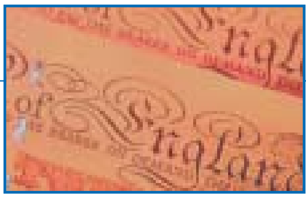


# Bank of England

## Annual Report 2003

# Contents

**Eddie George,** Governor

# Governor's Foreword

This is the last occasion on which I will write the foreword to the Bank of England's Annual Report, having had the immense privilege – and enormous pleasure – of serving the Bank as its Governor for the past ten years. At the time of my appointment in 1993, many of our preoccupations were very similar to those we have today – I see that in my first foreword I wrote about the importance of price stability as the primary objective for monetary policy. But what we did not fully appreciate as the Bank entered its fourth century was the extent and speed of the changes it was about to experience, which have proved to be among the most dramatic and interesting in its history.

It has been a period of great change in our responsibilities, most notably through the Government's decisions in 1997 to give us independent operational responsibility for maintaining monetary stability and to transfer banking supervision – but not responsibility for the stability of the financial system as a whole – to the Financial Services Authority. Perhaps less visible to the outside world, it has been a period of great change, too, to the internal workings of the Bank and a very testing time for all those who have been working here.

Happily, the decade as a whole has been a relatively benign period for the overall British economy. Inflation has remained low and remarkably stable. We have enjoyed continuous positive, quarter by quarter, output growth. Employment has risen fairly consistently. And unemployment has fallen to its lowest level for over a quarter of a century. Whatever the reasons for that outcome, it clearly demonstrates that there is no necessary trade-off between growth and stability in the medium and longer term, and indeed lends considerable support to the universal mantra of central banks that monetary stability, in the sense of consistently low and stable inflation, is a necessary – if not in itself sufficient – condition for sustainable growth.

That said the problems confronting us in maintaining monetary stability have become considerably more difficult over the past few years. Those problems originated essentially overseas. They began with the Asia crisis. That was followed a couple of years later by a sharp economic slowdown into mild recession in the United States and other major industrial countries, and by a related and sustained fall in global equity prices from their "irrationally exuberant" peaks. The weaker global environment was prolonged by a sequence of shocks, including the threat of terrorism following "9/11", the series of corporate governance and accounting failures in the United States, and most recently the uncertainty associated with the build up to war with Iraq, which weighed heavily on both financial markets and business and consumer sentiment.

These clouds over the economy, together with the persistent weakness during much of the period – and until relatively recently – of the euro exchange rate, have made life difficult for internationally – exposed businesses in the UK, including much of manufacturing. That has been reflected both in weak demand from abroad for our products and in declining business investment, here as elsewhere. There was little that either we or the Government could do to influence the international environment directly, but the Monetary Policy Committee was able to help offset much of the negative effect on the overall UK economy by reducing interest rates to encourage the growth of consumer demand. There was a cost however in terms of the two-speed domestic economy, with many manufacturers and some services sectors under pressure while consumers and the retail sector remained relatively buoyant. And there was a risk of an abrupt correction of this imbalance if the household sector became financially overstretched and suddenly drew in its horns. But with underlying inflation close to target we took the view over this period that unbalanced growth was better than no growth at all.

Happily, the war in Iraq is over, which has cleared some of the clouds away, lessening the downside risks for the world economy and for the markets. Looking ahead, we anticipate a gradual improvement in the external environment; while in the UK, the growth in public expenditure, together with a modest recovery in business investment, should cushion the necessary moderation in the growth of consumer spending which now appears to be underway. There is now a realistic prospect of better balanced growth in the UK, at around trend over the next two years, with inflation falling back to the target rate once the present upward short-term pressures, notably housing depreciation costs and Council Tax increases, begin to abate.

Given the stresses of the past few years the financial system as a whole has, from a UK perspective, held up very well. It is encouraging that the IMF, in its Financial System Stability Assessment published in February, concluded that "The UK's large and sophisticated financial sector features fundamentally sound and highly developed financial institutions, markets and infrastructure. It is supported by a financial stability policy framework that has been significantly strengthened in a number of ways in recent years, and that in many respects is at the forefront internationally."

The financial stability area of the Bank has kept a watchful eye on developments, both internationally and domestically, through its continuing very extensive contacts with markets and financial intermediaries, and working in close collaboration with the Treasury and the Financial Services Authority on the tripartite standing committee and participating actively in the work of the International Monetary Fund, the G7, G10 and G20, the Financial Stability Forum, and the Bank for International Settlements as well as liaising actively with other central banks. Developments in all these areas, and our analysis of them, are reported on regularly in the Bank's Financial Stability Review.

For some years we have been working with the FSA and others on initiatives to improve the handling of potential crises involving large complex financial institutions and we are closely involved in the international effort to improve the capacity of the financial system to deal with sovereign debt problems, on which further progress has been made this year. The Bank has also been playing a significant role over a number of years in the development of the new Basel Capital Accord.

In the markets, the Bank has continued to work with the private sector to improve the domestic and international market infrastructure. This year, the Bank provided the link to sterling for Continuous Linked Settlement, a new private sector system designed to eliminate risk in the settlement of foreign exchange transactions, which became operational in September. And with 9/11 still fresh in the memory, the Bank has intensified work on contingency arrangements for the markets generally and for its own operations.

There is much more to be done on all these fronts, to ensure continued low and stable inflation and to deal with, and hopefully forestall, threats to the financial system and to the infrastructure.

In all of this work, I cannot overstate how much I appreciate the efforts of all those staff who have served me during my period as Governor. Their quality and commitment throughout the institution remain as great as ever. They are the Bank's most valuable asset, and they have faced – and coped wonderfully well with – the long period of adjustment as the Bank adapted to the rapidly changing external environment and to meeting the new demands put upon us. They have responded admirably to the new challenges and continue to deliver the services provided by the Bank effectively and efficiently, as we have come to expect. I take this opportunity to express my gratitude to all of them, as well as to my past and present colleagues – as Deputy Governors, executive and non-executive Directors and fellow members of the Monetary Policy Committee.

My thanks go in particular this year to David Clementi, who retired as Deputy Governor for Financial Stability last August, and to four of our non-executive Directors who are sadly leaving at the end of May, when their terms of office expire – Roy Bailie, Dame Sheila McKechnie, John Neill, and Jim Stretton. To all of them I extend my sincere thanks for the contribution that they have made to the work of the Bank. I welcome our new non-executive Directors Brendan Barber, Peter Jay, David Potter and Heather Rabbats, who will join us from 1 June. And I would also say an early thank you to Sir Howard Davies, the former Deputy Governor, who will be leaving Court in September to become Director of the London School of Economics.

I am grateful, too, to Christopher Allsopp, a former non-executive Director, who leaves the MPC at the end of May after three years during which he made a very constructive contribution to our work. I welcome Richard Lambert, former editor of the Financial Times, who joins the MPC on 1 June, in time for my own last meeting as chairman of the Committee.

I will leave the Bank confident that its future is in excellent hands. Mervyn King, my successor as Governor, has been an absolute tower of strength throughout my own term, and is as totally committed as I have been to maintaining monetary and financial stability. He is joined by Sir Andrew Large, the Deputy Governor for Financial Stability since last September who has brought to the Bank a wealth of experience both as a banker in the private sector and as a financial services regulator. And they will be joined from 1 July by Rachel Lomax, an outstanding Civil Servant with longstanding experience of economic policy making and most recently Permanent Secretary of the Department for Transport, who will take over from Mervyn as Deputy Governor for Monetary Stability from 1 July. I wish them and the Bank as a whole every success in the challenging but very rewarding task ahead.

Governor of the Bank of England
May 2003

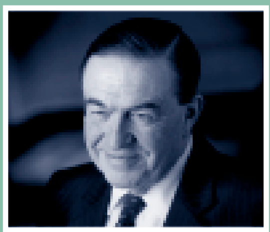
# The Court of Directors

## Members of the Court of Directors

**The Rt Hon. Sir Edward George**
Governor

**Mervyn King**
Deputy Governor

**Sir Andrew Large**
Deputy Governor



**Sir David Cooksey**

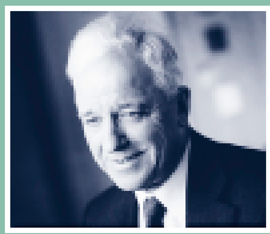
**John Neill, CBE**

**Dame Sheila McKechnie, OBE**

**Bill Morris, OJ**

**Kathleen O'Donovan**

**Bridget Blow**



**Sir Brian Moffat, OBE**

**Sir John Bond**

**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.
*Director,*
Advent VCT plc.
*Director,*
Advent 2 VCT plc.
*Director,*
The Establishment Investment Trust plc.
*Chairman,*
Small Business Investment Taskforce.
*Chairman,*
DTI Bioscience Innovation & Growth Team.

**Kathleen O'Donovan**
Appointed August 1999.

*Director,*
EMI Group plc.
*Director,*
Prudential.
*Director,*
Great Portland Estates.

**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,*
Royal Mail Group plc.
*Director,*
SMMT Industry Forum.
*Vice President,*
The Institute of the Motor Industry.
*Vice President,*
Society of Motor Manufacturers and Traders Limited.

**Bridget Blow**
Appointed June 2000.

*Principal Appointment,*
Chief Executive of ITNET plc.
*Member,*
British Computer Society.
*Companion,*
Institute of Management.

*Member,*
DTI's Industrial Development Board.
*Member,*
CBI President's 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.
*Deputy Chairman and Non-Executive Director,*
HSBC Holdings plc.

**Bill Morris, OJ**
Appointed June 1998.

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

**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**

**Sir Howard Davies**

**Roy Bailie, OBE**

**Sir Ian Gibson, CBE**

**Mary Francis, LVO**

**Sir Graham Hall**

**Dr DeAnne Julius, CBE**

**Laurel Powers-Freeling**

**Jim Stretton**
Appointed June 1998.

*Director,*
The Edinburgh Festival Society Limited.
*Chairman,*
The Wise Group.
*Trustee Director,*
Bank of England Pension Fund Trustees Ltd.
*Franchise Board,*
Lloyd's of London.

**Mary Francis, LVO**
Appointed 1 June 2001.

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

**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.
*Trustee,*
Tate Gallery.

**Sir Graham Hall**
Appointed 1 June 2001.

*Chairman,*
Yorkshire Forward Regional Development Agency for Yorkshire and the Humber.
*Interim Chairman,*
Bradford City Centre Urban Regeneration Co Ltd.

**Roy Bailie, OBE**
Appointed June 1998.

*Chairman,*
W&G Baird Holdings Limited.
*Director of Court,*
Bank of Ireland.
*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.
*Vice Chairman,*
Institute of Development Studies.
*Vice President,*
Society of Business Economists.

**Sir Ian Gibson, CBE**
Appointed August 1999.

*Director,*
BPB plc.
*Director,*
Northern Rock.
*Director,*
GKN.

**Laurel Powers-Freeling**
Appointed June 2002.

*Chief Executive,*
Marks and Spencer Financial Services Ltd.
*Director,*
Marks & Spencer plc.

# Governance and Accountability

This is the fifth 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 Sir Neville Simms and David Clementi expired and they were replaced by Laurel Powers-Freeling and Sir Andrew Large respectively.

Sir Howard Davies, Sir Ian Gibson, Kathleen O'Donovan and Bridget Blow were appointed for new three-year terms.

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.

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 (see below), 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 30.

### 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. This sub-committee, known as NedCo, has been chaired by Sir David Cooksey since 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 55.

### Remuneration Committee

The members of the Remuneration Committee during 2002/03 were John Neill (Chairman), Bill Morris, Sir Graham Hall, Roy Bailie and Laurel Powers-Freeling, the latter two having joined in June 2002. Jim Stretton stood down in May 2002. The Committee's approach to remuneration is set out in the Remuneration Report on page 43.

