Bank of England

Annual Report 2004

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Foreword by the Chairman of NedCo[1]

Sir David Cooksey, Chairman

The year 2003/04 saw a change of Governor and the start of a major strategic review, which will conclude this summer and provide a basis for the Bank's operational and financial planning over the next five years. The review is timely, coming five years after the changes associated with the Bank's independence and the new Act, and I very much welcome the energy and commitment of Mervyn King and the new Executive Team, both in driving forward the strategy process and in responding to issues such as the failure of the new banking system last July.

There has in addition been a small but significant change in the governance of the Bank. On taking office in July 2003, the new Governor suggested that there would be great advantages if there were a clearer separation between the functions of chairing the board and running the business, as recommended in the Combined Code on Corporate Governance.

Strictly, the Bank cannot comply with the Combined Code: the Governor, under the Bank of England Act, has to chair Court (the Bank's Board). However the Act also provides for a Committee of Directors ("NedCo"), consisting of all the non-executive members of Court, with a Chairman designated by the Chancellor, and this Committee, as set out on page 8,

1 The Committee of (Non-executive) Directors.

has an important role in reviewing the Bank's performance. As Chairman of this Committee, I agreed with the Governor that it would be entirely consistent with NedCo's supervisory role for it to receive and discuss reports that would previously have been taken directly to Court, provided that any decisions were made formally in a subsequent meeting of Court. The practice has therefore evolved of the bulk of the Bank's business being discussed at meetings of NedCo, with the Executive members of Court and other officials present by invitation. Under this procedure the separation of duties for substantive discussions has become clearer, with advantage I believe both to Court and to NedCo. After a trial period the arrangements were approved by a resolution of Court in May 2004.

The formal Report of NedCo, which is required by the 1998 Act, is given on pages 41-42, and the activities of the Bank are reviewed in the body of this Report. The Governor, in his own Foreword, discusses the progress of the Bank's Strategy Review, elements of which have already been brought to NedCo.

My thanks go to Sir John Bond, Sir Ian Gibson and Dr DeAnne Julius who are leaving the Court this year, and I welcome Amelia Fawcett, Sir Andrew Likierman and Sir John Parker, who take their places. Sir John Parker will succeed me as Chairman of NedCo next March, and at that point Geoffrey Wilkinson will take my place as a non-executive director.

Governor's Foreword

Mervyn King, Governor

I want to begin my first Annual Report as Governor by paying tribute to my predecessor, Eddie George, under whose guidance the Bank demonstrated that it had the authority, credibility and public acceptability to take on an independent monetary policy role and, through the Monetary Policy Committee, made a success of it.

My task is to build on that success. This means both maintaining the MPC's track record in meeting the inflation target and in explaining its actions, and applying to other parts of the Bank some of the lessons that have been learned in building the MPC.

With Court's agreement, I have already examined the organisation of the Bank. My aim has been to ensure that lines of authority and responsibility are clear, and contribute to efficient decision-making. In general this points to having fewer layers of management, and to making sure that responsibility is so far as possible given to individuals rather than to committees. The new high-level organisation of the Bank, set out on pages 12-15, reflects this approach. The new Executive Team, on which each of the Bank's five key business areas is represented by an Executive Director, replaces two former senior committees, and a layer of management between the Executive Directors and the Heads of Division has also been removed. Within the Executive Team, responsibilities are clearly allocated, and our next priority is to ensure that this principle applies further down the organisation as well.

The Executive Team, in conjunction with Court, has started on a fundamental review of the Bank's Strategy and Objectives, starting with the core purposes statement, through which we define the Bank's highest-level objectives. For some years the Bank has declared three core purposes and given equal prominence to each – they have related to monetary stability; to financial stability; and to the efficiency and effectiveness of the financial system. Monetary and financial stability are universally recognised as central banking concerns. The efficiency or effectiveness of the financial system, on the other hand, may matter to a central bank – but will matter most when the issues relate to its ability to discharge monetary policy operations or to safeguard the stability of the system as a whole. In other words, the third core purpose is essentially a part of the first two; and while the Bank may from time to time wish to support particular initiatives in the financial sector, we have concluded that the possibility of doing so should not in itself be a core purpose.

This does not mean that the Bank is drawing away from the City. Governor Cobbold's celebrated remark that the Bank should be a bank and not a study group is as true today as it ever was. We operate in markets daily; we stand at the centre of the payments system; we have a close interest in settlement systems. Beyond that, we benefit in many of our functions from the intelligence that a close contact with the markets provides. Where it has a useful contribution to make, and where this will not conflict with the work of other agencies, the Bank will continue to play a part in promoting an open and competitive financial sector in the UK.

The main strategic review will be completed in the summer so that budget planning for 2005/06 can start in good time. Some parts are already agreed and have been implemented: in Financial Stability, a reorganisation has taken place and a new Board created to ensure that work is focussed on key risks; and in the Markets area, a consultation on the future conduct of Open Market Operations is being launched. Also in the Markets area, a strategic objective of building market liaison and intelligence is being taken forward. Other work in train includes an assessment of the scope and nature of the support provided to the MPC, and of ways of reaping the benefits of the new forecasting model. I am determined, too, that we should continue our highly successful work in promoting public understanding of the case for price stability, and of the MPC's remit. In Banking, subject to the overriding aim of restoring the full functionality of the new banking system which failed last July shortly after its launch, a review of the scale of customer banking services is being conducted. In Central Services, the objective is to ensure a more

Governor's Foreword continued

professional and cost-effective service across a number of key functions, including HR; as part of this I have been delighted to welcome to the Bank Louise Redmond, who has taken on the role of HR Director.

In the meantime – as described elsewhere in this Report – we are taking steps to strengthen our project approval and monitoring processes, and our procedures for management of risk in the Bank. Responsibility for these functions has been taken on by the Deputy Governors, Rachel Lomax and Sir Andrew Large. I am grateful to them, and to the other members of the Executive Team who are playing an invaluable role constructing the new strategy of the Bank and who have each contributed significantly to the development of their own areas.

Our activities during the year are reviewed elsewhere in this Report. One major exception, omitted because it has nothing to do with the Bank's current functions, is the BCCI case. During the past year, the claim brought on behalf of depositors by the liquidators of BCCI has come to trial. The financial burden on the Bank is considerable – around 10% of the overall budget – and is detailed on page 26. More importantly, the trial will place significant personal burdens on witnesses, few of whom still work for the Bank. We have been advised that the Bank has a strong defence. There are important policy reasons for resisting claims of this kind against public bodies; and it is in any event impossible to contemplate settlement in an action in which 22 present and former members of this country's central bank are accused of dishonesty. With the full support of Court I am therefore determined that the claim will be vigorously defended.

I would like to record my thanks to the members of Court, and especially to those who are leaving this year – Sir Ian Gibson, Sir John Bond and DeAnne Julius – the latter after a connection with the Bank that included being a founder member of the Monetary Policy Committee. Sir David Cooksey will also be leaving the Bank at the end of the current financial year – I am immensely grateful to him for his wise counsel and support as Chairman of NedCo, the Committee of Non-executive Directors of the Bank, and for his support in developing the new governance arrangements described in his own foreword. Finally, I should record the sadness felt by all members of Court at the news of the death of Sheila McKechnie, who served on Court from June 1998 to May 2003.

My thanks and appreciation are also due to our staff. This has been a difficult year in some respects – the failure of the new banking system (page 20) placed exceptional burdens on staff in Banking Services and other parts of the Bank during the summer, and I was immensely impressed by the determination and dedication of the staff who sacrificed weekends and holidays to support the recovery process. Great credit too should go to the staff in Markets who managed a ground-breaking dollar borrowing for the Government, and to the team in Monetary Analysis which developed the new Quarterly Model. And away from the policy areas, all of our processes are supported by dedicated professional staff with whom it is a pleasure to work and whom it is an honour to lead. It is this, more than anything else, that makes me confident in the Bank's future.

Governor of the Bank of England
May 2004

The Bank's Core Purposes

The Bank's Core Purposes are determined by Court as part of its role in setting the Bank's Objectives and Strategy. The statement below was approved by Court in May 2004.

The Bank of England exists to ensure both monetary and financial stability.

1 Monetary Stability

Monetary stability means stable prices and confidence in the currency. Stable prices are defined by the Government's inflation target, which the Bank seeks to meet through the decisions on interest rates taken by the Monetary Policy Committee, explaining those decisions transparently and implementing them effectively in the money markets.

2 Financial Stability

Financial stability entails detecting and reducing threats to the financial system as a whole. Such threats are detected through the Bank's surveillance and market intelligence functions. They are reduced by strengthening infrastructure, and by financial and other operations, at home and abroad, including, in exceptional circumstances, by acting as the lender of last resort.

In pursuit of both purposes the Bank is open in communicating its views and analysis and works closely with others, including:

- Other central banks and international organisations to improve the international monetary system.

- HM Treasury and the Financial Services Authority, under the terms of the 1997 Memorandum of Understanding, to pursue financial stability.

The Bank will also play its part in promoting an open and internationally competitive financial centre in the UK, using its expertise to help make the UK financial system more efficient, where such efforts would be in the public interest and provided that they do not conflict with its primary responsibilities or those of other agencies.

Governance and Accountability

The current governance and accountability framework is set by the 1998 Bank of England Act, which provides for a Court of Directors, a Committee of Non-executive Directors within Court, and a Monetary Policy Committee.

