Bank of England

Annual Report 2006

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Contents

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 2006.

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

Core Purpose 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.

Core Purpose 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 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

In my first full year as the Chairman of the Committee of Non-executive Directors (NedCo) I have been struck how the Bank combines its respect for its traditional values with a progressive attitude towards managing. This has led to continuous improvements in the delivery of its core purposes.

We can look back on a year of significant progress. Our strategic debates have been crystallised by the Executive into a well defined set of priorities for 2006/07 linked to a reformed budgetary framework. These priorities will provide continuing momentum for the current programme of change.

During the year the Bank controlled its costs effectively, and it has delivered an outturn within the budget targets set by Court.

In addition it has been a year in which important milestones have been achieved. The preparation for the new framework for the Bank's money market operations, launched in May this year, is particularly noteworthy. We also undertook a major restructuring of the Financial Stability (FS) area coupled with a clarification of its primary purposes. This refocusing of FS together with the welcome tripartite review by Treasury, FSA and the Bank of the Memorandum of Understanding has given greater clarity to our respective roles, including those in the event of a financial crisis.

Progress however has gone beyond meeting these important milestones in that there has been further meaningful progress in the development of the Bank's management systems. We now have a more relevant cost accounting framework, allowing greater individual Executive accountability and more effective cost control across all of the Bank's activities. We have also made considerable progress in embedding leading project management practices which embrace all significant projects.

I am pleased with these outcomes and the fact that once again the Executive have responded very positively to the debates within NedCo on important control and accountability issues.

Commitment to continuous improvement and to being at the leading edge of central banks' practices mean that there is inevitably more to do. In particular, we will be looking to make further progress with the Bank's HR strategy in 2006/07 and take further steps in developing a more structured performance measurement and reward-linked system. Additionally, we will need to review the extent to which the refocus of the Bank's financial stability work meets its objectives.

It has been gratifying for the Bank to have reached a very successful conclusion to the BCCI trial. Non-executive Directors have strongly supported the Governor's stance in relation to the allegations made against the Bank and its

(1) The Committee of Non-executive Directors.

employees. I would wish to record my appreciation of the Governor's steadfast commitment to defending the reputation of the Bank and its staff in the face of this litigation. NedCo will continue to lend its full support as the Bank now seeks to recover its costs.

We continue, via formal and informal process, to evaluate the effectiveness of NedCo and Court on an annual basis. This is to ensure that we are not only effective in facilitating and challenging the Executive Team's management of the Bank but that we are fully meeting our responsibilities, as non-executive Directors, under the Bank of England Act.

Following on from the 2004/05 formal Board evaluation we have worked throughout the year on the action plan which flowed from it. This has largely been successfully executed. It has brought about important changes to improve the effectiveness of NedCo. These have included improving contact with the Treasury and greater opportunity to meet the Heads of Department in the Bank. It also led to non-executive Directors having greater individual contact with myself as Chairman, as well as sharing more informal time together to discuss issues.

Importantly, I believe NedCo through its process has contributed and challenged at the appropriate level and yet not invaded the space that is rightly that of the Governor and the Executive management. That is an ongoing challenge for any board and, once again, I will keep the operation of NedCo under continuous review as part of my role and ensure NedCo takes all necessary actions to improve its effectiveness.

Our Committees of Audit, Risk Policy and Remuneration have all continued to do important work. They have each been very effective with regular reports to NedCo. I am grateful to the Chair of each of these Committees for their professional leadership.

NedCo continues annually to ensure that the Bank provides members of the MPC with satisfactory flow of quality information and research to enable them to discharge their important duties effectively. This is carried out by an annual survey along with individual interviews with each MPC member (excluding the Governor) by myself. I am glad to report that MPC members collectively and individually had high praise for the Bank's support and the leadership of the Governor, as Chair of the MPC.

My thanks and appreciation go to Sir Brian Moffat and Sir William Morris (Chairman of our Remuneration Committee) for their service as Directors of the Bank. I warmly welcome David Rhind, James Strachan and Bob Wigley who join us in June. We have a rich array of talent and experience in our Members of Court, and I am grateful for the dedication and professionalism they have brought to bear on our debates during this past year.

May 2006

Foreword by the Governor

Mervyn King, Governor

In our *Annual Report* two years ago I described the Bank's strategic review, which started just after I became Governor, and the restatement of our Core Purposes that flowed from it. The vision was and remains to focus the Bank on the core functions set out in the 1998 Bank of England Act. We have reviewed each of the Bank's individual businesses, and set priorities which form the basis of our spending plans over the next three years.

The current priorities are described on page 16, but already we can claim to have made significant progress. The MPC has remained successful in meeting its objective: inflation is currently close to target and output close to trend. To meet the challenges ahead we need to keep our analysis at the cutting edge and to this end we are working towards a leaner and more experienced team of economists. In the implementation of monetary policy we have reformed our money market operations: these now represent a new benchmark for international best practice. Financial Stability has been reorganised, to focus on the assessment and reduction of risk under the oversight of the Financial Stability Board; and through a revision to the 1997 Memorandum of Understanding, we have clarified the Bank's role in Financial Stability in relation to those of the Treasury and the FSA.

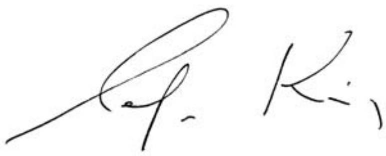
All this is reflected in our strategy for the coming year (page 25) and we have made particular efforts to engage the

Bank's staff, both in the planning process and in the launch of our annual priorities statement. In every part of the Bank we are dependent on the skills, experience and commitment of our staff.

Towards the end of the year the action brought against the Bank by the Liquidators of BCCI, which began in 1993 and went to trial in January 2004, was unconditionally withdrawn. In the action 22 current and former members of the Bank's staff were accused of dishonesty in their supervision of BCCI. There had never been a shred of evidence to support these disgraceful allegations. The Judge himself said on the day the case was dropped that the allegations against all 22 Bank Staff were 'wholly without foundation', and in his judgement, delivered in April 2006, he went on to disclose that a year previously that he had become so concerned about the case that he had decided both to consult and to warn the Lord Chief Justice that the case was 'a farce', and that 'the case as it was being pursued before me bore little or no relation to that which the House of Lords had considered fit to proceed to trial'. The Liquidators have been ordered to pay the Bank's costs on an indemnity basis. I am delighted that this foolish litigation has been brought to an end.

I am grateful to the Bank's Court for their continuing support and guidance as we deliver the strategy. Bill Morris and Brian Moffat both leave Court having made substantial contributions over the past six years: and I welcome David Rhind, James Strachan and Bob Wigley. Andrew Large left the Executive at the end of 2005 having made a notable contribution both to risk management within the Bank and to our business continuity arrangements, and in his place I welcome John Gieve as Deputy Governor for Financial Stability. I am also very pleased to welcome Juliet Wheldon, the Treasury Solicitor and Head of the Government Legal Service, who joins as Chief Legal Adviser in August.

I would like to thank the Deputy Governors and Executive Team for their full support in translating the vision into a reality. Finally, I would like to extend my thanks to the staff at the Bank, without whose skills, flexibility and commitment we would not have achieved so much over the past three years.



Governor of the Bank of England
May 2006

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. There remains at the end of the year one vacancy.

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.

NEDCO

The Act provides for a 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 42–47.

Since 2004 the normal practice has been for the business of Court to be discussed in meetings 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 17. 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 2005/06 were Sir William Morris (Chairman), Sir Graham Hall, Dr David Potter, Peter Jay, Geoffrey Wilkinson and Arun Sarin (from June 2005). 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 2005/06 were Amelia Fawcett (Chairman), Sir Brian Moffat, Mary Francis, Sir Andrew Likierman and Paul Myners (from June 2005). 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 2005/06 were Sir Andrew Likierman (Chairman), Amelia Fawcett, Dr David Potter, Paul Myners (from June 2005) and Sir John Parker (from February 2006). A Deputy Governor, the Head of the Risk Oversight Unit and the Head of Internal Audit normally attend the meetings of the Committee.

The functions of the Risk Policy Committee are to:

- Review and approve 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 normally meets four times a year.

MANAGEMENT STRUCTURE

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

The Court of Directors

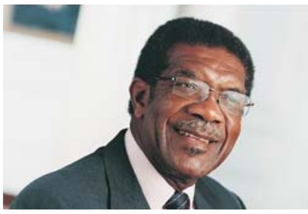
Members of the Court of Directors

Mervyn King
Governor

Sir John Gieve
Deputy Governor

Rachel Lomax
Deputy Governor

Sir John Parker



Sir William Morris, OJ

Sir Brian Moffat, OBE

Mary Francis, CBE LVO

Heather Rabbatts, CBE

Sir Callum McCarthy

Amelia Fawcett, CBE

Sir Andrew Likierman

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

Chairman,
National Grid plc.
Non-executive Director,
Carnival Corporation Inc. and Carnival plc.
Fellow,
Royal Academy of Engineering.
Member,
Defence Academy Advisory Board.

Heather Rabbatts, CBE
Appointed 1 June 2003.

Executive Deputy Chairman,
Millwall plc.
Non-executive Director,
The Film Council.
Founder and Former Chief Executive,
Impower.

Sir William Morris, OJ
Appointed June 1998.

Deputy Chairman,
Jamaica National Building Society Overseas UK.
Director,
England and Wales Cricket Board.
Member,
Commission for Integrated Transport.
Member,
The Panel of Mergers and Takeovers.
Sitting Member,
The Employment Appeal Tribunal.
Chancellor,
University of Technology, Jamaica.
Chancellor,
Staffordshire University.