### Audit Committee

The members of the Audit Committee during 2002/03 were Kathleen O'Donovan (Chairman), Bridget Blow, Sir Brian Moffat, Mary Francis and Jim Stretton, the latter having joined in June 2002 to replace Sir Neville Simms, who retired as Chairman at the end of May. The Deputy Governor (Financial Stability), the Finance Director and the Auditor normally attend the meetings of the Committee, and the Chairman of NedCo may also do so.

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. Internal administration is the responsibility of the Management Committee, the membership of which is shown on page 14.

The Bank's management structure and Heads of Function are shown on pages 12-15.

# 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 2003/04 are set out on page 34 of this Report. The Bank Objectives for 2002/03 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 16-29 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 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.

## Market Operations

Gilt-Edged and Money Markets
Foreign Exchange
Risk Analysis and Monitoring

The Gilt-Edged and Money Markets and Foreign Exchange divisions conduct the Bank's operations in the core financial markets. They establish short-term interest rates at the level required by monetary policy; manage the Bank's foreign currency operations; and, as agent, manage HM Treasury's foreign exchange and gold reserves. Drawing on a wide range of contacts in the UK and overseas, they contribute market analysis and intelligence to the Monetary Policy Committee and the Financial Stability Committee, and seek to promote efficient structures in the markets in which the Bank deals. The Risk Analysis and Monitoring Division is responsible for developing risk policy proposals for the Bank's financial operations, measuring risk and, with the front office, managing the risks involved in these operations.

## Financial Stability

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

The Financial Stability area has the main responsibility for discharging the Bank's remit to maintain the stability of the financial system as a whole. It works closely with the Treasury and the FSA through the Joint Standing Committee established in 1997 (page 16). Internally, 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 Mervyn King, Sir Andrew Large, Charlie Bean, Alastair Clark, Paul Tucker, Charles Goodhart, Mario Blejer and Bill Allen. The work of the area covers both UK and overseas financial markets. It seeks to 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 makes policy proposals and encourages changes designed to increase their overall safety and effectiveness. In addition, from June 2002, the area assumed responsibility for the work previously carried out by the Co-ordination Unit for Europe. The area also contributes to the monetary policy process, for example through the Bank's Deputy Governor for Financial Stability being a member of the Monetary Policy Committee. The area aims 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 (part of Financial Stability) 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 the supporting infrastructure. It leads the Bank's involvement in HM Treasury's National Changeover Plan work. In particular, it co-ordinates practical preparations in the wholesale financial markets for possible UK entry into the euro area through the City Euro Group, which the Bank chairs and on which all wholesale financial market participants are directly or indirectly represented. It is also responsible for practical preparations in the Bank itself. It represents the Bank in a range of EU committees and provides a body of expertise on the European Central Bank.

## Centre for Central Banking Studies

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.

## 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

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, property, personnel, the Governors' private offices, press and public relations, the investment unit and legal and information services.

## Banking & Market Services

Customer Banking
Market Services
Notes
Registrar's Department

Customer Banking Division provides banking services to the Government and other customers, principally central banks and other financial institutions. Notes Division manages the note issue, including the relationship with De La Rue, the supplier of notes to the Bank following the sale of printing operations in March 2003. Market Services Division operates the Real Time Gross Settlement (RTGS) system through which payments relating to the major UK payments and securities settlement systems are settled and, from this operational role, contributes 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.

# The Executive and Senior Management

## Governor's Committee

**Eddie George,** Governor

**Mervyn King,**
Deputy Governor,
Monetary Stability

**Andrew Large,**
Deputy Governor,
Financial Stability

**Alastair Clark,**
Executive Director,
Financial Stability

**Charlie Bean,**
Executive Director,
Monetary Analysis and
Statistics

**Paul Tucker,**
Executive Director,
Market Operations

## Management Committee

**Bill Allen,**
Director for Europe and
Deputy Director,
Financial Stability

**Paul Fisher,**
Head of Foreign
Exchange Division

**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

# Management Structure

**Clare Brady**
Auditor

**Peter Rodgers**
Secretary of the Bank and Public Relations

**Eddie George**
Governor

**Advisers to the Governors**

**Malcolm Glover**
Legal

**Professor Charles Goodhart**
Financial Stability

**Sir Peter Petrie**
European and Parliamentary Affairs

**Mario Blejer**
Centre for Central Banking Studies

**Mervyn King**
Deputy Governor
Monetary Stability

**Andrew Large**
Deputy Governor
Financial Stability

## 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 33**

**Joanna Place**
Monetary and Financial Statistics

## Market Operations

**Paul Tucker**
Executive Director

**Paul Chilcott**
Risk Analysis and Monitoring

**Paul Fisher**
Foreign Exchange

**David Rule**
Gilt-Edged and Money Markets

## Banking and Market Services

**Merlyn Lowther**
Chief Cashier

**Lee Dobney**
Notes

**Christopher Mann**
Market Services

**Colin Mann**
Customer Banking

**Geoff Sparkes**
Registrar's Department

**David Ingram**
Projects Co-ordinator

## Financial Stability

**Alastair Clark**
Executive Director

**Bill Allen**
Director for Europe

**Alex Bowen**
Financial Stability Assessment

**Peter Brierley**
Domestic Finance

**Stephen Collins**
G10 Financial Surveillance, including Co-ordination Unit for Europe

**Andrew Gracie**
Financial Industry and Regulation

**Andy Haldane**
International Finance

**Patricia Jackson**
Special Adviser

**John Trundle**
Market Infrastructure

## Central Services

**Clifford Smout**
Finance Director
Finance and Resources

**Andy Brookes**
Management Services

**Michael Craig**
Investment Unit

**John Footman**
Director of Personnel

**Peter Higgs**
Property Services and Security

**John Matheson**
Personnel

**Peter Rodgers**
Secretary's

# Review of Performance

## against Objectives and Strategy

This section of the Report provides an account of the Bank's performance during 2002/03 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 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 55-57. The objectives set for the year 2003/04 are shown on page 34.

### 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 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 note issue itself.

The Bank's second Core Purpose is to maintain 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/ 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 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 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 itself, and 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 past year, the Government has defined this in terms of a target for RPIX inflation of 2.5%. 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 the period March-October 2002, inflation was a little below target, averaging 2%. Thereafter it moved slightly above the target, averaging 2.8% over the period up to February 2003. No open letter has been required over the past year. The MPC's latest central projection, as described in the February *Inflation Report*, sees inflation remaining above target for most of this year, subsequently dropping back to target during the course of 2004, although that central projection is surrounded by considerable uncertainties.

## SUPPORT FOR THE MONETARY POLICY COMMITTEE

The MPC's own processes are described on pages 30-32. 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. The Agencies (page 33) 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. Overall the processes appear to be working satisfactorily at present, receiving positive feedback from the MPC. As a result, this year has seen only fine-tuning of the arrangements. An article describing the main MPC processes appeared in the Winter 2001 *Quarterly Bulletin*.

### The Pagan Report

The Bank and the MPC are keen that their activities conform to best practice amongst central banks. A key mechanism for ensuring that the monetary policy process is of high quality and continuously improving is that of peer review. Thus in 2000, Don Kohn of the Board of Governors of the US Federal Reserve was invited to conduct a review of the MPC's own processes; his Report (published together with the Bank's response in the Spring 2001 *Quarterly Bulletin*) led to a number of subsequent changes in MPC procedures. During 2002, Professor Adrian Pagan of the Australian National University and Nuffield College, Oxford, and a former member of the Board of the Reserve Bank of Australia, conducted a complementary review of the forecasting and modelling work carried out for the MPC by Bank staff in order to assess whether it was "state of the art". Professor Pagan submitted his report to Court in December 2002. It was subsequently published in the Spring 2003 *Quarterly Bulletin*, together with the Bank's response.

### The objectives of Professor Pagan's review were:

- To evaluate the technical quality of the modelling and forecasting methods used by the Bank, noting where they lag behind best practice or are capable of improvement;
- To identify any additional techniques or approaches that could usefully be employed;
- To evaluate the procedures employed for ex post forecast evaluation.

Professor Pagan's Report is generally positive about the Bank's forecasting and modelling activities, though he makes a number of recommendations as to how it might be further improved. With regards to the models that the Bank employs, he notes that there is a spectrum of modelling approaches, and that no single model is likely to be suitable for all the purposes that the MPC might want to use it for. This is consistent with the Bank's "suite of models" approach, which relies on a plurality of models to inform the Committee's judgements. But the Report does conclude that the primary macroeconometric model (the MTMM) used to prepare the quarterly projections does somewhat lag behind current "best practice". The Bank and the MPC have, in fact, been aware of the deficiencies of the MTMM, and considerable research effort during 2001/02 has been directed to developing a new model that addresses these limitations and better encapsulates the MPC's vision of how the economy functions. Professor Pagan concluded that this new model appeared likely to be "best practice and to correct many of the difficulties of the current model", though he felt it would be premature to draw a final conclusion about its effectiveness. It is expected that the new model will become fully functional during the course of 2003 and a major task for the coming year will be to ensure that the changeover to the new model is implemented smoothly. The Bank intends inviting Professor Pagan back at a suitable juncture in order to prepare a postscript to his Report that covers the practical performance of the new model.

Professor Pagan also assessed the Bank's forecasting record. Forecasting is not a mechanical process and requires considerable judgmental input on the part of the staff and the MPC. Professor Pagan noted that any deficiencies in the MTMM had not in themselves detracted from the accuracy of the MPC's published forecasts. However, there had – until recently – been a tendency for inflation to turn out persistently slightly lower than projected and the target. For instance the average over-prediction for inflation two years ahead was around 0.5% for the projections made between August 1997 and November 2000. But Professor Pagan concluded that the high degree of persistence in the inflation process implies that repeated runs of over- or under-prediction at the two-year horizon are to be expected and that the recent experience should not be considered unusual. He also showed that just a very small bias in predicting inflation one quarter ahead could result in an over-prediction of the annual inflation rate, two years out, of the order observed. He concluded that "the bias is probably as small as one could reasonably expect" and that "an observed bias in the forecast of the annual inflation rate two years out of just 0.5% is a tribute to the abilities of the Bank staff and the MPC". Nevertheless, the MPC and the Bank recognise that there are lessons to be learnt from even small forecast errors that persist, and continue to devote resources to the better understanding of their cause.

Professor Pagan also made a number of specific recommendations relating to the use of models at the Bank, how they are developed and maintained, and how the output from them can most informatively be presented. The Bank will follow up all of these suggestions.

### Other matters

Links between the Bank and the Office for National Statistics (ONS) have strengthened further over the last year. ONS have run a number of seminars for Bank staff where they explain how various statistics are constructed and Bank staff have given a number of presentations on how statistics are used. A number of workshops have also been held to discuss topics of mutual interest, such as chain linking. The MPC continues to specify its priorities for data provision and improvement under the Service Level Agreement with ONS.

As noted on page 28, recruitment and retention issues have eased over the past year. However the retention of high calibre and experienced economists remains a major priority. During 2002, a total of 31 economists were recruited to Monetary Analysis, while 19 economists left the area, mainly to other parts of the Bank. This year particular efforts have been made in developing tailored IT training programmes for individual staff members. Attention has also been directed at exploiting past investments in improved business processes in order to increase the effectiveness with which Monetary Analysis and other divisions support the MPC process.

## 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 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. Topics researched in the last year include: analysis of forecast errors and data revisions; measuring the capital stock; financial factors and investment; consumer spending and equity prices; the role of credit market imperfections in the transmission mechanism of monetary policy; factors affecting exchange rate movements; low inflation and structural change; 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 2003. 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 Committee met in January 2003 to set priorities for the coming budget year. Broad research themes were suggested by staff and then supplemented by the ideas of MPC members. The Committee then prioritised the themes, leaving Bank staff to develop an appropriate research programme to address the issues identified.