THE COURT OF DIRECTORS

The 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 10-11. During the year the terms of Sir John Neill, Roy Bailie, Dame Sheila McKechnie and Jim Stretton expired and they were replaced by Brendan Barber, Peter Jay, David Potter and Heather Rabbatts. As outgoing Chairman of the FSA, Sir Howard Davies resigned in September and was replaced by Callum McCarthy, his successor. Sir William Morris and Sir Brian Moffat were appointed for new three-year terms. Mervyn King's term as Deputy Governor expired in May 2003 and he was appointed to a new term as Deputy Governor before becoming Governor on 1 July. Rachel Lomax then succeeded him as Deputy Governor for Monetary Policy.

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. 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.

THE MONETARY POLICY COMMITTEE (MPC)

The Bank of England 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. Under the Act, the Bank's objectives in relation to monetary policy are 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. The MPC must meet at least monthly; its members comprise the Governor and Deputy Governors, two of the Bank's Executive Directors and four members appointed by the Chancellor. Membership of the MPC is given on page 16. The MPC's decisions are announced after each monthly meeting and minutes of their meetings are published two weeks later. The quarterly *Inflation Report* includes the MPC's projections of inflation and output.

NEDCO

The Act provides for a sub-committee of Court ("NedCo") consisting of all the non-executive Directors, with a chairman designated by the Chancellor of the Exchequer. The chairman of NedCo, Sir David Cooksey, is also Deputy Chairman of Court. NedCo has responsibilities 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 the terms and conditions of service of the four 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 pages 41-43.

COURT AND NEDCO PROCEDURES

On taking office the new Governor proposed that the procedures of Court should be adapted to bring them closer to the spirit of current corporate governance practice, in which the positions of the chairman and chief executive are separate, and the executive of a company reports to a board chaired by a non-executive.

Within the governance framework of the 1998 Act, this has been achieved by giving a much more prominent role to NedCo. Much of the business formerly discussed in Court is now discussed in NedCo, under Sir David Cooksey's chairmanship, with the Governor and other Executive members present by invitation. Under the new procedure, the Governor presents his executive report to NedCo, and this is followed by reports on other regular Bank business, including MPC procedures. Court then meets under the Governor's chairmanship to consider and approve matters which are its specific responsibility. In practice, the attendance at both meetings is the same. From time to time NedCo has a private meeting without the executive present to consider matters such as its own annual report.

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.

REMUNERATION COMMITTEE

The members of the Remuneration Committee during 2003/04 were Sir John Neill (Chairman until June 2003), Sir William Morris (Chairman from June 2003), Sir Graham Hall, Laurel Powers-Freeling, Sir Ian Gibson and Peter Jay, the latter two having joined in June 2003. The Chairman of NedCo attends meetings of Remuneration Committee. The Committee's approach to remuneration is set out in the Remuneration Report on pages 30-33.

AUDIT COMMITTEE

The members of the Audit Committee during 2003/04 were Kathleen O'Donovan (Chairman), Bridget Blow, Sir Brian Moffat, Mary Francis and David Potter, the latter having joined in June 2003 to replace Jim Stretton. The Deputy Governors, the Executive Director for Central Services, 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 Assist the Court in meeting its responsibilities for an effective system of financial reporting, internal control and risk management.

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.

The Committee normally meets four times a year.

MANAGEMENT STRUCTURE

The executive management of the Bank lies with the Governors and Executive Directors, whose responsibilities are set out on page 12.

The Court of Directors

Members of the Court of Directors

Mervyn King
Governor

Sir Andrew Large
Deputy Governor

Rachel Lomax
Deputy Governor

Sir David Cooksey

Sir William Morris, OJ

Sir Ian Gibson, CBE

Kathleen O'Donovan

Sir Graham Hall

Dr DeAnne Julius, CBE

Laurel Powers-Freeling

Brendan Barber

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

Chairman,
Advent Venture Partners LLP Ltd.
Director,
Advent VCT plc.
Director,
Advent 2 VCT plc.
Director,
The Establishment Investment Trust plc.
Chairman,
Small Business Investment Taskforce.

Sir Graham Hall
Appointed 1 June 2001.

Chairman,
Northern Growth Corridor Steering Group.

Sir William Morris, OJ
Appointed June 1998.

Member,
Commission for Integrated Transport.
Sitting Member,
The Employment Appeal Tribunal.
Chancellor,
University of Technology, Jamaica.

Dr DeAnne Julius, CBE
Appointed 1 June 2001.

Chairman,
The Royal Institute of International Affairs
Director,
Lloyds TSB Group.
Director,
Serco Group plc.
Director,
BP plc.
Director,
Roche Holding SA.

Sir Ian Gibson, CBE
Appointed August 1999.

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

Laurel Powers-Freeling
Appointed June 2002.

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

Kathleen O'Donovan
Appointed August 1999.

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

Brendan Barber
Appointed 1 June 2003.

General Secretary,
Trade Union Congress.
Director,
TUC Stakeholder Trustees Ltd.
Executive,
Board of Jubilee Debt Campaign.
Member,
Board of the Work Foundation.
Member,
Executive Committee of International Confederation of Free Trade Unions.
Member,
Executive Committee of European Trade Union Confederation.
Member,
Council of Institute of Employment Studies.
Trustee,
Tolpuddle Martyrs Memorial Cottages.
TUC Aid.
TUC Educational Trust.
TUC Charitable Trust.
TUC Stakeholder Trustees Ltd.

Bridget Blow

Sir Brian Moffat, OBE

Sir John Bond

Mary Francis, LVO

Peter Jay

Dr David Potter, CBE

Heather Rabbatts, CBE

Callum McCarthy

Bridget Blow
Appointed June 2000.

Chief Executive,
ITNET plc.
Member,
DTI's Industrial Development Board.
Member,
CBI President's Committee.

Peter Jay
Appointed 1 June 2003.

Trustee,
Oxfordshire Community Foundation.
Trustee,
Oxford Literary and Debating Union Trust.

Sir Brian Moffat, OBE
Appointed June 2000.

Deputy Chairman and Non-Executive Director,
HSBC Holdings plc.
Non-Executive Director,
NOSMAS Holdings BV.

Dr David Potter, CBE
Appointed 1 June 2003.

Chairman and Founder,
PSION plc.
Chairman,
Symbian Ltd.
Director,
Finsbury Technology Trust.
Member,
Council for Science and Technology.

Sir John Bond
Appointed 1 June 2001.

Group Chairman,
HSBC Holdings plc.
Director,
Ford Motor Company.
Director,
HSBC Bank plc.
Director,
The Hong Kong and Shanghai Banking Corporation Ltd.

Heather Rabbatts, CBE
Appointed 1 June 2003.

Managing Director,
4Learning@Channel4.
Non-Executive Director,
The Film Council.
Founder and Former Chief Executive.
Impower.

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.

Callum McCarthy
Appointed 20 September 2003.

Chairman,
The Financial Services Authority.

The Executive Team

Mervyn King,
Governor

Sir Andrew Large,
Deputy Governor,
Financial Stability

Rachel Lomax,
Deputy Governor,
Monetary Policy

Andrew Bailey,
Executive Director,
Banking Services and
Chief Cashier

Charlie Bean,
Executive Director,
Monetary Analysis and Statistics

Alastair Clark,
Adviser to the Governor

John Footman,
Executive Director,
Central Services

Nigel Jenkinson,
Executive Director,
Financial Stability

Paul Tucker,
Executive Director,
Markets

The diagram on the next page shows how responsibility for individual functions is delegated within the Bank. Each major function is headed by an Executive Director reporting to one or more Governors. The Governors and Executive Directors, along with Alastair Clark, who is an Adviser to the Governor, form the Executive Team, the Bank's senior management group, and this has replaced the former Governor's Committee and Management Committee. The Executive Team meets weekly, and other senior officials (for example the Finance, Human Resources and Communications Directors) join the meetings when matters within their areas of responsibility are discussed.

A more detailed overview of the main operational areas, and other management, is given on pages 14-15.

Management Structure

MERVYN KING
Governor

RACHEL LOMAX
Deputy Governor
Monetary Policy

Peter Rodgers
Director of
Communications

Clare Brady
Internal
Audit

ALASTAIR CLARK
Adviser to the
Governor

ANDREW LARGE
Deputy Governor
Financial Stability

CHARLIE BEAN
Executive Director
Monetary Policy

Monetary Analysis

Monetary & Financial
Statistics

Europe Co-ordination

Centre for Central
Banking Studies

PAUL TUCKER
Executive Director
Markets

Markets

JOHN FOOTMAN
Executive Director
Central Services

Clifford Smout
Finance Director

Louise Redmond
Human Resources
Director

Central Services

ANDREW BAILEY
Executive Director
Banking Services

Banking Services

Registrar's

NIGEL JENKINSON
Executive Director
Financial Stability

Financial Stability

Advisers to the Governor
Charles Goodhart (Financial Stability)
Malcolm Glover (Legal)
Mario Blejer (Centre for Central Banking Studies)

Organisation Overview

Monetary Analysis and Statistics

CHARLIE BEAN

Peter Andrews, Monetary Assessment & Strategy
Martin Brooke (from July), International Economic Analysis
Mark Cornelius, Inflation Report & Bulletin
Spencer Dale, Conjunctural Assessment & Projections
Neal Hatch, Structural Economic Analysis
Joanna Place, Monetary & Financial Statistics
Peter Westaway, Monetary Instruments & Markets

The Monetary Analysis (MA) 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 *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 (page 18), provides analytical information for the interest rate decisions taken each month by the 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.

