opinion this evaluation is a fair statement of the Bank's performance in relation to its objectives and strategy for 2001/02.

In particular, NedCo notes with approval that the reductions in spending on central services, and the successful implementation of the Bank's property strategy, put the Bank on course to meet the financial objective set in 1998 of achieving a reduction in overhead expenditure of £20 million a year. The Bank has also been successful in recruiting staff, and its retention rates are good by external standards. NedCo is confident that the Bank's pay and benefit arrangements support this.

NedCo welcomes the review of bank note printing operations. It notes the Bank's successful completion of the Government's gold sale programme, and the continuation of the programme of euro bill and note auctions. The introduction of Delivery versus Payment has been successfully completed, a major project which was a considerable success for the Bank and the City.

There have been significant advances in the Bank's use of IT in its internal processes; this includes data capture and management. In policy areas these changes have made the Bank more effective in its analysis, and in support functions they have enabled the Bank to reduce its overhead costs and offer the prospect of further savings in the future.

NedCo also notes that the Bank has responded quickly to the events of 11 September both in reviewing its own business continuity planning and, in conjunction with the Standing Committee, in co-ordinating that of the City.

The Bank's internal controls were kept under review as part of the responsibilities of the Audit Committee, which comprises non-executive Directors as set out on page 9. The Audit Committee, on behalf of both Court and NedCo, has reviewed the effectiveness of the system of internal financial control which operated during 2001/02, as reported in the internal controls section of the report from Members of Court (pages 51 and 52) which, so far as appropriate, forms part of NedCo's report.

Matters relating to the remuneration of the executive members of Court and to the terms and conditions of service of the members of the Monetary Policy Committee appointed by the Chancellor of the Exchequer were dealt with by the Remuneration Committee, which comprises non-executive Directors as set out on page 8. The report on remuneration for 2001/02 is set out on pages 45-48 and, so far as appropriate, forms part of this report.

The Monetary Policy Committee's procedures are described on pages 32-35. As provided for under Schedule 3 of the Act, Court receives a monthly report from the MPC and all members of the MPC are invited to attend Court, for that discussion and for other relevant discussions of the MPC's procedures. Additionally, NedCo has decided that, in order to keep the MPC's procedures under review, it would *inter alia*:

- Encourage periodic attendance by non-executive Directors at the pre-MPC meetings at which the Bank's staff present their latest analysis of relevant economic data to the members of the MPC;
- Hold discussions with MPC members (both collectively and individually) and with HM Treasury's representative at the MPC and others;
- Review the minutes of the monthly MPC meetings at which the MPC makes its decisions on interest rates and summaries of other meetings;
- Review the use of the Bank's quarterly *Inflation Report* which is approved for issue by the MPC;
- Encourage non-executive Directors to visit the Bank's Agents and take part in their contact activities;
- Review examples of the regional, sectoral and other information collected by the MPC during the year.

NedCo has kept under review the level and quality of support provided to the MPC, both from within the Bank and from outside sources such as the ONS, which last autumn made a presentation on its work to Court. NedCo welcomes the steps taken to implement the recommendations made in the review of MPC procedures by Don Kohn of the US Federal Reserve Board. It also welcomes the appointment by Court of Professor Adrian Pagan to review the Bank's forecasting methodology, and looks forward to a discussion with him, in Court, of the results of his review. NedCo notes that in the key monetary analysis area, the Bank has made good progress on resourcing issues and in particular has reached its budgeted numbers of staff, although it recognises the continuing need to address experience levels.

In NedCo's opinion, based on its review, the MPC's procedures, including those relating to the collection of regional, sectoral and other information, operated satisfactorily during the year. Although non-executive Directors did not attend meetings of the MPC itself, NedCo has no reason to believe that had they done so it would have altered its opinion.

Chairman of the Non-Executive Directors' Committee