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. Five Awaydays, covering 17 papers in total, took place over 2002/03. 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 **"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"**.

### 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. During the year the *Inflation Report* was restructured slightly so as to provide a clearer overall focus with a better balance between the constituent chapters.

### Parliamentary committees

The Governor and other MPC members appeared before the Treasury Committee three times to give evidence on the Inflation Report. There were three "confirmation hearings" at the Treasury Committee for new members of the MPC: Paul Tucker, Marian Bell and Sir Andrew Large. The Governor and Mr King appeared before the House of Lords Select Committee on Economic Affairs to give evidence on globalisation in July 2002. The Governor and other members of the MPC also attended the Lords Committee on Economic Affairs in December 2002. Mr Bean gave evidence along with Garry Young (from the Bank's Domestic Finance Division) to the same committee in January 2003 in a private session on economic aspects of an ageing population.

### 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 to exchange views with a wide variety of audiences. During the year, 50 formal visits, organised by the Bank's Agents, were made to the regions by MPC members, typically of one or two days, and a further five events were organised by the Agency for Greater London. 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 fifth in its series of meetings outside London, on this occasion in Liverpool.

While there were about 25 major published speeches on monetary policy by the Governor and other MPC members, both executive and external, during the year, they also gave around 100 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. More than two-thirds of all the 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 224,400 a week, compared with 211,000 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.

The Bank continued and improved the live webcast of the quarterly *Inflation Report* press conference, which is also stored on a server so 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. A live television broadcast continues alongside the webcast.

### Education programme

The Bank also continues to foster links with schools and universities. The main activity during the year was the launch of the third 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 third year attracted an entry of 219 schools in the first round, the same as a year earlier. The national final was held in London in March. The winning team was from St Paul's School, Barnes. 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 June 2001 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" (55%) is virtually the same as in the previous two surveys, but remains a little lower than the peak of 62% recorded following the cuts in interest rates after 11 September 2001. The proportion dissatisfied is 10%. Interpretation of these numbers requires some caution; and the Bank's concern is anyway to assess the extent to which its price stability role is understood as much as to explore public support for its actions. More detail will be available in the annual analysis of the polls to be published in the summer *Quarterly Bulletin*.

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

## ASSESSING RISKS TO FINANCIAL STABILITY

The objective set by Court was: **"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 payments systems), and to contribute to the debate on arrangements for handling financial crises"**.

### The Financial Stability Committee and the Standing Committee

Over the past year, the Bank's Financial Stability Committee (FSC) has continued its monthly meetings reviewing risks to financial stability and discussing possible policy responses. In some cases, the response may be for the Bank itself; but often it will be for others and the Bank's role is mainly to advise or recommend. The advice may be channeled through the tripartite Treasury/Bank/FSA Standing Committee, set up in 1997. But it may also be offered direct to the public or private bodies most immediately involved in an issue. Internationally, the advice or proposals may go to the IMF, to various international committees or to other central banks and finance ministries.

The Bank's analysis of and advice on financial stability issues is underpinned by a substantial programme of research. Such work now occupies about a fifth of the FS Area's resources. Examples of the issues considered over the past year are: the financial impact on companies of changes in the macro-economic environment; the conduct of sovereign debt re-negotiations as a strategic game between borrowers, private lenders, the official sector and the International Financial Institutions; derivative markets, credit risk pricing and credit market dynamics; and the simulation of flows through payment systems, as a basis for assessing implied credit exposures and liquidity requirements. The work has drawn on input from a number of part-time academic advisers – Professors Goodhart (LSE), Perraudin (Birkbeck), Shin (LSE) and Wood (Cass Business School).

### The IMF Financial Sector Assessment Programme (FSAP)

Following the Chancellor's commitment at the 1998 Annual Meeting, the IMF undertook during 2002 a comprehensive review of the UK's financial sector within the framework of the FSAP. This involved an examination both of structure – including for example market systems, regulatory arrangements and procedures for addressing money laundering and terrorist financing – and of transparency in terms of statistical information and also in relation to the formulation and execution of monetary and financial policy. Although a number of countries have undergone an FSAP review, this was the first time the exercise had been conducted for a financial market with the scale and complexity of the UK's. The IMF itself devoted substantial resources to the work, and this was paralleled by the input from the Treasury, the Bank and the FSA. The final report, which was published in March, presented a very favourable view of the UK's arrangements and made a number of positive comments about the Bank's role, related to the new monetary policy arrangements and also to the development of its financial surveillance capabilities, its oversight of payment systems and the transparency of its assessment of risks as reflected in the *Financial Stability Review*.

### Stress testing

One important aspect of the FSAP was the "stress testing" of the UK banking sector. This is shorthand for assessing the impact of various extreme scenarios on the income and assets of the banks. The Bank had already put a substantial effort into this kind of testing in developing techniques for judging overall financial stability and was able to draw on that experience for the purposes of the FSAP. Stress testing continues to be an important part of the FS area's work and is now being extended to try to understand better how pressures in one part of the financial system might be transmitted more widely.

### The new Basel Capital Accord

Work on this major initiative continued throughout the year with the Bank and the FSA making a major contribution. Once the broad structure of the new Accord had been established, there remained important questions about the calibration of the capital requirements. The Bank took a leading role in organising the various Quantitative Impact Studies, designed to test the implications of the new capital requirements for a range of banks both within and outside the G10. This work has required a significant commitment of staff time, both at a technical level but also in the coordination of analysis carried out by other central banks. Completion on time has been a significant factor in allowing discussions on the Accord as a whole to be brought to a conclusion.

### Handling LCFI crises

One of the important financial stability challenges facing central banks, regulators and finance ministries is to understand what kinds of issues would arise if a Large Complex Financial Institution (LCFI) were to get into difficulties, and to consider what measures might be taken in response. Various international groups have been looking at the issue, and in many of these the Bank has participated. Domestically, the broad framework for handling such cases is set out in the MoU agreed by the Treasury, the Bank and the FSA in 1997, but there are several detailed questions which require continuing work. In particular, the Bank has been considering what information and analysis it would need in order to offer a judgment on the market and systemic implications of a potential LCFI failure.

### International crisis management

Another continuing theme in the Bank's work has been its input to discussions on how to improve the capacity of the international financial system to deal with sovereign debt problems. This issue has acquired a higher profile since 1998 and has given rise to a great deal of debate in both official and private international groups. As noted in last year's Annual Report, the Bank prepared, jointly with the Bank of Canada, a paper setting out some ideas on a crisis resolution procedure. Some elements of those proposals have been picked up in later work. The Bank has taken a particular interest in the questions of policy on access to IMF resources and crisis resolution frameworks. The Bank also participated in the G10 group which drew up proposals on Collective Action Clauses, designed to facilitate easier resolution of competing creditor claims.

## EFFICIENCY AND EFFECTIVENESS OF UK FINANCIAL SERVICES

For 2002/03, the specific target set by Court was **"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"**.

### Payment and Settlement systems

A period of consolidation has followed the successful completion in 2001/02 of the programme of initiatives to enhance the effectiveness of UK payments and settlement systems. Work has taken place to improve the resilience of the central RTGS operations and the effectiveness of the control environment has been reviewed.

In September 2002, the merger of CREST, the main UK securities settlement system, and Euroclear, the international securities settlement system based in Brussels, was agreed. Although the short-term operational implications were limited, given that for the time being the systems will remain largely separate, the merger promises in the longer term to bring important benefits to the UK and European financial markets. The Bank has an interest in these developments as a user and also as a supplier of services to CREST, notably the use of central bank money to reduce intra-day exposures amongst the participating banks. The Bank's aim is to ensure that these desirable structural features are maintained in the combined entity.

### Structure of the Sterling Markets

Much of the Bank's work on developments in market practices and structures is conducted in partnership with practitioners. In the core sterling markets, this means the

Money Markets Liaison Group (MMLG), which is chaired by the Bank's markets area. It meets quarterly, and comprises members from major UK and overseas banks, market users such as fund managers and corporate treasurers, infrastructure providers, trade associations, and the Financial Services Authority. Over the past year, MMLG has discussed a range of subjects including market codes, infrastructure developments, and proposed changes to the calculation of the sterling overnight interest rate average (SONIA). Alongside HM Treasury and CREST, the Bank and the MMLG have also been involved in preparations for dematerialising money market instruments, allowing them to be issued into and settled through CREST. In particular, the Bank has drawn up pro forma standard terms of issuance for non-material equivalents of sterling certificates of deposit, bankers' acceptances and commercial paper.

Reflecting the central role of repo transactions in the Bank's monetary operations and the role of repo (secured money) markets in maintaining system liquidity, the Bank's markets area also chairs the Stock Lending and Repo Committee, which provides a forum for market participants, infrastructure providers and the authorities to discuss structural developments in London-based securities financing markets. Over the past year it has discussed market codes and legal agreements; equity lending and voting; the role of securities lending in supporting short selling and the proposed publication of stock lending statistics by CREST; and contingency planning. The Committee agreed that a publication on securities financing markets should be prepared to improve understanding of them among market analysts and commentators.

### Foreign Exchange Markets

A new private sector system which eliminates risk in the settlement of foreign exchange transactions, the Continuous Linked Settlement Bank (CLS Bank), became fully operational in September 2002 with the Bank providing the link to the system for sterling pay-ins and pay-outs.

Paralleling the MMLG in the domestic markets, the Bank's markets area chairs the Foreign Exchange Joint Standing Committee (the FXJSC), which comprises senior staff from many of the major banks operating in the London foreign exchange market plus representatives of brokers, corporate treasurers and the Financial Services Authority. As well as providing a forum for discussing broad market issues, the FXJSC has primary responsibility for maintaining the Non-Investment Products Code.

Among the many issues discussed by the FXJSC over the past year were developments in e-commerce, the introduction of Continuous Linked Settlement in the foreign exchange markets, and a possible change to the NIPs code[1] in respect of trading on behalf of unnamed principals. The sub-group has also discussed operational issues, for example possible improvements in relation to confirmation processing, standard settlement instructions and CLS. Proposed changes will be discussed with other international centres as appropriate.

### Business continuity plans

Although planning to deal with physical disasters of various kinds has been a long-standing aspect of firms' operational risk management, the intensity of effort in this area has increased significantly since 11 September 2001. Much of the work has been carried out within private sector firms and has been monitored by the FSA in the context of their supervisory relationship with these firms. The Bank has, however, taken a special interest in the preparedness of major pieces of market infrastructure, especially payment systems, as well as reviewing its own contingency arrangements as a central participant in a number of markets. In conjunction with the tripartite Standing Committee, the Bank has organised a number of roundtables bringing together private and public sector representatives to exchange information and views on aspects of business continuity planning. Again in a tripartite framework, it has participated in a test of communication and coordination arrangements.

**1:** The NIPs Code is a voluntary code of practice for conducting business in the foreign exchange, bullion and wholesale money markets.

As part of the wider programme of work following 11 September, MMLG has also considered how to respond to any widespread disruption to sterling money markets. Preparations have included exchanges of contact details and rehearsing emergency conference calls. MMLG has also reviewed what interest rate should be applied to market participants' involuntary overdrafts and credit balances with banks in the event of such disruption. The Group concluded that the presumption should be that it would be the Bank's official repo rate, which has the advantages of neutrality and of being known to all in the market, giving certainty and transparency. Nonetheless, consistent with the Non-Investment Products Code, MMLG concluded that the Bank should retain discretion to determine and publish a rate to apply to balances following market-wide disruption of this kind, taking account of the particular circumstances.

The FXJSC also discussed contingency planning and, early in 2002, established an Operations sub-group whose primary purpose is to aid efficient functioning of the foreign exchange and international money markets in the event of large-scale disruption.