Co-ordination Division for Europe

Stephen Collins
Paul Richards, Special Adviser

The Co-ordination Division for Europe is responsible for co-ordinating the Bank's relations with the European System of Central Banks (ESCB), the European Commission, and other EU institutions. This includes representing the Bank in a range of EU committees and providing expertise in relation to the Bank's role as a member of the ESCB. In addition, the Division co-ordinates contingency plans for possible UK euro entry, both in the Bank and in wholesale financial markets.

Centre for Central Banking Studies

Mario Blejer

The 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.

Markets

PAUL TUCKER

Paul Chilcott, Risk Management
Roger Clews, Special Adviser
Paul Fisher, Foreign Exchange
David Ingram, Special Adviser
David Rule, Sterling Markets

Sterling Markets Division conducts operations to establish short-term market interest rates at the level set by the Monetary Policy Committee, while meeting the liquidity needs of the banking system. Foreign Exchange Division manages the Bank's foreign currency operations; and, as agent, manages HM Treasury's foreign exchange reserves. These divisions maintain contingency plans for crisis operations. Drawing on a wide range of contacts in the UK and overseas, the area contributes market analysis and intelligence supporting the Bank's monetary and financial stability work. These divisions also seek to facilitate efficient structures in core wholesale markets. The Risk Management Division is responsible for measuring, monitoring and, with the front office, managing risks from the Bank's financial operations.

Central Services

JOHN FOOTMAN

CLIFFORD SMOUT, FINANCE DIRECTOR
LOUISE REDMOND, HR DIRECTOR
David Collins, Finance & Resource Planning
Michael Craig, Investment
Peter Higgs, Property Services
Chris Piper, Information Systems & Technology
John Trundle, Business Continuity
Andrew Wardlow, Secretary of the Bank

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 services. A new Business Continuity Division was formed at the start of 2004.

Internal Audit

Clare Brady

The Internal Audit Division provides an independent, objective assurance and consulting function to senior management under arrangements authorised by the Audit Committee on behalf of the Court of Directors. The Division examines, evaluates and reports on the adequacy of systems of internal controls and the effectiveness of risk management and governance processes.

Banking Services

ANDREW BAILEY

Lee Dobney, Notes
Chris Mann, Customer Banking
Geoff Sparkes, Registrar's
Alastair Wilson, Market Services

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.

Financial Stability

NIGEL JENKINSON

Ian Bond, Macro-Prudential Risks
Alex Bowen, Financial Stability Assessment
Peter Brierley, Special Adviser
Andrew Gracie, Financial Industry & Regulation
Andy Haldane, Market Infrastructure
Patricia Jackson, Special Adviser
Chris Salmon, International Finance

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.

Internally, a high level Financial Stability Board guides the work of the area, prioritising potential risks to UK financial stability, judging which warrant follow-up action and reviewing the progress made in mitigating the principal threats. The Board is chaired by the Deputy Governor for Financial Stability, Sir Andrew Large.

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. The area also contributes to the monetary policy process, and promotes public understanding of issues relating to financial stability through, for instance, the regular *Financial Stability Review*.

Review of Performance in 2003/04

The Bank's objectives for 2003/04 were set out in the 2003 Annual Report, and provided a framework for the Bank's activities during the year.

THE MONETARY POLICY OBJECTIVE

The Bank's first objective is to meet the inflation target set by the Government. The decisions of the Monetary Policy Committee, together with their analysis and forecasts, are published in the minutes of their meetings and in the *Inflation Report*, and are not covered further here. In terms of high-level outcomes, for the period March-December 2003, inflation was generally a little above the target for RPIX inflation of 2.5%, although it fell back from 3% in March and April to 2.5% in November. Under the new target measure for the Consumer Price Index (CPI – see below), inflation was below 2% over this period, averaging 1.4%. In the first three months of the new target, January to March 2004, CPI inflation was 1.3%.

SUPPORT FOR THE MONETARY POLICY COMMITTEE

The Bank's aim is to provide high-quality and comprehensive analytical support to the MPC. Within this, the most central task is, of course, the provision of a full range of high-quality briefing, analysis and research to support the monthly interest rate decision as well as the quarterly *Inflation Report* forecast round.

The basic processes now function smoothly, though relatively minor improvements and adjustments are made in response to

Members of the Monetary Policy Committee

Mervyn King

Sir Andrew Large

Rachel Lomax

Kate Barker

Charlie Bean

Marian Bell

Richard Lambert

Professor Stephen Nickell

Paul Tucker

MPC members' suggestions from time to time. Surveys of MPC members continue to indicate general satisfaction with the various inputs to the policy process. Arrangements for providing dedicated research support to individual members are also working well.

Topics that have required particular attention over the past year include:

- The change, from December, in the inflation target from 2.5% for RPIX to 2% for CPI. These measures differ in a number of ways: for instance housing depreciation and Council Tax are included in RPIX but excluded from CPI, and different methods are used in aggregating the constituent prices. The change in the target measure of inflation, and the associated change in the target itself, represent a change in the metric used to measure inflation rather than a substantive change in the objectives of monetary policy.

- Developments in the housing market and household borrowing. Understanding the relationship between high house-price inflation and high rates of household borrowing, and to what extent they are likely to pose a threat to future macroeconomic and price stability, has been a focus of work in Monetary Analysis and Financial Stability, as well as the External MPC Unit.

- Revisions to the National Accounts data connected with the introduction of chain-weighting and the uncovering of substantial VAT fraud affecting the trade statistics. Significant upward revisions to GDP around the millennium and changes in the composition of demand had implications for the Bank's assessment of the underlying level of potential output and the associated margin of spare capacity in the economy.

The major development was the introduction of a revamped quarterly macroeconomic model (BEQM). The purpose of the change is three-fold: to close some of the "missing links" in the previous medium-term macroeconomic model; to articulate the underlying economic structure better; and to identify separately expectations variables within key relationships. In so doing it is intended that the model will better match the conceptual framework of the Committee and prove to be a more flexible tool for articulating debates between members.

The revised model was used internally in parallel with the previous model in the February and May 2003 forecast rounds in order to gain experience within Monetary Analysis and to test the software. It was run "live" for the first time in the August 2003 round, with the models used in parallel in both the August and November 2003 rounds.
Professor Adrian Pagan, whose review of the Bank's forecast methodology was described in last year's *Annual Report*, has been invited to report on the operation of the new model. This will be completed during the Summer.

MPC members agreed broad themes for long-term research in 2003/04, which staff then elaborated into a specific research programme. That programme is on track.

EDUCATION AND PUBLIC UNDERSTANDING

The Bank aims to build and enhance public understanding of its monetary policy role and objectives through its education programme. Some 18,000 visitors to the Bank's museum have seen the audio-visual presentations on offer in its cinema, including over 160 school groups. The annual economics competition for schools and colleges – renamed Target Two Point Zero – which asks students to take on the role of the Monetary Policy Committee, attracted 236 entries in its fourth year, compared with 219 in the previous year. The winning team came from Highgate School in London. The competition continues to encourage interest in economics and improve understanding of monetary policy and the role of the Bank.

The Bank has continued, through speeches, publications and an education programme, to promote the case for price stability and understanding of the current framework. Governors and other MPC members have given evidence on a number of occasions to the Treasury Select Committee of the House of Commons and to other Parliamentary Committees.

Review of Performance in 2003/04 continued

Regional Agents

Chris Bailey,
South East & East Anglia

John Bartlett,
West Midlands

Chris Brown,
East Midlands

David Buffham,
North East

Kevin Butler,
South West

Phil Eckersley,
Northern Ireland

Wendy Hyde,
London

Adrian Piper,
Wales

Mark Pratt,
Yorkshire and the Humber

Tony Strachan,
Scotland

John Whitley,
Central Southern England

John Young,
North West

The *Inflation Report* and the MPC Minutes are the Bank's major regular publications on the operation of the policy framework. The Bank hosted an international conference on modelling techniques and approaches in March at which the revised quarterly model was publicised to an audience of policy-makers and academics. An article describing the model is in preparation for the *Quarterly Bulletin*, and in due course a book will appear describing it in greater length.

The Bank's regional Agents (above) play an important role in promoting understanding of the Bank's work as well as inputting to the MPC decisions. All of the MPC members have a full programme of regional visits and the new Governor has started a programme of monthly regional visits.

Since 2001 the Bank has commissioned and published opinion polls intended to measure public perceptions of the monetary policy process. The questions cover expectations of price and interest rate changes, perceptions of the impact of inflation and interest rate changes on the economy and the individual, perceptions of the relationship between interest rates and inflation, knowledge of who sets interest rates and satisfaction/dissatisfaction with the way the Bank is doing its job of setting interest rates. In February 2004, the net satisfaction index – the proportion satisfied with the way the Bank is doing its job minus the proportion dissatisfied – was 44%, very similar to the figures recorded in each of the previous six quarterly surveys, even though the latest survey followed two rises in interest rates. Interpretation of the numbers requires some caution, and the Bank's concern in the poll is anyway to assess the extent to which its price stability role is understood rather than to explore public support for its actions.