Sir Callum McCarthy
Appointed 20 September 2003.

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

Sir Brian Moffat, OBE
Appointed June 2000.

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

Amelia Fawcett, CBE
Appointed 1 June 2004.

Vice Chairman,
Morgan Stanley International.
Chairman,
London International Festival of Theatre.
Deputy Chairman,
National Portrait Gallery.
Member,
Council of the University of London.
Board Member,
The National Maritime Museum (Cornwall).
Director,
Business in the Community.

Mary Francis, CBE LVO
Appointed 1 June 2001.

Non-executive Director,
Centrica plc.
Non-executive Director,
St Modwen plc.
Non-executive Director,
Aviva plc.
Governor,
The Pensions Policy Institute.
Trustee,
Almeida Theatre.

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.
Member,
Steering Group, Governance and Oversight of the United Nations.

Sir Graham Hall

Brendan Barber

Peter Jay

Dr David Potter, CBE

Geoffrey Wilkinson

Paul Myners

Arun Sarin

Sir Graham Hall
Appointed 1 June 2001.

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

Geoffrey Wilkinson
Appointed 1 March 2005.

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

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.

Paul Myners
Appointed 1 June 2005.

Chairman,
Marks & Spencer plc.
Chairman,
Guardian Media Group.
Chairman,
Aspen Insurance Holdings.
Chairman of Trustees,
Tate.
Chairman,
Low Pay Commission.
Non-executive Director,
Bank of New York.

Peter Jay
Appointed 1 June 2003.

Executive Professor of Political Economy,
Henley Management College.
Chairman,
Oxford Literary and Debating Union Trust.
Trustee,
Oxfordshire Community Foundation.
Deputy Mayor,
Woodstock.

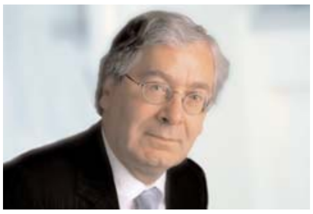
Arun Sarin
Appointed 1 June 2005.

Chief Executive,
Vodafone Group plc.
Director,
Vodafone Group plc.

Dr David Potter, CBE
Appointed 1 June 2003.

Chairman and Founder,
Psion plc.
Director,
Finsbury Technology Trust.
Governor,
London Business School.

The Executive Team



Mervyn King,
Governor

Sir John Gieve,
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

Stephen Brown
Internal Audit

ALASTAIR CLARK
Adviser to the
Governor

JOHN GIEVE
Deputy Governor
Financial Stability

CHARLIE BEAN
Executive Director
Monetary Analysis and
Statistics

Monetary Analysis

Monetary & Financial
Statistics

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)

Organisation Overview

Monetary Analysis and Statistics

CHARLIE BEAN

Peter Andrews, Monetary Assessment & Strategy[1]
Martin Brooke, International Economic Analysis[2]
Mark Cornelius, Inflation Report & Bulletin[3]
Spencer Dale, Conjunctural Assessment & Projections[4]
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, 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.

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 Rule, Sterling Markets

The main functions of the Markets Area include: conducting 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; managing the Bank of England's balance sheet; managing the United Kingdom's foreign exchange reserves, as the agent of HM Treasury; delivering financial market analysis and intelligence in support of the Bank's monetary and financial stability missions; and contributing to the management of financial crises.

In delivering its functions, the area draws on a wide range of financial market contacts in the United Kingdom and overseas, and also contributes to facilitating efficient core wholesale markets.

The Risk Management Division is responsible for identifying, measuring and, with the front office Divisions, managing risks from financial operations. Area-wide management is supported by a Chief Operating Officer and Unit.

(1) James Proudman, with effect from 1 September 2006.
(2) Mark Cornelius, with effect from 1 June 2006.
(3) Andrew Hauser, with effect from 1 July 2006.
(4) Martin Brooke, with effect from 1 June 2006.

Central Services

JOHN FOOTMAN

CLIFFORD SMOUT, FINANCE DIRECTOR
LOUISE REDMOND, HR DIRECTOR
David Collins, Finance & Resource Planning
Stephen Collins, Business Continuity
Michael Craig, Investment
Kevin Evans, HR Services
John Heath, Legal
Peter Higgs, Property Services
Ashley Howard, Risk Oversight
Chris Piper, Information Systems & Technology
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 policies, project support, IT, property, personnel, the Governors' private offices, press and public relations, the investment unit and legal services.

Internal Audit

Stephen Brown

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
David Ingram, Special Adviser
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.

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. It also provides the back-office functions to support the Bank's sterling and foreign currency transactions.

Financial Stability

NIGEL JENKINSON

Ian Bond, Financial Crisis Management
Peter Brierley, Special Adviser
Andrew Gracie, Systemic Risk Reduction
Andy Haldane, Systemic Risk Assessment
Chris Salmon, International Finance(1)

The Financial Stability area has the main responsibility for discharging the Bank's remit to contribute to the maintenance of the stability of the financial system as a whole. It works closely with HM Treasury and the FSA under the terms of the Memorandum of Understanding which was revised in March 2006.

Internally, a high level Financial Stability Board guides the work of the area identifying and prioritising potential risk to UK financial stability and judging which warrant follow-up action. The Board is chaired by the Deputy Governor for Financial Stability, Sir John Gieve.

The area seeks to detect risks to the structure and functioning of the UK financial system and to develop measures to strengthen the financial infrastructure at home and abroad to reduce those risks. 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) Phil Evans, with effect from 1 September 2006.

Review of 2005/06

The strategic priorities endorsed by Court for 2005/06, and published in last year's *Annual Report* were:

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 payment and settlement 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; and
- performance measurement.

The priorities for 2006/07 are shown on page 25.

MONETARY POLICY

The Bank's first objective is to meet the inflation target set by the Government. In terms of high level outcomes, CPI inflation rose over the course of 2005, in part due to the sharp increase in crude oil prices, and peaked at 2.5% in September before falling back to around the Chancellor's 2% target. Inflation was 1.8% in March 2006. Subject to meeting the inflation target, the Monetary Policy Committee (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 slowed in 2005 and is estimated by the ONS to have been 1.8%, a little below the economy's historical average growth rate. The Labour Force Survey measure of the unemployment rate was stable for most of 2005, rising to 5.1% of the workforce in the fourth quarter. The decisions of the MPC, 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's aim is to provide high quality and comprehensive support to the MPC. Within this, the most central task is the provision of a full range of high-quality briefing, analysis and research to support the monthly interest 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 previous years' surveys. In response to MPC members' suggestions, the regular monthly briefing session that takes place ahead of the policy meeting has been restructured further in order to integrate it more closely with the quarterly *Inflation Report* round.

During the course of the year, the Committee discussed a large number of economic issues. These included:

- The impact of the rise in energy prices. Oil and, more recently, gas prices rose sharply over the course of the year to reach historically high levels. There are three potential channels through which this could impact on the economy. First, higher energy prices have a direct effect on CPI inflation by boosting the domestic energy components of that index (for example, petrol and transport services such as air fares). Second, there could be indirect effects from energy price increases if workers bid for higher nominal wages to maintain their real consumption wage. Third, there could be a reduction in the supply potential for the economy if, for example, businesses scrap energy-intensive capital equipment.

- The low level of long-term real interest rates. Real interest rates have fallen to historic lows in the United Kingdom, the United States and euro area. This could reflect an imbalance between desired saving and desired investment, increased global liquidity, the behaviour of pension funds, or as part of the broader 'search for yield'. It is unclear whether long-term real interest rates will remain at their current levels and an unwinding could trigger a broadly-based decline in asset prices.

- The strength of domestic demand. Consumer spending growth picked up through 2005 after weakness in the early part of the year. However, the causes of the slowdown and the durability of the subsequent pickup remained uncertain, with movements in post-tax labour income, changes in interest rates and developments in the housing market all likely to have contributed. And the sustained weakness of reported investment spending was also hard to explain.

Members of the Monetary Policy Committee

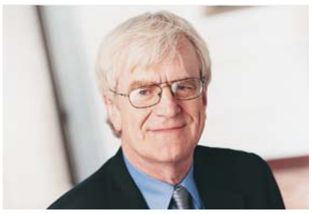
Mervyn King

Sir John Gieve

Rachel Lomax

Kate Barker

Charlie Bean



Richard Lambert(1)

Professor Stephen Nickell(2)

Paul Tucker

David Walton

(1) Richard Lambert's appointment as Director-General of the CBI was announced on 23 March 2006 and he ceased with immediate effect to participate in MPC discussions. His replacement has yet to be announced.
(2) Professor David Blanchflower has been appointed to the MPC with effect from 1 June 2006. He will replace Professor Stephen Nickell.

Review of 2005/06 continued

Regional Agents

Chris Bailey,
South East & East Anglia

John Bartlett,
West Midlands

Chris Brown,
East Midlands

David Buffham,
North East

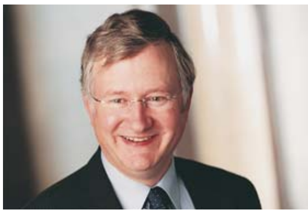
Kevin Butler,
South West

Phil Eckersley,
Northern Ireland

Wendy Hyde,
London

Adrian Piper,
Wales

Mark Pratt,
Yorkshire and the Humber



Tony Strachan,
Scotland

John Whitley,
Central Southern England

John Young,
North West

- Changes in the pattern of world trade. Over the past decade, there has been increased competition from low-cost producers in Asia and Eastern Europe. This may have affected a range of economic variables, for example it has reduced the price of certain consumer goods, contributing to a decline in the market share of UK producers in domestic and foreign markets.