## Finance for small firms

Over the past decade, the Bank has devoted substantial resources to reviewing the financing of small firms, especially the provision of bank finance. This work originated in the difficult relationships which emerged between banks and small firms during the recession in the early 1990s. Those relationships, certainly in terms of the provision of credit, have improved greatly over the years and recently the Bank has turned its attention to some other aspects of small firm finance. The regular annual review now typically includes, at the request of government ministers, an assessment of issues especially relevant to the financing of firms in economically-deprived areas, as well as a commentary on the position of ethnic minority businesses.

## The Centre for Central Banking Studies (CCBS)

CCBS (described on page 13) has maintained a full programme of events, in London and abroad, for central bank experts from around the world. During the year some 30 seminars and conferences were held in London, covering many of the analytical and technical aspects of central banking, from a practitioner's perspective. Speakers are experts in their field from the Bank of England, the London financial markets, academia and other central banks. Typically the seminars are for one week, for some 20-25 participants, while the conferences are larger-scale affairs. In total, 751 people attended these London-based events.

- Two Research Workshops were held in the Bank, on "International Capital Movements", and "Resolution of Banking Crises". These involved a week of lectures by leading experts, such as Kenneth Rogoff, Marcus Miller, Philippe Aghion and Hyun-Song Shin, and were attended by 141 people. As usual, each workshop was followed by a three-month research project at CCBS, involving a small group of researchers from other central banks.

- The Central Bank Governors' Seminar was held in July, and provided an opportunity for the governors or their representatives from 34 central banks to meet in London and discuss the international financial architecture, including presentations from Horst Kohler, Mervyn King and David Clementi.

- In addition to the programme of London events, CCBS had an extensive programme of events abroad. The subjects covered included inflation targeting, economic modelling and forecasting, monetary policy and operations, governance for central banks and communications. 12 regional seminars and research workshops were held in Asia (3), Africa (4), Eastern Europe (2), and Latin America and the Caribbean (3). A seminar was also provided in Ghana, on the inauguration of their Monetary Policy Committee. A total of 289 participants attended these seminars and workshops.

- CCBS also undertook 27 visits to central banks abroad, at their request, to offer expert advice, consultancy, or lectures.

## MARKET AND BANKING OPERATIONS

The objective for the Bank's banking and market functions 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"**. The markets and banking divisions are also closely involved in the initiatives to improve the effectiveness and efficiency of London's markets, described above.

### Open market operations and sterling markets

The Bank's sterling open market operations went smoothly during 2002/03. They achieved their purpose of implementing the interest rate decisions of the Monetary Policy Committee while providing sufficient funds to maintain liquid and orderly conditions in the sterling money markets and payments systems, supporting banks' liquidity management.

The stock of the Bank's short-term lending to the banking sector through open market operations increased over the year, reflecting growth of around £2 billion or just under 7% in the note issue.

### Foreign currency operations and foreign exchange markets

The Bank's foreign currency operations include providing foreign exchange and deposit services to government and foreign central bank customers, and the handling of the Bank's euro-denominated debt programmes and associated asset management.

During the year there were regular monthly auctions of 3 and 6 month euro-denominated bills, taking the stock of these liabilities outstanding at the end of the year to €3.6 billion. The Bank also issued the first €1 billion tranche of a third €2 billion three-year euro-denominated note, with the second tranche issued shortly after the end of the financial year. This issue brought the outstanding stock of these liabilities to €6 billion.

### The Bank's management of HMG's foreign currency reserves

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 an annual Remit and has met those objectives in 2002/03. At the end of March 2003, the gross reserves were approximately $42 billion and the net reserves about $16 billion.

### Risk management

A particular focus during the past year was further developing the risk management and controls framework for both the Bank's own business and for its asset management on behalf of HMG. Initiatives included the appointment of Operational Risk Officers in each of the Markets Divisions and an area Operational Risk Committee; improved management information and reporting; and an upgrade to the Bank's trading and financial risk management system.

### Market intelligence

A core role of the Markets area is to be a point of contact for market participants, and to gather and interpret market information to support the Bank's monetary policy and financial stability functions.

The Bank's operations give it regular and close contact with senior management, traders and risk managers at a wide range of domestic and international banks and securities dealers. In addition, the Bank is extending its contacts amongst market users and other intermediaries, such as corporate treasurers, insurance companies and fund managers. As well as in London and elsewhere in the UK, the Bank has over time built up a range of market contacts overseas, especially in New York and Boston. Over the past year, they played an important role in identifying and interpreting conjunctural and structural issues relevant to the Bank, many of them covered in the *Financial Stability Review* or in presentations to the MPC.

### The Note issue

During the year the Bank concluded its review of the options for its note printing operations at Debden. The

Bank's objectives were the quality and security of note supply, the interests of the staff and employment at the Debden site, and cost. In December, the Bank announced that it had decided that its objectives could best be met by sale to a third party, and had selected De La Rue (DLR) as the preferred bidder. After discussions with DLR, and full consultation with the Trades Unions and staff, the printing operations were transferred to the Bank's existing subsidiary, Debden Security Printing (DSP) on 7 March, and DSP was sold to DLR on 31 March. The Bank has negotiated with DSP a contract for the supply of Bank of England notes, with an initial term of seven years. Arrangements are being put in place within the Bank for quality assurance and to take forward future development work, including research into banknote security.

In 2002 the Bank introduced a new, more secure and more durable £5 banknote depicting Elizabeth Fry. The initial launch of the new banknote, in May, was marred by the discovery of a fault in the production process that allowed the serial numbers to be partially or wholly removed in some cases. The banknote was successfully re-launched in August.

Throughout 2002 the Bank continued to work with institutions engaged in the wholesale distribution of cash over the phased introduction of new arrangements for the issue and recirculation of banknotes. The focus has now turned to the development of a framework for the regulation of the quality of notes in circulation with a view to maximising the efficiency of note production, distribution, and recirculation.

As the second anniversary of the introduction of a new £10 banknote depicting Charles Darwin approached the Bank began the process of withdrawing from circulation the older, Dickens design. During 2002 the majority of the outstanding banknotes of the older design were taken out of circulation. The process will be completed during 2003 when legal tender status is withdrawn. Advance notice is always given of this action and other steps taken to ensure the public is aware. An announcement that legal tender status will be withdrawn from 31 July was made on 29 April.

Towards the end of 2002 the Bank began preparations for an innovative auction of low-numbered notes in aid of the Commonwealth Education Fund. The first lot, a £5 note of the new design bearing serial number HA01 000005 was "knocked down" by the Governor, who is Chairman of the Oversight Committee of the Commonwealth Education Fund.

### Banking services

The Bank has continued to seek out and implement steps to improve the quality and reduce the cost of the core banking services that it provides to the Government and the financial system.

The change programme to modernise the banking services is close to completion. The implementation of Globus, the selected IT package for the core banking system, has taken longer than planned but almost all of the necessary staff changes have been made, and the few remaining ones should occur in the summer of 2003.

### Stock registration

The Bank, through its Registrar's Department in Gloucester, continued to provide a high quality and cost effective stock registration service and operated its retail postal brokerage service. However the steady decline in volumes prompted a review, and in November 2002 HM Treasury issued a consultation paper entitled "Modernising the arrangements for registration and transfer of British Government Stock". Among other things, the paper proposed that all gilt holdings be dematerialised and held in CREST. As and when new arrangements are introduced, Registrar's Department will close; but in the meantime the Bank remains responsible for the gilt registration function, and is committed to ensuring a continued high quality service and a smooth transition to any successor arrangements.

## PREPARING FOR EMU

The Bank's objective for the year was: **"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"**.

### Preparing the Bank

Under the Government's policy of 'prepare and decide', the Bank continued during the year to plan so that it would be ready, in the event that the UK decided to join EMU. In these circumstances, the Bank would become a full member of the Eurosystem, and a number of changes would need to be implemented: there would be changes to the Bank's finances, balance sheet and governing legislation; the Bank would need to change the way in which it conducted monetary policy operations in order to participate in the operational framework of the Eurosystem; changes would be needed in the payment infrastructure; the Bank would need to adopt Eurosystem accounting conventions, and to introduce new statistical reporting forms so as to provide the data required by the ECB. The Bank would also have to plan for the introduction, at the appropriate time, of UK euro banknotes in place of sterling banknotes, and the withdrawal of sterling banknotes.

### Preparing the UK financial sector

During the year, the Bank continued to co-ordinate preparations in the City for the changeover in sterling wholesale financial markets, in the event that the UK decided to join EMU. Under HM Treasury's national changeover plan for a "managed transition" from sterling to the euro, sterling wholesale markets would be expected to operate in euro immediately from the entry date, whereas retail financial services would be expected to remain largely in sterling until later in the transition period after entry. In order to help market practitioners prepare for a changeover in sterling wholesale markets, the Bank published in the November Practical Issues a "City guide to a UK euro changeover". The City guide explains how the changeover in sterling wholesale markets would be expected to be handled, in the event of UK entry. It was drawn up in consultation with the City Euro Group, chaired by the Bank and with representation from all relevant markets associations and the clearing banks. The City guide is updated on the Bank's website.

### Impact of the euro on financial markets in the UK

During the year, the Bank continued to monitor the impact of the euro on financial markets in the UK, and published in the November Practical Issues a survey of the evidence about the UK's performance as a euro financial centre. This showed that, since the launch of the euro at the beginning of 1999, the City had maintained its market share. Bank officials also commented on drafts of two studies by HM Treasury, one on the location of financial activity and the other on the cost of capital. These are among a series of preliminary and technical 'pre-assessment' studies prepared by HM Treasury prior to its assessment of the Government's five economic tests.

### 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 is part of the Bank's quarterly conjunctural analysis of international economic prospects, which informs UK monetary policy and work on financial stability issues. It 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. The Bank is represented on ESCB committees, and keeps up to date with the Eurosystem's operating framework, as it evolves. Alongside HM Treasury, the Bank is a member of the Economic and Financial Committee, which meets regularly in Brussels to advise European finance ministers. The Bank also continues to maintain close contacts with central banks throughout Europe, including the accession countries.

## MANAGING THE BANK'S HUMAN RESOURCES

The Bank's objective for the year was **"through appropriate policies for recruitment, reward, 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"**.

The Bank's employment policies are discussed on pages 39-41. Last year, excluding the Printing Works, 198 staff joined the Bank and 218 left. Most of the departures arose under the Bank's redundancy and severance arrangements, connected with changes in the banking and central services areas. The resignation rate in the policy and analytical areas was 3%, significantly lower than in previous years, and this, coupled with an active recruitment policy at all levels, has resulted in the key areas being fully staffed for the first time since 1998.

Trends in the employment market, particularly among City firms, have clearly helped the Bank in its efforts to recruit and retain key staff; but these cannot be expected to persist indefinitely, and the Bank continues to keep a strong presence in the recruitment market, to sponsor students and new entrants seeking to acquire masters degrees in Economics or Finance, and to use the flexibility in its pay and job banding systems to build cadres of experienced staff in the key business areas.

The Employment Tribunal hearing of claims made in connection with the introduction of the Bank's new Benefits system took place during the year. Each of the claims made against the Bank was unsuccessful. Unifi has lodged an appeal in respect of part of the Tribunal's findings, and this is scheduled to be heard in July 2003.

A survey of staff attitudes was undertaken in December 2001 and the results of this were made available to management and staff during the year. They suggested a number of areas in which staff relations could be improved, and the Bank is addressing these. A further survey will be commissioned during the coming year.

## MANAGING THE BANK'S FINANCES

The financial objective for the year was: **"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"**.

The Bank's financial framework is discussed in more detail on pages 35-38 of this Report. In June 1998 the Cash Ratio Deposit scheme, described in more detail in that section, was put on a statutory footing by HM Treasury, on the understanding that the working of the scheme would be reviewed within five years. That review is now under way.

For 2002/03 Court set an expenditure budget of £220.5 million. The Bank's total spending for the year was £220.8 million, with the excess over budget reflecting higher-than-expected professional fees, linked to the Bank's defence of the BCCI case (see page 91). The other factors contributing to the outturn are discussed on page 35. Income has also been significantly above budget, in part as a result of higher banking volumes.