RISKS TO FINANCIAL STABILITY

Through the Financial Stability and Markets areas, and with the support of the Governors, the Bank has maintained a strong surveillance capacity over the past year.

The focus of surveillance has been sharpened to concentrate on the key risks to financial stability, and changes in those risks.

To help guide decisions on priorities, a new Financial Stability Board, chaired by Sir Andrew Large, has been created: it comprises FS senior management together with high-level representation from the Markets and Monetary Analysis areas of the Bank. That Board first met in March 2004, and will meet on a monthly basis in future. The Board has three principal functions:

- To review potential risks to financial stability in the United Kingdom, to prioritise them in terms of the scale of the threat they pose and to judge which warrant follow-up action.
- To review periodically the progress achieved in mitigating the principal threats to UK financial stability identified previously by the Board. For each major threat, to recommend whether action is necessary or whether the measures taken are sufficient.
- To consider major policy issues affecting UK financial stability and to propose the Bank policy line.

Liaison with HMT and the FSA centres on the regular monthly meetings of the Tripartite Standing Committee on Financial Stability. The Bank has produced a range of focussed papers for the Committee.

The Bank's **payments system oversight** work is now reported regularly in the *Financial Stability Review*. The mechanics of oversight have been improved through a number of initiatives: the regular series of oversight meetings has been extended to include the internal and external security auditors of key domestic payments systems; and relationships have been established with key external suppliers to payments systems, such as the new BACS infrastructure company. An active contribution has been made to the expansion of the Continuous Linked Settlement system to reduce foreign exchange settlement risk, as well as to work on the Basel Committee on Payment and Settlement Systems on the design of large-value payments systems. The Bank is also working closely with The London Clearing House (LCH) and CRESTCo to reduce payments risk.

Together with the FSA, the Bank is actively involved in the negotiation of a new international agreement (the Basel 2 Accord) to update arrangements for **prudential capital standards** in financial institutions, led by the Basel Committee of Banking Supervisors. The Bank chairs two subgroups responsible for the overall calibration of the Basel Standards. A Quantitative Impact Survey was co-ordinated across the G10 by the Bank, producing results that were well received by the Committee and which form an important input to the calibration of the Accord.

In 2002 the IMF introduced the **exceptional access framework** which the Bank had actively promoted. Over the past year the Bank has worked on measures that could be used to improve the accuracy of the assessment: an example is the article on debt sustainability in the December FSR. The Bank has also participated in discussions on a possible Code of Conduct governing debtor/creditor relations. In addition, the Bank has monitored emerging market bond issuance practice for adherence to the G10 model collective action clauses produced in September 2002, which are designed to support the orderly resolution of financial crises.

Review of Performance in 2003/04 continued

SMALL FIRM FINANCE

Since the early 1990s, the Bank has monitored the relationship between small firms and the banks and other sources of finance. When this work started these relationships were poor, partly for cyclical reasons although there were also important structural questions. The Bank consulted extensively with those involved, and published a series of Annual Reports on small firm finance, with additional reports on special topics including finance for technology companies and (at the Government's request) financial exclusion.

Since this work started there has been a substantial improvement in the range of facilities and other support available to smaller firms, both from the financial sector and from Government and regional agencies. Data sources have also improved. The background was set out in the 11th Annual Report on small firms' finance, published in April 2004, and the Bank has decided that with that Report its formal involvement in this area of work should cease. Contacts with the small firm sector continue though the Agents, and the Bank monitors the corporate sector as a whole for monetary and financial stability purposes. Banks, trade associations, government agencies and academic researchers are all now closely involved in the specific institutional issues, and are carrying on the work with which the Bank has been concerned.

BANKING AND MARKET OPERATIONS

A review of the way the Bank conducts Sterling **Open Market Operations** (OMOs) in support of monetary policy has been announced and a consultation paper is in preparation.

In June 2003, the Markets area, acting as the Treasury's agent for managing the official foreign currency reserves, organised the UK's first **foreign currency debt issue** for seven years. The five-year dollar eurobond was lead managed by Citibank, Deutsche, Goldman Sachs and Morgan Stanley, and was issued three basis points through the US Treasury yield curve and 33 basis points through LIBOR, some 13 basis points cheaper than financing the reserves via sterling. The operation reinforced the Markets area's experience in capital markets, deepening its range of contacts and so significantly enhancing its market intelligence network, which is itself a major strategic goal of the Markets area.

The launch of the **new core banking system** at the end of July very quickly led to serious operational problems. The background was reviewed in Audit Committee and Court, and the lessons are being reflected in the new project management framework for the Bank being developed by Rachel Lomax (page 21).

At present the system is operating with many manual workarounds. A relaunch project has been approved and is under way, with the aim of establishing robust straight-through processing and associated on-line links for customers.

The sale of the **Note Printing Operation** to De La Rue (DLR) was reported in last year's *Annual Report*; it was completed at the end of March 2003. The key success criterion for the Bank was to obtain an agreed supply of banknotes to the required quality and delivery schedules. This has been achieved.

The process for placing annual and quarterly orders for new notes under the new supply contract is fully bedded in. High levels of new note stocks in 2003 put the Bank in a position to be flexible about the timing of deliveries of new notes in order to facilitate the production of the new Iraqi currency at the Debden site.

The Bank is continuing to address the **quantity and quality of £5 notes** in circulation, which has attracted some public comment. Large volumes of new £5 notes have been made available to financial institutions and the Post Office for issue through normal channels, and the withdrawal of the old Stephenson note was announced in August. These measures have improved average quality, but quantities of £5 notes in circulation are determined by the rate of issue to users. About 50% of cash acquired by users is now issued through ATMs, the overwhelming majority of which are stocked with £10 and £20 notes only; and the proportion of cash issued through ATMs is forecast to rise to nearer 70% over the next 5 years, largely as a result of the introduction of direct payment of state benefits.

At the start of 2003 the older variants of both the £5 and £10 notes were still legal tender. Both designs were more heavily **counterfeited** than their replacements, which have the same level of security as the current £20. Legal tender status was withdrawn from the old £10 Dickens in July and from the £5 Stephenson in November.

Throughout the year, and alongside work to develop and pursue HM Treasury's strategy for modernising the arrangements for future **gilts registration and transfer**, the Registrar's Department in Gloucester has continued to provide a high-quality and cost-effective gilts registration service. The pursuit of a strategy for the migration of the stock registers to the new provider of registration services has occupied the Department for much of the past year. The issue of the Treasury's consultation paper, in November 2002, led to support being required for the formal tender process initiated by HM Treasury, with the issue of an "Invitation to Tender" (ITT) document in early August 2003, the subsequent selection of a 'preferred bidder' and the commencement of contract negotiations and migration planning. Whilst the new strategy was being pursued, Registrar's continued to offer a registration service not only to the British government but to some other parties, including some non-British governments and a small number of Local Authorities. These registers will also be migrated in the same timescale as the gilts register to a new registrar of the issuer's choosing. The Department has also continued the operation of an execution-only postal brokerage service to facilitate the buying and selling of gilts by the retail sector. The migration plan envisages the transfer of gilt registration to the new provider in December of this year.

BUSINESS PROCESSES AND CONTINUITY PLANNING

Within the Central Services area, a number of initiatives to improve business processes have been taken. These include:

- **Project Management:** following a review in 2003 a new approach to project authorisation, management, support and review has been agreed, with a new oversight Committee under Rachel Lomax. The Committee, and project managers across the Bank, will be supported by a new Project Support Unit.

- **Risk Management:** Sir Andrew Large is establishing a new Business Risk Committee that will oversee the process by which risk standards in the Bank are agreed and monitored. A new Risk Standards Unit has been created in the Finance area of the Bank.

- **Bank-wide information management:** the evolution of IT-based systems, including electronic document management, has created a need for central facilities to enable the Bank to manage, protect and access its information base. The requirements of business continuity, risk management and the Freedom of Information Act all point in the same direction. A new Head of Information has been appointed to lead this work.

During the year the Bank continued to enhance and test its business continuity arrangements. At the start of 2004 the Business Continuity Unit was combined with elements of Financial Stability to become a Division, covering both internal preparations and City-wide issues. The new Division is working closely with the FSA and HMT to promote and support improved business continuity planning within the financial sector. In addition, Sir Andrew Large chaired a government-sponsored Task Force examining the need for new statutory powers to help deal with major operational disruption in the financial services sector. Recommendations were published in the final report in December.

PERSONNEL AND EMPLOYMENT POLICIES

At the end of February 2004 the Bank employed 1,732 full-time staff and 176 part-time staff. Over the year, the number of staff fell by 244. During March 2003, some 240 Printing Works staff transferred to De La Rue plc following the decision to outsource the printing of bank notes. The remaining Debden staff employed by the Bank undertake facilities management and cash centre roles.

Nearly half of the 25 redundancies in 2003/04 related to the continuing reorganisation of the Bank's banking operations. A total of 113 staff have been made redundant as a result of this restructuring since March 2000. Other redundancies

Review of Performance in 2003/04 continued

related to changing working practices, mainly in the Central Services areas of the Bank.

The Bank recruited 161 staff in 2003/04. 33 new graduates joined during the year; 30 joined the main banking staff (2002/03: 43) and 3 joined the IT specialist group.

