Bank of England

Annual Report 2005

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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 reaffirmed by Court in May 2005.

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 United Kingdom, 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.

Foreword by the Chairman of NedCo[1]

Sir John Parker, Chairman

I was honoured to be appointed chairman of the Committee of Non-executive Directors (NedCo), succeeding Sir David Cooksey on 1 March 2005. I would wish to record here my deep appreciation to Sir David and the Governor, both of whom provided advice, induction and support to ensure a smooth and effective transition. The arrangements in place for meetings of NedCo and Court, established in 2003 to ensure a separation between the functions of chairing the board and the executive management of the Bank, work well and I fully support the arrangement. In my view, it facilitates executive accountability and non-executive oversight of the Bank's management and performance. The separate report from NedCo required by the 1998 Act is given on pages 42–45.

Since my appointment to Court as a non-executive Director in June 2004, the development of the Bank's strategy and oversight of its implementation has been a major part of Directors' discussions and considerations. Equally important, Directors have also agreed a new financial framework that provides a more effective link between the business functions of the Bank — centred around the two core purposes of monetary policy and financial stability — and the management of its resources. Throughout the year, I have been impressed by the vision and drive of the executive

(1) The Committee of Non-executive Directors.

management to sharpen the strategic focus of the Bank's work and the wider commitment of staff to undertake the work necessary to deliver the Bank's strategic goals. As I expected, the Bank sets itself very high standards. Real progress has been made and elements of the strategy have already been implemented, along with a new project management framework. There is, of course, much more work to be done, including the continued development of the Bank's financial management tools and the introduction of an integrated performance management system. Considerable progress has however been made by the Executive in establishing a Risk Framework and in strengthening internal controls. This work has been supported by the Audit Committee and the new Risk Policy Committee. It is an interesting time and I look forward to contributing further alongside my Court colleagues in the year ahead.

My role as chairman of NedCo includes facilitating the operation of the board so that it discharges its responsibilities under the Bank of England Act. As the main forum for discussions between the executive management and non-executive Directors of the Bank, NedCo has to be an effective body and one that maximises the contributions made. A full evaluation of the effectiveness of Court and its committees was carried out in 2004/05, led by an external consultancy specialising in board performance. Feedback has been provided to NedCo, the Executive Team and to individual Directors on performance and behaviours, and an action plan will be executed during the course of the coming year. This will embrace the suggestions for improving the management of NedCo and Court, including the content of agendas and the oversight of the Bank's strategy implementation. I will be keeping the operation of NedCo under continuous review as part of my role and ensuring actions to improve its effectiveness are undertaken.

My thanks and appreciation for their service as Directors of the Bank go to Bridget Blow, Kathleen O'Donovan and Laurel Powers-Freeling who stepped down in May. I warmly welcome Geoffrey Wilkinson who joined us in March, and Paul Myners and Arun Sarin who join us in June.

May 2005

Foreword by the Governor

Mervyn King, Governor

During the year we continued the fundamental review of Bank Strategy that started shortly after I took office as Governor. The main lines of this Review were described in our last *Annual Report*, and our objective has remained as stated there: to focus the Bank on the core functions that flow from the 1998 Bank of England Act — monetary policy and financial stability — and to ensure that we operate in those fields with unquestioned competence and authority. The Core Purposes were reviewed and agreed last year, and the strategies for the Bank's individual businesses were reviewed in detail over the course of 2004. The seven strategic priorities that flowed from this process were agreed by Court in November 2004, and are set out on pages 16–17 of this *Report*. They provide the basis on which are planning our spending budgets for the next three years.

Many of the initiatives arising from the new strategy are already in train. The Monetary Analysis divisions have become more focused on the monetary policy responsibilities of the Bank, and the mix of staff will shift towards fewer but more experienced economists. The reform of our money market operations has been extensively discussed with the market, and within the Bank a series of projects have started to deliver the new framework. Following our decision to withdraw from non-core banking work, a number of customers have moved, and we are in discussion with others. The work of financial stability is being given a new and tighter focus through the Financial Stability Board, and work is continuing on designing its future organisation. And a new and more disciplined approach to project management in the Bank has achieved a first tangible success with the relaunch of our new banking system.

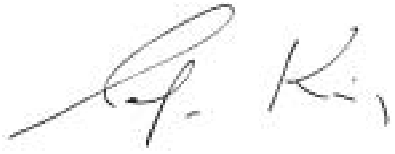
We have sought throughout to involve our staff in the strategy planning process, and during the year I have led communications sessions with every area of the Bank about our plans. Change can seem threatening but the themes of tighter focus and greater professionalism are I believe well understood and welcomed within the Bank, as they are on Court.

Outside the strategy, two developments should be noted. First, the Bank finally withdrew from its historic role as registrar of government stocks: the Registrar's Department at Gloucester closed and its business was transferred to a new service provider under contract to HM Treasury. I would like to record here my appreciation of the professional manner in which management and staff at Gloucester approached the transfer, maintaining to the end the high standards that have always characterised the work of the Department.

Second, the action brought against the Bank by the liquidators of BCCI has continued to give us new insights into the legal system. Nothing that has happened over the past year has changed my view — or that of the other members of Court — that this is a case that should never have been brought, and we remain confident that it will not be successful. As will be seen from this *Report* the expenses of defending the case are substantial but we have no doubt that it is right to do so and we will take every opportunity in due course to press for the fullest recovery of our costs.

I have been immensely grateful to members of the Court for their support over the past year, and in particular to Sir David Cooksey who retired as our senior Non-Executive Director and chair of NedCo during the course of the year. His advice and support have been invaluable to me and to all my colleagues on the Executive Team. In his place we are delighted and fortunate to welcome Sir John Parker, who brings to the Bank a wealth of board room and industrial experience.

Finally I record my gratitude to my colleagues on the Executive Team, the Heads of Division and the staff of the Bank for their support and good humour over the past year.



Governor of the Bank of England
May 2005

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

Court consists 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.

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.

During the year, Court commissioned an external review of its effectiveness. The purpose of the review was to evaluate how Court functioned and performed as a body, with a view to identifying ways to improve its operation and effectiveness. A series of actions have been agreed that will be taken forward in 2005.

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 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 — in which it is supported by the Audit, Risk and Remuneration Committees — 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 42–45.

Since 2004 the normal practice has been for the business of Court to be discussed in an extended meeting of Nedco, with the Executive present. Formal decisions are then taken in Court. Nedco also holds meetings from time to time without the Executive, so that it can fulfil its reviewing role.

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, 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 18. 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.

REMUNERATION COMMITTEE

The members of the Remuneration Committee during 2004/05 were Sir William Morris (Chairman), Sir Graham Hall, Laurel Powers-Freeling, Sir Ian Gibson (to May 2004), Dr David Potter and Peter Jay. The Chairman of

NedCo attends meetings of the Remuneration Committee. The Committee's Report on Remuneration is on pages 30–33.

AUDIT COMMITTEE

The members of Audit Committee during 2004/05 were Kathleen O'Donovan (Chairman), Bridget Blow, Sir Brian Moffat, Mary Francis, David Potter (up to May 2004), Sir Andrew Likierman and Amelia Fawcett (both from June 2004). The Deputy Governors, the Executive Director for Central Services, the Finance Director, the Chief Financial Accountant, the Head of Internal Audit and the external auditors normally attend the meetings of the Committee, and the Chairman of Nedco may also do so.

The functions of the Audit Committee are to:

- Assist the Court in meeting its responsibilities for an effective system of financial reporting, internal control and risk management.
- 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, their independence and their fees.
- 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.

RISK POLICY COMMITTEE

During 2004 a new committee of Court was formed to provide direction and assistance for Court in its responsibilities for the Bank's Risk Management Framework. This was structured along similar lines to the Audit Committee, with some common membership to ensure an effective dialogue and flow of information between both committees.

The members of the Risk Policy Committee during 2004/05 were Sir Andrew Likierman (Chairman), Amelia Fawcett, David Potter and Laurel Powers-Freeling. The Deputy Governor for Financial Stability, the Head of the Risk Standards Unit and the Head of Internal Audit normally attend the meetings of the Committee, and the Chairman of NedCo may also do so.

The functions of the Risk Policy Committee are to:

- Review and approval of the risk management policies, associated control systems and standards by which the Bank's risks are defined, controlled and measured, and the indicators used. This includes the review and assessment of the underlying policy and control framework.
- Recommend to Court the Bank's risk tolerance and strategy for managing all significant risks, including the monitoring and review of the Bank's aggregate risk profile, exposures and concentrations of risk and significant breaches.
- Consider management's regular review of risks, their estimated severity, the associated controls over these risks and monitoring processes, and draw to the attention of Court any material categories of risk whose crystallisation could result in material financial or reputational loss.
- Review and approve proposed changes to the general framework for the management of risk in the Bank.