Following the transfer of supervision to the FSA in 1998, the Bank agreed to reduce its centrally borne overhead costs by £20 million within five years. The Bank expects to achieve this around the middle of this year, when it plans to vacate Bank Buildings, which will become available for letting or sale, on the completion of the refurbishment of Head Office. The Bank has also rationalised its space elsewhere, completing the sale of its Leeds and Gloucester premises over the past year. Following the sale of printing operations, the Bank has leased a part of the Debden site to De La Rue, but retains ownership and management of the site.

## INVESTMENT AND BUSINESS CONTINUITY

Over the past year the Bank has continued to increase investment in IT in order to improve business and support processes. The objective set by Court was: **"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 a major business disruption"**.

The analytical areas – supporting the setting of monetary policy and financial stability – have continued to invest in better data management, improving capture, storage and access to economic data. Improvements have been made to internet access from the desktop, meeting the need for greater access by analysts to a wide range of information, while taking fully into account the Bank's strict security requirements.

The Bank's financial markets area is part way through a major investment program, with a number of co-ordinated projects to improve front, middle and back office processes, including the Bank's accounting systems. In some areas, notably the banking system, progress has been slower than projected, but we are confident that that project will be completed in the coming year.

A year ago the Bank started a project to improve Electronic Document Management. This has progressed well, with half of the staff already using the new system, and the rest on schedule for the coming year. The new system will help the Bank to meet its obligations under the Freedom of Information Act, preparation for which is well in hand.

The Bank's HR database project came fully on-line in the past year, significantly improving access to data and management information, while reducing administration costs. There have been further investments in related systems, including on-line systems for training, performance reviews and HR policies.

Desktop IT across the Bank has been reviewed in the past year, and a strategy set for the coming 3-5 years. External benchmarking, supported by the Bank's own internal survey, has confirmed that Bank staff are well supported in their day-to-day use of IT, but that efficiency could be improved by greater standardisation across the organisation. A key project for the coming year will be work on the Bank's e-mail system. This is complementary to the work on Electronic Document Management, forming an important part of the information strategy.

Delays in the implementation of the new banking system (Globus) have set back the completion of the C21 project, now scheduled for later this year, and have had knock-on effects on other projects.

The Bank has well-established procedures for business continuity, especially for financial market systems, and keeps these under close review. Providing and testing back-up arrangements has been a particular focus for the past year, and two new business continuity facilities have been completed, at Debden and at Head Office. Testing of the arrangements for business continuity and recovery have been, and will continue to be, an important part of this work.

# Monetary Policy Committee

## Processes

### Members of the Monetary Policy Committee

Eddie George

Mervyn King

Andrew Large

Christopher Allsopp*

Kate Barker

Charlie Bean

Marian Bell

Professor Stephen Nickell

Paul Tucker

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.

**Ms Kate Barker:** Member of Board of Governors, Anglia Polytechnic University. Member of Council, Society of Business Economists. Commissioner, Independent Football Commission. Government review of issues affecting supply of housing in the UK.

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

**Ms Marian Bell:** Member of the Assembly of the Cathedral and Abbey Church of St. Albans. Fellow of the Royal Society of Arts.

Rachel Lomax has been appointed to the MPC with effect from 1 July 2003.

*Richard Lambert has been appointed to the MPC with effect from 1 June 2003. He will succeed Christopher Allsopp.

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 9 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 addresses those aspects of the MPC which are relevant to the Directors of the Bank in discharging 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 consolidation, following the more significant changes in the previous two years in response to the external peer review by Don Kohn of the Federal Reserve Board (discussed in the 2001 *Annual Report*). A complementary technical review of the Bank's forecasting and modelling activities has been carried out during 2002 by Professor Adrian Pagan of the Australian National University and Nuffield College, Oxford, and a former member of the Board of the Reserve Bank of Australia. His findings are summarised on pages 17-18 of this *Report*. The arrangements for support to external MPC members, each of whom has the use of two economists to provide personal research support, appear to be working satisfactorily.

## THE MAIN MPC PROCESSES

A short summary of the main MPC procedures is provided in this section. Although there have been some minor 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 Charlie 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. The Minutes of the meeting are published two weeks later. Special meetings of the Committee can be convened if circumstances warrant: no such meetings have been held over the past year.

The Committee continues to be briefed by staff at a half-day pre-MPC meeting. Feedback from Committee members confirm that they find the briefing very useful. The briefing is also 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 structure of the quarterly forecast round has been fairly stable over the past twelve months. In particular the final meetings of the forecast round continue to be conducted in private with just the MPC and four staff members present so as to facilitate discussion and decision-making.

Two particular forecast challenges will confront the MPC and Bank staff during the course of the coming year. First, it is expected that a new macroeconometric model will replace the existing model. The new model addresses some of the recognised deficiencies of the existing model and should provide a more flexible tool for the articulation of discussions by the Committee. It is not expected to carry any implications for the policy decision itself, however. Second, the Office for National Statistics will be introducing "chain-linked" National Accounts in this year's Blue Book. That will necessitate the re-estimation of many of the models in the Bank's suite and may lead to some re-interpretation of the past. But again it is not expected to carry any immediate implications for the policy decision itself.

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 Bank's *Inflation Report* is generally seen as a model for the corresponding publications of other central banks. A recent report ("How do central banks write? An evaluation of the inflation reports of inflation-targeting central banks") prepared for the Bank of Norway by Andrea Fracasso, Hans Genberg and Charles Wyplosz of the Graduate Institute of International Studies, Geneva, consistently rates the Report highly on a number of different criteria and concludes that "the Bank of England's *Inflation Report*, the oldest inflation report which has inspired many other central banks, remains the model in virtually every dimension". In part in response to a suggestion from the Treasury Committee of the House of Commons, the Report has been slightly restructured in order to provide a more coherent commentary on supply-side developments in the economy and to provide a better balance to the constituent chapters.

### 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 Committee of the House of Commons and the Economic Affairs Committee of the House of Lords; media coverage and messages; and a range of ad hoc economics topics.

Committee members undertake a programme of regional visits and speaking engagements to explain the role of the MPC and the analysis and judgments underlying monetary policy decisions. These activities form part of the Bank's endeavour to build a constituency for low inflation, as well as providing opportunities to gather first-hand intelligence about economic developments. Members also make regular appearances before Parliamentary Committees of both Houses.

### Regional and other 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 draw together 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 throughout the UK. The Agents produce monthly written reports and give presentations at the pre-MPC meeting on economic conditions based on the most recent discussions with regional contacts. Taken together, these reports provide the Committee with an up-to-date view of developments in the economy. Each month the Agents also carry out a special survey on a particular issue of current interest to the MPC and give a presentation of the results at pre-MPC. The Spring 2003 *Quarterly Bulletin* contains an article describing the work of the Agencies.

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

## Regional Agents

**Chris Bailey,**
South East and East Anglia

**John Bartlett,**
West Midlands

**Chris Brown,**
East Midlands

**David Buffham,**
North East

**Kevin Butler,**
South West

**Sue Camper,**
Wales

**Phil Eckersley,**
Northern Ireland

**Wendy Hyde,**
Greater London

**Stuart Iles,**
Central Southern England

**Mark Pratt,**
Yorkshire and the Humber

**Tony Strachan,**
Scotland

**John Young,**
North West
With effect from 1 June

# Objectives and Strategy
## for 2003/04

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 2003/04 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 2003/04

**1/** To maintain and where relevant enhance the range and quality of information and economic briefing provided to the Monetary Policy Committee and to build and strengthen relationships with external sources of information.

**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, through interviews, and through other initiatives such as the Schools Competition.

**4/** To enhance the Bank's assessment of risks to financial stability, to support and/or undertake measures designed to increase the resilience of financial markets, and to contribute to the debate on arrangements for handling domestic and international 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 ensure that the Bank's financial markets and banking operations are conducted in a professional manner to achieve the Bank's policy objectives and customer mandates, within an effective and proactive risk management framework; that they are organised to yield high quality intelligence, analysis and experience supporting the Bank's core purposes; and that the Bank makes a full contribution to initiatives to improve the markets in which it deals.

**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 that the Bank recruits, retains and develops staff with relevant skills and experience through appropriate policies, including equal opportunities for women, ethnic minority and disabled staff, in order to build strong staff motivation and morale.

**9/** To maintain the Bank's overall spending within the agreed budget of £244.4 million for 2003/04 set by Court, and ensure that long term spending plans reflect continuing progress in improving cost-effectiveness.

**10/** To improve management information and the efficiency and robustness of business processes across the whole of the Bank, in particular through improved use of, and continued investment in, IT; and through the maintenance of appropriate back-up arrangements in the event of business disruption.

# Financial Framework

## for 2003/04

### Budget for 2003/04

Reflecting the objectives set out on page 34, Court has agreed an expenditure budget of £244.4 million for 2003/04. Nearly half of the increase over last year's budget represents additional legal expenses in relation to the BCCI case. Otherwise, the planned increase in spending comes to £13.3 million, around two-thirds of which is associated with higher income, in part reflecting the changes to note printing described on pages 25-26 and in part higher-than-expected volumes of banking business. As a result of the increase in income, unrecovered costs are up by less than £5 million.

**Bank Expenditure Budget**

| | 2002/03 Budget | 2002/03 Outturn | £m 2003/04 Budget |
|---|---|---|---|
| **Business units** | | | |
| Banking and Market Services[1, 2] | 37.9 | 34.8 | 69.5 |
| Printing Works[2] | 29.2 | 28.4 | 2.0 |
| Monetary Analysis and Statistics | 20.8 | 20.2 | 21.9 |
| Market Operations[1] | 13.2 | 12.3 | 17.1 |
| Financial Stability[3] | 12.1 | 11.5 | 13.2 |
| Registrar's Department | 3.5 | 2.8 | 2.9 |
| Centre for Central Banking Studies | 1.5 | 1.4 | 1.6 |
| | **118.3** | **111.3** | **128.2** |
| **Centrally borne costs**[4] | | | |
| Property Services and Security[2] | 31.2 | 33.0 | 34.0 |
| Personnel, Audit and Secretary's Department | 25.3 | 23.8 | 26.7 |
| Finance and central IT | 6.4 | 8.3 | 8.4 |
| Depreciation, VAT etc | 28.9 | 30.8 | 26.0 |
| | **91.7** | **96.0** | **95.1** |
| **Total of above** | **209.9** | **207.3** | **223.2** |
| BCCI legal fees | 10.6 | 13.5 | 21.2 |
| **Total expenditure** | **220.5** | **220.8** | **244.4** |

Due to roundings, the individual figures may not sum to the rounded totals.

1/ Banking and Market Services and Market Operations were formerly shown combined, as Financial Market Operations.

2/ From end-March 2003 the Printing Works ceased to exist as a separate budget centre, the costs of note production being borne within Banking and Market Services and Property Services and Security from that date.

3/ The Co-ordination Unit for Europe was formerly shown separately but is now included within Financial Stability.

4/ Some centrally borne costs were reassigned within subheadings during the year due to internal reorganisation.

A summary of the Bank's budget for the current year is given in the Table on page 35. The comparison with the previous year is made more complicated by the changes to arrangements for note printing; these affect the allocation of costs to Banking and Market Services, and Property Services and Security, as well as the Printing Works. In underlying terms, however, costs are higher in the Bank's main analytical areas (Monetary Analysis and Statistics, Financial Statistics, and Market Operations). This is principally due to a temporary increase in staff numbers as a result of continued recruitment (though at a rather slower rate than in recent years) despite a sharp fall in resignations. This additional spending will be managed down gradually in future years. Spending in Personnel Division is also higher, as a result of an enhanced external secondment programme.