Partly reflecting a lower resignation rate, the demand for new experienced and specialist staff has reduced somewhat. 29 mid-career staff were recruited, of which 8 were PhD level entrants (2002/03: 38). The majority were economists for the Financial Stability and Monetary Analysis areas of the Bank. Other areas (including Internal Audit, Customer Banking, Finance, Information Systems & Technology, Notes, Property Services, Secretary's and Risk Management) recruited professionally qualified and/or experienced specialists to fill specific vacancies.

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 via courses, the Intranet and a newly introduced CBT package. Staff 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, and takes part in benchmarking surveys for both gender and race.

The Bank continues to operate a range of policies to help staff balance work and family responsibilities, including paid time off for family emergencies and part-time and flexible working.

The proportion of women managers continues to increase, albeit slowly, and is currently 23.3% of the total. However, women occupy few of the most senior posts. A major research study of gender outcomes was undertaken this year and presented to Court. This is likely to prompt further policy initiatives.

The percentage of staff from ethnic minority backgrounds remains static at 6% but the "diversity" of Bank staff continues to increase largely due to the number of recruits from the EU; currently 19% of Bank analysts are foreign nationals.

The Bank uses the Department of Employment's "Positive about Disabled" symbol, which guarantees an interview to a disabled applicant meeting minimum job criteria. Where necessary the Bank provides specialist training and equipment to all staff with disabilities. This year the Bank has been concentrating on compliance with the Disability Discrimination Amendment Act ensuring access for all to the building.

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.

A further **staff opinion survey** was conducted at the end of 2003 and results were published to staff in early 2004. On almost all measures, the results were more positive than the previous surveys in 2001 and 1995. Staff are proud to work for the Bank and value the training and development opportunities available although, as previously, the fairness of the reward and promotion systems continues to be viewed more negatively. The high level of overall employee satisfaction with the Bank as an employer now compares favourably with financial services benchmarks.

In December 2003 a **gym** was opened for staff, providing a range of fitness equipment and exercise classes, alongside the existing occupational health facilities. By the end of the financial year membership was 35% of eligible staff, well on course to meet the 50% target by February 2005.

The main incremental objective during the year was to continue rebuilding the Bank's **career development**, training and succession planning function. The appointment of a new HR Director from the commercial sector is intended to give a new focus to manpower and succession planning, and to improve career development, induction and training provision across the Bank. A new strategy for HR will be a key part of the Central Services review.

Community Involvement

The Bank participates in a number of Education Business Partnership (EBP) activities in Greenwich, Hackney, Islington, 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 pupil mentors. A number of managers are matched with headteachers on the Partners in Leadership programme and some members of staff have become school governors. The Bank regularly offers work experience placements to partner schools in Hackney and Tower Hamlets, and summer placements to students taking part in the Corporation of London Business Traineeship Programme, London First and Greenwich Education Business Partnership schemes.

The Bank recognises the positive impact that a community programme can have on the development of its own staff. The Bank supports staff who take on community positions, such as trustees or board members, youth leaders and magistrates.

During 2003/04 the Bank contributed £757,000 in support of its community programme (2002/03: £755,000). This covered donations to charities and academic research, and the cost of other contributions to community-related activities. Donations in cash totalled £521,000 (2002/03: £495,000), while the cost of other community contributions, including time spent by staff on community involvement activities, was £236,000 (2002/03: £260,000). Donations to academic research amounted to £80,000 (2002/03: £60,000). An exceptional donation of £500,000 was made to the Houblon-Norman-George Fund for economic studies.

FINANCE AND PROPERTY

In accordance with the Bank's property strategy, now that the refurbishment of office space within the Head Office building is complete, other central London properties – Bank Buildings, Eagle House and 123 Minories – are being vacated. As a consequence options for the disposal of Bank Buildings and the lease on 123 Minories are now under consideration.

Following the receipt of planning permission for the Lawn Tennis Association to construct a National Tennis Centre on land at the Roehampton site, the sale of a 125-year lease for 25% of the site to the LTA for £9 million is expected to be completed shortly. The remainder of the site is occupied by the Bank's sports centre and the former Records Office, much of which has been let.

The Bank's Strategy and Objectives

Court sets the Bank's strategy and objectives, including its objectives for financial management. Since July 2003 a fundamental review of the Bank's strategy has been in train and this will not be complete until later this year. In the meantime Court has agreed a transitional strategy and a budget for 2004/05.

THE BANK'S CORE PURPOSES

The Core Purposes form part of the objectives and strategy of the Bank determined by the Court under Section 2 of the Bank of England Act 1998. They are reviewed each year, but have in practice changed little since they were first formulated in 1990, and not at all since 1998. The Core Purposes define the Bank's overriding objectives, and formed an obvious and necessary starting point for the strategy review.

As published in last year's *Annual Report*, the Core Purposes (in their most abbreviated form) were – (a) Maintaining the integrity and value of the currency, (b) Maintaining the stability of the financial system, both domestic and international and (c) Seeking to ensure the effectiveness of the UK's financial services.

The integrity and value of the currency clearly lies at the heart of any definition of central banking. The monetary stability objective is incorporated into the Bank of England Act, and the monopoly note issue function is also regulated by statute. There is thus no question about the continuing validity of this function as a core purpose of the Bank. The objective of securing financial system stability is conventionally based on the Bank's position as sole provider of system liquidity and its role at the heart of the payments system, and was recognised in the 1997 Memorandum of Understanding between the Bank, the Treasury and the Financial Services Authority.

It has proved difficult in practice to identify many strands in the Bank's work that are not reasonably closely related to the monetary and financial stability objectives. The Bank has over the years undertaken a number of initiatives to promote the effectiveness of the financial system – building settlement systems for gilts and money market instruments, for example – but most of these have had at least as much to do with reducing risk in the system, or improving the markets through which monetary policy is implemented, as with promoting any wider goal relating to effectiveness, efficiency or competitiveness. And the competence to take such initiatives forward has generally derived from the Bank's experience in and knowledge of the core money and credit markets – the markets in which a central bank most naturally operates.

The Bank has nevertheless on occasion undertaken tasks that are less closely associated with the core central banking functions, generally to correct a perceived market failure or to provide a neutral forum in which market participants can be helped to resolve differences. The Bank's recent efforts to improve the market for small firm finance (page 20) has been seen as falling into this category.

Such interventions do not themselves form a core purpose of the Bank. Court has however taken the view that the Bank should be prepared to intervene – typically for a limited period – in areas in which it has clear locus, expertise and authority, and this is indeed consistent with the Bank's policies over the past decade or more.

The revised Core Purposes, which are shown on page 7, reflect these conclusions.

INTERIM OBJECTIVES FOR 2004/05

Within each of the main business areas of the Bank strategic reviews are in train. These are described briefly in the Governor's Foreword, and will be drawn together in the summer, to form a basis for the Bank's strategy and budget for 2005/06. In the meantime the budget set for 2004/05 was based on interim objectives. These are:

- Continued provision of a high standard of support for the MPC.
- Development of a more focussed research programme into issues relevant to the MPC.
- Continued work to promote understanding of the MPC's remit and its processes.
- Development of the Financial Stability work under the new Financial Stability Board.
- Concluding the Bank's work on small firm finance.
- Relaunching the Bank's core banking system.
- Delivering a high standard of professionalism across the Banking and Market functions.
- Further development of market intelligence functions.
- Taking forward a market consultation on the conduct of Open Market Operations.
- Continued improvement in the Bank's Business Continuity arrangements and their integration with financial sector plans.
- Introduction of new approaches to the approval and monitoring of projects, and for setting and monitoring risk standards.
- Continued enhancement, under the new HR Director, of the Bank's career development and succession planning functions.

These may be modified in the light of the evolving strategic review, but the outcome of that will be fully reflected in the budget for 2005/06.

Financial Framework for 2004/05

BUDGET FOR 2004/05

As set out earlier in this *Report*, the Bank is developing a strategy to cover the next five years, incorporating detailed plans for its main business areas – Monetary Analysis, Markets, Banking Services and Financial Stability – and for the central services that support them. This strategy will form the foundation for the Bank's budget in future years and for its investment plans more generally. But until this work has been completed the budgetary focus is necessarily on the short term – ie on 2004/05 – and the budget presented here should be viewed in that light.

For 2004/05, Court has agreed an expenditure budget (excluding BCCI legal fees) of £225.1 million, an increase of £1.8 million, or 0.8%, over the budget for 2003/04. Within this total, operating expenses are budgeted to rise by £7.5 million to £209.6 million, but almost half of this increase merely reflects changes in budgetary assumptions for staff turnover, which feed into the projections for aggregate staff costs. The budget for revenue spending on investment projects is sharply lower, at £15.4 million compared with £21.1 million, with such spending being reassessed, and where appropriate postponed until the new Bank-wide strategy is finalised.