- The degree of tightness in the labour market. Employment growth remained reasonably firm for much of the past year, despite the moderation in output growth. As a result, labour productivity growth fell sharply. This may have reflected employers tending to retain their workforce during a temporary slowdown in order to avoid hiring and firing costs. Employment growth fell back towards the end of the year, suggesting that some of the hoarding may have started to unwind. An additional factor in the assessment of the balance between supply and demand in the labour market is the increase in migrant labour, which the Bank's regional agents indicate has boosted the potential pool of labour and restrained upward pressure on labour costs.

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 *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 and analysis relevant to other aspects of the Bank's work. Finally, the Bank's twelve regional agents collate scores to measure 28 economic variables — part of the intelligence gathered and presented to the MPC — and these have been published on the Bank's website.

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 gave 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 continued 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 51 such visits, with the Governor visiting all countries and regions of the United Kingdom.

The Bank continues to commission opinion polls intended to measure public perceptions of the monetary policy process. In the February 2006 poll, carried out by NOP, net satisfaction with the way the Bank is doing its job of setting interest rates stood at 49%, up from 47% in February 2005. Full survey results are published in the Summer *Quarterly Bulletin* each year.

Over the past year, the Bank has continued to develop its education programme to help build public understanding of its role and the importance of low inflation. A new schools resource, *Made of Money*, was introduced in 2006. It is aimed at secondary school students aged 14–16 and describes how the economy works and how it is controlled. Details are available on the Bank's website, which was redesigned in 2005, one of the aims being to make the site more accessible and engaging for non-specialists.

The Bank's annual economics competition for schools and colleges, Target Two Point Zero, which asks students to take on the role of the Monetary Policy Committee, continues to be popular. The competition attracted a record 269 in 2005, its sixth year. The winning team was from Tonbridge School. The Bank's museum attracted around 55,000 visitors in 2005/06. The Museum closed for redecoration in December and re-opened in May with a new exhibition on money and prices.

MONEY MARKET REFORM

The overall objectives of the Money Market Reform (MMR) programme, announced in May 2004, 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, in normal and stressed conditions; and to promote competitive and fair sterling money markets. Interim reforms — introduced in March 2005 — have already reduced (but not eliminated) the volatility of overnight market rates around the MPC's official rate. The new framework, with a launch date in May 2006, is a fundamental reform intended to bring a further decline in volatility.

The new framework is based on a reserve-averaging system with reserve scheme participants electing to maintain a target balance on average over a maintenance period running from one MPC meeting to the next. Those reserve balances are, for the first time in the Bank's history, remunerated at the MPC's official rate. Standing borrowing and deposit facilities are available on demand to a wide range of banks and building societies. The Bank's scheduled short-term open market operations move to weekly operations of one-week maturity, with a routine overnight fine-tuning operation on the final day of the maintenance period, and longer-term financing is provided at market rates.

Preparation for Money Market Reform (MMR) has been a major task over the past few years, involving over one hundred

Review of 2005/06 continued

Bank staff across four Directorates under a Markets-led programme management team. Over 60 banks and building societies are participating in the different elements of the new framework, a substantial increase on the previous framework. Final documentation for participants in the reformed framework was published in December and in January the Bank opened the application process to institutions wishing to participate in any of the facilities in the reformed system from the launch date. The preparation and trialling of IT systems was completed by November 2005, before internal and external dress rehearsals in January and April. The Bank is grateful for the co-operation of the firms and individuals who participated in these exercises, which brought the wide variety of people and processes involved in MMR together at the same time prior to launch.

In the run up to launch, the Bank changed the way it manages its balance sheet, introducing long-term repo lending in order to limit the growth in short-term repo lending when the introduction of reserves increased significantly the amount of funds the Bank needs to provide through its open market operations. The Bank is also considering over time providing longer-term financing through outright purchases of bonds.

BANKING OPERATIONS

Last year, the Bank undertook the first stage of implementing its new customer banking strategy, intended to focus on those banking activities required to enable the Bank to fulfil its responsibility as the central bank of the United Kingdom. A number of the Bank's activities do not fit that description, and are closer in nature to retail banking. Just over 250 customers have ceased conducting banking business with the Bank. Overall implementation of the new strategy will take longer, as expected at the outset, 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 £130 billion, of which £36 billion is accounted for by holdings of gold.

FINANCIAL STABILITY

The half-yearly *Financial Stability Review* brings together the results of much of the Bank's work on financial stability, including a regular overview of UK financial stability. The UK financial system remains healthy. Near-term risks to stability from the domestic economic environment and from conditions in global financial markets seem limited. The major UK banks continue to be profitable, well capitalised, and capable of withstanding significant adverse shocks to their balance sheets. Nevertheless, in the longer term, some significant downside risks remain. The accumulation of debt by many borrowers and the aggressive 'search for yield' across financial markets has continued. That has fuelled a rapid increase in highly leveraged financial products. The relaxation of lending criteria in some markets and increased appetite for potentially illiquid instruments may also have made the financial system more vulnerable. Previous experience suggests that such developments could herald future problems if assessments of risk were to change sharply.

The Bank continued its work on a number of fronts to help strengthen financial stability, including work on the case for global liquidity standards, the resolution of sovereign debt crises, and measures to promote transparency and accountability in the oversight of payment systems (reported below).

Two steps were taken over the past year to make the Bank's financial stability work more operational. One was the publication of an updated *Memorandum of Understanding* between the Bank, FSA and HM Treasury. The update, the first since the memorandum was agreed in 1997, clarifies the role of each organisation. The other was a reorganisation of the Financial Stability area to reflect more clearly the Bank's objectives. Their work is now based on four units focussing on risk assessment, risk reduction and planning for the effective management and resolution of financial crises. This work, and the collection of market intelligence to support it, is overseen by the Financial Stability Board,[1] which is responsible for identifying key risks and activities to mitigate them. This in turn feeds into meetings of the Standing Committee on Financial Stability held regularly with the FSA and HM Treasury.

MARKET INTELLIGENCE

The Bank's objective is to make the best possible use of market intelligence relevant to UK monetary and financial stability. Leveraging off its operational expertise, such as that required in the management of the United Kingdom's foreign exchange reserves on behalf of HM Government, Markets is building up and maintaining a global network of high-quality contacts in banking and capital markets. And the Bank continues to meet regularly with market participants through the Money Market Liaison Group, the Foreign Exchange Joint Standing Committee, the Securities Lending and Repo Committee and other groupings.

The process of establishing 'champions', specialising in different financial markets, with a regular internal meeting to discuss their findings is largely complete. Market intelligence is provided to the MPC and Financial Stability Board, and is used in the Bank's publications, such as the *Financial Stability Review* and the 'Markets and operations' article in the *Quarterly Bulletin*. 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. This investment in market intelligence work will strengthen the Bank's capacity to contribute, alongside the FSA and HM Treasury and its overseas counterparts, to the resolution of crises should they occur.

CRISIS MANAGEMENT

The Bank must ensure that it is fully able, within the Tripartite Standing Committee framework, to play its part in responding to financial crises or business disruption events, should they arise. The revised *Memorandum of Understanding* has made the role of Standing Committee in crisis management more explicit.

A great deal of work has been done among UK authorities to agree and test roles in crisis scenarios. In October, the Bank's Financial Stability area led a financial crisis management exercise for senior staff at the Bank, HM Treasury and FSA. A market-wide continuity exercise was conducted by KPMG in November in the area of business continuity, involving over 80 organisations.

Also within the Standing Committee framework, the Bank established in 2005 the Cross Market Business Continuity Group (CMBCG). Chaired by Paul Tucker (Executive Director, Markets), CMBCG provides a forum for the authorities, infrastructure providers and key firms to pool information in the event of a major operational disruption. Members of the CMBCG were successfully contacted on 7 July to contribute to an assessment of whether the terrorist attacks in London had caused any disruption to market infrastructure.

The Bank's own business resilience remains under continuous review, with contingency plans in place for all business areas and a schedule of tests to identify and remedy gaps. Split-site working is now a normal daily routine for the operation by the Bank of the Real Time Gross Settlement (RTGS) system, through which payments relating to the major UK payments and securities settlement systems are settled.

PAYMENT AND SETTLEMENT SYSTEMS

Three main payment and settlement systems use the RTGS platform to achieve the risk reduction that comes from real-time settlement. Average daily values settled in these three systems last year were £207 billion for the CHAPS sterling payments system, £173 billion for the CHAPS Euro system, and £300 billion for the CREST delivery-versus payment system. RTGS is a key piece of the UK's financial infrastructure, and as such it must have high availability. During 2005, the system was available for over 99.9% of the time, compared with 99.7% in 2004.

The Bank has decided not to become a directly participating central bank in the TARGET2 euro payments system, due to be

(1) An internal committee comprising John Gieve (Chairman), Andrew Bailey, Charlie Bean, Alastair Clark, Nigel Jenkinson, Mervyn King, Rachel Lomax and Paul Tucker.

Review of 2005/06 continued

introduced by the Euro system of central banks over a phased migration period starting in November 2007. The Bank does intend, however, to establish a connection to TARGET2 so that it can continue to make euro payments for itself and its customers.

The Bank issued its second annual *Payment Systems Oversight Report* in February 2006. The *Report* aims to increase transparency and accountability about the Bank's role in the oversight of UK payments systems. It explains the work undertaken by Systemic Risk Reduction Division to assess and seek mitigation of risks in UK payments systems, and includes assessments of the main UK payments systems against the Core Principles for Systemically Important Payment Systems (the international benchmark adopted by many major central banks for the purposes of payment systems oversight). It also outlines where the Bank has identified scope for these Core Principles to be updated and extended.