Within the total, the contribution of investment spending to the expenditure budget is little changed, at rather over £21 million, with higher IT investment budgets offsetting reduced spending on properties now that the refurbishment of the Bank's main premises in Threadneedle Street is almost complete.

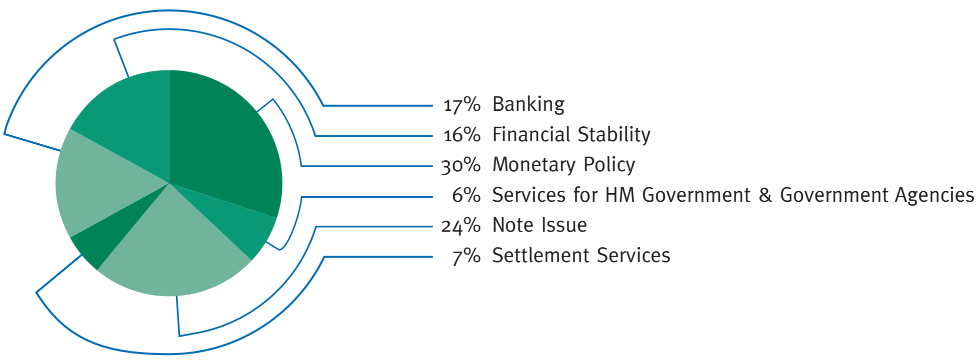
## Actual spending in 2002/03

BCCI-related legal fees were some £3 million higher than forecast, but despite that total spending in 2002/03 was only £0.3 million above budget. The underspend was most marked in Banking and Market Services (where it reflected delays to project spending), but was otherwise widely spread. The undershoot at the Printing Works reflected a reduced note order; that in the analytical areas was in part a reflection of a weaker rank mix than forecast. The increase in costs borne by Finance included professional fees associated with the sale of the printing operations.

## 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, the Bank's expenditures directly stemming from monetary policy analysis and its implementation include contributions from Market Operations and from the Press Office and Information Services in Secretary's

**Budgeted Costs of Functions 2003/04**



Department, as well as those recorded against Monetary Analysis and Statistics. The chart on the previous page shows the distribution of the Bank's budgeted costs for 2003/04 on a broad functional basis, with overheads fully allocated to functions.

### Medium-term spending plans

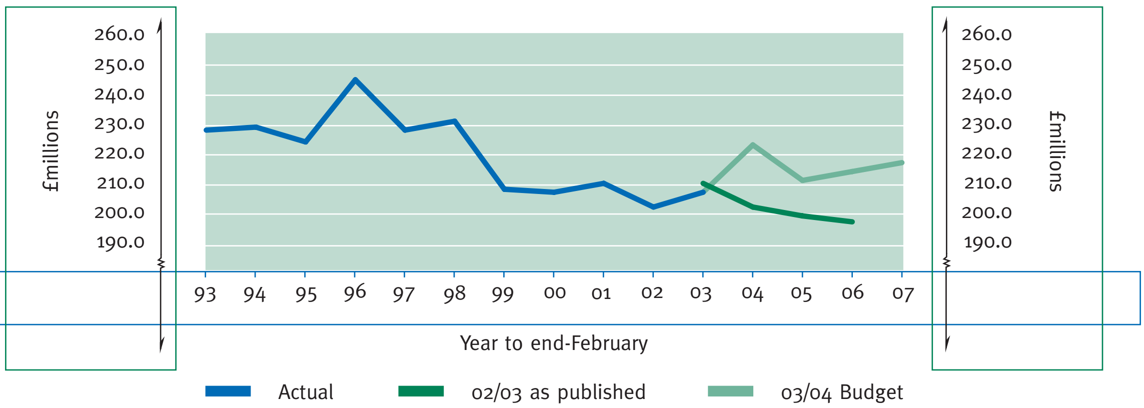
The medium-term expenditure plans continue to reflect improvements in the efficiency of processing activities and reductions in the costs of note production, together with some further progress in reducing overheads and other centrally borne costs. After several years in which more resources for policy work have been provided, these costs are expected to stabilise from 2004/05. However, in the short term any 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. In broad terms, around half of these savings have been staff-related, with the remainder predominantly reflecting reductions in building occupancy. The Bank expects this reduction to be fully achieved 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 since 1993 and the expected path (excluding BCCI costs) four years 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 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 unrecovered costs associated with its monetary policy and financial stability activities, but excluded any share of the £20 million overhead initially retained by the Bank.

**Bank Expenditure 1993-2007**
(excluding BCCI costs from 2001/02)




This chart shows figures for gross expenditure. Much of the increase this year is matched by higher income.

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%, and balances £1,615 million, implying an annual income of £64 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 in the process of being reviewed, now that the initial five-year period is nearly at an end. So although the Bank's income is coming under downward pressure, Court saw 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.

### 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. Given the current review of the CRD arrangements, in which the benchmark rate will be reassessed, Court is prepared for the time being to retain the benchmark of 7% for the year ahead.

# Personnel and Community Activities

## STAFFING

The table on page 40 shows the average number of people employed during the year by the Bank and its subsidiaries, including the Governors and Executive Directors, and the aggregate remuneration.

Chart 1 on page 40 shows how the composition of the Bank's staff changed between 2002 and 2003. As in recent years, staff numbers fell in Registrar's Department at Gloucester, at the Printing Works at Debden and in the Banking & Market Services area. There continued to be small increases in the numbers of staff working in the policy divisions of the Bank.

Major changes in the Bank's banking operations continued to be implemented during the year. Of the 70 staff made redundant, 60 redundancies related to the banking operations' C21 programme, driven by substantial new investment in systems and the development of multi-skilled teams. The other 10 were mainly due to continuing changing in working practices in the Central Services areas of the Bank.

The fall in staff numbers last year continued the well-established trend illustrated in Chart 2 on page 40. Although slowing, the decline in staff numbers is expected to continue as the effects of reductions in routine processing jobs, changed work processes and greater use of IT feed through.

### Recruitment

The Bank recruited 198 staff in 2002/03. This included 27 staff to work in IT and 48 clerical staff to work mainly in the operational areas of the Bank. Of this latter group, 24 joined at the clerical entrant levels (5 GCSE, 19 A-level), 1 as a secretary and 23 as experienced hires. The clerical entrant total was significantly less than in the previous year (2001/2002: 59 clerical recruits, of which 36 were at school level entrant levels).

In terms of graduate recruitment, the Bank's demand for high-quality candidates continued. 47 new graduates joined during the year; 43 joined the banking staff (2001/02: 42) and 4 joined the IT ranks. Because the Bank's retention rate has improved significantly, recruitment is likely to be at lower levels in the current year.

The demand for experienced and specialist staff remained high until the middle of the year. 38 mid-career staff were recruited. (2001/2002: 34). The majority were economists for the Financial Stability and Monetary Analysis areas of the Bank. Other areas (including Audit, Personnel Division, Property Services & Security Division and Secretary's Department) recruited professionally qualified and/or experienced specialists to fill specific vacancies. One recruit was at Head of Division level.

### Training and development

Several recent innovations within the training and development field were consolidated during the year. For the first time all areas of the Bank are operating a common competency framework as the basis for the annual appraisal system. The new on-line appraisal system means that managers throughout the Bank are using consistent standards in managing performance and have on-line access to a range of training opportunities to help develop capabilities. The on-line system also means that managers are able to report on development needs and conduct more accurate analysis of the training needed and the performance of their staff; this also supports career development which has been an important priority over the past year.

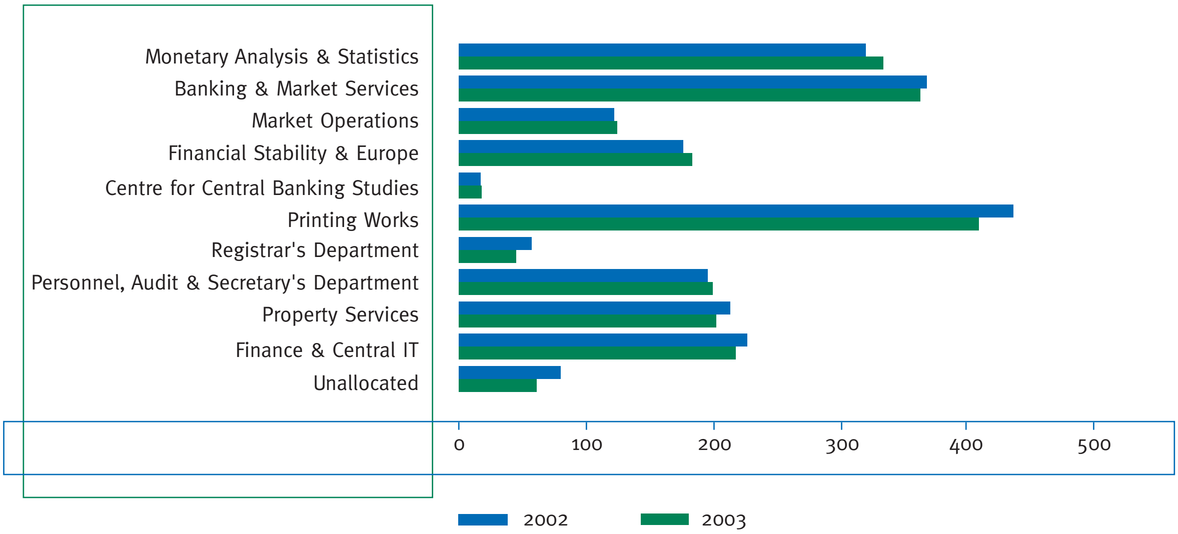
The competency framework supports the identification of both technical and softer skills. Management and leadership training needs are met through a range of courses offered by external providers, and individual executive coaching is also being used. 360-degree feedback was introduced to complement the existing upward feedback mechanism.

Training staff to improve their IT literacy continues to be important to the Bank, with 450 people having completed their European Computer Driving Licence (ECDL), a broad-based modular IT qualification, and

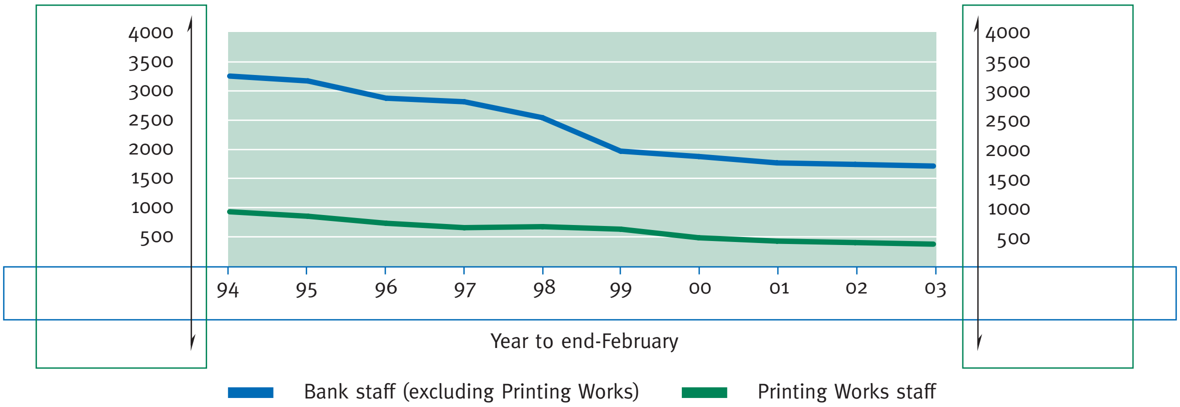
**Aggregate Remuneration and Average Number of Staff**

| | **2002/03** | | *2001/02* | |
|---|---|---|---|---|
| | **Aggregate remuneration (£m)** | **Average number of staff** | *Aggregate remuneration (£m)* | *Average number of staff* |
| | **81** | **2,187** | *80* | *2,241* |

**Numbers of Staff by Area 2002 and 2003** (Chart 1)




**Bank Staff Numbers 1993-2003** (Chart 2)



over 4000 tests passed. A promotional event took place this year to boost further the interest in learning about software, and also some of the possibilities of new hardware becoming available.