The Committee met twice in 2004/05. It will normally meet 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 John Parker

Sir William Morris, OJ

Kathleen O'Donovan

Bridget Blow

Brendan Barber

Peter Jay

Dr David Potter, CBE

Heather Rabbatts, CBE

Sir John Parker
Appointed to Court in June 2004. Appointed Chairman of the sub-committee of Directors in March 2005.

Chairman,
National Grid Transco plc.
Non-Executive Director,
Carnival Corporation Inc. and Carnival plc.
Chairman,
P&O Group plc.
Fellow,
Royal Academy of Engineering.
Member,
Defence Academy Advisory Board.
Member,
International Advisory Board of Citigroup.

Brendan Barber
Appointed 1 June 2003.

General Secretary,
Trades Union Congress.
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.

Sir William Morris, OJ
Appointed June 1998.

Director,
England and Wales Cricket Board.
Member,
Commission for Integrated Transport.
Sitting Member,
The Employment Appeal Tribunal.
Chancellor,
University of Technology, Jamaica.

Peter Jay
Appointed 1 June 2003.

Chairman,
Oxford Literary and Debating Union Trust.
Trustee,
Oxfordshire Community Foundation.
Deputy Mayor,
Woodstock.

Kathleen O'Donovan
Appointed August 1999.

Director,
EMI Group plc.
Director,
Prudential plc.
Director,
Great Portland Estates plc.
Director,
O2 plc.

Dr David Potter, CBE
Appointed 1 June 2003.

Chairman and Founder,
Psion plc.
Director,
Finsbury Technology Trust.
Governor,
London Business School.
Fellow,
Royal Academy of Engineering.

Bridget Blow
Appointed June 2000.

Director,
Serco Group plc.
Member,
DTI's Industrial Development Board.
Member,
CBI President's Committee.

Heather Rabbatts, CBE
Appointed 1 June 2003.

Head of Education,
Channel 4.
Non-Executive Director,
The Film Council.
Founder and Former Chief Executive,
Impower.

Sir Brian Moffat, OBE

Mary Francis, LVO

Sir Graham Hall

Laurel Powers-Freeling

Callum McCarthy

Amelia Fawcett

Sir Andrew Likierman

Geoffrey Wilkinson

Sir Brian Moffat, OBE
Appointed June 2000.

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

Callum McCarthy
Appointed 20 September 2003.

Chairman,
The Financial Services Authority.
Member,
University of Greenwich Court.

Mary Francis, LVO
Appointed 1 June 2001.

Non-Executive Director,
Centrica plc.
Member,
Press Complaints Commission.
Governor,
The Pensions Policy Institute.
Trustee,
Almeida Theatre.

Amelia Fawcett
Appointed 1 June 2004.

Vice Chairman,
Morgan Stanley International.
Chair,
London International Festival of Theatre.
Chair,
National Portrait Gallery Development Board.
Trustee,
National Portrait Gallery.
Member,
Council of the University of London.
Board Member,
The National Maritime Museum (Cornwall).

Sir Graham Hall
Appointed 1 June 2001.

Chairman,
Northern Growth Corridor Steering Group.
Chairman,
York Central Steering Board.

Sir Andrew Likierman
Appointed 1 June 2004.

Professor,
London Business School.
Non-Executive Director,
The Tavistock and Portman NHS Trust.
Non-Executive Director,
Barclays Bank plc.
Non-Executive Director,
Market and Opinion Research International (MORI) Ltd.

Laurel Powers-Freeling
Appointed June 2002.

Senior Vice President,
American Express Services.
Chairman,
American Express Insurance Services, Europe.
Director,
Environmental Resources Management Group.

Geoffrey Wilkinson
Appointed 1 March 2005.

Chief Executive,
South West Regional Development Agency.
Non-Executive Director,
South West Tourism.

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. 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

Richard Marsh(1)
Internal Audit
(Interim)

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

NIGEL JENKINSON
Executive Director
Financial Stability

Financial Stability

Advisers to the Governor
Len Berkowitz (Legal)
Mario Blejer (Centre for Central Banking Studies)

(1) Stephen Brown has been appointed Head of Internal Audit from July 2005.

Organisation Overview

Monetary Analysis and Statistics

CHARLIE BEAN

Peter Andrews, Monetary Assessment & Strategy
Martin Brooke, International Economic Analysis
Mark Cornelius, Inflation Report & Bulletin
Spencer Dale, Conjunctural Assessment & Projections
Neal Hatch, Structural Economic Analysis
Jo Paisley, 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 United Kingdom 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 United Kingdom and of the outlook for inflation and growth.

The work of the divisions, including reports from the twelve regional Agencies (page 20), 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 in the sterling money markets to implement the Monetary Policy Committee's interest rate decisions, while meeting the liquidity needs of the banking system as a whole. Foreign Exchange Division manages the Bank's foreign currency operations, and manages the Government's foreign exchange reserves as agent of HM Treasury. These divisions maintain contingency plans for crisis operations. Drawing on a wide range of contacts in the United Kingdom 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 identifying, measuring and, with the front office, managing risks from the Bank's financial operations. Area-wide management is assisted by a Chief Operating Officer and Unit.

Central Services

JOHN FOOTMAN

CLIFFORD SMOUT, FINANCE DIRECTOR
LOUISE REDMOND, HR DIRECTOR
David Collins, Finance & Resource Planning
Michael Craig, Investment
John Heath, Legal
Peter Higgs, Property Services
Ashley Howard, Risk Standards
Chris Piper, Information Systems & Technology
John Trundle(1), 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, risk standards, project support, IT, property, personnel, the Governors' private offices, press and public relations, the investment unit and legal services.

Internal Audit

Richard Marsh (interim)

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
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.

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
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 HM 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 and judging which warrant follow-up action. 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 and reduce risks to the structure and functioning of these markets and to the operation of the international financial system, and to develop measures to increase their overall safety and effectiveness. In addition it undertakes work to ensure that the Bank is ready to respond should a financial crisis occur. 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*.

(1) Stephen Collins has been appointed Head of Business Continuity from June 2005.

The Bank's Strategy

A review of the Bank's strategy and objectives was conducted between October 2003 and November 2004.

The starting point for the new strategy was the clear 'vision' of the Bank's role contained in the two core purposes, which were agreed by Court in May 2004 and published in last year's *Report*. The Core Purposes put the Bank more fully in line with the legislative changes of 1997–98 — focused on monetary and financial stability, aiming to secure authority and confidence at home and offering intellectual and practical leadership in the international community of central banks. These Core Purposes (shown on page 3) provide the criteria by which subsequent strategic decisions have been taken and objectives set.

Objectives for 2004/05 were set on an interim basis, and published in last year's *Annual Report*; they were:

- Continued provision of a high standard of support for the MPC.
- Development of a more focused 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.

The strategic review concluded in November 2004 with the adoption by Court of seven strategic aims; these underpin the strategy from 2005/06 onwards and have also influenced outcomes in 2004/05, as described in the following section of the *Report*. The seven strategic aims are:

1 The Bank should maintain its good track record of meeting the inflation target and contribute to the intellectual development of monetary policy.

2 Money market operations should ensure much less volatility in overnight sterling interest rates and support better liquidity management in the banking system, both day by day and in the event of stressed conditions.

3 The Bank's banking operations should be efficient and clearly focused on activities necessary to ensure monetary and financial stability.

4 The Bank should have a clear framework for identifying and reducing risks to financial stability affecting the

United Kingdom, using its influence to ensure proposed risk mitigants are adopted and drawing on a strengthened market intelligence capability.

5 The Bank should be fully prepared in its management of financial crises and its business continuity planning, within the Standing Committee framework.

6 The Bank should promote safe and efficient payments and settlements systems and be at the forefront of best practice in operational and policy areas.

7 To enable delivery of these strategic priorities, business standards will be raised across the Bank, particularly in the areas of:

- people development
- risk management
- project management
- performance measurement.

Review of 2004/05

The Bank's objectives for 2004/05 were set out in the 2004 *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. In terms of high level outcomes, CPI inflation during the period March 2004 to February 2005 averaged 1.4%, a little below the Chancellor's 2% target, and fluctuated between 1.1% and 1.6%. Subject to meeting the inflation target, the MPC is also charged with supporting the Government's general economic policy objective of achieving high and stable levels of growth and employment. GDP growth in 2004 as a whole is estimated by the ONS to have been 3.1%, a little above the economy's probable trend growth rate. The Labour Force Survey measure of unemployment was virtually unchanged throughout 2004, and stood at 4.7% of the workforce in January 2005, its lowest for 30 years. 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.