HUMAN RESOURCES

At the end of February 2006 the Bank employed 1,639 full-time staff and 197 part-time staff — this is approximately 3% fewer than at end February 2005.

The Bank recruited 167 staff in 2005/06. 19 new graduates joined during the year, down from 32 the year before. Recruitment for mid-career staff to analytical and managerial roles has decreased to 31 *(2004/05: 42)*. Seven of these were PhD level entrants, compared to ten PhD entrants in 2004/05. Twelve IT experienced specialists were also recruited *(2004/05: 10)*. Recruitment of clerical staff was slightly down on the previous year, at 71 *(2004/05: 79)*. 38 were A-level entrants (compared with four GCSE and 31 A-level entrants the previous year) — the rest had previous banking experience.

Over the same period, 218 people left the Bank. 53 departures were due to redundancy, two thirds of these arising from the closure of the gilts registration function. Most of the other redundancies that occurred last year were from Central Services and Financial Stability and generally resulted from restructuring in the areas concerned.

The Bank is firmly committed to career development and training for all its staff. Last year saw the successful introduction of a new leadership course for senior managers, a development framework for project managers and a number of initiatives to strengthen the career and training support for junior staff members. The Bank continues to offer a wide range of training courses for staff, and individual coaching for its senior managers.

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. During the past year this channel of communication was successfully used to bring different groups of staff on to a single set of terms and conditions of service. Another in the series of regular staff opinion surveys was conducted in November 2005, and for the first time was completed online, achieving a response rate of 75%. Bankwide results were distributed to all staff in December 2005. On almost all measures, the results were more positive than the previous surveys in 2003 and 2001, with overall employee satisfaction with the Bank as an employer continuing to increase, to a level which is now above financial services benchmarks.

The Bank continues to participate in benchmarking surveys for gender and race, and will conduct an Equal Pay Audit later in 2006.

Following consultation with staff, the Bank published a diversity strategy in April 2006, emphasising its strong commitment to merit-based staff recruitment and progression. A review of flexible working to support its diversity strategy was completed and work is under way to pilot new flexible working arrangements.

The proportion of managers who are women continues to edge higher and now stands at 28% of the total. However, women still occupy few of the most senior posts. The proportion of staff from ethnic minority backgrounds now stands at 6.5%. Foreign nationals now also account for 6.5%

of staff. Thirty-one nationalities, other than British, can be found in the Bank.

The Bank undertook a review of its arrangements for disabled staff and visitors in 2005. All new staff undertake diversity training as part of their induction programme. Clear guidelines are published on the Bank's Intranet to help both staff and their line managers.

Risk management

The Bank has further developed the Risk Management Framework. More information is given on pages 37–39.

Project management

A number of key projects were underway in the Bank in 2005/06, including money market reform and the successful implementation of a new general ledger. These projects in particular have involved delivering change across organisational lines. The Bank's Project Support Unit has continued to develop and maintain the Project Framework and act as a source of information for the project community in the Bank. Larger or more complex projects are subject to 'peer reviews' involving external experts and Bank staff. These are modelled on the Office of Government Commerce Gateway Process, which examines a programme or project at critical stages in its lifecycle to provide assurance that it can progress successfully to the next stage. The process is based on well-proven techniques that lead to more effective delivery of benefits together with more predictable costs and outcomes.

Review of 2005/06 continued

BANKNOTES

A priority relating to banknotes has been added to the set of strategic priorities for the Bank in 2006/07 (page 26). This box reviews the Bank's work on banknotes in 2005/06.

The Bank is responsible for providing banknotes that the public can use with confidence. By value, the average in circulation during last year was £35.5 billion. Last year the Bank issued 639 million new banknotes, and at the year end the number of Bank of England notes in circulation was just over 2 billion. In terms of the number of notes in circulation, the £20 accounts for the largest share, at around 63%.

In February 2006, a robbery occurred at a cash centre managed by one of the members of the Note Circulation Scheme (NCS). The total value of notes stolen was around £53 million, of which just under £25 million was stored on behalf of the Bank in bond holding. This is the longer-term storage of notes that makes up, for the most part, the seasonal component of the note issue (the annual peak of the note issue occurs at Christmas). Notes held in bond are not in issue, and hence not on the balance sheet of the Issue Department of the Bank. If stolen, however, they must be treated as in issue. The Bank received immediate payment for these notes and thus incurred no loss. In response to the robbery, Sir John Gieve (Deputy Governor, Financial Stability) has led a review of the security arrangements for NCS cash centres (including the Bank's own centres), and the arrangements of the NCS itself, to determine whether there is scope to change banknote distribution in ways that would improve security and reduce the likelihood of cash robberies. Security has been tightened in a number of ways as a result.

The Bank welcomes comments from the public on the note issue. One subject that features in such comments is the quantity and quality of £5 notes in circulation. The entry of £5 notes into circulation is restricted by their absence from ATMs, which account for over 60% of the value of notes acquired by individuals. The quality of £5 notes in circulation is affected by the length of time they spend in circulation before being banked and then subject to sorting for fitness. The Bank supplies new notes of all denominations to the wholesale cash industry on demand under the terms of the Note Circulation Scheme. It is continuing to work with the cash industry to increase the quantity and quality of £5 notes in circulation.

During calendar year 2005, some 505,000 counterfeit Bank of England notes were taken out of circulation. This represented 0.025% of the average stock of notes in circulation, and was 53% higher than the figure for 2004 as a whole. More details on counterfeit statistics can be found at: www.bankofengland.co.uk/banknotes/about/counterfeits.htm.

Based on technical analysis of all counterfeits taken out of circulation the Bank believes that three sources accounted for almost 90% of the total taken out of circulation last year. This indicates the presence of serious organised crime in banknote counterfeiting. The Bank works closely with law enforcement agencies to detect and stop counterfeiting. In early December last year, the National Crime Squad undertook a series of raids against individuals and facilities believed to be connected with the largest of the three main sources of counterfeits.

Alongside the work of the law enforcement agencies, the Bank tackles the threat of counterfeiting through information and publicity provided to the public to assist in checking that banknotes are genuine. Last year the Bank released new materials, including a short film, printed material, and a computer-based training package for cash handlers. These materials are available from the Bank at no charge. The banknote section of the Bank's website has also been enhanced, and can be viewed at: www.bankofengland.co.uk/banknotes.

The Bank's Priorities in 2006/07

The strategic priorities endorsed by Court for 2006/07 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 improve the design and production of banknotes in order to safeguard public confidence in the note issue.

5 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.

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

7 The Bank should promote safe and efficient payment and settlement systems and be at the forefront of best practice in operational and policy areas.

8 To enable delivery of these strategic priorities, we will embed new risk and project management standards across business areas and further develop the Bank's HR strategy and financial and budgetary processes.

The strategic priorities for 2005/06 have been rolled over into 2006/07 with the addition of a further priority relating to banknotes. This section gives more detail about the concrete steps the Bank plans to take in the year ahead. An underlying theme is a determination to streamline our processes — to improve quality and efficiency — and to show a capacity to adapt to technical advances, changing economic conditions, financial crises and disruptions to normal working conditions.

In the area of monetary policy, the priority is to support the MPC with first-rate and creative analysis, so that the Committee can take interest rate decisions that keep inflation close to the Government's target. That means recruiting and retaining able and experienced economists in Monetary Analysis, and making junior economists' jobs more interesting by reducing the grind of the monthly round. The Bank will take forward a range of initiatives to streamline processes and outputs for our conjunctural and assessment work, such as forecasts of the international economy. That will allow Monetary Analysis to run with smaller staff numbers overall. The Bank aims to pursue a vigorous research programme, in particular to improve its understanding of the reasons behind the unusual stability of growth and inflation in recent years. Links between research and regular assessment work will also be improved. One major project, running into 2007, is to develop a framework for coping with the uncertainty surrounding official economic data by combining it with surveys of business conditions, which are less formal but available to the MPC more quickly. The Monetary & Financial Statistics area is developing and applying an innovative cost-benefit framework for its own data collection, to reduce any unnecessary burdens on the banks that supply the data to the Bank.

In the area of implementing the MPC's interest rate decisions, the launch of the Bank's new framework for money market operations will expand and change the structure of the Bank's balance sheet, which is managed under a Remit, risk policies and controls. This may require additional trading and settlement capacity in Markets and Banking. The new framework, by allowing a wider group of banks to participate in the system, will also open up new channels for us to gather market intelligence.

The Bank's Priorities in 2006/07 continued

A key priority for 2006/07 is to make our financial stability work truly operational, following the reorganisation of the Financial Stability area. One aim is to be able to set up small and flexible teams of staff — sometimes drawn from across Directorates — in response to emerging sources of potential systemic risk. The focus will be on the major risks facing the UK financial system and this will be reflected in a new-style *Financial Stability Review*. Over the course of 2006/07, the Bank will also set out its position on a number of international issues, such as reform of the International Monetary Fund and international standards for liquidity.

In the second half of the year, the Bank plans to run further high-level business continuity and financial crisis management exercises with HM Treasury and the Financial Services Authority. Previous exercises have been very successful, and provided insights into the Bank's likely role in the event of real-life crises.

We will be giving more thought with the FSA and HM Treasury to the Bank's role in overseeing payments systems. As for the payments infrastructure itself, RTGS — the settlement infrastructure for the high-value interbank payments systems — was introduced in 1996, and the Bank will begin the process of thinking about possible replacement and alternative options, taking into account the potential impact of new payments services likely to be launched. That will be a major piece of work that Banking will take forward with Financial Stability and Markets.