### 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, who are encouraged to raise any instances of discrimination through the Bank's internal procedures. All 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 proportion of women managers in the Bank grew slightly to 22.4%. The national gender profile of those studying economics makes it unlikely that the Bank will recruit equal numbers of male and female graduates, but women now account for more than one-third of staff in the main analytical grade. The proportion of staff from ethnic backgrounds (black, asian, oriental) remains broadly unchanged at 6%. However the proportion of staff declaring themselves to be other than "British White" has increased further, to 11%. This reflects continuing efforts to recruit as widely as possible, and in particular recent success in recruiting EU nationals.

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 keeps under review its arrangements for consulting staff on matters affecting their interests. To facilitate this, the Bank also maintains a dialogue – both formal and informal – with representatives of the various recognised trade unions. As well as the established face-to-face formal consultation processes, briefings, notices, e-mails and the Bank-wide intranet continue to be used to ensure that staff are kept up to date with issues affecting them as individuals, and the Bank as an organisation.

The Bank has started a programme of regular staff opinion surveys. The first in this series was conducted in December 2001/January 2002, and the results were published to staff during 2002. The results were generally more positive than the previous full survey in 1995, with a relatively high level of overall employee satisfaction with the Bank as an employer. Bank policies and practice on equal opportunities, work/life balance, the office environment and the performance review system all scored well. The fairness of the reward and promotion systems fared less well; as did the Bank's career development arrangements, despite the strong endorsement of the Bank's training effort. A further survey will take place at the end of 2003.

During the year the Bank reviewed its statement of values, and this was promulgated to staff in 2003.

## COMMUNITY INVOLVEMENT

Last year the Bank contributed £755,000 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 £495,000, while the cost of other community contributions, including time spent by staff on community involvement activities, was £260,000. Donations to academic research amounted to £60,000.

The Bank's charitable giving policy primarily focuses on two areas: helping disadvantaged people to access worthwhile employment through training; and on supporting the staff's personal involvement in the community. £39,000 was donated to charities and schools in recognition of funds raised or time given by staff. This year five members of staff who undertake community work were awarded £3,000 each for the organisations they support through a new competition to promote community involvement, called The Bank of England Court Awards. Three members of Court were on the panel that judged the shortlist of ten entries. The Bank also matched, on a pound for pound basis, £95,600 donated by staff and pensioners to registered charities under the Give-As-You-Earn Scheme and £6,600 of staff fundraising for Marie Curie Cancer Care and the Anthony Nolan Trust. 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, including over 600 computers and 100 printers and scanners to Tools for Schools.

The Bank participates in a number of Education Business partnership (EBP) activities in Greenwich, Hackney, Islington, Newham, Tower Hamlets and Gloucestershire. Staff volunteers act as group facilitators at job finding skills workshops, interviewers at practice interview sessions, business reading and maths 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 areas.

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 an ethnic minority community organisation. The programme aims to develop the management and leadership skills of both the community partner and the business partner. Also, a number of staff hold community positions, such as trustees or board members, youth leaders and magistrates.

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 that they can help the wider community. To facilitate best practice HotC has produced a series of publications offering practical advice to both business and community organisations. During 2002 Bank staff, in partnership with the Brokerage Citylink, produced a work experience guide with the aim of encouraging City firms, large and small, to make available a number of placements for local students from the surrounding boroughs.

# 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 page 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. The Chairman of NedCo may also attend meetings.

### REMUNERATION STRUCTURE FOR THE GOVERNORS

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

#### Base salaries

The Governor, Sir Edward George, is currently serving the final year of a second five-year term, which began on 1 July 1998. On 1 July 2002 the Governor's salary was increased from £250,567 to £256,893, an increase of $2^1/_2$%, in line with the inflation target.

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 entitlements, were the principal benefits received during the year to 28 February 2003.

The table of emoluments on page 44 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 initially provided through the Court Pension Scheme, supplemented by an unfunded scheme. This is separate from the scheme for staff, and is described on pages 44-46.

#### 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 the sub-committee of non-executive Directors is £7,500 per annum. Non-executive Directors do not receive any post-retirement benefits from the Bank. Other than the Chairman of NedCo, Directors receive no additional fees for serving on Court Committees. The Bank does however meet certain travel expenses.

## 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

**Remuneration of Members of Court**

| | Salary (Note i) £ | Benefits £ | Total 2003 £ | Total *2002* £ |
|---|---|---|---|---|
| **Governors** | | | | |
| Governor | | | | |
| Sir E A J George | 254,784 | 4,579 | 259,363 | *249,909* |
| **Deputy Governors** | | | | |
| Mr D C Clementi (Note i) | | | | |
| (term expired 31 August 2002) | 158,537 | 844 | 159,381 | *208,051* |
| Mr M A King | 212,263 | 345 | 212,608 | *207,400* |
| Sir A M B Large | | | | |
| (from 3 September 2002) | 105,759 | 563 | 106,322 | – |
| **Non-Executive Directors** | | | | |
| (Note ii) | 77,500 | 400 | 77,900 | *77,891* |
| **Total** | **808,843** | **6,731** | **815,574** | ***743,251*** |

Notes

i/ Mr Clementi was required under the conditions applying to MPC members not to take up any appointment that might conflict with his MPC responsibilities for three months after the expiry of his term of office. He accordingly delayed taking up certain outside appointments and in consideration of this his Bank pay continued for three months after the end of his term.

ii/ Sir Howard Davies is a member of Court in his capacity as Chairman of the FSA. The Bank's Deputy Governor, Financial Stability, (Mr Clementi until 31 August 2002, then Sir Andrew Large) 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; Mr Clementi waived remuneration of £10,000 due from the FSA, and Sir Andrew Large also waived £10,000 due from the FSA.

**Pension Entitlements and Accruals (including unfunded entitlements)**

| | Accrued pension as at 28.2.02 (£pa) | Accrued pension as at 28.2.03 (£pa) | Increase in accrued pension (£pa) | Transfer value as at 28.2.02 (£) | Transfer value as at 28.2.03 (£) | Increase in Transfer value (£) |
|---|---|---|---|---|---|---|
| Sir E A J George (Note i) | | | | | | |
| *Joined 2 July 1962* | 1,663 | 6,774 | 5,111 | 32,400 | 128,500 | 96,100 |
| Mr D Clementi (Note ii) | | | | | | |
| *Joined 1 September 1998,* | | | | | | |
| *retired 30 November 2002* | 31,700 | 36,800 | 5,100 | 501,800 | 871,800 | 370,000 |
| | | | | | (Note ii) | |
| Mr M A King (Note iii) | | | | | | |
| *Joined 1 March 1991* | 88,400 | 97,800 | 9,400 | 1,463,300 | 1,680,500 | 217,200 |
| Sir A M B Large | | | | | | |
| *Joined 3 September 2002* | – | 3,000 | 3,000 | – | 48,200 | 48,200 |

Notes

i/ The Governor, Sir Edward George, reached the age of 60 on 11 September 1998, the normal retirement age under the Court Pension Scheme, after 36 years service. At normal retirement age, the Governor's pension entitlement was £168,000 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 £168,000 per annum 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 2003 an additional entitlement of £6,774 per annum had arisen (2002: £1,663)

ii/ Mr Clementi retired on 30 November 2002 and his pension was drawn at that date. The increase in transfer value in part reflects the drawing of his pension without adjustment for early payment.

iii/ Mr King has transferred into the Court Pension Scheme retained benefits from a previous employer, which are reflected in the accrued pension and transfer values shown in the table.

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 of four times salary in the event of death in service, allowances for a 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 pensions broadly match what would have been provided by the Court scheme in the absence of the cap. During the year ended 28 February 2003, unfunded entitlements were provided for Mr Clementi, Mr King and Sir Andrew Large. 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 £141,429 (*2002 £137,979*) per annum, pro rated for the number of days worked per week. They are appointed for terms of three years. Dr Sushil Wadhwani's term expired on 31 May 2002, and he was succeeded by Marian Bell. Ms Barker and Professor Nickell work in the Bank on a four day a week basis, and Mr Allsopp and Ms Bell work 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 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. During the year the Bank made payments on this basis to Dr Wadhwani and, from among the Executive members, to Mr Clementi and Mr Plenderleith.

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. Paul Tucker's current annual salary is £147,088; and Charlie Bean's is £154,350. 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 2003

### 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. This basis for preparing the financial statements has been followed for a number of years.

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 continues to adopt 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 2003 are given on pages 60-91, and show a profit after provisions and before tax of £89 million (2001/2002 £103 million). The decrease in profits compared to last year is mainly due to increased costs including pensions and other post-retirement benefits. After payment in lieu of dividend of £34 million (2001/2002 £42 million) and a tax charge of £21 million

(2001/2002 £19 million), the profit transferred to reserves amounts to £34 million (2001/2002 £42 million).

The statements of account for the Issue Department (which are given on pages 92-94) show that the profits of the note issue were £1,239 million (2001/2002 £1,410 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

At 28 February 2003 around £1.5 billion of Banking Department's assets comprised sterling money market refinancing provided through the Bank's open market operations (2002 £1.6 billion).

The size of Banking Department's balance sheet is affected by the size of Issue Department's deposit with Banking Department. On most days, this is around £50 million but it can be larger if settlement banks make significant use of the Bank's settlement bank late repo facility, which is always allocated to Banking Department and may be partly funded by an increase in Issue Department's Deposit.

The Bank issued three further tranches of 3 year euro-denominated Notes during the year. Two tranches, amounting to some €1,000 million, of the second issue of €2,000 million maturing in 2005 were sold by auction on 19 March and 16 April 2002. On 27 January 2003, the Bank created €2,200 million of Euro Notes maturing on 27 January 2006, for issue via auction. The first tranche of €1,000 million was auctioned on 14 January, and a further tranche of €1,000 million was auctioned, shortly after the end of the financial year, on 18 March. The proceeds of the issue have been invested in foreign currency assets together with related swaps so as to minimise exposure to interest rate and currency risk.

During the year the Bank reviewed its portfolios of foreign currency assets and the corresponding financing via Euro Notes and Euro bills, with a view to improving the efficiency of their management. With effect from 1 March 2003 a portfolio of approximately €3.6 billion foreign currency assets, financed by the Euro Bills, will be accounted for on a mark to market basis, with gains and losses arising from regular revaluation of market prices taken through the profit and loss account. This treatment will be adopted in the financial accounts of the Banking Department for 2003/04. The remaining securities, funded by the Euro Notes, continue to be accounted for on an amortised cost basis.

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 the stock of sterling money market refinancing provided through the Bank's open market operations (principally reverse repos of government securities) and the Ways and Means advance to HM Treasury, which has been fixed at £13.4 billion since April 2000.

## POST BALANCE SHEET EVENT

As explained on pages 25-26, the Bank decided to dispose of its note printing operations to De La Rue plc. In order to achieve this, the Bank's printing operations together with the machinery, stock and approximately 240 staff were transferred to the Bank's wholly owned subsidiary Debden Security Printing Ltd on 7 March 2003. The share capital in this company was then sold to De La Rue on 31 March 2003.

## 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 39-41.

## 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

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 £21 million in April 2002 and £21 million in October 2002 in respect of the year to 28 February 2002. In April 2003 the Bank paid the first payment of £16 million in respect of the financial year ended 28 February 2003 which was based on provisional figures. The balance of £18 million will be paid in October 2003.

## 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 6-9.

The Court of Directors has assessed its governance arrangements against the recommendations of the Higgs Review of the Role and Effectiveness of non-executive Directors. In most areas the Bank's practices closely match those recommended for private sector companies. Where the Bank does not comply with the Recommendations it is because statutory provisions require alternative arrangements (eg for appointments), or because the Bank has only one shareholder.