SUPPORT FOR THE MONETARY POLICY COMMITTEE

The Bank aims 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

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

rate decision as well as the analysis and projections in the quarterly *Inflation Report*.

The Bank conducts an annual survey of MPC members' general satisfaction with the various inputs to the policy process. The latest survey suggests that the general level of satisfaction is high and similar to that found in the previous year's survey. In response to MPC members' suggestions, some restructuring has taken place of the regular monthly briefing session that occurs ahead of the policy meeting so as to integrate it more closely with the quarterly *Inflation Report* round.

High-quality support requires able and experienced staff. While the quality of the staff in Monetary Analysis is high, experience levels are still relatively low reflecting the expansion in the number of economists during the period following the Government's decision to grant the Bank operational responsibility for monetary policy. Going forward, the aim will be gradually to increase staff experience levels.

A major undertaking in 2003/04 was the introduction of a revamped quarterly macroeconomic model (BEQM). That model is now used routinely in the construction of the MPC's quarterly economic projections. It was designed to be more flexible than the previous macroeconomic model and to have a more clearly articulated economic structure so as to facilitate the Committee's discussions. The Committee's experience with the new model has so far been very positive. Professor Adrian Pagan, who reviewed the Bank's forecast methodology in 2002, has produced a postscript to his report covering the new model which will appear in the Summer 2005 *Quarterly Bulletin*. Alongside the new model, the Committee continues to make use of a suite of other models to help provide alternative perspectives on the economic issues under discussion.

During the course of the year, the Committee has discussed a large number of economic issues. Major issues to highlight are:

- The prospects for house price inflation and the implications of movements in house prices for consumer expenditure. There is considerable uncertainty about the likely evolution of house prices relative to earnings and the response of household spending to slowing house price inflation. Much work has been carried out in the Bank trying to improve its understanding of developments in this area. Allied to this, the Bank has continued to expend considerable effort in improving its understanding of household borrowing and what threats, if any, the accumulation of debt might pose to macroeconomic stability.

- The measurement of output in the public sector. The Atkinson Review highlighted the many difficulties in measuring the output of the public sector. However, what matters for the pressures on consumer prices are the resources that the public sector absorbs, not the efficiency with which they are then used. The Bank has spent considerable effort in implementing this insight into its analysis and forecasting activities.

- The benign outturns for earnings growth and CPI inflation. As noted earlier, CPI inflation was relatively stable throughout 2004 and running a little below the 2% target, while pay growth has also remained relatively subdued. That was despite a tight labour market, a diminishing margin of spare capacity, a sharp pick up in oil prices and rising producer output price inflation. The Bank has been exploring the relative contributions of improved labour market structures, inward migration, increased international competition and falling imported goods prices, and improvements in productivity, especially within the distribution sector, to these outcomes.

- Data uncertainty. The complexity of the economy means that the Office for National Statistics faces a tremendous challenge in producing macroeconomic statistics that are both timely and reliable. More information about what has happened accrues over time leading to subsequent revisions in the data. The MPC needs therefore to take account of the uncertainty around the data in forming its assessment of the prospects for inflation. During the past year, the contrast between the official data for

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

manufacturing and the signals from business surveys and the Bank's regional Agents was particularly notable and led the Committee to put some weight on the latter evidence. The staff are developing a new methodology for combining information from such multiple sources in a systematic fashion.

In addition to providing conjunctural analysis and research, under the guidance of MPC, the staff of Monetary Analysis also conducts a substantial programme of long-term research designed to inform the Committee and enhance the Bank's analytical capabilities in the future. That programme is largely on track and improved arrangements for the communication of the results have been identified.

The Monetary and Financial Statistics Division collects data from the commercial banks and other financial intermediaries to support the Bank's pursuit of both its Core Purposes. It also passes some of these financial data to other institutions such as the Financial Services Authority, the Office for National Statistics and the European Central Bank in order to enable them to fulfil their obligations. However, while appropriate data are necessary for the Bank and these other bodies to conduct their business, its collection imposes costs on the suppliers of the data. The Bank is therefore developing a new programme of cost-benefit appraisal into the collection of its data in order to identify potential ways of easing the burden on those suppliers.

PUBLIC UNDERSTANDING AND EDUCATION

The Bank promotes the case for price stability and understanding of the current framework through the media of publications, speeches and its education programme. The *Inflation Report* and the MPC Minutes are the Bank's major regular publications on the operation of the policy framework. In addition, the *Quarterly Bulletin* carries background articles describing pieces of analysis that underpin the MPC's thinking, as well as articles describing developments in the markets, the Bank's operations and balance sheet, and analysis relevant to other aspects of the Bank's work. A major additional monetary policy publication this year was a book describing in detail the Bank's revamped quarterly macroeconomic model. Finally, a summary of the intelligence gathered by the Bank's regional Agents and presented to the MPC ahead of its policy meeting is now published alongside the MPC Minutes, rather than on a quarterly basis as was previously the case.

Public appearances by MPC members represent an important part of the Bank's effort to build public understanding of monetary policy. The Governor and other MPC members have given evidence on a number of occasions to the Treasury Select Committee of the House of Commons, as well as to other Parliamentary Committees. Furthermore, MPC members undertake an extensive programme of regional visits through the Agencies, meeting local business contacts and undertaking interviews with the regional press. During the past year, MPC members made a total of 54 such regional visits, with the Governor visiting all twelve nations and regions in the United Kingdom. The Bank's regional Agents also play an important role in promoting understanding of the Bank's work with business people and the public, in addition to their intelligence gathering role in support of the MPC's decision making.

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 the February 2005 poll, carried out by NOP, the net satisfaction index stood at 47%, up from 42% in November 2004.

Finally, the Bank aims to build and enhance public understanding of its monetary policy role and objectives through its education programme. Over the past year, there were 70,000 visitors to the Bank's museum, of which over 16,000 saw one of the presentations on offer in the cinema, including 170 school groups. The annual economics competition for schools and colleges, Target Two Point Zero, which asks students to take on the role of the Monetary Policy Committee, attracted 244 entries in its fifth year, compared with 236 in the previous year. The winning team came from Cranbrook School in Kent. The competition continues to encourage interest in economics and improve understanding of monetary policy and the role of the Bank. The Bank has produced a new educational resource for primary school children aged 9–11 on money and prices called Pounds & Pence. Over 5,500 packs have been requested by around 2,500 schools. The material is also available on the Bank's website.

MONEY MARKET REFORM

The previous *Annual Report* reported the launch of a fundamental review of how the Bank implements monetary policy in the sterling money markets. Significant progress has been made since then. The overall objectives of the Money Market Reform (MMR) programme were announced in May 2004. They are to stabilise overnight market interest rates at levels consistent with MPC's official rate; to promote a more efficient, safe and flexible framework for banking system liquidity management; to introduce a simpler and more straightforward framework; and to promote competitive and fair sterling money markets.

Following extensive consultation with the market and other interested parties, the architecture of the reformed system was announced in July 2004 and the detailed specification was published in April 2005. In broad outline, the reformed system will stabilise market interest rates via the combination of reserve averaging with a narrow corridor formed by the Bank offering standing deposit and lending facilities. Under reserve averaging, banks will be able to hold reserve balances at the Bank which, if held within a target range on average over a monthly maintenance period running between MPC meetings, will be remunerated at the MPC's official rate. Banks will choose voluntarily their own targets for reserves. This will be very different from the current long-standing UK system, in which balances with the Bank are unremunerated and banks have little scope to vary them from day to day. Open market operations will be much less frequent in the new system: weekly instead of at least twice daily. The Bank is now engaged on the practical preparations for the new system, which it currently expects to launch between March and June 2006.

DEVELOPING MARKET INTELLIGENCE

The strategy to build up gradually a market intelligence function was approved by the Executive Team and Court in the middle of 2004. The aim is to develop the Bank's contacts in domestic and global capital markets so as to strengthen its ability both to identify and to assess risks to financial stability, and to its capacity to contribute, alongside the FSA and HMT and its overseas counterparts, to the resolution of crises. The Bank is very grateful to the many firms and individuals, in London, New York and elsewhere, who commit to helping it with this work. Over the past year, some of the principal areas covered by these discussions have been the 'search for yield' in an environment of low short-term real interest rates globally, the rapid development of the structured credit markets, and the hedge fund industry.