In other areas of banking operations, there will continue to be a scaling back. One major implication of the new strategy is that over the next three years retail customer banking for government will end, with the Government obtaining those services instead from commercial banks. Over the next year, the Bank expects contracts to be awarded to the new service providers, with detailed planning ready for phased migration. Meanwhile, improvements to controls and systems will continue to be put in place: the Bank will upgrade the software used in its main banking system.

The year ahead will see a number of important initiatives in the area of banknotes. The Bank will work to incorporate security features that will make notes harder to counterfeit, and improve the IT and controls around note circulation.

For some time, the Bank has been aware of inconsistencies in the arrangements for the issuance of banknotes in Scotland and Northern Ireland. Seven banks issue notes in those jurisdictions (four in Northern Ireland and three in Scotland) under the terms of legislation dating back to 1845. The Bank has worked closely with HM Treasury on this subject, and last summer HM Treasury issued a consultation paper. The process of consultation is continuing, with a view to forming proposals to tackle the inconsistencies in the issuing arrangements. Alongside this, the Bank will implement the recommendations of its review of cash centre security and associated elements of the Notes Circulation Scheme, following the cash centre robbery in February.

Underpinning all plans, the role of Central Services is to support, efficiently and to a professional standard, both the Bank's day-to-day business and its plans for change. Extra resources will be put into HR in 2006/07 to enable a more effective partnership with business areas. The Bank will also review remuneration packages, including pension arrangements, to be sure that reward strategies are up to date and affordable, and to support a culture that focuses on outputs and recognises individuals' contributions. Flexible working will be reviewed in the year ahead, and the Bank's first annual report on diversity will be published in October.

Finance will be building on the platform established by last year's successful general ledger project and improving the costing system ahead of the next budget round. Work will continue across the Bank to improve the management of projects and risk. A performance measurement framework for the Bank as an organisation will also be developed, and efforts sustained to link budgets to business aims.

In IT, the focus will be on supporting innovation and streamlining processes in the Bank's analytical areas, simplifying the Bank's IT architecture with centrally set standards, and selective outsourcing to improve quality and reduce cost. The Property Services area will continue to improve procurement and to streamline ordering and payment processes.

Financial Review

The Bank draws up its medium-term spending plans within the context of its financial framework which has three main tenets:

- First, that the Bank will set a budget for spending on policy functions — monetary policy and financial stability — consistent with the figure given in the 2003 review of the Cash Ratio Deposit (CRD) scheme — ie £575 million over the five-year period from March 2003 to February 2008. This was the estimated product of the CRD regime, under which banks and building societies are required to place a percentage of their deposit base (0.15% of 'eligible liabilities') at the Bank interest-free. The Bank then invests those deposits in interest-yielding assets, generating income to fund its policy functions. The CRD ratio applies above a minimum threshold, designed to exempt small institutions.
- Second, that the other, remunerated, activities 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 flow through to the CRD-payer, but instead affect the Bank's capital.
- Third, that if spending on policy functions is in line with CRD income and other functions break even, the profit of the Bank is equivalent to the return on the assets in which its capital and reserves are invested — largely gilts and other AAA-rated sterling-denominated bonds. In recent years, spending on BCCI legal fees have been excluded from these calculations. The Bank's post-tax profit is shared 50:50 with HM Treasury.
- Court considers the operation of the Bank's financial framework in fulfilling its responsibilities under the 1998 Bank of England Act. The Bank introduced a new-style *Quarterly Financial Report* to Court early in 2005/06 to make it easier for Court to review the Bank's spending against this framework.

SPENDING IN 2005/06

Planned spending on policy functions in 2005/06 was £108.3 million, slightly below actual expenditure on policy functions in 2004/05. The outturn for spending on policy functions for 2005/06 was £104.3 million, well within the projection made in 2003.

Spending was below budget across most categories of expenditure, and in Monetary Analysis and Financial Stability in particular. Much of this related to lower staff costs. The reorganisation of the Financial Stability area resulted in 25 fewer jobs, and there were some job vacancies in other areas. However, the number of staff at senior manager level was higher in Monetary Analysis than in the previous year, reflecting steps to increase experience levels, a process which will continue over the next year.

Central costs were also slightly below budget, and there continues to be a rebalancing of spending within the Central Services budget. Growth areas include risk, projects, finance and audit, while costs are being reduced in process areas such as procurement, despite increased centralisation of some purchases, eg in categories of IT spending.

The net spending position on remunerated functions was close to budget, with a small surplus of £2.6 million.

With the collapse of the BCCI case, legal fees were well below budget. Separately, the £3.5 million reserve for contingencies was not used.

BUDGET FOR 2006/07

The budget plans for 2006/07 are consistent with the Bank's strategic priorities and represent broadly flat nominal spending on policy functions since 2003/04. This is currently projected to continue for the next few years. As such, the Bank's spending on **policy functions** is likely to remain within the level of CRD income assumed in the 2003 *CRD Review*. Process reviews are planned in all major areas, whether in monetary policy, financial market transactions or the provision of central services.

Financial Review continued

Bank expenditure by function[1] £ millions	**2004/05 Actuals**	**2005/06 Budget**	**2005/06 Actuals**	**2006/07 Budget**[2]
Policy functions				
Costs of:				
Monetary Policy	40.7	41.2	40.2	46.3
Financial Stability	29.7	31.9	29.1	32.0
Plus share of:				
Central costs	31.0	29.6	29.3	20.7
Buildings depreciation[3]	8.7	5.6	5.6	5.7
FX reserves (net)[4]	–	–	–	1.7
Total planned expenditure on policy functions	**110.2**	**108.3**	**104.3**	**106.5**
CRD income	113.2	117.9	119.7	122.1
Remunerated functions				
Costs of:				
Note Issue	40.4	42.8	40.8	53.5
Other Government	9.3	7.0	6.7	7.3
Banking & Settlement Services and Other	36.5	41.3	42.0	39.8
Plus share of:				
Central costs	20.7	18.3	18.0	13.7
Buildings depreciation[3]	4.9	5.0	5.0	5.2
Gross expenditure on remunerated functions	**111.9**	**114.4**	**112.5**	**119.6**
Income from remunerated functions	117.1	119.3	115.1	125.1
Net expenditure on remunerated functions	-5.2	-4.9	-2.6	-5.5
BCCI Legal Fees	***19.5***	***23.5***	***13.5***	***2.4***
Legacy costs[5]	–	–	–	6.0
Allowance for contingencies	–	*3.5*	–	–
Total gross expenditure	***241.6***	***249.7***	***230.3***	***234.4***

(1) Figures may not sum due to rounding.

(2) Some items of central costs transferred to business areas from 2006/07, eg irrecoverable VAT and training.

(3) Includes interest charge on buildings depreciation and land.

(4) Net costs transferred from remunerated policy functions from 2006/07 to reflect that foreign currency reserves are held to enable intervention on behalf of MPC for policy purposes.

(5) Pensioner benefits and interest on severance provisions (previously charged to policy functions and remunerated functions).

Budget plans for 2006/07 imply a small surplus (£5.5 million) for **remunerated functions**, consistent with the aim that income should cover costs, subject to reasonable charges to customers.

Underpinning spending plans for policy and remunerated functions are investment proposals of around £20 million a year. These are planning assumptions — all projects have to go through a separate approval process as part of the Bank's Project Framework. The table below shows proposals for major projects (more than £0.5 million) of strategic importance.

Strategic Priority	Project	Forecast total spend (£ millions)	Start date	Completion date
Monetary Policy	Data uncertainty	0.75	Q3 2005/06	Q3 2007/08
Money Market Operations	IT systems to support buying a portfolio of high-quality bonds	1.5–2.0	Q2 2006/07	Q2 2007/08
Banking Operations	Upgrade software for the Bank's main banking system	2.6	Q4 2005/06	Q2 2007/08
Banknotes	Upgrade to Notes Division processes and IT infrastructure	4.7	Q1 2006/07	Q4 2007/08
Enabling Strategy	IT Infrastructure Transformation Programme	4.2	Q1 2005/06	Q4 2006/07

Remuneration of Governors, Directors and MPC Members

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

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 salaries of the Governor and Deputy Governors are set on appointment in consultation with the Treasury.

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 2005 his salary was increased by 2½% from £269,899 to £276,647.

The Deputy Governors' salaries have been reviewed in line with the remuneration policy described above. From 1 March 2005, the salary of both Deputy Governors was increased by 2½% from £223,168 to £228,748; Sir John Gieve was appointed to this salary when he succeeded Sir Andrew Large as Deputy Governor with effect from 16 January 2006.

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 2006.

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 are each appointed by the Crown for five-year terms; they may be re-appointed. Other than the pension arrangements described below and a period of three months' continued employment by the Bank when they cease to be members of the MPC, the Governors have no termination provisions at the end of their appointments.

Under the Bank of England Act 1998, 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 only such directorship held during the past year has been the appointment to the FSA Board held by Sir Andrew Large until 15 January 2006 and Sir John Gieve from 16 January 2006.

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 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 appropriate travel and subsistence expenses.