Court has also taken note of the Proposed Guidance on Audit Committees contained in the Smith Report. Here again Court considers that it already adheres to most of the main recommendations but the terms of reference of the Audit Committee will be reviewed in the light of the final guidance.

### 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 considers 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 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 52-54, 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 2003 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. The Bank allows staff to take part in local political and community activity and may grant time off for such activity, but does not record the political interests supported in this way. Details of charitable donations are set out on pages 41-42.

## AUDITORS

On 1 January 2003 the Bank's external auditors PricewaterhouseCoopers converted to a limited liability partnership by transferring substantially all their business to a new entity PricewaterhouseCoopers LLP. The contract for the audit of the Bank was also transferred to the new firm and, accordingly, the audit report has been signed by PricewaterhouseCoopers LLP.

## 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 99% (2002 98%) of its bills within these timescales.

The Bank estimates that the average trade creditor payment days for 2002/03 were 17 (2001/02: 23). This is an arithmetical calculation and does not necessarily reflect our practice, described above, nor the experience of any individual creditor.

The Bank subscribes to the principles and practices of the Better Payments Practices Group.

# Risk Management

This section describes the management of risks arising in the Bank of England's financial operations. The Bank runs various types of risk in managing its own balance sheet (including the implementation of monetary policy); in its involvement in payment and settlement systems; and in acting as agent for HM Treasury in managing the UK's official foreign currency and gold reserves. The latter is covered at the end of this statement.

These risks are monitored and managed in the context of the Bank's internal control framework, described on pages 49-50.

## Developments in 2002/03

Over the past year there have been two significant developments that have affected the Bank's balance sheet. First, it was decided to issue a third €2 billion 3-year Euro Note, continuing the programme taken over from HM Government in 2001. The first €1 billion tranche was issued in January 2003, and the second €1 billion in March 2003, shortly after the end of the Bank's financial year. The Note programme has now reached its originally envisaged steady state size of €6 billion.

Second, it was decided to restructure the management and accounting of the balance sheet so that €3.6 billion of these Euro Notes are hypothecated to the portfolio of medium-term 'TARGET securities' (see page 48). The balance of €2.4 billion from the Euro Notes has been allocated to a buy-and-hold portfolio of high quality assets, consistent with current hedge accounting guidelines. This has in turn allowed the assets acquired with the proceeds of the short-term Euro Bill issuance programme, which had previously formed the 'TARGET' portfolio, to be placed in a separate portfolio. This will be actively managed if in due course it is decided that risk/return opportunities justify this.

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

## Reputational Risk

To operate effectively, the Bank needs to maintain a high level of public confidence. Risks to the Bank's reputation arise, for example, by failure to implement policy decisions effectively through its market operations, or in shortcomings in the services provided to government, central bank and banking sector customers. Potential risks are identified, evaluated and controlled using, for example, the risk and controls matrix referred to on pages 49-50. Reputational risk is also contained by the effective selection, development and assessment of staff, and by a clear structure for the management and oversight of the work of the Bank.

## Financial Risk

The work of Market Operations and of Banking and Market Services may expose the Bank to credit, market and operational risk.

The Bank is exposed to Credit Risk when it provides liquidity to financial institutions in the open market operations through which it implements interest rate decisions taken by the Monetary Policy Committee; and, intra day, in the sterling and euro wholesale payment systems (CHAPS and CHAPS euro), as well as in the securities settlement system CREST. Credit risk also arises in the management of the Bank's own funds, and in the banking services it provides to its customers.

Some of these operations involve the Bank, as a central bank, having to accept large exposures to counterparties because the scale of its operations is determined by the liquidity needs of the financial system as a whole. In these areas, credit risk is contained by dealing with counterparties that meet appropriate credit and functional criteria, and by ensuring that exposures are fully collateralised (with margin) by high-quality, marketable securities. These exposures are monitored on a regular basis, and additional margin is called as required. Further, the Delivery versus Payment (DvP) arrangements in CREST eliminate the intra-day exposures incurred by the Bank vis-à-vis CREST settlement banks.

The Bank's Credit Risk Advisory Committee (CRAC) reviews the counterparties with whom the Bank deals, as well as the issuers of securities that the Bank holds. CRAC is chaired by the Head of the Risk Analysis and Monitoring Division, which reports to the Executive Director for Market Operations, who is ultimately responsible for decisions on limits. CRAC 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. Where the Bank is not obliged to accept exposures to these counterparties because of the liquidity needs of the financial system as a whole, then credit and settlement limits are set for such counterparties.

The Bank is also exposed to Market Risk, principally through 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 the liquidity of asset markets. The Bank manages its exposure to market risk in ways that are consistent with the underlying purposes for which its operations are conducted. This is largely done through measuring the Value at Risk of mismatched positions. Value at Risk estimates, within a specified confidence interval and on the basis that the future will be like the past, the worst-case loss that a mismatched position could suffer as a result of potential changes in market conditions.

Details of the Bank's interest rate and foreign currency exposures are given in note 7 of the financial statements on pages 73-79.

In relation to interest rate exposures, the Cash Ratio Deposits and Note Issue liabilities are non interest bearing, whilst the principal assets – the Ways and Means advance to HM Government, and advances to the banking system through open market operations (which typically have a maturity of two weeks or less) – yield the Bank's repo rate. The Bank also holds a portfolio of high quality medium- to long-term securities, notionally matching a proportion of its capital and reserves and Cash Ratio Deposits, which is designed to ensure certainty of income over a longer horizon. Interest rate risk on term customer deposits is generally hedged by placing them on deposit, or in reverse repo, on similar terms in the market.

In relation to exchange rate risk, customer term deposits in currency and gold are employed on a fully matched basis. Sterling term deposits from customers are generally on-placed as foreign currency deposits or reverse repo, with foreign exchange swaps used to eliminate the exchange rate risk.

The Bank uses cross-currency, foreign exchange and interest rate swaps, and occasionally futures, when hedging its interest rate and exchange rate exposures in the portfolio of securities acquired with the process of its Euro Note and Euro Bill issuance programmes.

Other than the above, the Bank has not used derivatives on its own balance sheet over the past year.

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 exchange rate exposures on the Bank's balance sheet. No such operations have so far been conducted.

Operational risk 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 the financial markets. Shortcomings in any of these areas could have reputational or financial consequences.

Each business area is responsible for managing its operational risk and monitoring the associated controls. The Bank's Senior Management Committees review this process.

The controls in Market Operations were enhanced during 2002/03 by the appointment of Operational Risk Officers in each division. They, together with a new area Operational Risk Committee that meets quarterly, are charged with proactively assisting local management to anticipate where risks may crystallise, and ensuring that adequate controls are in place and working effectively. 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) goes through a new product procedure before senior management 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.

### The Exchange Equalisation Account

The Bank acts as agent for HM Treasury in managing the UK's foreign currency assets and gold reserves, and its foreign currency liabilities. These funds are not held on the Bank's balance sheet, but in the Government's Exchange Equalisation Account (EEA).

The risks incurred by the Bank in conducting this business are similar to those in relation to its own business, namely credit, market and operational risk; and the controls applied parallel those applied in respect of Bank business. The management of the EEA is conducted within a framework agreed annually with HM Treasury, which is described in the EEA Report and accounts published by the Government.

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

This section 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. Its functions are described on page 8 of the Annual Report.

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 2002 to 28 February 2003. The Core Purposes and Strategic Objectives of the Bank for 2002/03 are set out in the 2002 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 seven times during the year to satisfy itself that the delegated functions were being satisfactorily discharged.

The table on page 56 sets out attendance by the Bank's 16 non-executive Directors at meetings of Court, NedCo, the Audit Committee and the Remuneration Committee. The figures in brackets refer to the total number of meetings during the financial year.

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 16-29 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 2002/03.

In particular, NedCo notes that as a result of the reductions in spending on central services, and the completion of the Bank's property strategy, in 2003 the Bank will meet the financial objective set in 1998 of achieving a reduction in overhead expenditure of £20 million a year. NedCo is also pleased to note the Bank's success in recruiting staff. Combined with a weak trend in the City of London employment market, this has led to full staffing in key areas of the Bank for the first time since 1998. But NedCo endorses the Bank's policy of continued recruiting, so that it will have a strong presence in the employment market when this returns to more competitive conditions. NedCo has monitored the Bank's pay and benefit arrangements to ensure they support its recruitment policy. In the monetary analysis area, the Bank has reached its budgeted numbers of staff, but it recognises the continuing need to address experience levels.

Following a decision of Court to sell the bank note printing operations, NedCo welcomes the completion on 31 March 2003 of the sale of the business to De La Rue, accompanied by a contract under which De La Rue will supply notes to the Bank for an initial period of seven years. NedCo also welcomes the work done over the year to test the effectiveness of the Bank's business continuity plans.

There have been significant advances in the Bank's use of IT in its internal processes; this includes data

**Directors' Attendance**

| | Court(12) | NedCo(7) | Audit(3) | RemCo(4) |
|---|---|---|---|---|
| Sir David Cooksey | 12 | 7 | – | – |
| Mr John Neill | 12 | 7 | – | 4 |
| Sir Howard Davies | 8 | 5 | – | – |
| Mr Roy Bailie+ | 12 | 7 | – | 3 of 3 |
| Dame Sheila McKechnie | 9 | 6 | – | – |
| Mr William Morris | 9 | 6 | – | 2 |
| Mr James Stretton++# | 11 | 6 | 1 of 2 | 1 of 1 |
| Sir Ian Gibson | 10 | 5 | – | – |
| Ms Kathleen O'Donovan | 8 | 5 | 3 | – |
| Ms Bridget Blow | 11 | 7 | 2 | – |
| Sir Brian Moffatt | 8 | 5 | 2 | – |
| Sir John Bond | 9 | 4 | – | – |
| Ms Mary Francis | 10 | 6 | 2 | – |
| Sir Graham Hall | 10 | 6 | – | 4 |
| Dr DeAnne Julius | 10 | 5 | – | – |
| Ms Laurel Powers-Freeling*+ | 8 of 9 | 4 of 4 | – | 2 of 3 |
| Sir Neville Simms** | 2 of 3 | 2 of 3 | 1 of 1 | – |

Notes

+ RemCo member from June 2002.

++ Audit Committee member from June 2002.

# Remco member to May 2002.

* Appointed to Court June 2002.

** Retired from Court May 2002.

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 welcomes the progress now being made in tackling the software testing issues that have delayed the implementation of Globus, the IT package for the Bank's core banking system, which has also had a knock-on effect on other projects. Nevertheless the great majority of the savings made as a result of the reorganisation of the banking area, of which Globus is a part, have been achieved.

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 2002/03, as reported in the internal controls section of the report from Members of Court (pages 49 and 50) 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 9. The report on remuneration for 2002/03 is set out on pages 43-46 and, so far as appropriate, forms part of this report.

The Monetary Policy Committee's procedures are described on pages 30-33. 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 from within the Bank, using specially commissioned papers and presentations, and with the help of the discussions which take place during the MPC's monthly report to Court. It has taken a particular interest in the quality of information provided to the MPC from outside sources such as the ONS. NedCo welcomes the review of the Bank's forecasting methodology, which Court commissioned from Professor Adrian Pagan, and fully endorses the constructive response of the Bank to the report. NedCo is pleased that Professor Pagan has agreed to return to give a further report on the new forecasting model, in the light of practical experience with using it, once it comes into operation.

NedCo wishes to express its appreciation to Sir Edward George, who retires at the end of June, for his outstanding Governorship over the last 10 years, a period during which the Bank has undergone greater changes than probably at any time in its history, including of course taking on operational control of interest rates. Sir Edward has steered the Bank through this period with impeccable judgement. NedCo warmly welcomes Mervyn King as his successor.

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.

Chairman of the Non-Executive Directors' Committee