Bank Expenditure Budget

			£m
	2003/04 Budget	**2003/04 Outturn**	**2004/05 Budget**
Business areas			
Banking Services[1]	74.3	*70.7*	74.1
Monetary Analysis and Statistics[2]	23.6	*22.6*	24.6
Markets	17.1	*14.9*	14.3
Financial Stability[3]	13.2	*12.4*	13.0
	128.2	***120.5***	**125.9**
Central Services[4]			
Property Services and Security	34.3	*31.8*	32.6
Personnel, Internal Audit, Finance, IT and Secretary's	34.8	*35.8*	41.3
	69.1	***67.6***	**73.9**
Depreciation, VAT etc	26.0	*28.1*	25.2
Total of above	**223.2**	***216.2***	**225.1**
BCCI legal fees (incl VAT)	21.2	*21.0*	21.2
Total expenditure	**244.4**	***237.2***	**246.2**

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

1 Includes Registrar's and Printing Works.

2 Includes Statistics and Centre for Central Banking Studies.

3 Includes the Co-ordination Division for Europe.

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 26, in which the Bank's work has been grouped by main business area. With project spending sharply lower in the Banking and Markets areas, the overall increase is concentrated within Central Services, and reflects initiatives designed to strengthen the Bank's capacity in project and risk management, internal audit, business continuity, and knowledge management. In Banking, operating costs are some £2 million higher as a result of additional resources being devoted to improvements in the control environment, but in terms of overall spending these increases are offset by reductions in project spending.

ACTUAL SPENDING IN 2003/04

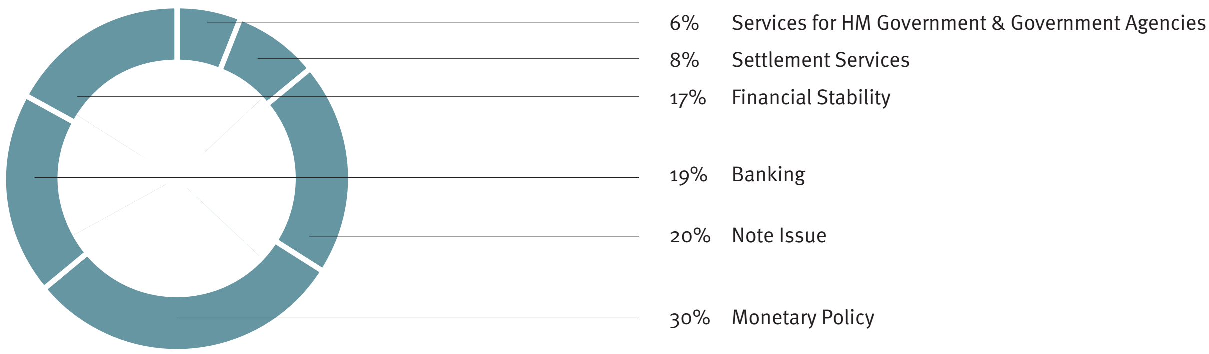
Total spending in 2003/04 was £7 million below budget, reflecting postponement or cancellation of projects in Banking Services, Markets and Property. In the light of these delays, which have been a feature of the past few years, the Bank's budgeting methodology has been adjusted so that the projections for investment for the coming year are now reviewed more critically. This process is intended to take greater account of the constraints on the Bank's capacity to undertake a large number of projects involving significant business process change at the same time.

In contrast to project spending, operating expenses were slightly above budget in 2003/04. This chiefly reflected an underestimate of staff costs (with fewer higher-paid employees leaving than had been assumed); as noted earlier, these estimates have in consequence been revised in the budget for 2004/05. Despite additional costs associated with remedial work on the new banking systems, operating expenses in Banking were within budget.

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 expenditure stemming from monetary policy analysis and its implementation includes contributions from Markets and the Press Office in Secretary's Department, as well as that recorded by Monetary Analysis and Statistics. The chart below shows the distribution of the Bank's budgeted costs for 2004/05 on a functional basis, with overheads fully allocated to functions. These percentages are similar to those shown for previous years, although there has been some reduction in the relative importance of note issue

Budgeted Costs of Functions 2004/05



Financial Framework for 2004/05 continued

costs, reflecting continuing improvements in the efficiency of the note production and distribution process.

MEDIUM-TERM SPENDING PLANS

The chart below shows the trend in the Bank's expenditure since 1996 and the expected path for the coming year. Given the strategy review, no projections are given for the years beyond 2004/05; projections for a number of years ahead will be provided next year, once the review has been completed.

CASH RATIO DEPOSITS AND THE FINANCIAL FRAMEWORK

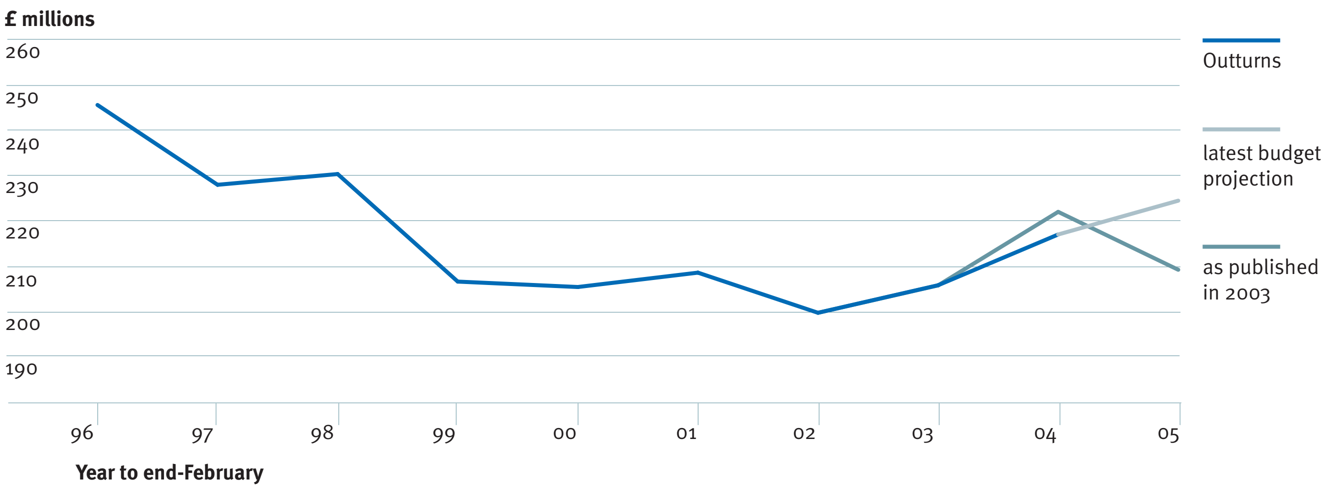
In planning its finances in the medium term, the Bank takes into account its available income. This comes from three principal sources: fees and charges to its banking and government customers, the income from the investment of its capital and reserves, and the investment of Cash Ratio Deposits.

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.

The CRD scheme was reviewed during 2003, five years after it had been placed on a statutory footing. The review concluded that:

- the scheme continued to be a suitable method of funding the Bank's sterling liquidity, monetary policy and financial stability operations;
- the "cash ratio" should remain at 0.15% of eligible liabilities, but that this be kept under review during the operation of the scheme;
- the minimum threshold for making deposits should be raised from £400 million to £500 million, as measured by eligible liabilities;
- there should be a further review of the scheme within the next five years; and
- the transparency of the scheme should be enhanced where possible, for instance by publishing a more detailed breakdown of expenditure by function. Such a table is provided on the following page.

Bank Expenditure 1996-2005
(excluding BCCI costs from 2001/02)



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. The review of the CRD arrangements noted that over the period from March 2003 to March 2008, the investment yield on an accruals basis was expected to average around 6%, assuming that investment and accounting policies remained unchanged.

Market yields are significantly lower than 6%, but the Bank's income on its investments is accounted for on an accruals basis, with yields calculated in this way lagging market yields. Nevertheless, this effect is unwinding as the gilts in question mature, and Court will therefore continue to keep the adequacy of CRD income under review. Indeed, if these funds (averaging £1,740 million in the past year) had been invested at the Bank's repo rate, it would have implied an annual income of only £64 million in 2003/04, rather than the £106 million shown below.

From the table below it can be seen that CRD-related income (calculated on an accruals basis) and expenditure are expected to remain close to balance in the coming year. This is on the assumption used in the review, that CRDs will grow at 4.5% from now on, a rate that is assumed to be broadly in line with that of nominal GDP.

Bank Expenditure Budget by Function

			£m
	2002/03 Actual	2003/04 Actual	2004/05 Budget
Function			
CRD-related			
Monetary Policy	64.9	*65.2*	65.9
Financial Stability and Other	34.3	*41.1*	45.4
Total CRD-related expenditure	**99.2**	***106.3***	**111.3**
Government			
Note Issue	50.5	*44.9*	44.9
Other Government	12.0	*12.4*	13.8
Government (including Note Issue)	**62.5**	***57.4***	**58.7**
BCCI Legal Fees	**13.5**	***21.0***	**21.2**
Banking & Settlement Services and Other[1]	**45.6**	***52.4***	**55.1**
Total Expenditure by Function	**220.8**	***237.2***	**246.2**
Memo item:			
CRD-related income	**105.3**	***106.1***	**110.9**

1 Includes any differences between cost accounts (on which these figures are based) and financial accounts, relating to the amortisation of revenue spending in investment projects.

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 the relevant labour market supply and demand factors and individual performance. In addition to recommending salary levels, the Committee may recommend the payment of bonuses as a means of rewarding special services or personal performance. In proposing salary and bonuses, the Committee takes appropriate account of both internal and external salary comparisons in so far as these bear upon the supply of and demand for the requisite skills. Where relevant, the Committee commissions external advice on the levels of pay and benefits in the light of the above criteria. However, in advising Court on remuneration at senior levels within the Bank, it also bears in mind the Bank's position within the public sector. When a new appointment is made, the Committee also considers the pension benefits to be provided. 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 are:

Base salaries

The Governor, Mervyn King, is serving a five-year term which began on 1 July 2003; he succeeded Sir Edward George, who retired on 30 June 2003. Mr King's salary on appointment was set at £263,317, a 2½ % increase on the salary of his predecessor in the previous year. The Governor's remuneration is customarily reviewed each year on the anniversary of his appointment.