Remuneration of Members of Court

	Salary £	Benefits £	Total 2005/06 £	Total 2004/05 £
Governor				
Mr M A King				
Joined 1 March 1991	274,398	942	275,340	*268,137*
Deputy Governors				
Sir A M B Large				
Joined 3 September 2002				
Retired 15 January 2006 (Note i)	199,422	982	200,404	*224,307*
Ms J R Lomax				
Joined 1 July 2003	228,748	727	229,475	*223,875*
Sir E J W Gieve				
Joined 1 January 2006 (Note ii)	38,125	196	38,321	*0*
Non-executive Directors				
(Note iii)	103,500	0	103,500	*100,375*
Total	**844,193**	**2,847**	**847,040**	***816,694***

Notes

i Sir Andrew Large commuted, on retirement, the whole amount of his unfunded pension for a taxable lump sum. The cash value, as calculated by the Court Pension Scheme actuary, was £473,402 gross.

ii Sir John Gieve joined the Bank on 1 January 2006 and temporarily held the position of Adviser to the Governor prior to his appointment as Deputy Governor with effect from 16 January. His remuneration as Adviser to the Governor was at the same rate as paid to the Deputy Governors.

iii Sir Callum McCarthy has been a member of Court since 22 September 2003 in his capacity as Chairman of the FSA. The Deputy Governor, Financial Stability — Sir Andrew Large, then Sir John Gieve — similarly sits on the Board of the FSA. All have agreed to waive the remuneration due from the other body. Accordingly, Mr McCarthy waived remuneration of £6,000 due from the Bank and Sir Andrew Large and Sir John Gieve respectively waived remuneration of £19,788 and £2,712 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 or civil partner'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 is contracted to provide 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 2006, 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 considered the impact on the pension arrangements for members of the Bank's Executive of the introduction of the Lifetime Allowance from April 2006. Mr King and Ms Lomax, who have been subject to the 1989 pensionable earnings cap, will continue to accrue pension entitlements in both the Court Pension Scheme and by way of unfunded benefits

Unfunded pension benefits will not be granted in future. Instead, on reaching the Lifetime Allowance, members will have the opportunity to opt out of accrual in the Court Pension Scheme, and to receive a salary supplement in lieu, on a basis that is cost neutral to the Bank.

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.

Pension Entitlements and Accruals (including unfunded entitlements)

	Transfer value as at 28.2.05 (£)	Transfer value as at 28.2.06 (£)	Increase in transfer value[1] (£)	Accrued Pension as at 28.2.05 (£pa)	Accrued Pension as at 28.2.06 (£pa)	Increase in accrued pension (£pa)	Transfer value of additional pension earned during year ended 28.2.06 (£)
Mr M A King	2,674,000	3,571,700	897,700	127,700	147,100	19,400	387,300
Sir A M B Large[2]	359,900	624,400	264,500	18,000	25,300	7,300	181,400
Ms J R Lomax	248,600	470,600	222,000	12,400	20,300	7,900	175,400
Sir E J W Gieve	–	6,400	6,400	–	293	293	6,400

(1) In addition to the value of extra accrual, the increases in transfer values reflect changes in assumptions, in particular a 0.7% reduction in the rate used to discount future liabilities.

(2) Sir A Large left the Bank and drew his pension and lump sum in January 2006.

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 were paid £149,314 *(2005: £145,672)* per annum, pro rated for the number of days worked per week. They are appointed for terms of three years. Professor Nickell worked in the Bank four days a week, and Ms Barker, Mr Lambert and Mr Walton worked in the Bank for three days a week. They were 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 to cover under the Bank's group medical insurance scheme. They received a sum equal to 15% of salary towards their own pension provision. On leaving the Bank, MPC members are paid their salary for a period of three months; during that period the Bank has the right to veto any employment that an MPC member may wish to take up where it would represent a conflict with their former MPC responsibilities. The Committee intends next year to review the remuneration of MPC members, ten years after the MPC's formation.

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 annual salary during the year was £162,289; and Charlie Bean's was £171,981. Both are eligible for the Bank's normal range of benefits, including non-contributory pensions.

Governance, Financial Statements and Risk

GOVERNANCE OF THE BANK

The role of the Court of Directors and its Committees, and the names of the members of the Court of Directors, together with the principal outside appointments of the non-executive Directors, are given on pages 8–11.

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 2006 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 2 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. The accounting framework adopted is set out on pages 54–62.

PRINCIPAL ACTIVITIES AND REVIEW OF OPERATIONS

The Bank's core purposes are set out on page 3. The Governor's Foreword, the Review of 2005/06 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 post-tax profits of Banking Department are shared equally with HM Treasury unless the Bank and HM Treasury agree otherwise.

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. The Companies Act permits UK incorporated companies to prepare their financial statements either in accordance with International Financial Reporting Standards as adopted by the European Union (IFRS) or in accordance with UK Generally Accepted Accounting Principles (UK GAAP). The Bank has chosen to adopt the recognition and measurement requirements of IFRS together with the presentation and disclosure framework explained below.

IFRS and the Companies Act have been used as a model for the presentation and disclosure framework to provide additional information and analysis of key items in the financial statements except insofar as the Bank considers certain disclosures inappropriate to its functions.

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 Bank's financial statements disclose less detail of certain elements than would be required under either IFRS or UK GAAP. Disclosure limitations include:

- Constituent elements of the income statement.
- Note disclosures for income and expenses, particularly relating to net interest income and provisions.
- Related disclosures in the balance sheet, cash flow statement and notes to the financial statements.
- Business segments.
- Contingent liabilities and guarantees.

The Bank has adopted the new accounting framework outlined above with effect from 1 March 2004 and has followed the transitional provisions set out in IFRS 1 (First-time Adoption of IFRS) which is applied by entities using IFRS for the first time. Further details regarding the adoption of the framework is provided in note 2(a) 'Form and presentation of the financial statements'.

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 2006 are given on pages 50–109, and show a profit after provisions and before tax of £99 million on the new accounting basis *(2004/05: £106 million)*. After a tax charge of £19 million *(2004/05: £37 million)*, on which there is tax relief of £14 million *(2004/05: £11 million)* and a payment in lieu of dividend of £47 million *(2004/05: £38 million)*, the profit transferred to reserves amounts to £47 million *(2004/05: £42 million)*.

The statements of account for the Issue Department (which are given on pages 110–112) show that the profits of the note issue were £1,698 million *(2005/06: £1,618 million)*. These profits are all payable to HM Treasury. In accordance with the Currency and Bank Notes Act 1928, the assets of the Issue Department comprise securities sufficient to cover the fiduciary note issue.

Balance sheets

The Bank has adopted the accounting framework previously outlined for Banking Department with effect from 1 March 2004 and has followed the transitional provisions set out in IFRS 1 which is applied by entities adopting IFRS for the first time. In accordance with the exemptions in IFRS 1, IAS 32 (Financial Instruments: Disclosure and Presentation) and IAS 39 (Financial Instruments: Recognition and Measurement) have only been applied from 1 March 2005 and therefore comparative amounts for financial instruments in respect of the year ended 28 February 2005 remain on a UK GAAP basis.

Reconciliations of the new accounting framework to UK GAAP and explanations of the differences are set out in note 33 for:

- Profit before and after tax for the year ended 28 February 2005.
- Net assets as at 1 March 2004, 28 February 2005 and 1 March 2005.

At 28 February 2006 around £3.2 billion of Banking Department's assets comprised sterling money market refinancing provided through the Bank's open market operations *(2005: £2.4 billion)*.

The size of the Banking Department's balance sheet is affected by the size of the 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 sterling and foreign currency deposits taken from central banks, and banks and building societies. At 28 February 2006 total deposits from central banks were £11.4 billion *(2005: £9.8 billion)* and from banks and building societies £3.2 billion *(2005: £2.3 billion)*.

On 27 January 2006 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 28 January 2008. In addition the Bank also created €3,300 million of Euro Notes maturing on 27 January 2009, for issue via auction. The first €2,200 million was auctioned on 24 January 2006 with the auction of the second €1,100 million tranche taking place shortly after the end of the financial year, on 28 March 2006. 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.

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 market operations (principally reverse repos of government securities) and the Ways and Means advance to HM Treasury, which has been unchanged at £13.4 billion since April 2000.

Consolidated Balance Sheet

The separation of Banking from Issue in the Accounts is required by statute. A summary consolidated Bank balance sheet as at 28 February 2005 is set out on page 37.(1) It is provided for information purposes only, to assist comparison with other central banks.

The growth in total liabilities during the year was driven by two key factors. Firstly, at the balance sheet date, notes in circulation had increased to £37 billion *(2005: £35 billion)*. Notes were matched by reverse repos of £24 billion *(2005: £21 billion)* and the Ways and Means advance of £13 billion *(2005: £13 billion)*.

Secondly, sterling deposits from central banks, rose from £3.0 billion in 2005 to £4.5 billion in 2006; although foreign currency deposits remained relatively constant at £6.9 billion *(2005: £6.8 billion)*. Within assets, there were year-on-year increases in foreign currency reverse repos from £3.9 billion to £4.7 billion, in sterling deposits placed out via foreign currency swaps from £1.5 billion to £1.7 billion, and in deposits placed out in open market operations from £2.4 billion to £3.2 billion.

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 £20 million in April 2005

(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 with an effect on net assets is that Banking Department follows accruals accounting and Issue Department does not. Subsidiaries of Banking Department have not been consolidated on the grounds of immateriality. Comparative information is provided in accordance with the accounting framework of Banking Department set out in note 2(a) 'Form of presentation of the financial statements' to the Annual Accounts.