RISKS TO FINANCIAL STABILITY

The Bank maintained a close watch on developments in the financial system to identify potential sources of vulnerability and strain that could threaten the maintenance of UK financial stability. Given the importance of London as a major international financial centre, monitoring risks in global capital markets forms an important part of this appraisal.

A high level Financial Stability Board, chaired by Sir Andrew Large, was launched in March 2004 to review threats identified through surveillance and market intelligence and to explore options for risk reduction and strengthening the resilience of the UK financial system. The Board meets regularly and provides advice on the Bank's input to the Joint Standing Committee on Financial Stability, held regularly with the FSA and HM Treasury under the terms of the 1997 Memorandum of Understanding. The Board also advises on the main themes to be covered in the half-yearly *Financial Stability Review*.

MANAGING FINANCIAL CRISES

Ensuring that the Bank is fully able, within the Standing Committee framework, to play its part in responding to financial crises should they arise is one of the Bank's strategic priorities (page 17). A new financial crisis management team was created in 2004 to improve planning and preparations. Arrangements are being enhanced in three areas: strengthening internal co-ordination and preparation of different Bank functions that would be involved in managing a financial crisis; improving planning with the FSA and HM Treasury on how the three authorities would work together most effectively; and bolstering arrangements for co-operation with other authorities internationally to manage and resolve a cross border problem. In each area, the Bank has been involved in exercises to test the enhanced arrangements.

BUSINESS CONTINUITY

A new Business Continuity Division was established at the start of 2004, to bring together the Bank's own business continuity preparations and its role in helping co-ordinate financial sector preparations for an operational disruption. That wider role is undertaken jointly with the FSA and HM Treasury. The three authorities run a website about financial sector continuity (www.fsc.gov.uk) both to provide information about who does what in planning and testing but also to be used as a communications tool in the event of a major incident. As part of their preparations for responding to major operational disruptions, the Bank, FSA and HMT tested their own decision-making in an exercise in May, and a market-wide exercise was held in November. The latter was led by the tripartite authorities and involved some 300 people from over 40 financial institutions testing communication processes and the co-ordination of responses between the authorities and the private sector.

The authorities published a report in October which reviewed progress made by the financial sector in the areas where action was recommended by the Task Force on Major Operational Disruption (which was chaired by Sir Andrew Large and published in December 2003). The other main tripartite initiative is a benchmarking project, led by the FSA, to obtain more detailed information on the resilience of financial sector institutions and to establish a consensus as to best practice in financial sector resilience.

Internally, the Bank has reviewed its own level of resilience and its planning and testing procedures. The scope of back-up facilities has been broadened and physical facilities and business and decision-making processes are tested regularly. Some split-site working has been introduced in key areas.

PAYMENT SYSTEM OVERSIGHT

A key strand of the Bank's financial stability work, and a responsibility assigned to the Bank under the 1997 Memorandum of Understanding between the Bank, HM Treasury and the Financial Services Authority, is the oversight of payment systems. Through its oversight, the Bank seeks to ensure that payment systems supporting the UK economy are designed and operated in a way that protects the stability of the financial system, and reduces risk of disruption to the wider economy.

To promote transparency and accountability in the discharge of these responsibilities, the Bank published in 2005 a first annual *Payment Systems Oversight Report*. The *Oversight Report* sets out the role and objectives of the Bank in relation to oversight of UK payment systems, provides an assessment of UK payment systems against the internationally-recognised Core Principles for Systemically Important Systems, as well as an account of the Bank's work to mitigate payment system risk in 2004 and its oversight priorities for 2005.

Over the past year, the Bank has also sought to adapt its oversight to ensure it remains effective and efficient where payment systems and infrastructure supporting financial activity in the United Kingdom are operated or managed on a cross-border basis. The Bank has signed memoranda of understanding establishing co-operative oversight arrangements between relevant central banks and regulatory authorities with key roles in the supervision of LCH. Clearnet Group, Euroclear and SWIFT.

PAYMENTS SYSTEM OPERATIONS

The Bank operates the Real Time Gross Settlement (RTGS) system though which payments relating to the major UK payments and securities settlement systems are settled. Three main payment and settlement systems use the RTGS platform to enable the risk reduction that comes from real time settlement. Average daily values settled in these three systems last year were £206 billion for the CHAPS sterling payment system, £154 billion for the CHAPS Euro system, and £269 billion for the CREST delivery-versus-payment system. RTGS is a key piece of the United Kingdom's financial infrastructure, and as such it must have high availability. During 2004, the system was available for 99.7% of the time, an improvement from 98.7% in 2003.

GILTS REGISTRATION

At the end of 2004, the gilts registration and transfer functions undertaken by the Registrar's Department in Gloucester were successfully moved to a new service provider. HM Treasury continues to be responsible for ensuring that the service is provided. The transfer brought to a close the Bank's history as a registrar, which can be dated back to its foundation in 1694.

BANKNOTES

The Bank is responsible for providing banknotes that the public can use with confidence. Last year the Bank issued 735 million new banknotes, and at the year end the number of Bank of England notes in circulation was just under 2 billion. By value, the average circulation during last year was £34 billion. In terms of the number of notes in circulation, the £20 accounts for the largest share, at around 62%. The

Bank is continuing to look for ways to ensure that adequate numbers of £5 notes can enter circulation, and thereby to address both the quantity and quality of £5 notes.

During calendar year 2004, some 325,000 counterfeit Bank of England notes were taken out of circulation. This represents 0.017% of the stock of notes, and is approximately 11% below the figure for 2003 as a whole. More details on counterfeit statistics can be found at www.bankofengland.co.uk/banknotes/about/counterfeit.htm. The Bank believes that most counterfeits are taken out of circulation by the police or the banking system after one use, whereas genuine notes are re-circulated several times a year. This further reduces the likelihood of the public encountering counterfeit notes. Moreover, they are not evenly distributed in the economy because the source of counterfeits is often associated with serious organised crime.

The Bank has a three-pronged approach to tackling the threat of counterfeiting, encompassing the security features of the banknotes, information and publicity provided to the public to assist in checking that banknotes are genuine, and working closely with law enforcement agencies to detect and stop counterfeiting.

REVIEW OF CUSTOMER BANKING

As part of the work on the Bank's strategy last year, a review of its customer banking operations was undertaken. This concluded that the Bank should focus on those banking activities required to enable it to fulfil its responsibilities as the central bank of the United Kingdom. In contrast, a number of the current activities do not fit that description, and are closer in nature to retail banking. Many of these have grown up over a long time, reflecting the Bank's lengthy history. Implementation of the conclusions of the review will see just over 300 customers leave the Bank. Many of these will have left by the end of this year, though the overall programme of implementation will take longer, in particular because of the greater complexity of migrating retail banking activities for the major government users. The Bank will remain an important provider of banking services to government, but with the focus on high-value activities.

The Bank will likewise continue to provide custodial services to a range of customers. Total assets held by the Bank as custodian are around £200 billion, of which £29 billion is accounted for by holdings of gold.

THE BANK'S CORE BANKING SYSTEM

Last year's *Annual Report* described the problems encountered by the Bank in launching its new core banking system in the summer of 2003. Following the launch, the system operated with many manual workarounds and without some of the functionality originally envisaged. Towards the end of last year, the system was successfully re-launched, thereby enabling the introduction of effective straight-through-processing and associated on-line links for customers.

BUSINESS SUPPORT

HR Policies

At the end of February 2005 the Bank employed 1,713 full-time staff and 188 part-time staff — this is broadly the same number of staff employed as at end February 2004. During this period 196 individuals joined the Bank and 200 left.

Approximately one-third of the 47 redundancies in 2004/05 related to the final phase of the re-organisation of the Bank's banking operations — the C21 Programme. Since the process began in March 2000, a total of 130 staff have been made redundant. Most of the other redundancies that occurred last year were from the Central Services area of the Bank and generally resulted from changing working practices and, in particular, the increased use of technology.
The Bank recruited 196 staff in 2004/05. 32 new graduates joined during the year; 31 joined the main banking staff *(2003/04: 33)* and 1 joined the IT specialist group *(2004/05: 3)*.

The demand for new experienced and specialist staff has increased substantially. 42 mid-career staff were recruited to analytical and managerial positions *(2003/04: 29)*. 10 of these were PhD level entrants. More than half of the experienced hires were for specialist positions (accountants, auditors and lawyers) in the Central Services area. In addition to these, 10 IT experienced specialists were also recruited *(2003/04: 19)*.