The Deputy Governors' salaries have been set in line with the remuneration 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 non-salary benefits received during the year to 29 February 2004.

The table of emoluments on page 31 includes payments by the Bank of tax due in respect of notional benefits of travel on Bank business. These arise because of the Inland Revenue's practice of treating travel by spouses/partners accompanying a Governor or Deputy Governor on official business as a taxable benefit. The presence of a spouse/partner on certain official business is regarded by the Bank as necessary and accordingly the Bank, under a PAYE Settlement Agreement with the Inland Revenue, 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 page 32.

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 remunerated 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.

Remuneration of Members of Court

	Salary £	Benefits £	Total 2004 £	*Total 2003 £*
Governors				
Governor				
Sir E A J George				
(term expired 30 June 2003)	85,631	832	86,463	*259,363*
Mr M A King				
(Deputy Governor until 30 June 2003)	247,766	535	248,301	*212,608*
Deputy Governors				
Sir A M B Large	216,667	1,257	217,924	*106,322*
Ms J R Lomax				
(from 1 July 2003)	144,445	506	144,951	*–*
Mr D C Clementi (Note i)	–	–	–	*159,381*
Non-executive Directors				
(Note ii)	77,500	383	77,883	*77,900*
Total	**772,009**	**3,513**	**775,522**	***815,574***

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 on 31 August 2002 of his term of office as Deputy Governor. He accordingly delayed taking up certain outside appointments and in consideration of this his Bank remuneration continued for three months from the end of his term.

ii Mr Callum McCarthy has been a member of Court since 22 September 2003 in his capacity as Chairman of the FSA; his predecessor, Sir Howard Davies, was similarly a member of Court until 19 September 2003. The Bank's Deputy Governor, Financial Stability (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 £2,800 due from the Bank and Mr McCarthy waived remuneration of £2,200. Sir Andrew Large waived £20,000 due from the FSA.

Remuneration of Governors, Directors and MPC Members continued

PENSIONS OF THE GOVERNOR AND DEPUTY GOVERNORS

The Court Pension Scheme, in which the Governors participate, is a non-contributory occupational pension scheme. Executive Directors are also members of the scheme. The normal retirement age is 60, and the accrual rate 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 pensionable 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 29 February 2004, unfunded entitlements were provided for Mr King, Sir Andrew Large and Ms Lomax. Provision for these unfunded benefits is made in the Bank's financial statements.

Pension Entitlements and Accruals (including unfunded entitlements)

	Accrued pension as at 28.2.03 (£pa)	Accrued pension as at 29.2.04 (£pa)	Increase in accrued pension (£pa)	Transfer value as at 28.2.03 (£)	Transfer value as at 29.2.04 (£)	Increase in transfer value (£)
Sir E A J George (Note i)						
Joined 2 July 1962	6,800	7,400	600	128,500	131,000	2,500
Mr M A King						
Joined 1 March 1991	97,800	110,100	12,300	1,680,500	1,962,200	281,700
Sir A M B Large						
Joined 3 September 2002	3,000	10,200	7,200	48,200	174,200	126,000
Ms J R Lomax						
Joined 1 July 2003	–	4,800	4,800	–	82,000	82,000

Notes

i The previous 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, Sir Edward's pension entitlement was £168,000 per annum. Under the Court Pension Scheme, his remuneration became non-pensionable on his 60th birthday and, accordingly, no further pension entitlement under this scheme accrued, although to reflect deferment the pension increased each year until drawn. Court granted Sir Edward an additional ex-gratia unfunded pension, to reflect his service from his normal retirement date, which comprised the difference between the £168,000 per annum referred to above and two-thirds of his final salary on retirement. This further entitlement accrued over his second term of office and provision for its cost was made over this period. At his retirement on 30 June 2003 an additional entitlement of £7,435 per annum had thus arisen.

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 remuneration arrangements of these members of the MPC.

The four members of the MPC appointed by the Chancellor are paid £145,672 (2003 £141,429) per annum, pro rated for the number of days worked per week. They are appointed for terms of three years. Christopher Allsopp's term expired on 31 May 2003, and he was succeeded by Richard Lambert; Professor Nickell's term also expired on that date, and he was appointed for a further three-year term. Ms Barker and Professor Nickell work in the Bank four days a week, and Mr Lambert 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. 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.

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 £155,289; and Charlie Bean's is £158,981. Both are eligible for the Bank's normal range of benefits, including non-contributory pensions.

Report from Members of Court

PRINCIPAL ACTIVITIES AND REVIEW OF OPERATIONS

The Bank's Core Purposes are set out on page 7. The Governor's Foreword, the Review of Performance 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 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. The Issue Department and the Banking Department are accounting designations – neither is an organisational unit of the Bank.

Banking Department

In preparing the financial statements of the Banking Department, the Bank, under the Bank of England Act 1998, is subject to requirements corresponding to those of the Companies Act 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, in particular with regard to the limitation described below. 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 Act 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 29 February 2004 are given on pages 46-79, and show a profit after provisions and before tax of £72 million (2002/03 £89 million). The decrease in profits compared with last year is in part due to legal fees relating to the BCCI case. After payment in lieu of dividend of £30 million (2002/03 £34 million) and a tax charge of £12 million (2002/03 £21 million), the profit transferred to reserves amounts to £30 million (2002/03 £34 million).

The statements of account for the Issue Department (which are given on pages 80-82) show that the profits of the note issue were £1,234 million (2002/03 £1,239 million). The change 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 29 February 2004 around £1.4 billion of Banking Department's assets comprised sterling money market refinancing provided through the Bank's open market operations (2003 £1.5 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.

On 29 January 2004, the first of the Bank's 3-year Euro denominated Notes (originally issued in 2001) matured. Over the financial year the Bank auctioned the €1,000 million second tranche of the Note maturing on 27 January 2006. In addition the Bank also created €2,200 million of Euro Notes maturing on 29 January 2007, for issue via auction. The first €1,000 million was auctioned on 20 January, with the auction of the second €1,000 million tranche taking place shortly after the end of the financial year, on 16 March. The proceeds of the issue of the Notes have been invested in foreign currency assets together with related swaps so as to minimise exposure to interest rate and currency risk.

As mentioned in last year's *Annual Report*, 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 and associated swaps, financed by the Euro Bills, has been made available for active management and therefore 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 has been adopted in the financial accounts of the Banking Department for 2003/04. The net effect of the change on 1 March 2003 was a reduction in the value of the portfolio of £4 million. The remaining securities, funded by the Euro Notes, continue to be accounted for on an amortised cost basis.

The nature of the Issue Department balance sheet remains as in previous years, but the footings have increased due to a rise in the note circulation. The matching assets remain similar to previous years and include 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

On 1 May 2004, the Bank subscribed further capital of €16.1 million to the European Central Bank, as a contribution to the increase in the European Central Bank's costs caused by the accession of ten new countries. This accession has also led to a realignment of the shareholdings in the capital of the European Central Bank of existing member countries. The Bank's shareholding decreased from 15.9764% to 14.3822% as a result of this change.

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 21-23.

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 £16 million in April 2003 and £18 million in October 2003 in respect of the year to 28 February 2003. In April 2004 the Bank paid the first payment of £14 million in respect of the financial year ended 29 February 2004 which was based on provisional figures. The balance of £16 million will be paid on 5 October 2004.

Report from Members of Court continued

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 8-11.

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 pages 13-15, 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 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 Management Division (RMD) formerly the Risk Analysis and Monitoring Division, 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 38-39, as required under FRS 13.

vii A procedure, supported by the maintenance of a Bank-wide risk and controls framework, 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 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.

As reported elsewhere in the *Annual Report*, the introduction of a new banking system in July 2003 encountered problems. Although neither the Bank nor its customers incurred significant losses, the Bank incurred costs in rectifying the position. The Bank has reviewed the lessons to be learned from this in terms of project management and procedures. Audit Committee, on behalf of Court, has been particularly involved in this process.

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 29 February 2004 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 in so far 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.

THE ENVIRONMENT

The Bank monitors the impact on the environment of its operations, which is mainly through the use of power and the generation of waste material. It tries to minimise its impact through better use of its premises (as described elsewhere in the Report), using increasingly power-efficient equipment and the use of recycled materials.

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 any political interests supported in this way. Details of charitable donations are set out on page 23.

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% (2003 99%) of its bills within these timescales.

The Bank estimates that the average trade creditor payment days for 2003/04 were 17 (2002/03: 17). 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.

Report from Members of Court continued

Risk Management

This section describes the management of risks at the Bank of England. The Bank runs various types of financial 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 last is covered at the end of this statement. In a wider context, operational and other non-financial risks arise in the execution of all of the Bank's functions. Identified risks are monitored and managed according to the Bank's internal control framework, described on pages 36-37.

DEVELOPMENTS IN 2003/04

The Executive Team has instituted a review of the overall framework for risk management in the Bank. A Risk Standards Unit has been established, whose initial tasks are to review the Bank's existing model of risk assessment; to develop a comprehensive set of Bank-wide risk standards; and to establish indicators in line with the Bank's appetite for each category of risk.