Summary consolidated balance sheet	2006 £m	*2005 £m*
Assets		
Treasury and other bills	0	*718*
Ways and Means advance	13,370	*13,370*
Loans and advances	38,236	*34,285*
Financial assets designated at fair value through profit or loss	5,663	*0*
Debt securities	0	*8,248*
Derivatives financial instruments	291	*0*
Available for sale securities	3,705	*0*
Other assets	349	*990*
Total assets	**61,614**	***57,611***
Liabilities		
Notes in circulation	36,914	*35,416*
Deposits	15,616	*13,376*
Derivatives financial instruments	98	*0*
Debt securities in issue	0	*5,914*
Financial assets designated at fair value through profit or loss	6,512	*0*
Other liabilities	742	*1,514*
Capital and reserves	1,732	*1,391*
Total liabilities	**61,614**	***57,611***

and £18 million in October 2005 in respect of the year to 28 February 2005. In April 2006 the Bank paid the first payment of £23 million in respect of the financial year ended 28 February 2006 which was based on provisional figures. The balance of £24 million will be paid on 5 October 2006.

RISK MANAGEMENT

The Bank's activities require it to identify, assess and manage a wide range of risks effectively. The Bank's risks are managed through a framework that relates the policy and structure of risk management to the Bank's strategy and objectives. The framework identifies the roles and responsibilities of key parties in the risk management process and applies to all categories of risk.

Developments in 2005/06

During the financial year, the Risk Oversight Unit (formerly known as the Risk Standards Unit) took forward the work begun in the previous period to develop a Bank-wide risk strategy, implement the new risk framework and communicate the essentials of the approach to staff.

Specifically, progress was made to establish documented Bank Risk Standards for each category of risk. The standards are a way of defining the nature of particular categories of risk, the guiding principles for control mechanisms that can be put in place to mitigate them, and the indicators that can both track risk on a day-to-day basis and also help us establish our risk tolerance. During 2005, 8 (out of a total of 12) standards were approved by the risk committees and Court for publication within the Bank. The remaining work related to Risk Standards will be completed by June 2006.

The Risk Oversight Unit also revised the Turnbull annual risk assessment process during 2005. This was enhanced across the Bank and resulted in a more focused review of the material risks. Revised assessment criteria were developed and implemented, designed to simplify the process and promote consistency.

The Bank recognises that the risk policy documentation it has delivered is just one element of an effective risk strategy and framework. The progress made to deliver Risk Standards and the enhancements made to the Turnbull process have provided a platform upon which to continue to improve the Bank's risk framework. 2006 will see more focus on enhancing the Bank's approach to risk reporting, which will improve the assurance provided to senior management (especially Court) within the Bank. The plans to deliver this include:

1 The provision of a risk reporting information pack for Business Risk Committee, Risk Policy Committee, Executive Team and Court, which is aligned to the Bank's strategy and objectives.

2 A revision of Bank-wide guidelines on event/incident capture and reporting, to improve consistency and completeness of information.

3 Embedding the reporting process across the Bank, so that it becomes the vehicle for delivering assurance to Court for approval of Combined Code of Corporate Governance (Turnbull).

4 Developing a more effective link between the Bank's key risk exposures and the business planning process.

One of the Risk Oversight Unit's priorities is to ensure that all members of staff have the opportunity to learn more about the Bank's approach to risk management. During 2005 a short leaflet was produced, explaining the basic concepts and stressing the key message that each employee has a responsibility for being aware of, and understanding, the risks faced in relation to the activities and processes under his/her stewardship. Further risk publications for staff are planned for 2006/07.

This work is overseen by the Business Risk Committee, which considers the practical implementation of risk policy and the degree of risk tolerance, and is chaired by a Deputy Governor; and the Risk Policy Committee, which is a committee of Court structured on a similar basis to the Audit Committee, with some common membership to ensure a effective dialogue and flow of information. The staffing of the Risk Oversight Unit was further strengthened in late 2005 with the recruitment of two risk specialists with extensive experience of risk management in financial institutions.

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 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 counterfeiting 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. The 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. The evolving Risk Framework will focus on 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 incorporates policies, management information, risk indicators and controls to ensure that the policies are adhered to. 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.

Financial risk is discussed in note 31 to the Annual Accounts.

Internal Controls

The Court of Directors has responsibility for ensuring that the Bank has adequate systems of internal control so it reviews the systems and their use each year. The implementation and maintenance of the risk management and internal control systems are the responsibility of the Executive Directors and other senior management. The systems are designed to manage rather than eliminate the risk of failure to achieve business objectives, and to provide reasonable assurance against material misstatement or loss.

Court confirms that a process for identifying, evaluating and managing the Bank's significant risks has operated throughout the year. This process accords with the guidance contained in the Combined Code issued by the Financial Reporting Council.

The key features of the control system are set out as 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 Bankwide 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, who reports quarterly to the Executive Team and Court. The financial risks and associated controls are separately reported on pages 93–102, as required under IAS 30 and IAS 32.

7 A Bankwide 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 risk management in each of their areas of responsibility. In particular, such reports cover the nature and scale of the risks, how they are managed and monitored and, taking into account the control framework, the likelihood of risks materialising. In addition, the reports include any weaknesses or failures in controls during the year. 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 Bankwide 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 similar to those in relation to the Bank's own business, namely credit, market and liquidity risk; and the controls applied parallel those applied in respect of Bank business. The management of the EEA is conducted within a framework agreed annually with HM Treasury, which is described in the *EEA Report and Accounts* published by HM Treasury.

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 22–23.

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, using increasingly power-efficient equipment and 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.

The Bank continued to play an active role in community initiatives and supported the voluntary work undertaken by its staff. During 2005/06 the Bank contributed £617,000 in support of its community programme *(2004/05: £616,000)*. Donations in cash totalled £389,000 *(2004/05: £409,000)*, this included £15,000 made to organisations that staff volunteer for via the Bank of England Court Awards; £5,000 for the David Sharp School Governor Awards; £42,000 to the Staff Volunteering Awards Scheme and £32,000 matched funding under the payroll Give-As-You-Earn Scheme. The cost of other community contributions, including time spend by staff on community involvement activities was £228,000 *(2004/05: £207,000)*, and donations to academic research amounted to £155,000 *(2004/05: £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 98% *(2005: 99%)* of its bills within these timescales.

The Bank estimates that the average trade creditor payment days for 2005/06 were 19 *(2004/05: 22)*. 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 2005 to 28 February 2006, referring where relevant to other sections of the *Annual Report* which cover non-executive Directors' responsibilities as members of Court.

In addition to their responsibilities as members of Court, non-executive Directors of the Bank have specific responsibilities under the Bank of England Act. This includes 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.

NEDCO

NedCo has continued to be the principal forum for discussing and assessing the main strategic and financial management issues facing the Bank, which inform the formal decisions taken by Court. The arrangement whereby the Bank's Executive Team — led by the Governor — report to, and discuss issues with NedCo ensures that the executive management of the Bank is effectively accountable to the wider board. Non-executive Directors are satisfied that the Bank's governance arrangements enable them to monitor, assess and challenge the Bank's executive management in order to fulfil their responsibilities. Over the past year, further improvements have been made in the quality of the regular information provided to non-executive Directors, notably to support their oversight of the implementation of the Bank's strategy and its financial and project management.

Following the evaluation of the effectiveness of Court and NedCo in 2004, a series of actions was identified to improve the operation of Court and NedCo. During the past year, most of the actions have been implemented or are in progress. These include improved monitoring of agenda items and actions from meetings, more interaction with the senior managers in the Bank and the Bank's shareholder, and improved regular financial reporting consistent with the Bank's financial framework. A further evaluation exercise is being undertaken in 2006. This will aim to identify further actions to ensure continuous improvement in the way NedCo and Court operates.

NedCo is a large body with a rotating membership, drawn from a variety of backgrounds and arenas. It remains important that non-executive Directors of the Bank bring a range of relevant skills and experiences to the Bank. The opportunity NedCo has had to discuss these requirements with HM Treasury has been useful. The Committee looks forward to welcoming new non-executive Directors in 2006.

THE BANK'S STRATEGY AND ITS IMPLEMENTATION

Following agreement of the Bank's strategic priorities in 2004, oversight of the implementation of the programme of work to deliver the strategy has been a central part of NedCo discussions throughout 2005/06. The Bank's performance is reviewed on pages 16–24 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 2005/06.

The progress on implementing strategy is now systematically presented to, and reviewed by NedCo. Much work remains to be done and there continue to be uncertainties in some areas. Nonetheless, non-executive Directors judge that there has been significant and measurable progress during the year. The review of strategy has defined an ambitious programme of work. It has given the Bank a strong focus to improve the delivery of its two core purposes of monetary and financial stability, and a clear programme to strengthen each of its business areas.

NedCo has received and discussed regular quarterly updates on implementation of the work programme and elements of it have been discussed in a modular way through the past year. These have included the proposed withdrawal from retail banking activities, money market reforms, refocusing financial stability work and enriching the staff mix in the Monetary Analysis area. A key element of the strategy has been the money market reform programme which has progressed well to meet its principal objective of reducing volatility in overnight interest rates. Non-executive Directors have considered the impact the changes will have on the size and structure of the Bank's balance sheet, and the risk policies and controls that are being put in place to manage this, through the Audit and Risk Policy Committees.

There has also been good progress in the area of financial and operational crisis management preparation, both within the Bank and between the tripartite authorities. The Bank's business continuity arrangements continue to be tested and split-site working has been extended for some critical operations. Non-executive Directors welcome the new *Memorandum of Understanding* between the Bank, FSA and HM Treasury which clarifies the roles of the three authorities, including those relating to crisis management.