A total of 79 clerical staff were also recruited — this represents a significant increase against previous years *(2003/04: 48)*. Nearly half of the clerical recruits were school leavers — 4 GCSE entrants and 31 A Level entrants (compared with 0 and 14 in 2003/04) — the rest were experienced hires. Approximately half of the experienced clerical hires were recruited for their banking skills.

The Bank remains fully committed to diversity in the workplace and endeavours to avoid any form of discrimination. This commitment is demonstrated by the provision of information and training to staff via courses, the Intranet and a CBT package. 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 now stands just above 25% of the total. However, women still occupy few of the most senior posts. The proportion of staff from ethnic minority backgrounds now stands at 6.7%. However this figure masks the 'diversity' of the Bank. 28 nationalities, other than British, can be found in the Bank — foreign nationals now account for more than 6% of staff as a whole and for more than 20% of analysts. These developments are being monitored and assessed by a Diversity Task Force chaired by the HR Director.

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 recognised trade union. A further staff opinion survey will be conducted later in the year.

The Bank's Whistleblowing Policy has been revised to ensure that it plays a more effective role in risk management. The policy now offers staff a wider range of ways in which they can raise concerns, in confidence. These include an external helpline. The Audit Committee will regularly review the policy's effectiveness.

The Bank continues to invest in the development of its employees, and in particular the development of management and leadership skills. This year has seen the introduction of a number of new management courses as well as a steady increase in the use of individual coaching to support senior managers. More formal succession planning procedures are being introduced, with the close involvement of the Executive Team.

Project Management

The introduction of new arrangements for approving and monitoring major projects were foreshadowed in the last *Annual Report* and during the year the new Projects Group, chaired by Rachel Lomax, has established itself. Its aim is to ensure that all such projects are consistent with the Bank's strategy; that they are only undertaken after a proper assessment of the risks and available resources, and that they are managed according to approved project disciplines. It is supported by a strengthened Project Support Unit, headed by an external recruit, and by a sub-group of the Executive Directors responsible for the processing of transactional and accounting information.

Risk Management Framework

The development of the Bank's Risk Management Framework, and the structure being created to support this, is described on pages 37–40.

Freedom of Information

In January 2005 the Bank became subject to the disclosure requirements of the Freedom of Information Act, except in relation to the 'excluded' functions of monetary policy, Last Resort Financial Assistance and Private Banking. A project to prepare the Bank was undertaken, a publication scheme launched, and in the first four months of the year 836 FoI

Review of 2004/05 continued

requests were logged and successfully handled, though some more complex requests, requiring consultation with third parties or consideration of public interest issues, were not dealt with within the 20-day target. Responses that involve significant new disclosures are highlighted on our website at www.bankofengland.co.uk/foi.

Property

The policy of concentrating the Bank's London activities into the Threadneedle Street building was successfully realised last year with the final withdrawal from New Change. Bank Buildings, the Bank's only other central London property, was put on the market in early 2005.

Financial Review

THE BANK'S FINANCIAL FRAMEWORK

Over the past year, the Bank has re-examined the financial framework within which it operates, and adapted its budgeting procedures so as to conform to it more closely and transparently.

In planning its spending over the medium term, the Bank takes account of the sources of income — principally the fees and charges to its banking and government customers; the returns from investing its capital and reserves; and the returns from investing Cash Ratio Deposits (CRDs).

Under the CRD scheme, deposit-taking institutions place interest-free balances with the Bank in order to finance the costs of its sterling liquidity, monetary policy and financial stability functions. The most recent review of the scheme, in 2003, estimated that these costs would be of the order of £575 million in the period from March 2003 to February 2008. The review concluded that the scheme continued to be a suitable method of funding the unremunerated activities of the Bank, and that its transparency should be enhanced by publishing more details, for instance of expenditure by function. This is contained in the table, which also shows the budget for the current year.

Previously the focus of the Bank's budget has been on gross spending, but the Bank has now decided to place greater emphasis on the functional approach that underlies the CRD scheme.

In particular:

- The Bank will set a budget for spending on policy functions consistent with the figure given in the CRD review — ie £575 million over the five-year period.

- The other functions of the Bank will be expected to break even over the medium term. In these areas the focus will be on net spending, although the Bank will remain committed to providing value for money, without running undue risks. Any losses or gains from these activities will not be charged to the CRD-payer, but instead to the income from capital.

- If spending on policy functions is in line with CRD income, and other functions break even, then the Bank will show a profit on its activities. This profit will be equivalent to the return on the gilts and AAA bonds in which the Bank's capital and reserves are invested. Using current accruals-based accounting rules, this will approximate to a pre-tax, pre-dividend return of 6%.

- Spending on BCCI legal fees will be excluded from all of these calculations.

2004/05

Total expenditure on policy functions in 2004/05 was in line with the overall budget forecast, and a £1 million allowance for contingencies went unspent. However, within the total, central costs were higher than expected. That partly reflected efforts to build the Bank's corporate capacity — on risk, projects and accounting — in line with its strategic priorities. There were also unexpected one-off costs associated with the ongoing work programme to strengthen business continuity and IT resilience.

Spending on policy functions in business areas was lower than expected. In Monetary Analysis and Financial Stability, lower staff costs related to a less experienced profile of staff in place than was foreseen in the budget. Steps are in place in these areas to build and retain experienced staff. In Markets, there were a number of staff vacancies, filled by the close of the financial year. Savings have also been achieved on items such as travel. Some projects spending was also delayed in Financial Stability, but the Bank's project spending as a whole has been much closer to budget than in the past, reflecting more critical and realistic resource planning.

CRD income increased by over 6% in 2004/05, compared with budgeted growth of 4.5%, as a result of higher interest rates and faster growth in Cash Ratio Deposits.

Financial review continued

Bank expenditure by function[1] £ millions	**2003/04 Actual**[2]	**2004/05 Budget**[2]	**2004/05 Actual**	**2005/06 Budget**
Policy functions				
Costs of:				
Monetary Policy	37.8	41.6	40.7	41.2
Financial Stability	30.6	31.5	29.7	31.9
Plus share of:				
Central costs	27.5	28.3	31.0	29.6
Buildings depreciation[3]	10.4	8.9	8.7	5.6
Total planned expenditure on policy functions	**106.3**	**110.3**	**110.2**	**108.3**
CRD income	106.1	110.9	113.2	117.9
Net expenditure on remunerated functions	**4.4**	**1.1**	**-5.2**	**-4.9**
Costs of:				
Note Issue	39.5	39.8	40.4	42.8
Other Government	9.4	10.4	9.3	7.0
Banking & Settlement Services and Other	34.7	37.3	36.5	41.3
Plus share of:				
Central costs	20.8	19.7	20.7	18.3
Buildings depreciation[3]	7.1	5.0	4.9	5.0
Gross expenditure on remunerated functions	**111.5**	**112.2**	**111.9**	**114.4**
Income from remunerated functions	107.0	111.2	117.1	119.3
The Bank's gross expenditure				
Total planned expenditure on policy functions	106.3	110.3	110.2	108.3
Gross expenditure on remunerated functions	111.5	112.2	111.9	114.4
BCCI Legal Fees	**21.0**	**21.2**	**19.5**	**23.5**
Allowance for contingencies[4]		**1.0**		**3.5**
Total gross expenditure	***238.8***	***244.7***	***241.6***	***249.7***

1 Figures may not sum due to rounding.

2 Revised to reflect improved accuracy of functional reporting.

3 Includes interest charge on buildings depreciation and land.

4 A budgeted allowance of £1.0 million was unspent in 2004/05.

The Bank's remunerated functions earned net income of £5.2 million in 2004/05, against a projection for net expenditure of around £1 million in 2004/05. Income from banking customers was more buoyant than expected, and recoveries from payment and settlement system work rose, partly reflecting temporary factors. The Bank continues to set as an objective 'break-even' in these functions over time. The gross costs of remunerated functions were close to budget.

The other main item of the Bank's expenditure in 2004/05 was for legal fees associated with the BCCI trial. These were a little lower than expected, and took the total of the Bank's overall expenditure just below the budgeted figure.

Budget for 2005/06

The budget for 2005/06 is consistent with the staged implementation of the Bank's new strategy, and provides the additional resources needed to make this strategy effective. These include the reform of our money market operations, the building of experience in MA, extending our market intelligence work, reviewing customer banking and strengthening our accounting, project and risk frameworks. At the same time, measures are being put in place to improve efficiency where possible and to deliver process improvements in our back office and Central Service functions.

Planned expenditure on the policy functions has been set well within the limit set by projected CRD income. This reflects in part a decision to retain a reserve which would be available for contingencies and to support initiatives consistent with the strategy. In addition there are also a number of current uncertainties, for instance relating to pension costs, which suggest that the risks to the spending forecast are on the upside. By budgeting on a prudent basis, the Bank expects that spending outturns both in the current year and in the two following years to February 2008 will be within the limit envisaged at the time of the CRD review.