There have been no major changes during the year in the Bank's use of financial instruments, including derivatives. As mentioned in last year's Report, a portfolio of approximately €3.6 billion of foreign currency assets was redesignated as available for active management with effect from 1 March 2003. Accordingly, since that date, the securities and the related swaps have been accounted for on a mark-to-market basis. Two developments during the year affecting the management of risk in the Bank should be mentioned. First, a new Risk Committee in the Markets area of the Bank, chaired by the Markets Executive Director, was established to streamline discussion of risk issues relating to that area's business. Second, a Project Support Unit has been set up to provide central guidance and support to project managers, drawing on the lessons of recent project management experience both within the Bank and elsewhere.

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

OPERATIONAL AND NON-FINANCIAL RISK

Operational risk may arise directly or indirectly through inadequate internal processes, accounting, human error, systems or business continuity failures, fraud or inadequate legal and other documentation. Each business area is responsible for managing its operational risk and monitoring the associated controls. The Bank's senior management review this process.

Operational risk, together with other mainly non-financial risks, such as those associated with human resources, strategy, accounting and business control, are the types of risk faced by any institution. As a central bank, the Bank also faces risks that arise in the pursuit of its core purposes. For example, it is vital that the economic analysis and forecasts that underpin the decisions on interest rates taken at the monthly meetings of the Monetary Policy Committee are based on accurate economic data and robust financial models. Similarly, the responsibility for maintaining confidence in the note issue requires that strict standards of banknote design and printing quality are applied, given that the crystallisation of the risk of widespread forgery would be very serious. To operate effectively, the Bank needs to maintain a high level of public confidence. Shortcomings in any of these areas could have reputational or financial consequences. Potential risks are identified, evaluated and monitored using the risk and controls framework referred to on pages 36-37. Human resource 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

Financial loss may crystallise as a result of exposure to credit, market, or liquidity risk. Operational risk may contribute to any of these risks.

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; intra day, in the sterling and euro wholesale payment system (CHAPS and CHAPS euro); in the securities settlement system, CREST; in the management of the Bank's own funds; and in the course of the banking services it provides to its customers.

In providing liquidity via Open Market Operations and, intra-day, via the Bank's operation of wholesale payment systems, 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. 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), chaired by the Head of the Risk Management Division, reviews regularly the creditworthiness of market counterparties and issuers to whom the Bank may take discretionary credit exposures, whether overnight or at longer maturities. CRAC makes recommendations to the Executive Director for Markets, who is responsible for decisions on limits. CRAC is supported by a credit risk analysis team, which draws on relevant knowledge and experience across the Bank as a whole, as well as market indicators and the output of ratings agencies.

The Bank is 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 exposures 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 (VaR) of mismatched positions. VaR estimates – for a pre-defined time period and confidence interval – the maximum expected loss on a position given the historical volatility of the returns on different assets, and the historical correlations between those returns. Details of VaR exposures relating to the actively managed portfolio are provided in note 7 of the financial statements on page 63.

Details of the Bank's interest rate and foreign currency exposures are also given in note 7 of the financial statements on pages 59-67.

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 proceeds 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 were conducted during the financial year.

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

Report from Members of Court continued

currency liabilities. These funds are not held on the Bank's balance sheet, but in HM Government's Exchange Equalisation Account (EEA).

The risks incurred in conducting this business are similar to those in relation to the Bank's own business, namely credit, market and liquidity 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 HM Treasury.

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 Committee of Non-executive Directors – NedCo – and how it has discharged them. 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.

The Bank of England Act delegates certain functions of Court to the Committee of Non-executive Directors. The functions of NedCo 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 2003 to 29 February 2004.

On assuming the Governorship, Mervyn King outlined to Directors his vision for the Bank, which has resulted in a number of significant changes to the management of the Bank over the year, both in terms of senior personnel and the approach to the formulation of the Bank's strategy. NedCo warmly supports this vision and welcomes the formation of the new Executive Team and changes to the management structure. It also welcomes the work that is underway to develop a medium-term strategy for the Bank, supported by a series of strategic reviews of business areas. It wishes to see this process completed in time for it to inform next year's budget formulation. Non-executive Directors have been monitoring the development of the Bank's new strategy and will be considering the business area reviews as they are completed. As an initial part of the Bank's strategy formulation, Directors discussed and agreed the Bank's new statement of its core purposes, which recognises the Bank's central functions and its current role and position in relation to the economy and financial markets.

During the year, the procedures of Court and NedCo have been adapted. These are explained on pages 8-9 of the *Annual Report*. Within the governance framework of the 1998 Act, the changes have given a more prominent role to NedCo. They have enabled a more focussed debate centred on management issues and allowed the executive of the Bank to report more effectively to non-executive Directors. The effectiveness of the changes and current corporate governance practice will be kept under review by non-executive Directors.

The Bank's performance was reviewed by Court and is evaluated on pages 16-23 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 2003/04. NedCo notes the Bank's determination to learn lessons from the problems it has encountered with the introduction of its new banking system and, alongside this, to introduce a new framework to support and improve project management more widely. The continuing efforts to develop the Bank's approach to, and work on, risk management and business continuity planning are also welcomed, including the establishment of a Committee of Court to oversee risk governance. Further work will be required in the year ahead to ensure that the benefits of the enhanced project management, risk management and business continuity functions are realised across the Bank. The successful transfer of banknote printing to De La Rue has been a notable achievement of the past year.

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 by Court and NedCo.

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 2003/04, as reported in the internal

Report by the Non-executive Directors of the Bank of England continued

controls section of the Report from Members of Court (pages 36-37) 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 2003/04 is set out on pages 30-33 and, so far as appropriate, forms part of this Report.

The Monetary Policy Committee's procedures are described on pages 16-17. As provided for under Schedule 3 of the Act, Directors receive a monthly report from the MPC and all members of the MPC are invited to attend a full discussion with Directors on monetary policy and the economy every three months and for other relevant discussions on the MPC's procedures.

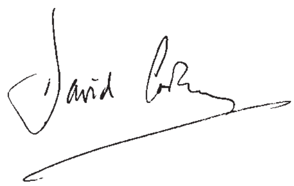
In order to keep the MPC's procedures under review, non-executive Directors periodically attend pre-MPC meetings at which the Bank's staff present their latest analysis of relevant economic data to the members of the MPC; hold discussions with MPC members (both collectively and individually) and with 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; visit the Bank's Agents and take part in their contact activities; and 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. Staffing in the Monetary Analysis area has been at a satisfactory level over the year but there is still a need to increase levels of experience amongst staff.

The change to the Government's inflation target announced by the Chancellor in December 2003 has not required changes to MPC procedures and the transition has been seamless in that respect. The new Bank of England Quarterly Model has been successfully introduced into the forecasting process. Members of the MPC have expressed their satisfaction with its introduction and operation to date. Following the introduction of the new model, a new format for the quarterly forecasting round was introduced, which has been widely welcomed by members of the MPC. Further work is required to ensure that MPC members are kept fully abreast of research work after agreement of the MPC's research priorities. NedCo will consider a review of the new model by Professor Adrian Pagan later in 2004.

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.

NedCo also welcomes the reports from the Review of Statistics for Economic Policymaking by Christopher Allsopp, published in December 2003 and March 2004, which have made a number of recommendations to improve the quality and availability of national and regional data.



The table on page 43 sets out attendance by the Bank's 16 non-executive Directors at meetings of Court and NedCo, the Audit Committee and the Remuneration Committee. The figures in brackets refer to the total number of meetings during the financial year. Attendance by other members of Court is also listed.

Attendance

	Court (12)	NedCo (11)	Audit (5)	RemCo (5)
Sir David Cooksey	11	11		
Sir William Morris	11	10		5
Sir Ian Gibson+	4	6		1 of 3
Ms O'Donovan	9	9	5	
Ms Blow	9	9	5	
Sir Brian Moffat	8	8	2	
Sir John Bond	4	7		
Mrs Francis	10	10	5	
Sir Graham Hall	10	10		4
Dr Julius	9	9		
Mrs Powers-Freeling	8	8		5
Mr Barber*	5 of 9	5 of 8		
The Hon Peter Jay* +	8 of 9	8 of 8		3 of 3
Dr Potter*$	7 of 9	7 of 8	3 of 3	
Ms Rabbatts*	4 of 9	5 of 8		
Mr McCarthy**	3 of 5	4 of 5		
Dame Sheila McKechnie#	1 of 3	1 of 3		
Mr Stretton# $$	3 of 3	3 of 3	1 of 1	
Mr Bailie# ++	3 of 3	3 of 3		2 of 2
Mr Neill# ++	3 of 3	3 of 3		2 of 2
Sir Howard Davies##	2 of 3	4 of 6		
Sir Edward George	4 of 4			
Mr King	10	6 of 6^		
Sir Andrew Large	10	5 of 6^		
Ms Lomax	7 of 8	6 of 6^		

* Appointed to Court 1 June 2003.
** Appointed to Court 22 September 2003.
\# Retired from Court 31 May 2003.
\## Resigned from Court 19 September 2003.
$ Appointed to Audit Committee 1 June 2003.
$$ Retired from Audit Committee 31 May 2003.
\+ Appointed to RemCo 1 June 2003.
++ Retired from RemCo 31 May 2003.
^ Attendance by invitation since September 2003.