It was noted in last year's *Report* that further work had been necessary in the areas of financial stability and customer banking to reconsider options for implementing the strategic priorities. The new structure of the Financial Stability area is now in place. It needs more time to be tested and assessed, and staffing changes need to be implemented gradually to achieve the objective of having small and flexible teams of more senior staff to focus on the identification of emerging sources of potential systemic risk. Non-executive Directors anticipate further significant progress in this area. During 2006/07, they will want to assess the extent to which the Bank's work is becoming more focussed on risk assessment, risk reduction and financial crisis management as envisaged. The role and leadership of the Financial Stability Board — which will assess overall systemic risk and prioritise work — will play an important part in achieving objectives in this area in 2006/07. Non-executive Directors will play close attention to this during the year.

Non-executive Directors have continued to monitor the implementation of the strategy for customer banking. Progress depends in part on the Government Banking Programme, of which the transfer of the Government's retail payments activities from the Bank is a part. It will be important to maintain the momentum of the implementation of the customer banking strategy to enable the Bank's banking operations to become more focussed and better aligned to the two core purposes.

The Bank's project management framework is facilitating the implementation of the strategy and has again operated well over the past year. Non-executive Directors are satisfied that good project management principles and standards are increasingly embedded across the Bank's work.

Non-executive Directors also note that the Central Services area, notably the IT, HR and finance functions, is becoming better integrated into the workings of the Bank's business functions. In addition, there has been good progress in improving the efficiency and cost effectiveness of specific areas of work, particularly procurement and IT infrastructure. A new general ledger system has been successfully implemented.

There is, however, more to do across the Central Services area in 2006/07. Non-executive Directors anticipate further progress, particularly in relation to the Bank's human resources strategy, to implement planned changes to the staff mix in both the Monetary Analysis and Financial Stability areas. Change inevitably takes time in this area.

Last year's *Report* noted that non-executive Directors would consider further the development of an effective performance measurement and management framework. Work has been undertaken to enable progress to be tracked against the Bank's strategic priorities and key milestones. Clear lines of accountability for individual members of the Bank's Executive Team are in place, and good work has been undertaken to align directorate-level budgets with the Bank's strategic priorities. A challenge for the year ahead will be to extend this work to develop a structured performance measurement framework that maps the Bank's outputs to its financial framework and individuals' objectives and, in turn,

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

performance assessment and remuneration. Non-executive Directors will be able to contribute actively to the oversight of this work.

FINANCIAL MANAGEMENT

During 2004/05 the Bank re-examined the financial framework within which it operates, and adapted its budgeting processes to better align its resources with this framework. Over the past year there has been progress in building on these foundations, in a way that more clearly links the Bank's strategic priorities to the allocation and management of resources across the Bank. This has helped the non-executive Directors to monitor resource allocation within a disciplined cost control environment and to ensure that the implementation of the Bank's strategic priorities is facilitated by financial planning and cost management.

As noted above, the regular financial reporting to NedCo has been further improved by developing a suite of reports that relate the Bank's costs and income more closely to the financial framework and individual Executive Directors. In addition, overhead allocation has been improved and simplified, with legacy costs unrelated to the Bank's operational functions being treated separately and certain other costs (such as VAT and elements of training) allocated directly to business areas. Non-executive Directors support these changes which have further improved the transparency of financial reporting to them.

The budget agreed by Court for 2006/07 to 2008/09 is discussed on pages 27–29. In the view of the non-executive Directors, it represents good overall cost control and ensures financial resources are prioritised in a way that is consistent with the implementation of the Bank's strategy over the coming years. In addition, a more realistic provision has been made to reflect the cost of pension benefits for staff.

There are inevitably uncertainties ahead that will impact on the Bank's financial position. These include progress with the strategy for customer banking, the future framework for the provision of staff pensions, and the final settlement of costs relating to the BCCI litigation. Nonetheless, non-executive Directors believe that the Bank's current financial position and management support its current programme of work to deliver the Bank's core purposes.

During the year, the Bank moved its financial reporting onto a basis consistent with new international financial reporting standards (IFRS), as reflected in the Accounts. The new general ledger should enhance the quality and integrity of the financial data produced within the Bank. Further work is planned in the coming year to update the Bank's costing systems, and by introducing greater flexibility this should make the Bank better able to adapt to changes in circumstances. Non-executive Directors support these advances. As noted above, a priority for 2006/07 will be to link the financial management of the Bank with performance measurement and management.

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. The terms of reference of each of the committees has been reviewed during the year.

Non-executive Directors note that the Audit, Risk Policy and Remuneration Committees have operated effectively during the year. All committees provide regular reports to NedCo and Court and discuss key issues. Non-executive Directors welcome the significant progress that has been made during the year on the Bank's risk management framework and the development of a series of risk standards relevant to the Bank's operations and environment. The extent to which these new standards are fully embedded in the work of the Bank will be an important consideration in 2006/07, as the Bank focuses on quarterly risk and incident reporting.

The Bank's internal controls were kept under review as part of the responsibilities of the Audit Committee. The Audit Committee, on behalf of both Court and NedCo, has reviewed the effectiveness of the system of internal financial controls which operated during 2005/06, as reported in the internal controls section of the *Annual Report* (pages 39–40) which, so far as appropriate, forms part of NedCo's report. In discharging this role, the Audit Committee has liaised closely with the Risk Policy Committee.

Matters relating to the remuneration of the executive members of Court and to the terms and conditions of service of the members of the Monetary Policy Committee appointed by the Chancellor of the Exchequer were dealt with by the Remuneration Committee, which comprises non-executive Directors as set out on page 8. The report on remuneration for 2005/06 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

The Monetary Policy Committee's procedures are covered on pages 16–19. 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 for a discussion of the report every three months and for other relevant discussions on the MPC's procedures.

In order to keep the MPC's procedures under review, non-executive Directors periodically attend pre-MPC meetings at which the Bank's staff present their latest assessment and analysis of relevant economic data to 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, including special surveys undertaken by the Agents in response to issues raised by the MPC.

Additionally, a questionnaire on the procedures supporting monetary policy is completed each year by MPC members. Responses to the questionnaire are an input into the interviews undertaken with individual members of the MPC by the Chairman of NedCo to discuss MPC procedures and processes.

Overall, MPC members continue to consider the support that they receive from the Bank as very satisfactory. MPC members are satisfied with the monthly data assessment, analysis of conjunctural issues and research work undertaken by Bank staff to support their decisions. The information gathered by the Bank's Agents is also viewed positively. The more structured approach to the Agents' intelligence gathering has increased its effectiveness and Agents' special surveys continue to be useful to the MPC. The surveys concerning labour market issues have been particularly valuable.

The quarterly forecasting process is also judged to be satisfactory in terms of improving understanding of key issues and helping MPC members reach their policy decisions. Material received to support the forecast meetings is well regarded and the meetings are judged to be effective. Some members of the MPC would like more time for discussion relative to time spent on presentations. The importance of the choice of key issues at the outset of the forecast round has also been stressed.

Experience of using the Bank of England Quarterly Model has increased further over the past year. The interaction between the model and the forecast remains an important consideration for MPC members. Given the complexities of the model, the need for discussion outside the forecast round is an important aspect of the process, particularly when changes to model specifications impact on benchmark forecasts.

ONS data remain a key ingredient of MPC processes. MPC members acknowledge the difficulties inherent in the ONS's ongoing task, though previous under-investment continues to be seen as a factor that has constrained progress with data improvements. Improved provision of service sector data remains the MPC's priority for the ONS, where further progress is anticipated this year.

Members of the MPC have expressed some concern about the pressures placed on the main forecast team during the

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

forecast process. Consideration is being given to this issue in the context of the wider aim to increase experience levels in the Monetary Analysis area. The high quality of Bank staff supporting the MPC is considered to be an important part of maintaining the credibility and reputation of the MPC. NedCo will continue to monitor implementation of the strategy for the Monetary Analysis area 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.

The table on page 47 sets out attendance by the Bank's 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 total number of meetings during the financial year. Attendance by other members of Court is also listed.

Attendance

	Court (12)	NedCo (11)	Audit (4)	RemCo (4)	Risk Policy (3)
Sir John Parker † ~/	11	11	3	3	1 of 1
Sir William Morris	10	10		4	
Sir Brian Moffat	9	9	1		
Mrs Francis	9	9	4		
Sir Graham Hall	11	11		4	
Mr Barber	8	8			
The Hon Peter Jay	11	11		4	
Dr Potter	10	10		4	1
Ms Rabbatts	8	8			
Sir Callum McCarthy	10	11			
Ms Fawcett	8	8	4		2
Sir Andrew Likierman	10	10	4		3
Mr Wilkinson +	10	10		4	
Mr Myners * $ ~	5 of 9	5 of 8	3 of 3		1of 1
Mr Sarin * £	6 of 9	6 of 8		2 of 3	
Ms Blow # =	3 of 3	3 of 3	1 of 1		
Ms O'Donovan # =	3 of 3	3 of 3	1 of 1		
Mrs Powers-Freeling # ~~	2 of 3	2 of 3			1 of 1
Mr King	12	11 ^			
Ms Lomax	9	9 ^			
Sir John Gieve >	2 of 2	2 of 2 ^			
Sir Andrew Large <	8 of 10	8 of 9 ^			

*	Appointed to Court 1 June 2005.
>	Appointed to Court 16 January 2006.
#	Retired from Court 31 May 2005.
<	Retired from Court 15 January 2006.
$	Appointed to Audit Committee 1 June 2005.
=	Retired from Audit Committee 31 May 2005.
+	Appointed to RemCo 1 March 2005.
£	Appointed to RemCo 15 June 2005.
~	Appointed to Risk Policy Committee 14 September 2005.
†	Attendance as an observer at Audit Committee and Remco.
~/	Appointed to Risk Policy Committee 16 February 2006.
~~	Retired from Risk Policy Committee 31 May 2005.
^	Attendance by invitation.