Remuneration of Governors, Directors and MPC Members

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

REMUNERATION POLICY

The Remuneration Committee's approach is to review salaries annually, aiming to set remuneration and conditions of service to reflect adequately 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 that began on 1 July 2003. The Governor's remuneration is customarily reviewed each year on the anniversary of his appointment; from 1 July 2004 his salary was increased by 2½% from £263,317 to £269,899.

The Deputy Governors' salaries have been reviewed in line with the remuneration policy described above. In 2004, the review date (together with that for the Executive Directors) was changed from 1 January to 1 March; the salary of both Deputy Governors was increased by 3% from £216,667 to £223,168.

Benefits

The Remuneration Committee also keeps under review other benefits available to the 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 28 February 2005.

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, pays, on a grossed-up basis, 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 to the Bank only. With Court's approval other directorships relevant to the Bank's work may be accepted, but any fees must be paid to the Bank. The Governor is a Director of the Bank for International Settlements, and Sir Andrew Large is a member of the FSA Board. In both cases fees are dealt with on the basis described above.

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 £6,000 per annum; the remuneration of non-executive Directors who chair the Remuneration Committee, the Audit Committee, the Risk Policy and the Trustee Boards of either of the Bank's occupational pension schemes is £9,000 per annum; and the remuneration of the Chairman of the Sub-Committee of Non-executive Directors is £12,000 per annum.
Non-executive Directors do not receive any post-retirement benefits from the Bank. Other than the Chairmen of the Committees of Court, Directors receive no additional fees for serving on those Committees. The Bank does however meet certain travel expenses.

Remuneration of Members of Court

	Salary £	Benefits £	Total 2005 £	Total 2004 £
Governor				
Lord George				*86,463*
Mr M A King				
Joined 1 March 1991	267,705	432	268,137	(i)*248,301*
Deputy Governors				
Sir A M B Large				
Joined 3 September 2002	223,168	2,416	225,584	*217,924*
Ms J R Lomax				
Joined 1 July 2003	223,168	707	223,875	*144,951*
Non-executive Directors				
(Note ii)	100,375	0	100,375	*77,883*
Total	**814,416**	**3,555**	**817,971**	***775,522***

Notes

i includes Mr King's remuneration as Deputy Governor to June 2003.

ii Mr Callum McCarthy has been a member of Court since 22 September 2003 in his capacity as Chairman of the FSA. 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, Mr McCarthy waived remuneration of £5,750 due from the Bank and Sir Andrew Large waived £22,292 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 28 February 2005, 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.

The Remuneration Committee has taken note of the changes to the pensions tax regime included in the Finance Act 2004 and to be implemented from April 2006. The Committee is actively considering the implications of these changes for the current arrangements for pension provision for the Governor and Deputy Governors and what variations to those arrangements may be required.

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 £149,314 *(2004 £145,672)* per annum, pro rated for

Pension Entitlements and Accruals (including unfunded entitlements)

	Transfer value as at 29.2.04 (£pa)	Transfer value as at 28.2.05 (£pa)	Increase in transfer value (£pa)	Accrued Pension as at 29.2.04 (£pa)	Accrued Pension as at 28.2.05 (£pa)	Increase in accrued pension (£pa)	Transfer value of additional pension earned during year ended 28.2.05 (£)
Mr M A King	2,092,500	2,674,000	581,500	110,100	127,700	17,600	297,000
Sir A M B Large	187,000	359,900	172,900	10,200	18,000	7,800	149,600
Ms J R Lomax	87,800	248,600	160,800	4,800	12,400	7,600	149,400

Note

The transfer values shown for 29 February 2004 have been restated to reflect new longevity assumptions adopted in 2005. On the basis of the longevity assumptions used in 2004 the transfer values would have been £1,962,200 for Mr King, £174,200 for Sir Andrew Large and £82,000 for Ms Lomax.

the number of days worked per week. They are appointed for terms of three years. Ms Barker's term expired on 31 May 2004 and she was re-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 £162,289; and Charlie Bean's is £171,981. Both are eligible for the Bank's normal range of benefits, including non-contributory pensions.

Governance, Financial Statements and Risk

PRINCIPAL ACTIVITIES AND REVIEW OF OPERATIONS

The Bank's core purposes are set out on page 3. The Governor's Foreword, the Review of 2004/05 and the Financial Review give a detailed account of the Bank's activities and operations during the year.

PRESENTATION OF THE FINANCIAL STATEMENTS

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

The Banking Department comprises all the other activities of the Bank. 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 the Companies Act requirements relating to a banking company. The Bank may, however, disregard a requirement to the extent that it considers it appropriate to do so, having regard to its functions, 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 Acts and applicable Accounting Standards. In particular, there is less disclosure in respect of interest income and expense and any provisions for bad and doubtful debts, together with consequential restrictions in detailed disclosures in the balance sheet, cash flow statement and the notes to the financial statements.

In preparing this year's financial statements the Bank continues to adopt the transitional arrangements of FRS 17 on pensions and other post-retirement costs.

Issue Department

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

FINANCIAL RESULTS

The Banking Department's financial statements for the year ended 28 February 2005 are given on pages 48–81, and show a profit after provisions and before tax of £100 million *(2003/04 £72 million)*. The increase in profits compared with last year is principally due to increased Cash Ratio Deposits and higher interest income. After payment in lieu of dividend of £38 million *(2003/04 £30 million)* and a tax charge of £24 million *(2003/04 £12 million)*, the profit transferred to reserves amounts to £38 million *(2003/04 £30 million)*.

The statements of account for the Issue Department (which are given on pages 82–84) show that the profits of the note issue were £1,618 million *(2003/04 £1,234 million)*. The change was the net effect of more notes in circulation on average during the year and higher interest rates. These profits are all payable to HM Treasury. In accordance with the

Currency and Bank Notes Act 1928, the assets of the Issue Department comprise securities sufficient to cover the fiduciary note issue.

Balance sheets

At 28 February 2005 around £2.4 billion of Banking Department's assets comprised sterling money market refinancing provided through the Bank's open market operations *(2004 £1.4 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.

During the year there was an increase in foreign currency deposits taken from central banks, which rose from £3.3 billion in 2004 to £6.8 billion in 2005.

On 28 January 2005, one of the Bank's three-year euro-denominated Notes (originally issued in 2002) matured. Over the financial year the Bank auctioned the €1,000 million second tranche of the Note maturing on 29 January 2007. In addition the Bank also created €2,200 million of Euro Notes maturing on 28 January 2008, for issue via auction. The first €1,000 million was auctioned on 18 January, with the auction of the second €1,000 tranche taking place shortly after the end of the financial year, on 15 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, 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 was first adopted in the financial accounts of the Banking Department for 2003/04.

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.

The nature of the Issue Department balance sheet has changed little over the year. The assets matching the note issue remain largely 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. From the fourth quarter, Gilts were no longer held.

Consolidated Balance Sheet

The separation of Banking Department from Issue Department in the Accounts is required by statute. A summary consolidated Bank balance sheet at 28 February is set out on page 36.(1) It is unaudited and provided for information purposes only, to assist comparison with other central banks.

The growth in total liabilities during the year is primarily the result of increased foreign currency deposits from central

(1) Consolidated is defined as combined Banking and Issue Departments. Information has been consolidated without adjustment for the existence of differences in accounting policies between Banking and Issue Departments. The only accounting policy difference of significance is that Banking Department follows accruals accounting and Issue Department does not. If Issue Department had applied the accruals concept in accordance with UK accounting principles, accrued income within other assets would have been higher by £21 million and other liabilities greater by £21 million. Subsidiaries of Banking Department have not been consolidated on the grounds of immateriality.

	2005 £m	*2004 £m*
Assets		
Treasury and other eligible bills	718	*1,372*
Ways and Means advance	13,370	*13,370*
Loans and advances	33,944	*27,086*
Debt securities	8,248	*8,460*
Equity investments, participating interests and shares in group undertakings	58	*47*
Other assets	1,156	*1,140*
Total assets	**57,484**	***51,475***
Liabilities		
Notes in circulation	35,416	*36,015*
Deposits	13,376	*7,717*
Debt securities in issue	5,914	*5,739*
Other liabilities	1,180	*444*
	55,886	*49,915*
Capital and reserves	1,598	*1,560*
Total liabilities	**57,484**	***51,475***

banks, which rose from £3.3 billion in 2004 to £6.8 billion in 2005. Sterling deposits taken from central banks also increased from £0.9 billion in 2004 to £2.3 billion in 2005. On the asset side, there was a corresponding movement in the level of foreign currency reverse repos, from £0.2 billion in 2004 to £3.9 billion in 2005 and an increase in the level of sterling deposits placed out via foreign currency swaps from £0.8 in 2004 billion to £1.5 billion in 2005.

At the balance sheet date, notes in circulation decreased year on year (2005 £35,416 million; *2004 £36,015 million*), although during the year the average notes in circulation were higher.

The decrease in notes in circulation was offset by a similar decrease in holdings of Treasury Bills (2005 £718 million; *2004 £1,372 million*) and the sale of Gilts (2005 nil; *2004 £116 million*).

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 on 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 £14 million in April 2004 and £16 million in October 2004 in respect of the year to 28 February 2004. In April 2005 the Bank paid the first payment of £20 million in respect of the financial year ended 28 February 2005 which was based on provisional figures. The balance of £18 million will be paid on 5 October 2005.

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 10–11.

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

The Court of Directors is responsible for ensuring that the financial statements, as prepared on the basis set out therein, present fairly the state of affairs of the Banking Department as at 28 February 2005 and of the profit for the year to that date. The statements of account of the Issue Department are prepared in accordance with provisions agreed between the Bank and HM Treasury to implement the requirements of the Currency and Bank Notes Act 1928 and the National Loans Act 1968. The Court of Directors is responsible for ensuring that the statements of account are prepared in accordance with these requirements.

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

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

RISK MANAGEMENT

The Bank's activities requires it to identify, assess and manage a wide range of financial and non-financial risks effectively. The Bank's risks are managed through a developing risk management framework of risk standards, organisational arrangements and risk measurement together with monitoring processes that are closely aligned with its activities and key risk categories.

Developments in 2004/05

During the financial year, the Risk Standards Unit began to co-ordinate the work entailed in enhancing further the Bank's risk management culture and in developing a Bank-wide risk strategy and framework. The Unit was strengthened with the external appointment of a new Head of Risk Standards in early 2005. He will be taking forward the Bank's risk management strategy, developing the central unit, and providing oversight to the Bank's internal control framework. This work will look to build on the existing approach, and concentrates on developing a sound risk management framework which covers:

- development of Risk Governance policies, the high level risk standards for the Bank sponsored at senior executive level;
- Bank-wide methodologies and tools to identify, assess and monitor risk;
- risk management information across the Bank aligned to the Governance structure;
- development of an oversight and compliance process to ensure Bank-wide consistency and risk control within the risk management framework; and
- improved risk awareness and skills development.

The key objective of the risk management framework is to ensure that appropriate actions will be taken to identify and manage the risks to which the Bank is exposed. It is designed to deliver the following benefits:

- broader understanding at all levels of the Bank of risk and control issues and the factors influencing them;

- greater focus on the policy and analytical risks faced by the Bank;
- prompt identification and escalation of those risk issues that could result in material impact to the Bank;
- clear responsibility for risk management at all levels;
- ability to take account of risk tolerance in decision making;
- sharing of best practice across the Bank to improve the control environment;
- reduced reliance over time on annual self-assessment; and
- promotion of a risk-aware culture.

Two new committees are overseeing this work: firstly the Business Risk Committee considers the practical implementation of risk policy and the degree of risk tolerance, and is chaired by Sir Andrew Large, who advises the Executive Team in matters of risk policy; secondly the Risk Policy Committee is a committee of Court structured on a similar basis to the Audit Committee, with some common membership to ensure an effective dialogue and flow of information. The Risk Policy Committee recommends to Court the Bank's overall risk tolerance and policy for managing all significant financial and non-financial risks. Its role is outlined in the Governance and Accountability section on page 9.

Financial Risk

The following notes describe the approaches that the Bank takes in reponse to financial and to operational and non-financial 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; intraday, 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.

The Bank's Credit Ratings Advisory Committee (CRAC), reviews regularly the creditworthiness of market counterparties and issuers to whom the Bank may take 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.

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 largely through measuring the Value at Risk of mismatched positions. Details of VaR exposures relating to the actively managed portfolio are provided in note 7 to the financial statements on pages 61–65. Details of the Bank's interest rate and foreign currency exposures are given in note 7 of the financial statements on pages 61–65.

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.

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, and in its general banking business. Otherwise, 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.

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. More specific to the central bank's role, there are also a number of policy and analytical non-financial risks arising from the processing, analysis and modelling of data, and the assessment of the external environment, all of which could have an impact on the Bank's ability to implement its objectives effectively.

As a central bank, the Bank faces risks that arise in the pursuit of its two core purposes. Across all of the key objectives that underpin the two core purposes, the Bank faces operational and analytical non-financial risks. 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 processes described in the Internal Controls section below. The evolving developing risk management framework will contribute to this and allow a more consistent view of these risks. Each business area is responsible for managing its operational and non-financial risks and monitoring the associated controls. Enabling the risk management framework will require a thorough review of processes, the events that are likely to give rise to these types of risk and the most appropriate risk and control structure.

The risk management framework and the internal control system more generally are part of the governance structure designed to provide Court with the assurance that the controls are fit for purpose.

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 below:

1 An organisational structure, as shown on page 13, that is closely aligned to the Bank's Core Purposes.

2 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.

3 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.

4 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.

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

6 Oversight of the management of the Bank's balance sheet as a whole and monitoring of the financial performance is delegated to the Executive Director, Markets. Quarterly reports are presented to Business Risk Committee, the Executive Team and Court. The financial risks and associated controls are separately reported on pages 61–69, as required under FRS 13.

7 A Bank-wide risk management framework which includes a central risk management unit, a committee reporting to the Executive (the Business Risk Committee) and a sub-committee of Court (the Risk Policy Committee).

8 A process under which the Executive report to Court once a year on risks and controls 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. The system of internal control is subject to scrutiny by the Executive and by Internal Audit, the head of which reports to the Governor.

9 A risk-based Internal Audit programme is prepared annually and is endorsed by the Audit Committee on behalf of Court. 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 above, the introduction of a new risk framework is intended to strengthen existing arrangements for the identification and control of risk at a Bank-wide level. Oversight of the implementation of the new framework is provided by the Business Risk Committee and the Risk Policy Committee.

Exchange Equalisation Account

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

The risks incurred in conducting this business are 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.

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 24–25.

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. This *Report* is printed on 80% recycled paper.

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. One member of staff was adopted as a prospective parliamentary candidate: the Bank has established procedures in such cases for assessing and managing any risks to the impartiality with which it is seen to conduct its functions.

The Bank continued to play an active role in community initiatives and supported the voluntary work undertaken by its staff. During 2004/05 the Bank contributed £616,000 in support of its community programme *(2003/04 £757,000)*. Donations in cash totalled £409,000 *(2003/04 £521,000)* this included £15,000 made to organisations that staff volunteer for via the Bank of England Court Awards; £6,000 for the David Sharp School Governor Awards and £32,000 to the Staff Volunteering Award Scheme. The cost of other community contributions, including time spent by staff on community involvement activities was £207,000 *(2003/04 £236,000)*, and donations to academic research amounted to £80,000 *(2003/04 £80,000)*.

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% *(2004 99%)* of its bills within these timescales.

The Bank estimates that the average trade creditor payment days for 2004/05 were 22 *(2003/04 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 by the Non-executive Directors of the Bank of England

This section contains the *Report* from non-executive Directors required by Section 4(2)(a) of the Bank of England Act 1998. It describes the responsibilities under the Act of the Committee of Non-executive Directors — NedCo — and how it has discharged them. The *Report* relates to the period from 1 March 2004 to 28 February 2005, referring where relevant to other sections of the *Annual Report* which cover non-executive Directors' responsibilities as members of Court.

Non-executive Directors, as members of Court, have responsibilities under the Bank of England Act to manage the Bank's affairs, other than the formulation of monetary policy. This includes determining the Bank's objectives and strategy. The Act delegates certain functions of Court to NedCo, including reviewing the Bank's performance in relation to its objectives and strategy, monitoring the Bank's financial management, and reviewing the procedures of the MPC. The functions of Court and NedCo are described more fully on page 8.

GOVERNANCE

The modifications to the procedures of Court and NedCo in 2003/04, which gave a more prominent role to NedCo, have continued to work well and allowed a greater focus on management issues in NedCo meetings. The changes have also allowed the Bank's executive management to utilise more effectively the knowledge and experience of non-executive Directors.

In the past year, Court has undertaken a formal evaluation of its effectiveness, the first such exercise managed by external consultants. Following the review, actions have been identified to improve the operation of Court and its committees — for example, in relation to the management of agendas, the style of meetings, project management oversight, committee terms of reference and input into succession planning in the Bank. Non-executive Directors were fully involved in the process and welcome the opportunities it has provided to make improvements to the effectiveness of the Bank's governance arrangements.

STRATEGIC PRIORITIES AND FINANCIAL MANAGEMENT

The past year has been marked by discussion and agreement by Court of the Bank's strategic priorities, consistent with the restatement of its core purposes in 2003. The formulation of the strategy involved a consideration of a number of business reviews in NedCo. The strategy provides the Bank with a greater overall sense of its future direction, consistent with its core purposes, and has established the basis for a better linkage between the core purposes, the Bank's financial management and the objectives of the various business areas of the Bank.

The non-executive Directors attach considerable importance to the development of the Bank's strategy and its implementation. Good progress has been made on a number of fronts, notably money market reforms and monetary analysis. In other areas it has been necessary to undertake further work — for example customer banking and financial stability — to assess or reconsider options for implementing the strategic priorities. As a result, progress is more advanced in some areas than others. However, the non-executive Directors welcome the encouraging overall progress that has been made to date. It will be important to maintain momentum to ensure the Bank's strategic goals are met despite the number of challenges and uncertainties that may lie ahead.

Non-executive Directors have also supported the aim of developing a more robust financial management framework, to be an effective tool for delivering the Bank's core purposes and strategy. This is work-in-progress. The agreed budget for 2005/06 enables the implementation of the Bank's strategy, notably in the areas of money market reform, the change in balance of resources to support monetary policy and the Bank's IT strategy. But there remain uncertainties about the detailed financial implications of some aspects of the strategy in future years — such as customer banking — that will require further consideration. There are also other uncertainties, such as the future framework for the provision of pensions, which will need to be resolved in order for budgets for future years to be finalised.

Non-executive Directors will be considering further how the Bank's strategy is fully embedded in the management of the Bank, both financially and operationally. They will be focussing on two key areas in the year ahead; first, the Bank's financial management framework, linking the strategic priorities to the allocation and management of resources across the Bank; and second, the development and use of an effective performance measurement and management framework to evaluate the Bank's activities in terms of its core purposes and strategic priorities. In turn, the financial management framework and performance framework will need to be integrated, along with the performance appraisal system for the Bank's staff.

THE BANK'S PERFORMANCE

The Bank's performance is reviewed on pages 18–26 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 2004/05. In particular, NedCo welcomes the successful re-launch of the Bank's new banking systems. Lessons from the earlier difficulties with the project have been incorporated into both banking operations and project management more generally. There has been significant progress over the year in terms of developing the approach and framework supporting project management in the Bank — the establishment of the Projects Group, the recruitment of a project management specialist to head the Projects Support Unit, the introduction of peer reviews and the ongoing work to improve the skills of project managers in the Bank.

To implement its strategy, the Bank needs to undertake a number of major projects, notably money market reform, which involve sizeable risks. The improved approach and project management framework in place will benefit these projects in terms of increased alertness to the risks involved and their mitigation. Non-executive Directors particularly support efforts to ensure that projects involving different areas of the Bank are actively managed at all levels across functional and divisional boundaries.

The Bank's risk management framework has also progressed over the past year and non-executive Directors have supported the formation of the Risk Standards Unit to support business areas and the Risk Policy Committee. Further work will need to be undertaken over the next year to develop the Bank's risk standards and to integrate them further into the operational work of the Bank.

In addition, the successful transfer of the Government's gilts registration business from the Bank to a private sector provider, the continued development and testing of the Bank's business continuity and crisis management approach and systems, and the further consolidation of the Bank's property portfolio have also been important developments over the past year.

AUDIT, RISK POLICY AND REMUNERATION COMMITTEES

Certain of the work required to fulfil NedCo's delegated functions is carried out by the Audit, Risk Policy 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. Court has agreed the terms of reference of the Risk Policy Committee and its relationship with those of the Audit Committee, which have been revised accordingly.

The Bank's internal controls were kept under review as part of the responsibilities of the Risk Policy Committee, which comprises non-executive Directors as set out on page 9. The Risk Policy Committee, on behalf of both Court and NedCo, has reviewed the effectiveness of the system of internal financial control which operated during 2004/05, as reported in the report on Governance, Financial Statements and Risk (pages 34–41) 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

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

by the Chancellor of the Exchequer were dealt with by the Remuneration Committee, which comprises non-executive Directors as set out on pages 8–9. The report on remuneration for 2004/05 is set out on pages 30–33 and, so far as appropriate, forms part of this report. Non-executive Directors have also discussed the principles which should guide consideration of the pension arrangements for members of the Court Pension Scheme.

MPC PROCEDURES

As provided for under Schedule 3 of the Act, non-executive Directors receive a monthly report from the MPC and all members of the MPC are invited to attend NedCo every three months for that and 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; receive the minutes of the monthly MPC meetings, the Bank's quarterly *Inflation Report* and summaries of other meetings; visit the Bank's Agents and take part in their activities; and review examples of the regional, sectoral and other information collected by the MPC during the year. Additionally, questionnaires on the procedures supporting monetary policy are completed each year by MPC members. Responses to the questionnaire are an input into the interviews undertaken with members of the MPC by the Chairman of NedCo to discuss MPC procedures and processes.

NedCo has kept under review the level and quality of support provided to the MPC from within the Bank. MPC members continue to consider the support that they receive from the Bank as very satisfactory. They are satisfied with the monthly data assessment and analysis of policy issues, and the quarterly forecasting process. Communication of the Bank's economic research output to the MPC has been highlighted as an area for further refinement, which is being addressed.

Members of the MPC have continued to express their satisfaction with the operation of the new Bank of England Quarterly Model, which is fully bedded into the quarterly forecasting process. MPC members believe the new model is a more useful and flexible tool for their forecast discussions insofar as it has an improved structure that better captures the MPC's view of how the economy functions. Some MPC members have suggested that modelling issues that are sometimes considered within forecast meetings might usefully be discussed outside the quarterly forecasting process. Non-executive Directors note the positive review of the new model undertaken by Professor Adrian Pagan.

Staffing in the Monetary Analysis area has been considered over the past year as part of the formulation of the Bank's strategy. Although staffing levels have been at a satisfactory level over the year, non-executives Directors support the aim to increase levels of experience amongst staff and action is being taken to bring this about. NedCo will monitor implementation of the strategy for the Monetary Analysis area over the coming year and its impact on MPC procedures.

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. Further consideration of the information and support made available to the MPC will be undertaken alongside the implementation of the strategy for the Monetary Analysis area over the coming year.

The table on page 45 sets out attendance by the Bank's 16 non-executive Directors at meetings of Court and NedCo, the Audit Committee, the Risk Policy Committee and the Remuneration Committee. The figures in brackets refer to the

Attendance

	Court (12)	NedCo (11)	Audit (4)	RemCo (4)	Risk Policy (2)
Sir David Cooksey	11	11			
Sir William Morris	8	8		4	
Ms O'Donovan	9	9	4		
Ms Blow	9	9	3		
Sir Brian Moffat	8	8	2		
Mrs Francis	11	11	3		
Sir Graham Hall	10	10		4	
Mrs Powers-Freeling~	6	8		1 of 1	2
Mr Barber	7	8			
The Hon Peter Jay	11	11		4	
Dr Potter $$ + ~	10	10	1 of 1	2 of 3	2
Ms Rabbatts	8	8			
Mr McCarthy	9	9			
Ms Fawcett * $ ~	7 of 9	7 of 8	3 of 3		2
Sir Andrew Likierman * $ ~	7 of 9	8 of 8	3 of 3		2
Sir John Parker *	7 of 9	8 of 8			
Sir Ian Gibson # ++	2 of 3	2 of 3			
Sir John Bond #	1 of 3	1 of 3			
Dr Julius #	1 of 3	1 of 3			
Mr King	12	11~~			
Sir Andrew Large	9	10~~			
Ms Lomax	8	9~~			

* Appointed to Court 1 June 2004.
\# Retired from Court 31 May 2004.
$ Appointed to Audit Committee 1 June 2004.
$$ Retired from Audit Committee 31 May 2004.
\+ Appointed to Remuneration Committee (RemCo) 1 June 2004.
++ Retired from RemCo 31 May 2004.
~ Appointed to Risk Policy Committee 1 June 2004.
~~ Attendance by invitation.

total number of meetings during the financial year.
Attendance by other members of Court is also listed.